Greetings from the Chair:

First and most importantly, I hope that all of you and your loved ones are healthy, safe and well. As always, the intangible of this Committee is the friendships. This period of time is no exception.

There is much education to be done regarding unincorporated entities. We each see the challenges every day. How can we lead change? How can we help one another improve practice and business?

One initiative underway is building bridges with groups outside of this Committee. We are working on ideas with the current leadership of the Young Lawyers Division and the Law Student Division. We also are building greater synergies with our liaisons to other groups.

Webinars are a great opportunity. The audience size is unmatched, especially when we combine efforts with other groups. Please keep webinars in mind as a great resource for you and a wonderful educational and client development tool.

What would be most helpful to you in your work with unincorporated entities? That is what we are committed to facilitating. We rely on your ideas, suggestions, criticisms and complaints.

We are looking forward to seeing many of you in Chicago for the Section’s Annual Meeting, September 10-12, 2020. As of right now, the
Section is proceeding with its Annual Meeting, and we are planning accordingly.

Thank you, Christina

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PLEASE SAVE THE DATE FOR THE 2020 ANNUAL LLC INSITUTE: NOVEMBER 12 – 13, TAMPA, FLORIDA.

Details to follow. Suggestions for events and programs? Please forward to Christina Houston.

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Redundant Suspenders Support Punitive Damages

By: Gerald V. Niesar
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A recent California Appellate Court decision involves the common law-developed duty of loyalty of an employee to the employer, and the statute that voids most covenants not to compete. Techno Lite, Inc. v. Emcod, LLC, et al, California Court of Appeal, 2d Dist., January 21, 2020. In this case, the only thing the suspenders (as in 'belt and suspenders') held up was an award of punitive damages. But, I believe the Court got it wrong and should have let the fraud cause of action drop.

The facts and procedural history of the case are both complex. For purposes of this analysis, I am limiting the background to the salient facts and law that focus on what became an award of punitive damages to the employer based upon the employees' promise that, if they were allowed to conduct a side business selling the same products as those they were hired to sell for the employer, they would not do so in a manner that would compete with the employer's business. It does not appear from the opinion that this promise was in a written document.

By way of further background, in the year I was one year old two major events happened (in addition to my first birthday party): the Japanese bombed Pearl Harbor thus dragging the United States into WWII, and the California legislature passed a law that was signed by the then Governor and subsequently codified as Business and Professions Code Section 16600. That law reads as follows: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." That seems pretty clear, unambiguous and easy to understand, even for lawyers. What is “excepted” are, as explained by the California Supreme Court: “noncompetition agreements in the sale or dissolution of corporations (§ 16601), partnerships (ibid. § 16602), and limited liability corporations (sic) (§ 16602.5).” Edwards v. Arthur Anderson LLP, 44 Cal. 4th 937 at 946 (2008).

As noted above, sometime after their employment began with Techno Lite, the three employees began a separate limited liability company (defendant Emcod, LLC) that was engaged in essentially the same business of selling lighting fixtures as was Techno Lite. When Techno Lite’s owners learned of this activity, they obviously were concerned. This led to serious discussions that culminated in the three employees’ “agreement” that they would not conduct Emcod’s business in a way that would compete with Techno Lite. This subsequent agreement is what I refer to as the “suspenders” because the obligation to avoid competing with the employers’ business was already an important part of their employment agreement which, by law, incorporates both the common law duty of loyalty, and Labor Code Section 2863.

Despite their promise that they would not compete with Techno Lite through the Emcod business, the employees not only did compete, but actually diverted to Emcod customer inquiries directed to Techno Lite. Eventually this led to litigation with Techno Lite suing the employees for a host of causes of action, and in an amended complaint, adding causes of action for fraud and unfair business practices. The trial court found the three employees liable for fraud and unfair competition. On appeal, the employees argued that they could not be guilty of fraud (when they allegedly agreed to a covenant not to compete) because that agreement was void under B&P

1 The author acknowledges the valuable contributions to this article made by Carolina Juvin, Esq., associate with Niesar & Vestal LLP.
Code Section 16600. Without a finding of fraud, there was no basis for imposing punitive damages which the trial court did in the original amount of $625,926, but subsequently reduced to $29,321 each, for a total award of $87,963.  

Where the Appellate opinion in *Techno Lite* goes off track is in its discussion of Section 16600. For instance: “[S]ection 16600 has consistently been interpreted as invalidating any employment agreement that unreasonably interferes with an employee’s ability to compete with an employer *after* his or her employment ends. (citation omitted) However, the statute does not affect limitations on an employee’s conduct or duties *while employed.*” (emphasis in original). And later, referring to the *Edwards v. Arthur Anderson* opinion: “*Edwards* did not address—much less invalidate—agreements by employees not to undermine their employer’s business by surreptitiously competing with it while being paid by the employer.” That last sentence is absolutely true. What is also true is that the *Edwards* court was not addressing a covenant not to compete that was effective during the person’s employment. The *Edwards* opinion, to the extent it pertains to Section 16600, is limited to considering whether the Ninth Circuit’s “narrow restraint” exception to Section 16600 was the law of California. And the Court concluded it was not. One can deduce that the Supreme Court was reading the statute’s unambiguous language—“every contract” imposing a covenant not to compete, other than the three statutory exceptions, is void. A “narrow restraint”, and presumably a “current employee”, exception is inconsistent with that language.

This analysis presents yet another puzzling question. It would seem that the combination of the employee’s duty of loyalty, along with Labor Code Section 2863 impose, at the very least, a narrow restraint on the employee’s ability to engage “in a lawful profession, trade, or business.” She cannot work for a competitor of her employer. Each employment arrangement is based upon a written, oral or implied contract between the employer and the employee. What is the logical reasoning that exempts employment contracts from the unambiguous language of Section 16600? With this disconnect between the employment laws discussed above and Section 16600, it would seem that the only way to avoid litigation over the confusing state of the law will be for the legislature to create a fourth exception to Section 16600. The following is proposed for that exception: “Section 16602.6: Section 16600 does not apply to any employer-employee agreement, whether written or oral, during the period of the employee’s active employment.”

However, that simple clarification runs smack into another confounding California innovation—AB5. This new law, effective January 1, 2020, mandates that any worker who cannot be shown to be outside the law’s ABC test must be treated as an employee in California, irrespective of the intent of the hiring entity and the worker with regard to their relationship. AB5 has already generated massive litigation concerning truckers, ‘gig’ workers such as Lyft and Uber drivers, stringers for publications, singers, dancers, etc. Assuming it applies to Uber and Lyft, for example, tens of thousands of those drivers will be classified as employees of both companies. Does that give either company the right to demand adherence to the duty of loyalty? Or consider the highly skilled winemaker who works for three or four different wineries. As an independent contractor, she has no obligation to refrain from working for a competitor of one of her winery clients; as an employee, there is that duty of loyalty that can create a messy and unintended situation.

Taking this issue to the level of the absurd (but why not, we are in California), how financial matters. The trial court said, in ruling that the restrictions were a permitted “narrow restraint.” “There were more than enough of these wealthy folks…in L.A. for all CPAs to do the kind of work [Edwards] was doing…There wasn’t even perhaps a minimal restriction on his ability to work.”

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2 In 1988, a California Court of Appeal held that there is no cause of action in California for “tortious breach of contract” which had been used in lower courts to establish a basis for awarding punitive damages in a breach of contract action. *Pugh v. See’s Candies* - 203 Cal. App. 3d 743, 250 Cal. Rptr. 195 (1988) (review denied)

3 The restrictive covenant in Edwards would have prevented him from: (a) working for any client he had worked for while at his employer, for a period of 18 months following end of employment; and (b) soliciting any client of the employer to whom he had been assigned, for a period of 12 months post-employment. The services were advising wealthy clients on

4 The worker will be a statutory employee if he or she satisfies any one of the following tests: (a) the worker is free from control and direction from the hiring entity; (b) the work performed is outside of the usual course of the hiring entity’s business; and (c) the worker is customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed.
does a literal reading of Section 16600 square with the duties of partners to one another? And how does it not make void any provision in a partnership agreement such as: “Each partner shall devote his or her full time and attention to the conduct of the Firm’s business and account to the Firm for any compensation or payment received from any person if the work performed is within the scope of the Firm’s usual business activities.”? If you are in one of the many states that are considering legislation similar to Section 16600, as has been reported in recent legal publications, it will behoove you to ensure that the statute actually adopted addresses these issues with appropriate carve-outs for all relationships that business people believe should be allowed to be protected by a covenant not to compete.

### 2020 Considerations of Uniform Unincorporated Business Organization Acts

As of the end of February, the following Uniform Business Entity Acts are pending in various states as follows:

- The Limited Cooperative Association Act is pending in Illinois as SB 2147
- The Revised Limited Liability Company Act (2006) is pending in both South Carolina (SB 265) and Wisconsin (AB 854)
- The Revised Limited Partnership Act (2001) is pending in Wisconsin (AB 854/SB 810)
- The Revised Uniform Partnership Act (1997) is pending in South Carolina (SB 267)
- The Uniform Protected Series Act is pending in both Colorado (HB 1906) and Tennessee (HB 1296)
- The Unincorporated Nonprofit Association Act is pending in South Carolina (SB 260/HB 3211)
Co-Founder Squeezed Out in Conversion from LC to Corporation Adequately Pled Claims for Fraud, Breach of Fiduciary Duties, Aiding and Abetting, and Civil Conspiracy

By: Albert H. Manwaring, IV
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Simon Ogus was a co-founder of a sports-technology news company. He owned 44.5 percent of the LLC’s units, held veto power over major decisions of the company, and had employment protection based on a requirement that the company could only terminate his employment for cause. After outside investors began making large investments in the company, several officers and directors persuaded Mr. Ogus to: (1) approve a conversion of the LLC to a corporation; (2) sign a written consent of stockholders to expand the size of the board of directors; and (3) execute a shareholders agreement that gave the company the option to purchase Mr. Ogus’ shares if his employment was terminated for any reason, at fair market value, as determined in good faith by the board. One month later, the company terminated Mr. Ogus without cause and proposed to purchase his shares. Mr. Ogus brought suit, claiming that the officers and directors conspired to remove him from the company and eliminate his 44.5% interest to enrich themselves, and transfer control of the company to Oak View Group, a private equity & venture fund. Defendants moved to dismiss his suit.

The Court held that Mr. Ogus had adequately pled that defendant officers and directors had fraudulently induced him to approve the conversion of the company to a corporation by promising that Mr. Ogus would retain his managerial role and his veto power over major decisions after the conversion, and that they had also assured him falsely that he would be appointed to the board of directors. The Court also sustained fiduciary duty claims against the officers and directors that allegedly pressured Mr. Ogus to approve the conversion under arbitrary time constraints, to have intentionally misrepresented information regarding the effect of the conversion, and to have terminated Mr. Ogus in bad faith solely to permit the company to repurchase his shares. The Court also found that Mr. Ogus had pled a sufficient claim that the defendant private equity fund had aided and abetted the breach of fiduciary duty, because the fund’s board designee allegedly knowingly participated in the bad faith termination of Mr. Ogus, and her knowledge could be imputed to the fund. Accordingly, the Court found that this alleged conduct was sufficient to support a claim for civil conspiracy among the officers, directors, and the private equity fund.
Death of Limited Partner Disarms Derivative Action

By: Peter Mahler
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I’ve yet to see him make a court appearance, and hope I never do, but the Grim Reaper sure has a knack for disrupting business divorce litigation involving LLCs and limited partnerships.

To begin with, the statutory default rules for New York limited partnerships and limited liability companies essentially are the same for transfer of ownership interests and rights of the estate of a deceased partner or member. This is no coincidence. Many provisions in the LLC Law enacted in 1994 are modeled on the Revised Limited Partnership Act (RLPA) enacted several years earlier.

Death. Under the default rules governing the estate’s rights upon the death of a partner in a limited partnership or an LLC member (RLPA § 121-706; LLC Law § 608), the decedent’s executor or other legal representative may exercise all of the partner’s/member’s rights “for the purpose of settling his or her estate or administering his or her property,” including any power under the partnership or operating agreement of an assignee to become a limited partner or member.

Assignment. Unlike shares in corporations, which generally are freely transferable and convey the entire package of economic, voting, and other rights associated with the shares, and except as otherwise provided by agreement, the assignment of LP and LLC interests conveys only the assignor’s rights to receive distributions and profit/loss allocation (RLPA § 121-702; LLC Law § 603). The assignee can become a partner or member only if the partnership or operating agreement so provides, or if the other partners or members give their consent (RLPA § 121-704; LLC Law § 604).

When the Grim Reaper strikes, the combined effect of the default rules can block an estate representative from commencing a derivative action against the entity’s controllers, or from stepping into the shoes of a decedent in a pending suit brought by the decedent while alive. The same holds true for actions seeking judicial dissolution and to inspect books and records, both of which statutorily condition standing on the petitioner being a partner or member.

This blog previously featured the Budis v Skoutelas and Pappas v 38-40 LLC cases in which courts held that the express terms of operating agreements, providing that the “successor in interest” of a deceased LLC member shall succeed to the decedent’s economic rights but shall not acquire member status, deprived the decedents’ executors of standing to bring derivative actions against the LLC’s controlling members.


A Family-Owned Limited Partnership

Weinstein involves a third-generation, family-owned limited partnership that owns and manages a 16-story commercial building in Manhattan. In June 2019, Lois Weinstein as limited partner sued her half-sister Rita Sklar as general partner, alleging what the petition describes as “an absolutely shocking record of fraud, tax fraud, deceit, breach of fiduciary duties, gross negligence and incompetence, oppressive and unfair dealings toward the other limited partners.” Did I mention the petition suggests that Sklar has “dementia or another mental disorder”? So much for sisterly love. Weinstein’s 118-paragraph petition, the caption of which styles her as suing “individually and on behalf of the Partners of the LP” — notice it does not say, on behalf of the LP; I’ll come back to that later — does not identify any specific cause of action. Its final demand for relief seeks judicial dissolution of the LP under RLPA § 121-802, the discharge of Sklar as the LP’s “manager,” the appointment of a receiver to sell the realty, and an accounting.

Enter the Grim Reaper

Weinstein died five months after filing her petition, in November 2019. Her death automatically stayed the proceedings.

After the Manhattan Surrogate issued preliminary letters testamentary to two friends of Weinstein named as her executors, Weinstein’s counsel, now acting as counsel to the estate representatives, moved by order to show cause to substitute them as petitioners in the proceeding.

Counsel’s six-paragraph affirmation in support cited as the basis for his motion the above-
mentioned RLPA § 121-706 providing that an executor or other legal representative may exercise all of the deceased partner’s rights “for the purpose of settling his or her estate or administering his or her property.” Counsel’s affirmation also relied on and quoted a portion of Section 8.2.B of the governing Limited Partnership Agreement (“Death or Disability of the Limited Partner”) stating that upon a limited partner’s death, the executor “shall have the rights of such Partner subject to the provisions of this Agreement.”

Counsel’s quotation omitted the section’s final sentence which essentially tracks RLPA § 121-702, stating:

Such successor in interest shall not become a Substitute Partner except upon compliance with the provisions of Section 8.3 and 8.4 hereof.

Sections 8.3 and 8.4 likewise follow the scheme of RLPA § 121-702, providing that an assignee of a partnership interest has no right “to substitute . . . as a Partner in his place without the prior written permission of the other Partner” and that an assignee who is not substituted as a partner “shall have the right to receive the same share of the profits and losses and distributions of the Partnership to which his Assignor would have been entitled.”

Sklar opposed the motion to substitute, characterizing Weinstein’s petition as a “derivative action” which the estate representatives lack standing to maintain as a non-partner both under Sections 8.2, 8.3, and 8.4 of the LP Agreement and under RLPA § 1002 (b) (“Limited Partners’ Derivative Action”) which provides:

In a derivative action, at least one plaintiff must be a limited partner at the time of bringing the action and (i) at the time of the transaction of which he complains, or (ii) his status as a limited partner had devolved upon him by operation of law or in accordance with the terms of the partnership agreement from a person who was a partner at the time of the transaction of which he complains.

In regard to subdivision “(ii)” of the statute, Sklar argued that Weinstein’s partnership interest “devolved upon” her legal representatives neither in accordance with the LP Agreement nor “by operation of law” given that, under Weinstein’s will, the representatives had no present or prospective ownership interest in Weinstein’s partnership interest which, ironically or not, her will left to Sklar’s two children (Weinstein was childless).

The Court Denies Substitution

The first paragraph of Justice Borrok’s decision succinctly frames the issue and announces the outcome:

The critical issue is whether a personal representative of an estate has standing to maintain a derivative lawsuit on behalf of a New York limited partnership that was commenced when the decedent was alive and was a partner. Because the court holds that a personal representative cannot, the motion for substitution must be denied.

In reaching its conclusion, the decision summarizes the LP Agreement’s provisions addressing the death of a partner and the circumstances under which a successor in interest is treated as a mere holder of an economic interest versus a substitute partner.

Justice Borrok’s analysis then turns to case precedent, finding “instructive” two cases involving suits brought by estate representatives of deceased LLC members:

- In Pappas v 38-40 LLC, involving a New York LLC, the court dismissed derivative claims for lack of standing based on the operating agreement’s express provision that upon a member’s death, the personal representative of the estate is a successor in interest only and is entitled only to allocations and distributions but does not automatically become a member of the LLC.

- In Estate of Calderwood, involving a Delaware LLC, the court dismissed a suit brought by the estate representative of a deceased LLC member seeking a declaration that the estate had stepped into the shoes of the decedent and succeeded to all of the rights and privileges of a member under the operating agreement, an accounting, the imposition of a constructive trust, and to inspect company books and records. The court held that the under the LLC’s operating agreement, the estate was a
successor-in-interest only, with rights to distributions, but was not a member and did not obtain the rights previously possessed by the decedent.

Even though they involve LLCs and not limited partnerships, Justice Borrok finds that the "principles" underlying the Pappas and Calderwood cases "compel" the conclusion that the Weinstein estate representatives lack standing to pursue a derivative lawsuit. As he further explains:

Here, like in Pappas and in Estate of Calderwood, . . . pursuant to the terms of the governing documents of the company, the personal representative succeeds to owning the equity interest in the business without becoming a substitute limited partner in the partnership. It is of no moment that [Weinstein’s legal representatives] acquired their interest in the partnership by operation of law (cf. Pessin v Chris-Craft Indus., Inc., 181 AD2d 66 [1st Dept 1992] [finding contemporaneous ownership requirement under BCL § 626 satisfied where plaintiff acquired shares by operation of law]). In this respect, this action is not analogous to a corporate stockholder derivative suit where the issue of contemporaneous ownership may be satisfied through, e.g., a will (e.g., Singer v State Laundry, 188 Misc 583, 586 [Special Term, NY Cnty 1947]). Put another way, unlike in a corporation where the estate becomes a stockholder by operation of law, the personal representative in the limited partnership may never become a successor limited partner under the terms of the Partnership Agreement. As such, [Weinstein’s legal representatives] simply lack standing to maintain this lawsuit and cannot be substituted for Ms. Weinstein. [Emphases in original.]

Is It a Derivative Action, and Does it Matter?

Justice Borrok’s decision appears to accept as a given Sklar’s characterization, in her papers opposing the substitution motion, of Weinstein’s lawsuit as a derivative action. Because he moved by order show cause, Weinstein’s counsel did not have the opportunity to file reply papers challenging that characterization or any other aspects of Sklar’s opposing arguments.

I’m not convinced the characterization fits. The petition is not styled as a derivative action. Its caption identifies Weinstein as suing individually and on behalf of the partners of the LP, not on behalf of the LP. The petition does not allege demand or demand futility as required in a derivative action. Most importantly, its demand for relief does not seek any recovery on behalf of the LP. What it seeks is judicial dissolution and relief ancillary to dissolution.

But I’m also not convinced it matters to the outcome of the case. RLPA § 121-802 authorizes a petition for judicial dissolution “[o]n application by or for a partner.” Weinstein unquestionably had standing to sue for judicial dissolution of the LP when she filed the case in June 2019. Following her death five months later, can the estate representatives continue prosecuting the dissolution action as within their powers granted under RLPA § 121-706 to “exercise all of the partner’s rights for the purpose of settling his estate or administering his property”?

A “yes” answer to the question faces significant hurdles, namely, explaining why the statute’s reference to “partner’s rights” does not implicate the LP Agreement’s provisions depriving the estate representatives of partner status and thereby defeating their standing to seek dissolution under RLPA § 121-802. The same would hold true applying LLC Law §§ 608 and 702 if we were looking at an LLC whose operating agreement had restrictive transfer-upon-death provisions similar to those in the LP Agreement in Weinstein.

I’ve not seen any case law providing the answer, so we’ll just have to wait for the Grim Reaper’s next intervention in a pending LLC or LP dissolution case.
LLCs Do Not Have Families

By: Thomas E. Rutledge
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In a recent decision by a trial court in New York, it was determined that an LLC does not have a family. Bellstell 7 Park Avenue LLC v. Seven Park Avenue Corp., 2019 N.Y. Slip Op. 29402, 2019 WL 7421760 (Sup. Ct. New York County Dec. 23, 2019).

This dispute arose out of the characterization of certain unsold shares in a housing cooperative. The owner of “unsold shares” may sublet the property or assign the lease without the requirement of the approval of the cooperative’s Board of Directors or other shareholders. Rather, only the building’s managing agent’s approval is required. This case involved the question of whether the shares related to a particular unit would be characterized as unsold.

Bellstell, holding all of the unsold shares of in the cooperative, is a New York limited liability company for which the sole member is a New York corporation. That New York corporation is in turn owned by an Italian corporation named Edilverde e Beni Internazionali S.p.A. In November 2015, with the approval of the building’s managing agent, Bellstell sublet one of its apartments to Ciro Campagnoli. Campagnoli holds a 50% contingent remainder interest in Edilverde.

Under the lease agreement, unsold shares remain in that category until “the holder of such shares (or a member of his family) becomes a bona fide occupant of the apartment.” 2019 WL 7421760, *2. Bellstell would assert, in effect, that the “member of his family” language could never apply to it as it is only applicable when applied to natural persons. On the other side of that coin, an LLC or other business entity does not have family members, and therefore the proviso is inapplicable when it is the holder of the unsold shares. Conversely, 7 Park Avenue would assert that because Campagnoli is a principal of Bellstell’s ultimate owner and a member of the family that ultimately controls it, he should be treated as a member of Bellstell’s family.

Rejecting the argument of Seven Park Avenue, the court wrote:

Put simply, this court sees no principled or practical means of defining when an individual’s ties to an LLC would suffice to make them a “family member” of the LLC for purposes of determining when the individual’s occupancy of an apartment strips the apartment’s shares of unsold-share status under the lease at issue here. The court therefore concludes that as a matter of law, the only reasonable reading of “member of his family” in ¶ 38(b) of the lease is that this language does not encompass individuals connected to LLCs or corporations that hold unsold shares. Id., *4 (footnote omitted).
Chancery Rejects Challenge to Financing Made Open to All Investors, Reasons the LLC Operating Agreement Allows Self-Interested Conduct, so any Claims Must Assert Bad Faith

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Verdesian Life Sciences, LLC is an agricultural company focused upon rolling up various companies with proprietary plant health technologies. All members of the Board of Managers of Verdesian were appointed by Paine Schwartz Partners, LLC (“Paine”), a private equity firm that owned over seventy percent of the Class A Units of the company. Paine also benefited from a management agreement that entitled it to receive certain management fees tied to acquisitions. The LLC Operating Agreement required the Managers to perform their duties in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of Verdesian. However, the Operating Agreement also allowed Managers and Members to “consider only such interests and factors as such Manager or Member desires, including its, his or her own interests” when facing discretionary decisions. The Court of Chancery concluded that the Operating Agreement “directs the Managers to operate in good faith and with ordinary care and effectively exculpates Managers for conflicted, negligent and other detrimental decisions … so long as taken in good faith.”

Plaintiffs were minority interest holders who believed that the Managers actively concealed important information about Verdesian’s last, and by far largest, roll-up acquisition, which was going to be completed in part through raising equity from current investors. Specifically, an outside auditor and a customer of Verdesian had warned the Managers that the reported earnings of the acquisition target were not sustainable, but these warnings were not passed on to the minority interest holders who were then in the process of purchasing additional interests. The Court accordingly allowed a fraud claim to proceed.

The Court rejected, however, Plaintiffs’ argument that a later financing involving the issuance of a new class of preferred equity interests violated the LLC Operating Agreement and should be subject to entire fairness review. Citing WatchMark v. ARGO Global Capital LLC, 2004 WL 2694884 (Del. Ch. Nov. 4, 2004), the Court stressed that all investors in Verdesian had an equal opportunity to participate in the funding round. The Court found unpersuasive the plaintiffs’ argument that the round was intentionally set at too high a price to discourage participation from the minority investors; the Court noted that the fact the management-insiders participated at the same price belied the allegation, which also was plead only in a conclusory manner. Notwithstanding the possibility that the controlling shareholder and the Managers it controlled might have acted in their own self-interest, the Operating Agreement explicitly contemplated and allowed self-interested decisions. For there to be a breach, the Managers must act in bad faith. The Court found that Plaintiffs had failed to adequately allege that the equity offering was made in bad faith and dismissed the claim for breach of the Operating Agreement.
Death of an LLC Member: Part II

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Published in Business Law Today on January 8, 2020

In the July issue of BLT I described briefly the consequences of the application of RULLCA's default rule to members of a limited liability company (LLC) who fail to provide for member death. Readers suggested a follow-up piece that would provide suggestions to avoid those consequences.

The issue arises because, unlike the shares of a corporate shareholder all of whose rights, unless otherwise provided in a shareholders agreement, pass to his or her estate, when an LLC member dies, unless something is provided to the contrary, his or her interest divides, with only economic rights passing to the estate. The management rights devolve upon the remaining members. In a multi-member LLC (MMLLC), where the pick-your-partner principle of partnership law applies, this result is clearly appropriate. In a single member LLC (SMLLC) pick-your-partner protection is oxymoronic.

The consequences for the decedent's heirs are different in the MMLLC from those in the SMLLC. In the former, the estate is treated as an assignee or transferee of the economic rights. The now former member, dissociated at death, has provided his or her heirs with little or no authority to enforce their inherited economic rights. They are at the mercy of the remaining LLC members who may choose not to make distributions. They have no right to participate in the direction, whether wise or foolhardy, in which the surviving members may take the LLC. Recovery of the decedent's capital account will not be realized until the LLC dissolves if that event should ever occur. The estate has no right to compel the LLC's dissolution or, perhaps, to acquire information as to the LLC's ability to make distributions.

In the SMLLC, where the economic rights also pass to the estate, the problem is that if the estate does not act within a short statutory period to name a successor member who accepts the role, the memberless LLC dissolves with whatever unintended consequences flow from that event.

Knowledgeable business lawyers will protect against these consequences. When a multi-member LLC is formed, and all the members are on the same side of the table and don't know who will be the first to die, the lawyers will offer suggestions as to how the members may wish to provide for death in their operating agreement. If admission to membership of one or more successors to a deceased member is not desired, perhaps a buy-out on death can be negotiated, or provision made for the heirs to have certain rights short of participation in management.

In the SMLLC provision should also be made in the operating agreement for the one future event that is certain to occur. Here are a few suggestions.

1. Treat the member's interest similar to that of a sole shareholder in a corporation. The operating agreement might provide that:

Upon the death of the member (or last surviving member in a multi-member LLC), the member's estate is admitted to membership in the LLC on the member's

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1 Ott v. Monroe, 2011 WL 5325470 (Va. 2011); An LLC interest, like a partnership interest, is comprised of two separate components. The first is the management right to control or participate in administration. The second is the economic or financial right to participate in the sharing of profits and losses and receipt of distributions. The only interest alienable is the economic interest.


5 Succession of McCalmont, 261 So.3d 903 (La. App. 2018): As a mere assignee the deceased member's estate as could not access the LLC's books and records to determine if it was getting its fair share of distributions.

date of death with both economic rights and full management authority.

The time gap between the date of death and the appointment of an executor or administrator for the estate, during which business operations may not be able to be directed, might be addressed by naming an interim manager.

2. The operating agreement might name a successor member admitted to membership immediately upon the death of the member.  

3. If the governing statute permits, name a special member who has no capital account or percentage interest in the LLC and thus should not impair its disregarded status for income tax purposes.

4. If the governing statute permits, the concept of a springing member might be utilized.

5. Instead of placing the membership interest in the individual, it may be placed in a revocable trust for the client (a) if a trust may be an LLC member and (b) if the client is willing to incur the complexity and cost of a trust agreement in addition to an operating agreement.

My attention has been called to The Uniform TOD Securities Registration Act, part of the Uniform Non-Probate Transfers on Death Act, promulgated in 1989 when LLCs were in their infancy. Its design is to provide the owner of securities an alternative to the process of probate. Although the statute’s definition of security is broad enough to encompass an interest in an LLC, the statute does not address the dichotomy between economic and management rights. It is doubtful that, in a multi-member LLC, authorization for non-probate transfer overrides the pick-your-partner principle. The statute’s usefulness to a SMLLC, limited by the definition of Registering Entity, may present practical difficulties.

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**New York Expands Member Liability for Unpaid Wages**

New York has long had a statute applicable to both domestic and foreign corporations providing for the imposition of liability on the 10 largest shareholders for failure to pay wages. See New York Business Corporation Law § 630. In the same vein, in 2014 New York adopted a statute providing, inter alia, that the member that the 10 largest members of an LLC bear joint and several liability for certain unpaid wages. In order for an employee to move against the members, they must satisfy certain notice requirements and, as well obtain a judgment against the LLC that remains unsatisfied for 90 days. N.Y. LLC Act § 609(c).

As drafted, this statute has been applicable only to LLCs organized in New York. Looking at the issue from the opposite perspective, it has not been applicable to the members of a foreign LLC transacting business in New York.

Well, that is the case until February 20, 2020. That day an amendment to § 609 of the New York LLC Act will go effective, it providing, in effect, that the same rule applicable previously to the 10 largest members of the domestic LLC will be equally applicable to the 10 largest members of a foreign LLC. With this change, foreign LLCs doing business in New York need to pay even more attention to compliance with wage and hour laws. At the same time, ne'er-do-wells will not be able to use foreign LLCs as a “planning opportunity” with which to engage in wage-theft activities.

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7 152 (Fla. App. 2015): Where supported by adequate consideration, contracts transferring a property interest upon death are neither testamentary nor subject to the Statute of Wills, but are instead evaluated under contract law. See also, in the corporate context, Jimenez v. Carr, 764 S.E.2d 115 (Va. 2014).

8 Support for this proposition is Historic Boardwalk Hall, LLC v. C.I.R., 694 F.3d 425 (3rd Cir. 2012), where the entity involved was not recognized as a partnership for tax purposes because the purported partner had no meaningful stake in its success or failure.
The Curious Case of the Expelled LLC  
Member Bound by Operating Agreement he Never Signed

By: Peter Mahler  
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The case of Shapiro v. Ettenson ranks as one of the more consequential ones in the realm of New York’s LLC jurisprudence.

For those not familiar with the case, about which I’ve posted before here and here, in 2015 the lower court ruled, and in 2017 the appellate court affirmed, that Section 402(c)(3) of New York’s LLC Law authorized two members holding a majority interest in a three-member LLC to enforce against the third member, who never approved or signed it, an operating agreement adopted almost two years after the LLC’s formation, including provisions for mandatory capital calls and member expulsion. The ruling stands as a stark reminder to those contemplating joining an LLC as a minority member not to do so without having a definitive written operating agreement in place at the time of joinder.

Within days of the appellate court’s affirmance, the majority members sent a notice to Robert Shapiro, the minority member, expelling him from the LLC. The notice stated, in sync with the operating agreement’s expulsion provision, that Shapiro “failed or refused to perform his duties and responsibilities as a Member or Manager” and “engaged in unauthorized and other bad faith conduct that has had (and is continuing to have) a material adverse impact on the business or affairs of the Company.”

Shapiro responded with a new lawsuit contesting the grounds for his expulsion and asserting direct and derivative claims for damages against the majority members. Last month — over two years after the suit’s commencement — Manhattan Supreme Court Justice David Benjamin Cohen issued a ruling granting in part and denying in part the defendants’ motion challenging Shapiro’s amended complaint. While finding that certain claims were precluded by the initial litigation, and dismissing others, the court kept alive Shapiro’s claim for wrongful expulsion and upheld his standing to assert derivative claims.

Shapiro’s complaint recites the history of the LLC’s formation by the three, co-equal members and commencement of business operations without an operating agreement in early 2012 as an exclusive distributor of an exercise and therapeutic device called the HyperVibe Whole Body Vibration Machine. Starting around September 2013, relations between Shapiro and his co-members deteriorated when the latter allegedly demanded a cut in Shapiro’s salary as part of a “scheme to force [Shapiro] out of [the LLC] and keep the profits of [the LLC] for themselves.”

The complaint then goes on to relate that, in late 2014, after the majority members adopted an operating agreement without Shapiro’s consent, cut off his salary, and made a capital call coupled with dilution for failure to comply, Shapiro brought his first lawsuit challenging the operating agreement’s validity and salary payments taken by the majority members. It also relates the lawsuit’s outcome adverse to Shapiro and, in its immediate aftermath, the majority members’ allegedly wrongful notice of expulsion.

The complaint asserted seven causes of action, including derivative claims to recover salary payments taken by the majority members and seeking damages for other alleged financial improprieties, along with direct claims for breach of the operating agreement in connection with the attempted expulsion, fraudulent conveyance, accounting, and breach of fiduciary duty.

The Expulsion Challenge Survives a Dismissal Motion

The majority members moved to dismiss the complaint in its entirety. As noted already, their motion succeeded insofar as Justice Cohen determined that Shapiro’s derivative claims to recover salary payments and other disbursements by the LLC for legal fees and business-related expenses were barred by claim and/or issue preclusion arising from the first lawsuit. Justice Cohen also

Shapiro v. Ettenson, 2019 NY Slip Op 33793(U) [Sup Ct NY County Dec. 23, 2019].

The Complaint

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dismissed the fraudulent conveyance claim for failure to state a valid claim, and the fiduciary breach claims as duplicative of Shapiro’s contract breach claims.

Not so for Shapiro’s claim for breach of the operating agreement in connection with his expulsion and for derivative claims not otherwise precluded by the first lawsuit.

The majority members made a two-pronged argument. First, they argued that, as an expelled, former member, Shapiro lacked standing to pursue derivative claims. Second, they contended that Shapiro “waived” his direct claims related to his expulsion by failing to follow the procedures and timeline in Article 13 of the operating agreement requiring arbitration of any dispute concerning a member’s expulsion or the “Fair Value Amount” to be paid an expelled member in redemption of his membership interest.

Justice Cohen disagreed. He found that Shapiro’s second cause of action predicated on wrongful expulsion is a direct rather than derivative claim “because plaintiff seeks to vindicate his individual rights” for breach of contract based on the allegation that “defendants failed to follow the dissociation procedures in the Operating Agreement.”

As to the question of Shapiro’s standing to pursue derivative claims, Justice Cohen observed that it “turns on his expulsion from [the LLC]” which in turn rests on the majority members’ contention that Shapiro lost his right to challenge his expulsion by not initiating arbitration as required by the operating agreement. Here again, Justice Cohen disagreed, writing:

Defendants’ argument that plaintiff failed to pursue arbitration is unpersuasive... Counter to defendants’ assertion, section 13.03(d) does not place the burden of pursuing arbitration solely upon plaintiff. Rather, section 13.03(d)(i) provides, in relevant part, that the “remaining Members... and the Expelled Member shall mutually agree upon and designate an arbitrator not later than forty-five (45) days following the Expulsion Date.” Plaintiff’s February 24, 2017 response to his expulsion should have alerted defendants to his intent to contest the issue, and under the plain reading of section 13.03(d), plaintiff and defendants were obligated to mutually select an arbitrator. Even though plaintiff did not submit a counteroffer on the value of his interest, nothing in section 13.03(d) precluded defendants from proposing a prospective arbitrator. Furthermore, if plaintiff rejected the arbitrator nominated by defendants, then section 13.03(d)(i) provides that “any party may apply to the American Arbitration Association, or any successor thereto, to designate a single arbitrator.” Defendants do not dispute that they failed to avail themselves of this provision.

Justice Cohen further explained that, while Shapiro’s initiation of litigation may have operated to foreclose him “from affirmatively pursuing his claim in an arbitral forum,” it did not foreclose him “from seeking redress in any venue” as defendants argued. “[G]iven their own inactivity,” he added, “defendants may have arguably waived their right to pursue arbitration as well.” Thus, even though the issue of Shapiro’s member status “is more properly determined in arbitration,” he concluded, “neither party has moved to compel arbitration or for a stay of this proceeding.”

On that note, Justice Cohen granted Shapiro leave to file a second amended complaint, pleading his constructive trust claim derivatively, and ordered the majority members to answer it within 20 days of service.

An End in Sight?

Seemingly not. The litigation between Shapiro and the majority members has entered its sixth year. Justice Cohen’s decision sets the stage for discovery and eventual trial which could take two or more years to complete, likely punctuated with additional motions and interlocutory appeals.

I’m in no position to know the stakes or say if they justify the time, effort, and expense. Only the parties can make that assessment. Only the parties know whether the passage of six years, during which presumably they’ve had little or no direct contact, has cooled the passions bred by the initial falling out. Only the parties know whether years more of legal fees on top of those incurred already call for a cold-
eyed settlement before embarking on the next phase of litigation.

But whatever the outcome for the parties, let it be said, the case of Shapiro v Ettenson already has left an indelible mark on LLC governance when members launch their LLC without an operating agreement, as happens with greater frequency than you might think.

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**Illinois Makes Organization of LLCs More Complicated**

Consequent to changes in administrative regulations effective January 1, 2020, it is now more complicated to either organize an LLC in Illinois or to qualify a foreign LLC to transact business in that jurisdiction.

With respect to LLCs organized in Illinois, if the articles of organization identify as a manager a business entity (i.e., not a natural person), the articles of organization must be accompanied by a good standing certificate issued by the state, whether that be Illinois or foreign, under which the manager-entity is organized. There is a similar filing requirement when the articles of organization are amended or an annual report is filed that adds a new entity-manager that is not already either organized or qualified to transact business in Illinois.

With respect to foreign LLCs seeking to qualify to transact business in Illinois, again, if the company has an entity-manager, the application for the certificate of authority to transact business must include a good standing certificate issued with respect to that entity-manager, whether organized in Illinois or in a foreign jurisdiction. When the application for certificate of authority is amended to add a new entity-manager, a good standing certificate from its jurisdiction of organization will likewise be required.
More Than Just The Tetons: A New Chancery Court Makes Wyoming Well Worth Discovering

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But for the missing photo of the magnificent Tetons, volume 11, number 1 of the 2011 Wyoming Law Review might be mistaken for a sales piece published by the Wyoming Business Council—the state’s economic development agency. Two articles in the journal tout Wyoming’s business and trust friendly laws. "The Undiscovered Country: Wyoming’s Emergence as a Leading Trust Situs Jurisdiction," Christopher Reimer argues that the state’s laws on directed trusts, trust protectors, self-settled trusts, and private trust companies, among other tools justify that claim. A few pages earlier, Dale Cottam and four others make similar claims with regard to limited liability companies. Not only did the new 2010 Limited Liability Company Act ("LLC Act") replace Wyoming’s original—and first-in-the-nation—act, they point out, it included some "home cooking" that makes the Cowboy State the place to be . . . organized.2 Come for the Tetons; stay for the business and trust friendly laws and the lack of a state income tax.

Seven years later, Amy Staehr revisited that theme in her piece "The Discovered Country: Wyoming’s Primacy as a Trust Situs Jurisdiction."3 In it, she updates what Wyoming’s part-time legislature had been up to in the intervening years. Among other things, new legislation provided more privacy protection to trusts and better asset protection with a new Wyoming Qualified Spendthrift Trust. Likewise, limited liability companies could now have a more flexible management structure. The message was again clear: Yes, the vistas are expansive and the sunsets beautiful, but have you looked at our business and trust friendly laws lately? "I think it’s exciting what Wyoming’s trying to do with its laws," says Michael Greear, a state representative and member of the state’s Chancery Court Committee. “Anything we do to get more business and still keep the population at 500,000 is all good."

But there was a hitch: Wyoming’s court system. It had essentially two tiers: Nine District Courts of general jurisdiction and a Supreme Court, the state’s only appellate court. And only the Supreme Court reported its cases online. In 2019 it issued 151 opinions, just 3 of them involving trusts and businesses, down from the 159 it heard in 2018, again, only 3 of them dealing with trusts and businesses. In short, Wyoming had great new business and trust laws, but too few court opinions published online to help interested observers discern how Wyoming courts might interpret those laws, an essential ingredient to a stable climate for business entities and trusts.

It didn’t help that recently—and unfortunately—the Court’s 2014 GreenHunter Energy case put the fear of creditors into the hearts of businessmen and women. The case’s result was certainly just, but the rule of the case appeared to ignore new veil piercing provisions in the LLC Act. It’s worth noting that the Wyoming legislature did its part to provide stability. Almost immediately after the Court issued its opinion, the legislature amended the LLC Act to essentially reset the law clearly and unequivocally to pre-GreenHunter days.4

In its 2019 session, the Wyoming Legislature acted again, this time to increase the size and density of the paper trail created by Wyoming courts in hopes of becoming the Delaware of the West. Delaware has a Chancery court, its docket devoted to trusts and business; so should Wyoming. And voilà! After a concerted effort by some forward-thinking legislators and a stroke of the Governor’s pen, Wyoming has a Chancery Court dedicated to hearing nothing but trust and business cases. Senate File 0104, the bill that started it all, now sits enconced as Chapter 13 of Title 5 of the Wyoming Code. Where the court will sit and when it will open is another matter. ‘Two things will dictate when the factory is up and running: the adoption of court

1 Pg. 165 (2011).
4 See “Wyoming Supreme Court Upholds Decision to Pierce the Veil of Single-Member LLC,” Rutledge, Thomas; November 13, 2014,

rules and making sure we’ve got the IT—the caseload management system and e-filing—in place,” says Senate President Drew Perkins, sponsor of the bill.

The Act mandates $1,500,000.00 of initial funding for the court and contains a broad outline for how the court should operate, among other things. In April 2019, the Supreme Court issued an order establishing the Chancery Court Committee to fill in the details of that outline. Justice Kate Fox was appointed its chairperson. “She gets two thumbs up,” Greear says. “She put together a great committee.”

The Committee did its job, particularly in developing court rules. Finally, on January 7, 2020, an email went out to the Wyoming Bar, asking for comments on the proposed rules. The comment period ends on May 15, 2020, and final rules will go into effect six months later on November 15, 2020. That date makes sense because there is still a lot to work through, according to Justice Fox. That includes the rules, but also who the judges will be and where their court will sit. “The plan is to appoint judges with expertise in the statutory areas, much like in Delaware. Wyoming Chancery Court judges must be experienced or knowledgeable in the subject matter jurisdiction of the court,” she explains.

The court’s jurisdiction includes everything from breach of contract to fraud and misrepresentation, from statutory violations of laws governing asset sales and protecting trade secrets to transactions involving the Uniform Commercial Code and the Uniform Trust Code. Disputes concerning employment agreements, insurance coverage, and dissolution of corporations, LLCs, and other entities can all be heard by the Chancery Court. The statute says the Court “shall employ “alternative nonjury trials, dispute resolution methods and limited motion practice and shall have broad authority to shape and expedite discovery,” a good idea, given that the new law requires “effective and expeditious resolution of disputes,” a term of art that means a majority of the actions filed in the court must be resolved with 150 days of filing. “The sponsors of the bill view the Chancery Court as kind of a business draw,” Fox says. “A speedier court with more particular [business and trust] expertise should be attractive to businesses who are considering incorporating in or coming to Wyoming.”

As for where the court will sit, “it will likely be in Casper or Cheyenne, just because they are bigger,” she continues. “But it’s also possible, depending on the case and where the parties are, that the judges could be mobile and hear cases in places like Jackson.”

The smart money is on Casper. It’s centrally located, new money was recently appropriated for a new state office building there, and it has good air service. “Last week I had meetings in New York with our investment bankers,” says Greear, who lives in Worland, Wyoming, where he’s the CEO of Wyoming Sugar Company. “I flew out of Casper, had a nice dinner in New York, met with my bankers and was home the next day. United and Delta service Casper really well.”

Perkins, who lives and works in Casper, hopes there will eventually be one or more courts outside of his hometown, maybe one in Cody or Sheridan and one in Cheyenne, for example. “That’s my vision for it, anyway. The idea is not about having the court in Casper; it’s about having the court available for quick resolution.”

As they say, time will tell. The job now is to get the first court up and running with a judge knowledgeable about business and trust law expeditiously issuing opinions. The hope is that, when published, those opinions will consistently and clearly demonstrate how things are done in the Wyoming. And done right, it’s all good—for the Equality State and the businesses that locate there.

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5 Wyo. Stat. § 5-13-111
two major oil and gas competitors—Energy Transfer Partners, L.P. and Energy Transfer Fuel, L.P. (collectively, "ETP") and Enterprise Products Partners, L.P. and Enterprise Products Operating LLC (collectively, "Enterprise")—agreed to explore the viability of a major pipeline project, which they referred to as “Double E.” In three written agreements, ETP and Enterprise expressed their intent that neither party be bound to proceed until each company’s board of directors had approved the execution of definitive agreements.

In March of 2011, the parties entered into a confidentiality agreement that laid out the parties’ rights and responsibilities with respect to confidential information exchanged during the discussions. The confidentiality agreement stated:

The Parties agree that unless and until a definitive agreement between the Parties with respect to the Potential Transaction has been executed and delivered, and then only to the extent of the specific terms of such definitive agreement, no Party hereto will be under any legal obligation of any kind whatsoever with respect to any transaction by virtue of this Agreement or any written or oral expression with respect to such a transaction by any Party or their respective Representatives, except, in the case of this Agreement, for the matters specifically agreed to herein.

In April of 2011, the parties signed a Letter Agreement with an attached “Non-Binding Term Sheet.” The letter stated:

Neither this letter nor the JV Term Sheet create any binding or enforceable obligations between the Parties and, except for the Confidentiality Agreement . . . no binding or enforceable obligations shall exist between the Parties with respect to the Transaction unless and until the Parties have received their respective board approvals and definitive agreements memorializing the terms and conditions of the Transaction have been negotiated, executed and delivered by both of the Parties. Unless and until such definitive agreements are executed and delivered by both of the Parties, either [Enterprise] or ETP, for any reason, may depart from or terminate the negotiations with respect to the Transaction at any time without any liability or obligation to the other, whether arising in contract, tort, strict liability or otherwise.

The Non-Binding Term Sheet outlined the basic features of the potential transaction and contemplated that a "mutually agreeable Limited Liability Company Agreement would be entered into" to govern the joint venture.

Finally, also in April of 2011, the
parties signed a Reimbursement Agreement that provided the terms under which ETP would reimburse Enterprise for half the cost of the project’s engineering work. That agreement also recognized that the parties were “in the process of negotiating mutually agreeable definitive agreements” for the project and stated that nothing in it would “be deemed to create or constitute a joint venture, a partnership, a corporation, or any entity taxable as a corporation, partnership or otherwise.” ETP’s pleadings stated that “as of the date of [these agreements] . . . the parties had not yet formed a partnership."

By May, the parties had formed a team to pursue Double E. The key to forming a successful venture was obtaining sufficient shipping commitments, and the parties marketed Double E to potential customers as a “50/50 JV” and prepared engineering plans for the project during the spring and summer. A Federal Energy Regulatory Commission rule governing new interstate pipelines requires an “open season” of 30 to 45 days in which shippers are asked to commit to daily barrel volumes and tariffs. The initial open season was unsuccessful. The parties extended the open season twice more. On the last day of the second extended open season, Chesapeake Energy Corp. made a large commitment to ship, and ETP was hopeful that Chesapeake’s commitment would draw in other shippers who had been holding out. A few days earlier, however, Enterprise had begun preparing its exit by negotiating with a Canadian pipeline company (“Enbridge”), and Enterprise ended its relationship with ETP a few days after the last day of the second extended open season. Enterprise and Enbridge ultimately pursued another pipeline arrangement that became a financial success, and ETP sued.

ETP’s theory at trial was that ETP and Enterprise had formed a partnership to “market and pursue” a pipeline through their conduct, and Enterprise breached its duty of loyalty by pursuing the project with Enbridge. The jury found that “ETP and Enterprise create[d] a partnership to market and pursue a pipeline project to transport crude oil” and Enterprise had not complied with its duty of loyalty. The jury found compensatory damages in the amount of $319,375,000 and benefit gained by Enterprise as a result of its misconduct in the amount of $595,257,433. The trial court reduced the disgorgement award to $150 million and otherwise rendered judgment on the verdict for ETP for a total of $535,794,777 plus postjudgment interest.

The court of appeals reversed and rendered judgment for Enterprise based on the conditions precedent in the agreements entered into between the parties (and alternatively on the basis that the alleged purpose of the partnership—to market and pursue a pipeline—did not have the potential for profit and that the alleged partnership thus could not satisfy the statutory definition of a partnership as a matter of law). ETP appealed to the Texas Supreme Court.

The Texas Supreme Court first explained that § 152.051(b) of the Texas Business Organizations Code (which contains the Texas General Partnership Law) states that “an association of two or more persons to carry on a business for profit as owners creates a partnership, regardless of whether: (1) the persons intend to create a partnership; or (2) the association is called a ‘partnership,’ ‘joint venture,’ or other name.” Further, § 152.052(a) sets forth the following non-exclusive factors that indicate persons have created a partnership:

(1) receipt or right to receive a share of profits of the business;

(2) expression of an intent to be partners in the business;

(3) participation or right to participate in control of the business;

(4) agreement to share or sharing:

(A) losses of the business; or

(B) liability for claims by third parties against the business; and

(5) agreement to contribute or contributing money or property to the business.

Section 152.003 provides that “[t]he principles of law and equity and the other partnership provisions supplement this chapter unless otherwise provided by this chapter or the other partnership provisions.”
The court noted that it had characterized the application of the statutory factors in a previous decision as a “totality-of-the-circumstances” test, under which expression of an intent to be partners carries no greater weight than any other factor. The court acknowledged that “under § 152.051(b), persons can create a partnership regardless of whether they intend to,” and the court explained that this provision derives from Section 202(a) of the Revised Uniform Partnership Act, the official comment to which warns that parties “may inadvertently create a partnership despite their expressed subjective intention not to do so.” The court pointed out, however, that it had previously “expressed skepticism that the Legislature ‘intended to spring surprise or accidental partnerships on independent business persons.’” The court stated that it had not previously addressed the question of whether persons may “override the default test for partnership formation in Chapter 152 by agreeing not to be partners until conditions precedent are satisfied.”

Relying on “other ‘principles of law and equity’” and the strong Texas policy favoring freedom of contract, the court concluded that the “parties’ freedom to contract for conditions precedent to partnership formation can override the statutory default test, in which intent is a mere factor.” The court stated that “[a]n agreement not to be partners unless certain conditions are met will ordinarily be conclusive on the issue of partnership formation as between the parties.” In a footnote, the court stated that “[s]uch an agreement would not, of course, bind third parties, and we do not consider its effect on them.”

The court acknowledged that performance of a condition precedent can be waived or modified, but the court stated that ETP was required either to obtain a jury finding on waiver or to prove waiver conclusively, neither of which ETP did. The court explained further that “only evidence directly tied to the condition precedent is relevant. Evidence that would be probative of expression of intent under § 152.051(a)—such as ‘the parties’ statements that they are partners, one party holding the other party out as a partner on the business’s letterhead or name plate, or in a signed partnership agreement’[footnote omitted]—is not relevant. Nor is evidence that would be probative of any of the other § 152.052(a) factors. Otherwise, a party in ETP’s position could claim waiver in virtually every case.” According to the court, ETP did not point to any evidence that Enterprise specifically disavowed the requirement of definitive, board-approved agreements or that Enterprise intentionally acted inconsistently with that requirement. The court rejected the argument that the effect of the conditions precedent was subsumed in the five factors considered by the jury, and the court stated that the evidence on which ETP relied—that the parties held themselves out as partners and worked closely together on the Double E project—was not relevant to the issue of waiver of definitive, board-approved agreements. Because the court disposed of the case on the basis of the conditions precedent, the court did not address the alternative holding of the court of appeals that the purpose of the partnership alleged by ETP—to market and pursue a pipeline—was not a “for profit” purpose as is required by the statute to create a partnership.


The court held that three individuals who entered into negotiations to form a mortgage lending business by becoming members of an existing LLC did not create a general partnership and that the trial court’s finding to the contrary was clearly erroneous.

In the fall of 2009, Harry Korotki, Joel Wax, and Mark Greenberg entered into negotiations to merge their licensed mortgage lending companies and operate them as one. The surviving entity of the merger was to be MAS Associates, LLC (“MAS”), which was owned 91% by Greenberg’s wife before the merger and which was to be owned by Korotki, Wax, and Greenberg, along with another existing minority member of MAS, after the merger. Each party was represented by its own counsel, and they also retained regulatory attorneys to create a “neutral” draft of the parties’ business arrangement. The regulatory counsel drafted and circulated a summary of the parties’ meeting memorializing their goal of becoming members of MAS in specified percentages. The summary of the meeting also reflected that the potential arrangement would be
structured into an interim period and a post-interim period. During the interim period, Korotki and Wax would be employees of MAS until approvals and licensing were obtained, they would be entitled to receive one-third of the profits, their companies would be liquidated, and their mortgage licenses would be surrendered. In November 2009, the regulatory counsel provided drafts of an “Interim Agreement” outlining the interim period before Korotki, Wax, and Greenberg were to become members in a manner similar to the earlier summary and an “Operating Agreement Outline” contemplating each party’s obligations post-membership. As contemplated by the interim agreement, the three men each made indirect contributions to MAS of $150,000 by making payments to Greenberg’s wife. Negotiations over the Interim Agreement and the Operating Agreement Outline continued for several months. Around this same time, the business began experiencing losses and the parties did not finalize the agreements because they did not want to spend more money on attorney’s fees. By summer 2010, MAS was beginning to make a profit, and the parties decided to begin drawing a salary of $10,000 per month each. As of November of 2010, the parties still contemplated becoming members or owners of MAS and anticipated signing the Interim Agreement by the end of the year. After year-end distributions of commissions and income to the three men, they each made an additional contribution to MAS of $125,000 by again making a payment to Greenberg’s wife. As MAS began to grow, its need to secure additional lines of credit increased. As collateral to secure a line of credit, Greenberg and Wax agreed to pledge their own, personal resources. Korotki, however, refused to be personally liable for any amounts exceeding his one-third share, which eventually led to the unraveling of the venture. In the spring of 2011, Korotki informed Greenberg and Wax of his decision to quit. When Greenberg, Wax, and Korotki failed to negotiate the terms of Korotki’s departure and buyout, Korotki sued for breach of contract and declaratory judgment under the Revised Uniform Partnership Act. The trial court ruled that the parties intended to form a partnership. Greenberg and Wax appealed, and the Maryland Court of Special Appeals affirmed the trial court’s ruling. Greenberg and Wax sought review by the Maryland Court of Appeals, which granted their petition.

The court first generally discussed the nature of LLCs and general partnerships, explaining that LLCs are creatures of statute formed pursuant to the Maryland Limited Liability Company Act. In contrast to an LLC, which is formed by the execution and filing of articles of organization, there are no formal requirements to form a partnership. The Maryland Revised Uniform Partnership Act (“RUPA”) defines a partnership as “the unincorporated association of two or more persons to carry on as co-owners a business for profit ...”, and provides that a partnership can result whether the individuals expressly “intended to form a partnership and whether or not the association is called ‘partnership,’ ‘joint venture,’ or any other name.” An “unincorporated association or entity created under a law other than” RUPA or another state’s partnership law “is not a partnership.” The existence of a partnership depends on the intent of the purported partners, which may be proved by an express agreement or inferred from conduct. The court cited the following statutory rules applicable to the determination of whether a partnership was formed: “(1) joint tenancy or ownership of property ‘does not by itself establish a partnership’; (2) sharing ‘gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest’ in the property generating the returns; and (3) any person receiving ‘a share of the profits of a business is presumed to be a partner,’ unless such share is received in the payment of debt, wages or services rendered, rent, annuity or benefit, interest on a loan, or sale of a business or property. Corps. & Ass’ns § 9a-202(D)(1)-(3).”

It was undisputed that there was no enforceable written agreement, therefore, the court examined whether there was competent material evidence for a factfinder to conclude that the parties formed a general partnership. Wax and Greenberg argued that the trial court conflated two distinct forms of business entities—LLCs and partnerships. They asserted that the trial court erred in ruling that a lawfully formed LLC could simultaneously be the vehicle for operating a separate unnamed “combined mortgage lending business” partnership. In other words, they argued that the trial court ignored the statutory language preventing
organizations formed under other statutes from being partnerships. Although the court agreed that an LLC cannot simultaneously be a partnership, the court also agreed with Korotki that it is possible to construct a scenario where the existence of a partnership and LLC are not mutually exclusive. “Most relevant here, one could imagine a scenario where parties intend to become members of an existing LLC but abandon that attempt in favor of a partnership. It is also not inconsistent with the statutory language, per se, for an association conducting its operations in conjunction with an LLC to intend to form a partnership. The question is whether the parties have done so in this case, and, accordingly, we turn to a close analysis of the record.”

The court first discussed the negotiations to form an LLC, discussing at some length a Delaware case relied on by Greenberg and Wax. In Ramone v. Lang, No. Civ.A. 1592-N, 2006 WL 905347 (Del. Ch. Apr. 3, 2006), the court concluded that there was no partnership between the parties because “to find that their failure to reach accord on an LLC agreement, without more, left them as general partners would be inequitable and unprincipled, given the reality that they never agreed on their obligations to one another.” The parties’ agreement was nothing more than an engagement “to get engaged,” which is not sufficient to form a general partnership. The court found this case to present a similar situation, and stated that the most important factor in this case was that the parties never abandoned their efforts to become members of MAS. According to the court, “[a]ctions consistent with [the parties’] mutual understanding [to become members of an LLC] could not fairly contribute to an implied partnership.”

The court next discussed management and control of the entity, which is a factor that courts commonly examine to evaluate partnership intent. Wax and Greenberg argued that the parties’ roles were consistent with being managers in a manager-managed LLC and that referring to each other as partners, in the colloquial sense, is not indicative of a partnership. They also asserted that MAS was the only entity through which the parties operated. Korotki argued that the parties made decisions only after consulting each other and that each had equal control in the management process, pointing out that the parties were all signatories on the business bank accounts, they referred to each other as partners, and employees referred to them as partners. The court viewed the evidence of shared management as consistent with the typical high-level managerial responsibilities of an LLC manager, and the parties were negotiating to become members in MAS, first becoming managers of MAS, which was a manager-managed LLC. Thus, the court did not consider the managerial activities of the parties as supporting an intent to form a partnership. The court also attached no weight to the colloquial use of “partner,” which the court pointed out was mostly used by Korotki. The court also pointed out that none of the parties protested their holding out to the world that they were operating within the structure of an LLC.

The court next discussed Korotki’s argument that his capital contributions showed he was an equal owner of a new entity formed with Wax and Greenberg. The court acknowledged that a “common factor courts use to determine whether parties intended to form a partnership is whether they made capital contributions to the endeavor.” However, the court did not view the payments that were made to Greenberg’s wife, which were then transferred to MAS, as a contribution to a partnership. The court explained that “[t]he trial judge treated these payments as if they were made to a partnership under the guise of capital contributions to an LLC. But to accept this conclusion would be to treat a capital contribution to an LLC as a capital contribution to a partnership—as if the entities were one-in-the-same—which is expressly prohibited by Corps. & Ass’ns § 9A-202(c).” The court concluded that the evidence and law necessitated a finding that the payments to Greenberg’s wife were actually loans rather than capital contributions to a new entity, and a loan is not evidence of partnership intent.

Finally, the court discussed the evidence with respect to the sharing of profits and losses. Wax and Greenberg argued that any profits Korotki received should be characterized as wages because Korotki was considered an employee of MAS.
and received a W-2 form showing his wages. They asserted that the evidence was consistent with MAS being a manager-managed LLC and Korotki being a manager. In addition, they testified that the parties never agreed to share losses equally and that the evidence showed Korotki’s unwillingness to share MAS’s liabilities equally. Korotki asserted that he received a share of profits, rather than wages, and that RUPA thus presumes him to be a partner. He claimed that the fact that he was paid in W-2 wages did not make the payments employment wages. The court found the evidence that the parties intended to be employees of MAS during the interim period before membership to be overwhelming, and the court stated that the regular payments of $10,000 per month, which were denoted as salary on MAS’s payroll, were compensation that did not contribute to any presumption of partnership. The court attached importance to the fact that MAS and all three men treated all payments as wages, not profits. Additionally, the court found it significant that Korotki never agreed to be equally liable for the debts incurred by the purported partnership. He refused to co-sign a warehouse line of credit or an indemnity agreement covering his share of liabilities from the line of credit.

In sum, the court concluded that evidence of equal control and joint decision-making authority did not in these circumstances support a conclusion of partnership. Further, the trial court erred when it classified Korotki’s $275,000 in payments to Greenberg’s wife, the 91% member of MAS, as capital contributions rather than loans. Further, any presumption of partnership based on profit sharing was undone by the parties’ unabandoned intent to become members of MAS and their treatment of payments from MAS as wages. Moreover, Korotki resisted being held jointly and severally liable for the debts of the purported partnership. For these reasons, the record lacked the necessary evidence to conclude that the parties intended to form a partnership.

**Veil Piercing**

Two ousted members of a Georgia LLC brought a direct action against a third member and several of his entities, alleging that the defendants carried out a takeover scheme by causing a funding crisis. The court of appeals affirmed in part, holding that the ousted members could bring a direct action against the third member and stated claims for breach of the operating agreement, breach of fiduciary duty, fraud, and veil piercing. However, the court reversed in part and held that the third member’s alleged breach of fiduciary duties was not a violation of a membership interest purchase agreement.

Dr. Goldsmith, a neurologist who specialized in complex ear procedures, started ICOT Hearing Systems, LLC (“ICOT Hearing”) to provide low-cost hearing aids. Jason Jue became involved in the early stages of ICOT Hearing and assisted in building the company into a multimillion-dollar enterprise, running the day-to-day operations as its sole manager. ICOT Hearing was wholly owned by ICOT Holdings, LLC (“ICOT Holdings”). Prior to the events at issue in this case, Goldsmith and Jue together held a majority interest in ICOT Holdings and controlled ICOT Hearing and ICOT Holding (collectively, “ICOT”). Tracy Young founded and controlled the operations of TMX Finance LLC, TitleMax of Texas, Inc., and TitleMax of Georgia, Inc. (collectively, the “TMX Defendants”), which were a “family of companies” consisting of title pawn companies and other businesses.

In August 2015, Young began personally lending money to ICOT. Goldsmith, Jue, and Young shared the goal of selling ICOT to a third party for upwards of “hundreds of millions of dollars in the near term.” Young encouraged Jue to “put his foot on the gas” regarding ICOT operations and assured Jue and Goldsmith that he would provide more funding.

In March 2016, ICOT Hearing, ICOT Holdings, Jue, Goldsmith, Young, and Young’s limited liability company, TY ICOT Investments (“TY Investments”), entered into a restructuring agreement under which Young loaned additional funds to ICOT Hearing and guaranteed two bank loans (the
“Restructuring Agreement”). As part of the restructuring, TY Investments purchased membership units in ICOT Holdings from Goldsmith and minority members and obtained exclusive one-year options to purchase additional units from Goldsmith and minority members. TY Investments’ purchase and its options were memorialized in a Membership Interest and Purchase Option Agreement entered at the time of the restructuring of ICOT Holdings (the “Goldsmith Agreement”). As an additional part of the restructuring, ICOT Holdings and its members executed an Amended and Restated Operating Agreement (the “Operating Agreement”), which contained provisions placing certain duties on the company’s managers, including the duties to conduct the business in good faith, to not engage in wrongful conduct, and to act in a manner that would not result in improper personal benefit to the managers. The Operating Agreement also provided to TY Investments the power to appoint one of three managers to ICOT Holdings’ board of managers. TY Investments then appointed Young, who agreed to comply with the terms of the Operating Agreement while serving in that position. Following the restructuring and prior to execution of the options, Jue and Goldsmith retained their controlling interest in ICOT Holdings. On the other hand, if TY Investments had executed all of the options it acquired as a result of the restructuring, then Young, through TY Investments, would have a majority interest in ICOT Holdings.

In March 2017, Goldsmith and Jue filed a direct action against Young and TY Investments (collectively, the “Young Defendants”) and against the TMX Defendants. The plaintiffs’ amended complaint included claims for breach of the Operating Agreement, breach of fiduciary duties, breach of the Goldsmith Agreement, fraud, vicarious liability of the TMX Defendants based on the conduct of their personnel, veil piercing, civil conspiracy, and aiding and abetting a breach of fiduciary duty.

The complaint alleged that, after the restructuring, Young orchestrated the following takeover scheme in order to obtain a controlling interest in ICOT Holdings without having to exercise the options: (1) caused an “existential funding crisis” by derailing funding from third-party capital providers; (2) refused to sign the guarantee for a previously negotiated line-of-credit unless he received warrants from Goldsmith and Jue, resulting in short-term cash flow problems; (3) drove away third-party buyer with statements that put the company’s financial health in a poor light, disparaged Jue, and threatened to dilute the membership interests of Goldsmith and Jue; (4) initiated an inspection of ICOT’s books and records in preparation for the takeover; (5) leveraged the funding crisis to control ICOT Holdings’ board of managers by appointing an ally, misrepresenting that ally’s appointment was necessary for ICOT Holdings to draw on the line-of-credit; (6) coordinated vote with the ally to terminate Jue as manager of ICOT Holdings; and (7) diluted Goldsmith and Jue and obtained majority control by issuing a capital call when he knew that the line-of-credit was available and that the plaintiffs lacked the funds to make a pro rata contribution pro rata. After Young took control of ICOT Holdings, he contacted the same third-party buyer and proposed a discounted sale. Considering their diluted position and the discounted sale price, neither Goldsmith nor Jue would receive money from the sale. The defendants answered and later moved to dismiss, contending that the plaintiffs were not entitled to bring a direct claim and had failed to state any viable claims against them. The trial court denied the defendants’ respective motions. The defendants filed applications for interlocutory appeal, which the court granted, leading to the present companion appeals.

One of the issues addressed by the court on appeal was the TMX Defendants’ argument that the plaintiff sought to hold them liable for Young’s alleged misconduct under an outsider reverse veil-piercing theory and that Georgia does not recognize this theory. Although the court agreed with the TMX Defendants that Georgia does not recognize outsider reverse veil piercing (i.e., imposing liability on the entity for a third-party judgment against an owner), it concluded that the plaintiffs stated a claim for veil piercing. The court cited Georgia case law for the proposition that the general purpose of veil piercing is to hold an individual owner liable for the obligations of the entity, but it can also be used to hold a parent company liable for the obligations of a wholly-owned subsidiary or to hold a family
of entities liable for the obligations of each other. The court pointed out that the complaint included allegations that the TMX Defendants are a “family of companies” owned and governed solely by Young, that Young controls all operations of the TMX Defendants, that Young used the TMX Defendants for the personal purpose of causing harm to the plaintiffs, and that veil piercing of the TMX Defendants is authorized and appropriate because Young used these “entities to defeat justice, perpetuate fraud, and evade contractual and tort responsibilities.” The court agreed with the TMX Defendants that Georgia law foreclosed any attempt to reach the assets of the TMX Defendants for a judgment debt personally incurred by Young under the theory of outsider reverse veil-piercing. However, construed in the light most favorable to the plaintiffs, the amended complaint stated a claim for holding TMX Finance, LLC, liable for any judgment debt incurred by its subsidiaries, TitleMax Texas, Inc. and TitleMax Georgia, Inc., under a veil-piercing theory, and for holding the TMX “family of companies” liable for any judgment debt incurred by each other under such a theory.

**McKay v. Longman, 211 A.3d 20 (Conn. 2019).**

The Connecticut Supreme Court recognized the doctrine of outsider reverse veil piercing and affirmed the district court’s judgment based on reverse veil piercing of several LLCs. Although the court noted that a Connecticut statute prohibiting the application of outsider reverse veil piercing was passed on the same day that oral arguments were heard in the case, the court concluded that passage of the statute did not affect the court’s decision to uphold the trial court’s application of reverse veil piercing given the prospective nature of the statute and the unfairness that would result if the statute were applied to this case, which was commenced nearly nine years earlier to collect on a foreign judgment rendered in the mid 1990s.

Robert McKay and Stuart Longman were business partners. In July 1996, after a falling out, McKay obtained a multimillion-dollar judgment in New York against Longman. McKay’s efforts to collect on this judgment were unsuccessful, including attempts to attach Longman’s assets in the form of two pieces of Connecticut real property: the Longman’s family residence located in Ridgefield (the “Ridgefield Property”) and commercial property located in Greenwich (the “Greenwich Property”). Longman transferred ownership of the Ridgefield Property and the Greenwich Property (collectively, the “Properties”) between himself and certain entities in which he held an interest. After learning of these and other transactions, McKay sued Longman and several of those entities, including Sapphire Development, LLC (“Sapphire”), Lurie Investments, LLC (“Lurie”), R.I.P.P. Corp. (“RIPP”), and 2 Great Pasture Road Associates, LLC (collectively, the “Entities”). McKay also sued a lender that made a loan to Sapphire secured by a mortgage against the Ridgefield Property. McKay’s suit included allegations that specific transfers of the Properties from Longman to the Entities were fraudulent transfers under Connecticut law and requested that the trial court impose constructive trusts on the Properties. McKay also sought to have the mortgage against the Ridgefield Property declared void on the basis that Longman lacked authority to bind Sapphire to the mortgage agreement under the Connecticut LLC statute. Finally, McKay alleged that the Entities were alter egos of Longman and asked the trial court to apply reverse veil piercing to the Entities to satisfy the New York judgment. Following a bench trial, the trial court rendered judgment in favor of McKay on his fraudulent transfer and alter-ego claims and granted the requested relief. The parties appealed.

The court first considered McKay’s claim that the trial court erroneously held that he lacked standing to bring an action under Conn. Gen. Stat. § 34-130 (which describes the agency powers of a manager or member of a Connecticut LLC) where the action challenged Longman’s authority, as a member of Sapphire, to bind Sapphire to the mortgage agreement regarding the Ridgefield Property. The court concluded that McKay, who was not a party to the mortgage or a third-party beneficiary of it, did not fall within the zone of interests that § 34-
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130 was meant to protect, and the trial court correctly determined that he did not have standing to challenge Longman’s authority to enter into the mortgage agreement on behalf of Sapphire. The court noted in a footnote that McKay effectively sought a “windfall” by arguing, on the one hand, that Longman exercised the type of control and domination of Sapphire supporting treatment of Sapphire as his alter ego while asking, on the other hand, that the court find Longman did not have the authority to obtain a mortgage on Sapphire’s behalf.

The court next reviewed the trial court’s findings that Longman fraudulently transferred ownership of the Properties under the clearly erroneous standard and held that these determinations were correct. The court concluded that the record supported the trial court’s finding that Longman fraudulently transferred the Ridgefield Property to Sapphire in December 2007. The record revealed that Longman and his wife owned Sapphire directly and indirectly, he was the company’s sole decision maker, and he used this insider status to develop a history of back-and-forth transfers with the company that dated back to the time of the New York judgment. These transfers enabled Longman to use the Ridgefield Property as security for multiple loans, some of which were obtained in an individual capacity and paid off by subsequent loans acquired in a representative role. The court noted that the transfers allowed Longman to extract equity from Sapphire because the Ridgefield Property was the company’s only asset, yet the company received no benefit. Specifically, Sapphire obtained a mortgage in October 2007 to pay off a prior loan made to Longman individually one month earlier and gave him the balance of roughly $200,000 before it transferred the property back to Longman so that he could close on a new personal loan that was secured by the property. In November 2007, Longman executed this latest loan but only after he transferred title back to Sapphire for $1 in consideration. Longman then waited to record the transfer back to Sapphire until early December 2007 and waited another three weeks to record the mortgage, allowing him to obtain a loan without ever holding the proceeds in his name. The nominal consideration combined with the New York judgment left Longman insolvent. Thus, the court held that the trial court properly determined that Longman’s December 2007 transfer of the Ridgefield Property to Sapphire was fraudulent because it was intended to shield the property from creditors.

The court also concluded that there was support in the record for the trial court’s finding that Longman fraudulently transferred the Greenwich Property to Lurie in February 2010. The evidence showed that Longman funneled the purchase money from his personal bank account through the Entities. The record also showed that Longman held title to the property in his name for nearly one week before he transferred it to Lurie, which was owned solely by his wife, for $10 in consideration. After the property was sold to a bona fide purchaser a few months later, Longman controlled the sales proceeds and distributed various amounts to the Entities and his personal bank account. Although the court acknowledged an understanding to replenish the source of the purchase money, the court reasoned that there was no apparent rationale—other than the avoidance of creditors like McKay—for Longman to first transfer the property to Lurie, sell it, and then distribute the proceeds. Therefore, the court held that the trial court properly determined that Longman fraudulently transferred the Greenwich Property to Lurie in February 2010.

The court next held that outsider reverse veil piercing was a viable remedy in Connecticut and adopted a three-step test for its application. The court began its analysis by describing reverse veil piercing as an extension of traditional veil piercing and noted that both equitable remedies disregard an entity’s separate legal existence. After stating that the same legal principles govern these two types of piercing, the court pointed out a fundamental distinction: traditional piercing imposes liability on an owner for a judgment against the entity, while reverse piercing imposes liability on the entity for a judgment against an owner. Then the court noted that there are two general forms of reverse piercing: insider and outsider. Insider reverse piercing applies when an entity’s owner seeks to disregard the entity’s form for the owner’s benefit. Outsider reverse piercing, or “third-party reverse piercing” (the form at issue in this
case), applies when an outsider or third party (e.g., a creditor of an owner) seeks to disregard the entity’s form to satisfy a judgment against an owner out of the entity’s assets. Because reverse piercing shifts liability to the entity, the court acknowledged concerns that reverse piercing allows creditors to bypass normal judgment collection procedures, potentially harms innocent owners and creditors, and should not be applied if adequate remedies at law (e.g., attachment, garnishment, charging order, avoidance of a fraudulent transfer, etc.) are available.

The court’s test for outsider reverse veil piercing contains the following three steps: (1) the plaintiff-outsider must prove the elements of either the instrumentality rule or the identity rule, as provided in traditional piercing cases; (2) trial courts must weigh the impact of reverse piercing on nonculpable owners and creditors; and (3) trial courts must consider whether adequate remedies at law are available. Thus, the court’s test for outsider reverse piercing is rooted in traditional piercing case law but extends that analysis to attend to the concerns specific to reverse piercing. Step one requires the plaintiff-outsider to prove the elements of either the instrumentality rule or the identity rule. The court cited Connecticut case law for the proposition that the instrumentality rule examines the relationship of the defendant-owner to the entity and requires proof of three elements: (1) the defendant-owner controlled and dominated the entity; (2) such control was used by the defendant-owner to commit a fraud or other wrong that goes beyond the plaintiff-outsider’s mere inability to collect on a judgment; and (3) the control and wrong proximately caused the plaintiff-outsider’s loss. Further, a court assesses the first element of control and domination by considering a number of factors that include:

1. the absence of [entity] formalities;
2. inadequate capitalization;
3. whether funds are put in and taken out of the [entity] for personal rather than [entity] purposes;
4. overlapping ownership, officers, directors, personnel;
5. common office space, address, phones;
6. the amount of business discretion by the allegedly dominated [entity];
7. whether the [entities] dealt with each other at arm’s length;
8. whether the [entities] are treated as independent profit centers;
9. payment or guarantee of debts of the dominated [entity]; and
10. whether the [entity] in question had property that was used by other of the [entities] as if it were its own.

On the other hand, the identity rule has one element that requires the plaintiff-outsider to show “that there was such a unity of interest and ownership that the independence of the [entity] had in effect ceased or had never begun, [in which case] an adherence to the fiction of separate identity would serve only to defeat justice and equity by permitting the economic entity to escape liability . . . .” If the trial court finds that the plaintiff-outsider has met step one and satisfied either the instrumentality or identity rule, then it is required to weigh the impact of reverse piercing on nonculpable owners and creditors under step two and consider whether adequate remedies at law are available under step three.

The court reviewed the trial court’s decision to reverse pierce the Entities under the clearly erroneous standard and held that the trial court’s application of outsider reverse piercing was proper. Longman and the Entities claimed that the evidence did not support the conclusion that the entities were alter egos (e.g., step one) and that the reverse piercing-specific concerns precluded relief (e.g., steps two and three). In support of their challenge to the trial court’s analysis under the instrumentality rule, Longman and the Entities argued that McKay did not present evidence of ownership by Longman, control, and proximate causation. The court rejected this argument and concluded that the trial court’s analysis of the instrumentality rule was not clearly erroneous. The trial court found, and the court agreed, that Longman exercised control and domination over the Entities after considering evidence of the relevant factors: Sapphire’s sole asset, the Ridgefield Property, produced no income but was the location of the Longman family residence and none of the Entities had capital or income other than inter-entity transfers or contributions from Longman’s personal bank account [second factor]; “pervasive” payment of personal expenses of Longman's
family members and Longman’s regular allocation of Lurie funds to his wife and children for spending money [third factor]; consistent, interconnected ownership by Longman family members and Longman, in effect, was the actual decision maker [fourth factor]; the Ridgefield Property was listed as the business address for most of the Entities [fifth factor]; the inter-entity transactions had no stated or identifiable business purpose and were subject to Longman’s “discretion” [sixth and seventh factors]; a Sapphire mortgage application listed Lurie and Great Pasture under “bank accounts,” Lurie’s principal transaction of selling the Greenwich Property was isolated and took place only after a fraudulent transfer from Longman, and the other Entities had no observable material profit generation [eighth factor]; Sapphire was essentially a guarantor of the December 2007 mortgage on the Ridgefield Property made to Longman individually [ninth factor]; and Longman was able to tap the equity of Sapphire and draw down assets of the other entities without regard to a business purpose [tenth factor]. Therefore, the court concluded that the trial court properly decided that McKay established the first element of the instrumentality rule. Next, the court concluded that it was not clearly erroneous for the trial court to find that nonculpable owners or creditors were not negatively affected and there was no adequate remedy. Among those the trial court identified as innocent owners and creditors of the Entities were Longman’s wife, his son, and the Ridgefield Property mortgagees. The trial court then found that there was no basis for concern after taking into account the following evidence: Longman’s wife received her ownership in the entities for no consideration, gave him “full and effectively sole [decision-making authority],” and authorized or ratified his conduct; although Longman’s son was one of Great Pasture’s managers, his membership in any of the Entities ended before the Properties were fraudulently transferred; the Ridgefield Property mortgagees (i.e., Sapphire’s creditors) were secured creditors; and the reverse-piercing remedy was in the general nature of a “backup” to McKay’s fraudulent transfer claims. As to the trial court’s conclusion that there was no adequate remedy, that court’s reasoning focused on the context surrounding the transfers of the Ridgefield Property and the Greenwich Property. The trial court found that the “hook” in the Ridgefield Property transfers was the brief period of time during which Longman owned the property in relation to the relevant time frame overall. The trial court also found that, regarding the Greenwich Property transfer, the “multiplicity of entities [and] constant movement of money” made it nearly impossible to calculate monetary damages under a fraudulent transfer claim. Thus, the court concluded that the trial court correctly decided steps two and three and held that outsider reverse piercing was properly applied to the Entities.

Fourth, the court held that the trial court did not clearly err when it declined to reverse pierce several other entities that McKay alleged were Longman’s alter egos. Although the record showed that Lurie did transfer some of the proceeds from the sale of the Greenwich Property to these entities, there was evidence that these other entities were engaged in legitimate business and nonculpable owners would be prejudiced by a piercing. Therefore, the court distinguished the Entities from these other entities and concluded that it was not clearly erroneous for the trial court to decline to reverse pierce them.
In a footnote, the court observed that prior to releasing this opinion, the Connecticut Legislature passed legislation that codified the instrumentality test for traditional veil piercing and prohibited reverse veil piercing. Because the amendment was prospective in nature and McKay initiated this litigation nearly nine years earlier, the court concluded that its decision to uphold the trial court's application of reverse piercing was not affected.


The Colorado court of appeals held that the evidence did not support piercing the veil of a single-member, single-purpose LLC to hold its non-member property management company liable for a judgment against the LLC.

Hinds, the owner of a condominium unit, obtained a default judgment against the LLC that built his building and initially sold the units. The judgment was based on the sale of handicap parking spaces to non-handicapped buyers years before Hinds bought his condo unit. By the time Hinds sought to collect the judgment, management of the condo development had been contracted out by the LLC to a management company and the LLC had wound down and no longer had any assets. Hinds brought a garnishment action in which he sought to pierce the veil of the LLC and hold Sedgwick liable for the judgment against the LLC. Sedgwick appealed.

While there is Colorado precedent applying corporate veil-piercing principles in the LLC context, the court of appeals noted that Colorado’s appellate courts had not previously addressed corporate veil piercing in the context of a single-member, single-purpose LLC managed under a contract by another company. The court first described the three-part inquiry that is necessary to determine whether it is appropriate to pierce the corporate veil: (1) whether the corporate entity is the alter ego of the person or entity in issue; (2) whether justice requires recognizing the substance of the relationship between the person or entity sought to be held liable and the corporation over the form based on use of the corporate fiction “to perpetrate a fraud or defeat a rightful claim”; and (3) whether an equitable result will be achieved by disregarding the corporate form and holding a shareholder or other insider personally liable for the acts of the business entity. The court concluded that the evidence in this case failed to support the first prong of alter ego and thus did not analyze whether the second and third prongs were met.

In conducting its de novo review of the alter-ego prong, the court discussed the multi-tiered ownership structure of the LLC and noted testimony that the multi-tiered structure was adopted to fulfill a requirement of one of the lenders on the condo development project. The court pointed out that Sedgwick served as the initial corporate manager of the LLC and its parent and was paid a fee for certain services but had no ownership interest in the LLC. The court commented that “[o]ne might question whether a court can pierce the corporate veil to hold liable a non-owner company that merely provided management services to an LLC,” but the court refrained from deciding that issue because no party raised it.

The court listed the following factors (not all of which need to be shown to establish alter-ego status) considered by courts in determining whether a corporate entity is the alter ego of the person or entity in issue: (1) whether the corporation is operated as a distinct business entity; (2) whether funds and assets are commingled; (3) whether adequate corporate records are maintained; (4) whether the nature and form of the entity’s ownership and control facilitate misuse by an insider; (5) whether the business is thinly capitalized; (6) whether the corporation is used as a “mere shell”; (7) whether legal formalities are disregarded; and (8) whether corporate funds or assets are used for noncorporate purposes. The court stated that the district court erred in considering these factors in the context of this case without taking into account the characteristics of a single-member, single-purpose LLC (although the court acknowledged the challenge faced by the district court given the dearth of precedent addressing those characteristics). The court
pointed out the following provisions contained in the Colorado Limited Liability Company Act and stated that a court should tread even more carefully where the company in question is a single-member LLC:

(1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

(2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.

§ 7-80-107(1)-(2) (emphasis added by the Colo. court).

The court pointed out that some of the formalities required in the corporate context (such as board meetings and minutes) do not apply in the single-member LLC context and added that, “where, as here, management of the LLC is provided under contract by a management company, traditional veil-piercing factors may be even harder to apply.” Addressing each of the factors relied on by the district court, the appellate court concluded that the record as a whole did not support an alter-ego finding that would permit piercing the LLC’s veil. Overall, the court commented that it was unclear whether the district court recognized that Sedgwick was the manager under a management contract and was not an owner-manager of the entity. In any event, the court stated that several of the district court’s findings of fact did not necessarily show a disregard of the corporate form since they were consistent with the LLC’s operation as a single-member LLC as well as with Sedgwick’s role as manager of the entity through a contract to provide such services.

Specifically, the appellate court found fault with the district court’s analysis of several of the alter-ego factors. First, with respect to ownership, control, and unity of interest, the district court appeared to conflate findings regarding the control exercised by an individual who was an owner and manager in the multi-tier structure with control exercised by Sedgwick. The court of appeals stated that the district court’s findings did not show control by Sedgwick beyond what would be expected under the contractual role of manager of the LLC. Second, the district court’s findings regarding failure to follow corporate formalities were based on the absence of a board of directors and lack of minutes of board meetings, which the appellate court found were not factors weighing in favor of piercing in this context. Third, the circumstances relied on by the district court to conclude that the LLC’s form facilitated misuse by an insider did not point to misuse by Sedgwick but rather related to the control exercised by the previously mentioned individual owner and manager. Next, the court agreed with the district court that the LLC was not a mere shell, but disagreed that it was undercapitalized. The court stated that the LLC’s property had substantial intrinsic value as evidenced by the ability to attract investors and institutional lenders. Also, there was no evidence that the LLC was not able to pay all its known creditors when it wound down. According to the court, “[u]ndercapitalization is not determined by whether a single-purpose LLC might be able to pay liabilities that are incurred only after the LLC has reached the end of its useful life and has ceased operating.” Finally, the court disagreed with the district court that a joint settlement entered into by the LLC, Sedgwick, and related entities in a suit against them by the homeowners’ association constituted commingling of assets and use of corporate funds for noncorporate purposes. To the contrary, the court stated it was “common knowledge among lawyers and judges that joint settlements that benefit unrelated parties often take place.”

In sum, the court concluded that the elements for piercing the veil could not be met because the evidence presented to the district court was insufficient to establish that the LLC was the alter ego of Sedgwick. A concurring judge agreed with the majority’s
analysis of the alter-ego prong but wrote separately to assert that Hinds also failed to prove the second requirement—that the corporate form was “used to perpetrate a fraud or defeat a rightful claim.”

**Entity Nature of Partnership or LLC**

*Erie Ins. Exchange v. EPC MD 15, LLC, 822 S.E.2d 351 (Va. 2019).*

The court held that an insurance policy did not cover damaged property owned by a wholly owned LLC subsidiary of an LLC named insured. The language of the policy did not support the named insured’s argument that it “acquired” the property by virtue of controlling the LLC subsidiary that owned the property.

The named insured (EPC MD 15, LLC or “EPC”) on a commercial property insurance policy sued the insurer claiming that the policy covered fire damage to property owned by its wholly owned LLC subsidiary (Cyrus Square, LLC or “Cyrus”). EPC argued that coverage was provided under a coverage extension that applied to buildings newly “acquired” by EPC after issuance of the policy. Nine months after the policy was issued, EPC acquired the sole membership interest in Cyrus, and within 90 days after its acquisition of the membership interest, fire damaged Cyrus’s building. EPC reasoned that it acquired the building when it became the sole member of Cyrus.

The court discussed the nature of an LLC (which it described as a type of entity “[c]reated to amalgamate characteristics of both partnerships and incorporated entities”) as a legal entity separate and distinct from its members and cited case law and provisions of the Virginia LLC statute illustrating or applying this principle, such as the distinction between LLC property and the membership interest of a member and the liability protection provided to members. The court stated that these principles do not change merely because an LLC has only one member.

The court reviewed language used in various provisions of the policy—the Declarations, coverage and coverage-extension provisions, and subrogation and exclusion provisions—and concluded that all these provisions undermined EPC’s argument that it “acquired” Cyrus’s real property because it “controlled” Cyrus. The court agreed with Erie’s “more common sense interpretation” that the named insured must actually acquire the property and not merely the property owner for the coverage-extension provision to apply.

The Texas Court of Appeals held that the trial court could compel production of books and records by an LLC via deposition of the LLC’s designated representative and sanction the representative for invoking the Fifth Amendment as a shield against disclosure of the books and records, but the trial court could not prohibit the representative from invoking the Fifth Amendment privilege to the extent oral testimony was sought from the representative that might incriminate the representative.

The plaintiff in the underlying lawsuit sought to depose an LLC and an individual representative, and they invoked the right to refrain from incriminating themselves. The trial court then ordered that the LLC designate a “corporate representative” and indicated that the corporate representative would not be allowed to invoke the right against self-incrimination when being deposed as corporate representative and would be subject to sanctions if he did so. The LLC argued that “[t]here was no absolute rule’ preventing ‘the sole member and only knowledgeable representative of a limited liability company from invoking the Fifth Amendment right against self-compelled incrimination” and that the LLC and its representative should not be forced to choose between asserting their constitutional rights or being subject to sanctions. The court of appeals in this mandamus proceeding relied on case law in the corporate context and In re Russo (summarized below) in analyzing and resolving the issues as follows:

A corporation and its human representatives are two distinct entities. Moreover, a corporation, like other “artificial entities” has no right under the Fifth
Amendment of the United States Constitution to avoid incriminating itself. Braswell v. United States, 487 U.S. 99, 102-103, 108 S.Ct. 2284, 101 L.Ed.2d 98 (1988); In re Russo, 550 S.W.3d 782, 788 (Tex. App.—Houston [14th Dist.] 2018, orig. proceeding). This verity has been used to require corporate representatives who are the custodian of corporate records to produce those records even though doing so may tend to incriminate the representative. In re Russo, 550 S.W.3d at 788. Yet, it is just as true that the same representative cannot be made to incriminate himself via “his own oral testimony.” Braswell v. United States, 487 U.S. at 114, 108 S.Ct. 2284 (quoting Curcio v. United States, 354 U.S. 118, 77 S.Ct. 1145, 1 L.Ed.2d 1225 (1957) (emphasis added). And, in Texas, no one can deny that a person acting on behalf of a corporation may be held criminally responsible for the conduct taken on behalf of the corporation. See Tex. Penal Code Ann. § 7.23(a) (West 2011) (stating that “[a]n individual is criminally responsible for conduct that he performs in the name of or in behalf of a corporation or association to the same extent as if the conduct were performed in his own name or behalf.”); Ex parte Canady, 140 S.W.3d 845, 850 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (stating the same). From these, we derive the answer to the question at hand. The trial court may compel a corporate representative to appear for deposition and testify on behalf of the corporation. So too may it order the custodian of corporate books and records to produce same despite the chance that doing so incriminates both the custodian and the corporation. But, the trial court may not compel the representative designated to testify on behalf of the “artificial entity” to provide oral testimony that would incriminate himself.

Thus, the court concluded that the trial court could compel disclosure of books and records sought via a deposition of the LLC’s designated corporate representative and sanction the representative for invoking the Fifth Amendment as a shield against disclosure of the books and records, but the trial court could not prohibit the representative from invoking the Fifth Amendment privilege to the extent oral testimony was sought from the representative that might incriminate the representative. To the extent the trial court’s order was a blanket prohibition on assertion of the Fifth Amendment privilege at the risk of sanctions, the order was an abuse of discretion.


The Texas Court of Appeals held that an individual member of an LLC could not rely on the Fifth Amendment privilege against self-incrimination to avoid producing documents sought in a discovery request in the underlying proceeding, even if the act of production incriminated the individual, because there was evidence the documents were records of the LLC, and an artificial entity has no right against self-incrimination.

The plaintiff in the underlying proceeding served requests for production of documents on the controlling member of numerous LLCs, Christopher Russo, and Russo attempted to invoke the act-of-production privilege against self-incrimination under the Fifth Amendment. The trial court ordered Russo to produce the documents, and Russo sought to compel the trial court to vacate the order in this mandamus proceeding. The court of appeals denied the writ of mandamus because artificial entities are not protected by the Fifth Amendment, and an individual is not permitted to invoke the Fifth Amendment privilege to avoid producing records of an entity even if the records might incriminate the individual personally. Russo argued that the documents at issue, which consisted mostly of email communications, were not records of any of his LLCs, but rather were personal records. The court concluded that the evidence indicated that the emails were likely records of an LLC because they were sent or received by Russo as an agent of an LLC in the course of its business. Further, there was evidence that the Yahoo email account was used by Russo to conduct business of his LLCs. To invoke the privilege and avoid production, Russo had the burden to prove that the withheld documents were personal and not records of his entities, and Russo failed to meet that burden.

Authority of Member or Manager of LLC

A creditor of an LLC member alleged and prevailed on fraudulent-transfer and reverse veil-piercing claims allowing the creditor to reach certain property of the LLC, and the creditor sought to have the mortgage on the property declared void so as to render the property unencumbered by the mortgage when enforcing his judgment. The Connecticut Supreme Court held that the creditor of the LLC member did not have standing to challenge the member’s authority under the LLC statute to enter into the mortgage agreement on behalf of the LLC because the creditor was not a party to, or third-party beneficiary of, the mortgage agreement.

Robert McKay and Stuart Longman were business partners. In July 1996, after a falling out, McKay obtained a multimillion-dollar judgment in New York against Longman. McKay’s efforts to collect on this judgment were unsuccessful, including attempts to attach Longman’s family residence located in Ridgefield (the “Ridgefield Property”). Longman transferred ownership of the Ridgefield Property between himself and certain entities in which he held an interest, including Sapphire Development, LLC (“Sapphire”). After learning of these and other transactions, McKay sued Longman and several of those entities, including Sapphire. McKay also sued a lender that made a loan to Sapphire secured by a mortgage against the Ridgefield Property. McKay’s suit included allegations that specific transfers of properties from Longman to his entities, including a transfer of the Ridgefield Property to Sapphire, were fraudulent transfers under Connecticut law. McKay also sought to have the mortgage against the Ridgefield Property declared void on the basis that Longman lacked authority to bind Sapphire to the mortgage agreement under the Connecticut LLC statute. Finally, McKay alleged that Sapphire and certain other entities were alter egos of Longman and asked the trial court to apply reverse veil piercing to these entities to satisfy the New York judgment. Following a bench trial, the trial court rendered judgment in favor of the lender on the basis that McKay did not have standing to challenge the enforceability of the mortgage since McKay was not a party to or third-party beneficiary of that transaction. The trial court rendered judgment in favor of McKay on his fraudulent-transfer and alter-ego claims and granted the requested relief. The parties appealed.

The court first considered McKay’s claim that the trial court erroneously held that he lacked standing to bring an action under Conn. Gen. Stat. § 34-130 (which describes the agency powers of a manager or member of a Connecticut LLC) where the action challenged Longman’s authority, as a member of Sapphire, to bind Sapphire to the mortgage agreement regarding the Ridgefield Property. The court examined the language of § 34-130, which addresses the power and authority of members and managers to execute legal instruments in the context of ordinary business transactions and extraordinary business transactions and on behalf of member-managed and manager-managed LLCs. According to the court, based on “the plain language of the statute, only members or managers—who represent either their own interests as agents or those derivative of the limited liability company—and the parties with whom those members or managers contract fall within the zone of interests protected by § 34-130.” Thus, the court concluded that McKay, who was not a party to the mortgage or a third-party beneficiary of it, did not fall within the zone of interests that § 34-130 was meant to protect, and the trial court correctly determined that he did not have standing to challenge Longman’s authority to enter into the mortgage agreement on behalf of Sapphire. Because the court concluded that McKay did not have standing to challenge the mortgage, the court did not determine whether Longman was authorized to enter into the mortgage agreement based on the alleged ratification of the mortgage by the other member of the LLC. The court noted in a footnote that McKay effectively sought a “windfall” by arguing, on the one hand, that Longman exercised the type of control and domination of Sapphire supporting treatment of Sapphire as his alter ego while asking, on the other hand, that the court find Longman did not have the authority to obtain a mortgage on Sapphire’s behalf.

The court then reviewed and analyzed at length McKay’s fraudulent-transfer and reverse veil-piercing claims, and the court affirmed the trial court’s judgment in favor of McKay on his fraudulent-transfer claims with respect to the Ridgefield
Property and another property. The court also affirmed reverse veil-piercing claims against several of Longman’s entities.

**Fiduciary Duties**


Two ousted members of a Georgia LLC brought a direct action against a third member and several of his entities, alleging that the defendants carried out a takeover scheme by causing a funding crisis. The court of appeals affirmed in part, holding that the ousted members could bring a direct action against the third member and stated claims for breach of the operating agreement, breach of fiduciary duty, fraud, and veil piercing. However, the court reversed in part and held that the third member’s alleged breach of fiduciary duties was not a violation of a membership interest purchase agreement.

Dr. Goldsmith, a neurologist who specialized in complex ear procedures, started ICOT Hearing Systems, LLC (“ICOT Hearing”) to provide low-cost hearing aids. Jason Jue became involved in the early stages of ICOT Hearing and assisted in building the company into a multimillion-dollar enterprise, running the day-to-day operations as its sole manager. ICOT Hearing was wholly owned by ICOT Holdings, LLC (“ICOT Holdings”). Prior to the events at issue in this case, Goldsmith and Jue together held a majority interest in ICOT Holdings and controlled ICOT Hearing and ICOT Holding (collectively, “ICOT”). Tracy Young founded and controlled the operations of TMX Finance LLC, TitleMax of Texas, Inc., and TitleMax of Georgia, Inc. (collectively, the “TMX Defendants”), which were a “family of companies” consisting of title pawn companies and other businesses.

In March 2016, ICOT Hearing, ICOT Holdings, Jue, Goldsmith, Young, and Young’s limited liability company, TY ICOT Investments (“TY Investments”), entered into a restructuring agreement under which Young loaned additional funds to ICOT Hearing and guaranteed two bank loans (the “Restructuring Agreement”). As part of the restructuring, TY Investments purchased membership units in ICOT Holdings from Goldsmith and minority members and obtained exclusive one-year options to purchase additional units from Goldsmith and minority members. TY Investments’ purchase and its options were memorialized in a Membership Interest and Purchase Option Agreement entered at the time of the restructuring of ICOT Holdings (the “Goldsmith Agreement”). As an additional part of the restructuring, ICOT Holdings and its members executed an Amended and Restated Operating Agreement (the “Operating Agreement”), which contained provisions placing certain duties on the company’s managers, including the duties to conduct the business in good faith, to not engage in wrongful conduct, and to act in a manner that would not result in improper personal benefit to the managers. The Operating Agreement also provided to TY Investments the power to appoint one of three managers to ICOT Holdings’ board of managers. TY Investments then appointed Young, who agreed to comply with the terms of the Operating Agreement while serving in that position. Following the restructuring and prior to execution of the options, Jue and Goldsmith retained their controlling interest in ICOT Holdings. On the other hand, if TY Investments had executed all of the options it acquired as a result of the restructuring, then Young, through TY Investments, would have a majority interest in ICOT Holdings.

In March 2017, Goldsmith and Jue filed a direct action against Young and TY Investments (collectively, the “Young Defendants”) and against the TMX Defendants. The plaintiffs’ amended complaint included claims for breach of the Operating Agreement, breach of fiduciary duties, breach of the Goldsmith Agreement, fraud, vicarious liability of the TMX Defendants based on the conduct of their personnel, veil piercing, civil conspiracy, and aiding and abetting a breach of fiduciary duty.

The complaint alleged that, after the
restructuring, Young orchestrated the following takeover scheme in order to obtain a controlling interest in ICOT Holdings without having to exercise the options: (1) caused an “existential funding crisis” by derailing funding from third-party capital providers; (2) refused to sign the guarantee for a previously negotiated line-of-credit unless he received warrants from Goldsmith and Jue, resulting in short-term cash flow problems; (3) drove away third-party buyer with statements that put the company’s financial health in a poor light, disparaged Jue, and threatened to dilute the membership interests of Goldsmith and Jue; (4) initiated an inspection of ICOT’s books and records in preparation for the takeover; (5) leveraged the funding crisis to control ICOT Holdings’ board of managers by appointing an ally, misrepresenting that ally’s appointment was necessary for ICOT Holdings to draw on the line-of-credit; (6) coordinated vote with the ally to terminate Jue as manager of ICOT Hearing; and (7) diluted Goldsmith and Jue and obtained majority control by issuing a capital call when he knew that the line-of-credit was available and that the plaintiffs lacked the funds to make a pro rata contribution pro rata. After Young took control of ICOT Holdings, he contacted the same third-party buyer and proposed a discounted sale. Considering their diluted position and the discounted sale price, neither Goldsmith nor Jue would receive money from the sale. The defendants answered and later moved to dismiss, contending that the plaintiffs were not entitled to bring a direct claim and had failed to state any viable claims against them. The trial court denied the defendants’ respective motions. The defendants filed applications for interlocutory appeal, which the court granted, leading to the present companion appeals.

The court first considered the Young Defendants’ argument that the plaintiffs’ claims were derivative in nature because they were not separate and distinct from other members of ICOT Holdings and, thus, had to be brought pursuant to the procedural requirements for filing a derivative action under the Georgia Limited Liability Company Act. The court acknowledged the general rule that dilution claims are derivative because they do not constitute a separate and distinct injury but noted an exception where wrongdoers have seized control of the entity by fraud. Because the plaintiffs’ loss of control resulted from Young’s alleged takeover scheme in breach of his fiduciary duties as a manager and through false representations and omissions about funding, the court determined that the plaintiffs could bring a direct claim against the Young Defendants because the alleged harm to plaintiffs was different from that experienced by the company and its minority members and this special injury was sufficiently pled. Furthermore, the court determined that Goldsmith was entitled to bring a direct action for the alleged breach of the Goldsmith Agreement and Jue was entitled to bring a direct action based on his alleged wrongful termination as manager of ICOT Hearing.

Next, the Young Defendants contended that the plaintiffs failed to state a claim for breach of the ICOT Holdings’ Operating Agreement and breach of fiduciary duties. Specifically, the Young Defendants maintained that neither Young’s failure to provide additional funding beyond what was previously loaned and guaranteed under the Restructuring Agreement nor his vote for a capital call that led to dilution could support a claim for breach of the Operating Agreement or breach of fiduciary duty. The court cited the Georgia LLC Act and case law for the proposition that the managing members of an LLC owe fiduciary duties to the company and its members, but such fiduciary duties may be modified or eliminated by the operating agreement. Under the Operating Agreement, managers were required to act in good faith, refrain from intentional misconduct, and avoid any improper personal benefits. The court disagreed with the Young Defendants, reasoning that Young: (1) derailed additional funding from third-party capital providers solely to implement his takeover scheme; (2) refused to sign the line-of-credit guarantee solely to create a funding crisis; (3) made false representations to a prospective third-party buyer so as to delay any sale and increase his leverage over the plaintiffs; and (4) made false representations to Jue about the provider of the line-of-credit requiring the ally’s appointment to ICOT Holdings’ board of managers and orchestrating the capital call for the sole purpose of ousting the plaintiffs from control. Therefore, the court concluded that the complaint asserted that Young had acted in bad faith, had engaged
in intentional wrongful conduct, and had acted for the purpose of obtaining an improper personal benefit.

Third, the court agreed with the defendants’ argument that the plaintiffs failed to state a claim for breach of the Goldsmith Agreement. The complaint alleged that Goldsmith agreed to give TY Investments the options to purchase membership units from him “in exchange for Young comporting with the terms of the Operating Agreement” and that Young breached this agreement when he allegedly violated his fiduciary duties. However, the Goldsmith Agreement contained a provision that specified Goldsmith’s grant of the option to Young was in exchange for $100 and Young’s agreement to provide additional funds as part of the restructuring. Because Young’s promise to comply with all of his duties as manager under the Operating Agreement was not part of the consideration for Goldsmith’s grant of the option, the court concluded that the plaintiffs failed to state a claim for breach of the Goldsmith Agreement.

The court next considered the contention of the defendants that the plaintiffs failed to state a claim for fraud and failed to plead fraud with particularity. The court concluded that the complaint did not disclose with certainty that the plaintiffs would not be entitled to relief on their claim for fraud under any state of provable facts. Among the court’s conclusions in this regard was its conclusion that the complaint did not indicate that the plaintiffs would be unable to come forward with evidence of fraudulent representations about additional funding that fell outside the scope of the merger clause in the Restructuring Agreement and that the contractual provision in the Goldsmith Agreement allowing for a due diligence inspection did not preclude the plaintiffs from pursuing a fraud claim based on the inspection that allegedly occurred.

The court then considered whether the plaintiffs sufficiently pled that the TMX Defendants could be held vicariously liable for their employees’ actions when they inspected ICOT’s books and records. According to the TMX Defendants, the complaint indicated that their personnel were acting at the direction of Young and not within the scope of and in furtherance of the TMX Defendants’ business. The court observed that the complaint alleged that the TMX Defendants were owned and controlled by Young, that he had control over employees of the TMX Defendants, and that he used this control to fly employees of the TMX Defendants to ICOT’s offices in order to inspect its books and records and to learn its operations. Therefore, the court relied on common-law agency principles to hold that the complaint sufficiently pled allegations of vicarious liability.

Sixth, the court considered the TMX Defendants’ argument that the plaintiff sought to hold them liable for Young’s alleged misconduct under an outsider reverse veil-piercing theory and that Georgia does not recognize this theory. Although the court agreed with the TMX Defendants that Georgia does not recognize outsider reverse veil piercing (i.e., imposing liability on the entity for a third-party judgment against an owner), it concluded that the plaintiffs stated a claim for veil piercing. The court cited Georgia case law for the proposition that the general purpose of veil piercing is to hold an individual owner liable for the obligations of the entity, but it can also be used to hold a parent company liable for the obligations of a wholly-owned subsidiary or to hold a family of entities liable for the obligations of each other. The court pointed out that the complaint included allegations that the TMX Defendants are a “family of companies” owned and governed solely by Young, that Young controls all operations of the TMX Defendants, that Young used the TMX Defendants for the personal purpose of causing harm to the plaintiffs, and that veil piercing of the TMX Defendants is authorized and appropriate because Young used these “entities to defeat justice, perpetuate fraud, and evade contractual and tort responsibilities.” The court agreed with the TMX Defendants that Georgia law foreclosed any attempt to reach the assets of the TMX Defendants for a judgment debt personally incurred by Young under the theory of outsider reverse veil-piercing. However, construed in the light most favorable to the plaintiffs, the amended complaint stated a claim for holding TMX Finance, LLC, liable for any judgment debt incurred by its subsidiaries, TitleMax Texas, Inc. and TitleMax Georgia, Inc., under a veil-piercing theory, and for holding the TMX “family of companies” liable for any judgment.
Finally, the court declined to dismiss claims against the TMX Defendants for aiding and abetting a breach of fiduciary duty and civil conspiracy.

In sum, the court of appeals affirmed the trial court and held that the plaintiffs could bring a direct action against the Young Defendants; that the plaintiffs’ complaint stated for breach of the Operating Agreement, breach of fiduciary duty, fraud, and veil piercing; and that the plaintiff could not pursue a claim for outsider reverse veil piercing under Georgia law but could pursue a traditional veil-piercing claim. The court also reversed in part, holding that the trial court erred by not dismissing the plaintiffs’ claims against the Young Defendants and the TMX Defendants for breach of the Goldsmith Agreement.


The Arizona Supreme Court answered three certified questions concerning fiduciary duties owed to an Arizona LLC, holding that: (1) an LLC manager owes common-law fiduciary duties to the LLC as an LLC agent; (2) an LLC member owes common-law fiduciary duties to the LLC if the member acts as an agent of the LLC; and (3) Arizona LLC law permits an operating agreement to limit or eliminate such duties, except for the implied covenant of good faith and fair dealing.

In consolidated bankruptcy cases involving alleged breaches of fiduciary duties in an Arizona manager-managed LLC, the Bankruptcy Court for the District of Arizona certified the following questions to the Arizona Supreme Court: (1) Does a manager of an Arizona LLC owe common-law fiduciary duties to the company? (2) Does a member of an Arizona LLC owe common-law fiduciary duties to the company? (3) Can the operating agreement of an Arizona LLC lawfully limit or eliminate those fiduciary duties?

The Arizona Supreme Court began by acknowledging that the current Arizona LLC statute does not expressly impose any fiduciary duties on members or managers. The court also observed that there was no Arizona case law directly on point; however, the court stated that the LLC statute imported “the law of agency” into the statute. A.R.S. § 29-854(B). Thus, the court applied Arizona LLC law and common-law agency principles to answer the certified questions. After a review of the principal-agent relationship, the court stated that “[a]n agent is a fiduciary with respect to matters within the scope of [their] agency.” Restatement (Second) of Agency §§ 1, 12, 13. The court then summarized prior cases concerning non-LLC business forms for the proposition that the fiduciary role of an agent includes a duty of loyalty, a duty of good faith, and a duty of care.

The court’s analysis of the first two certified questions focused on the agency default rules under the Arizona LLC statute. The court answered the first question affirmatively and held that a manager of a manager-managed Arizona LLC owes common-law fiduciary duties to the company under the LLC statute because a manager is an agent of the LLC. The statutory default rule provides that each member is deemed an agent of the LLC “for the purpose of carrying on its business in the usual way,” A.R.S. § 29-654(A)(1). However, if management of the LLC is vested in one or more managers, then a member is not automatically an agent “solely by reason of being a member except to the extent that” a manager or the operating agreement delegates authority to that member. § 29-654(B)(1). Further, such managers are deemed agents of the LLC for the purpose of its business. § 29-654(B)(2). Therefore, a manager of a manager-managed LLC, as an agent of the company, owes common-law fiduciary duties to the LLC.

The court then affirmatively qualified its answer to the second certified question, holding that a member of an Arizona LLC owes common-law fiduciary duties to the company under the LLC statute if the member acts as an agent of the LLC. According to the court’s analysis of the statutory default rules, a member’s agent status is dependent on the management model of the LLC. If the company is member-managed, then each member is an agent of the LLC for the purpose of its business under the initial default rule cited above. § 29-654(A)(1). On the other hand, a member of a
manager-managed LLC is an agent of the company to the extent the member is delegated authority by a manager or the operating agreement. § 29-654(B)(1). Thus, under either management model, a member acting as an agent of the company owes common-law fiduciary duties to the LLC.

Next the court considered whether the LLC statute allows an operating agreement to modify these duties. The court qualified its answer to the third question as well, holding that the LLC statute permits the operating agreement of an Arizona LLC to limit or eliminate common-law fiduciary duties, but the agreement may not eliminate the implied covenant of good faith and fair dealing. Under the LLC statute, an operating agreement governs the internal relations of the LLC and “may contain any provision that is not contrary to law and that relates to . . . the rights, duties or powers of its members, managers, officers, employees or agents.” § 29-682(B). The court observed that neither the LLC statute nor other applicable law broadly prohibits an operating agreement from modifying fiduciary duties that otherwise would be owed to the LLC; however, the court relied on public policy considerations and Arizona case law in support of the proposition that an operating agreement may not eliminate the implied covenant of good faith and fair dealing because that covenant is implied in every contract. As a result, an operating agreement may limit or eliminate common-law fiduciary duties that a manager or member owes to the LLC, except for the implied covenant of good faith and fair dealing.


The Georgia Court of Appeals reversed the trial court’s grant of a directed verdict in favor of the majority members of a Delaware LLC and the company’s chairman of the board on a minority member’s claim for breach of fiduciary duties. The court concluded that the majority members and chair were not entitled to the directed verdict because there was evidence at trial, however slight, that the chair was not negotiating with interested buyers in good faith.

Michael Miller was the chief executive officer of FiberLight, LLC (“FiberLight”), a Delaware LLC, and owned a minority interest in the company. The majority members of FiberLight were several entities. James Lynch was the executive chairman of FiberLight’s board of directors and had the majority of votes on FiberLight’s board. Lynch reported to others associated with FiberLight that multiple private equity firms had submitted bids to buy the company. One bid was from General Atlantic and a second bid was from Summit. Although discussions with General Atlantic and Summit occurred at different times, there was a similar pattern to the negotiations: first, bidder submits a letter of intent to FiberLight that summarizes valuation and closing conditions; next, Miller and bidder complete the due diligence process; then, Lynch states he is not doing the deal because bidder has “retraded” (i.e., wanted to change the price).

Miller filed an action against the majority members and Lynch (collectively, the “defendants”) for, among other things, breach of fiduciary duties under Delaware law in connection with the unsuccessful attempt to sell FiberLight. The trial court granted summary judgment in favor of the defendants, and Miller appealed. On appeal, the court affirmed in part and reversed in part. On remand, the defendants moved for a directed verdict. Miller responded that the defendants, acting through Lynch, “shut down [and cut off] negotiations [and] didn’t do a deal that could have been done, and that’s the breach of fiduciary duty.” The trial court granted the defendants’ motion, determining that there was no breach because the letters of intent were not binding offers that FiberLight could have accepted. Miller again appealed.

On the second appeal, Miller argued that the grant of directed verdict was error and should be reversed, and the court agreed. The court stated that Georgia statutory and case law make clear that a directed verdict cannot be granted if there is any evidence, even slight evidence, to support a contrary verdict. The court then quoted Delaware case law for the proposition that one who manages an LLC can breach fiduciary duties to minority members by “failure to negotiate with an interested buyer in good faith — [this conduct] is governed by traditional fiduciary
duties of loyalty and care.” Thus, the court would reverse the directed verdict if any evidence supported Miller’s claim for breach of fiduciary duties. The court considered it important that Miller not only argued that the defendants rejected offers to purchase FiberLight, but repeatedly contended that they breached fiduciary duties to him by ending negotiations with interested bidders, and that Lynch made such decisions without consulting either FiberLight’s board of directors or its minority owners. Furthermore, there was evidence at trial to support Miller’s arguments. Although Lynch’s testimony included a characterization of General Atlantic’s bid as “very strong” and an assertion that he was unable to close that deal because the bidder had financing issues, an email from Lynch read “GA retraded as I expected they would and we are done.” According to Miller’s testimony, FiberLight was “turning everything down” while similar companies were selling, Lynch never came to him or other board members to discuss the bids and made his decisions unilaterally, and a retrade was not a good reason to end negotiations. Miller further testified that General Atlantic’s initial bid exceeded FiberLight’s expectations, and even though he was not told the amount of the reduced bid, it could have withstood a ten percent reduction. An investment banker involved in the sales process testified that “[y]ou would always inform the owners or the board as to the bids that came in and the price.” Therefore, the court concluded that there was evidence at trial, however slight, that Lynch was not negotiating in good faith, in support of Miller’s claim for breach of fiduciary duties. Thus, it was error for the trial court to grant the directed verdict and the court of appeals reversed.

The defendants argued that the court should affirm for several reasons, including an exculpatory provision in FiberLight’s governing documents purportedly precluding Miller’s claim and the assertion that the business judgment rule protected FiberLight’s decision not to sell. Because the trial court had neither addressed nor otherwise ruled on these issues, the court declined to do so at this stage of litigation.

**Colquitt v. Buckhead Surgical Assocs., LLC, 831 S.E.2d 181 (Ga. App. 2019).**

In January 2013, Dr. Colquitt and Dr. McGill founded Buckhead Surgical Associates, LLC (“BSA”), a medical practice, and Buckhead Surgery Center, LLC (“BSC”), the practice’s surgery center. Colquitt was the first managing member of the practice, and three other doctors later joined the practice as members of BSA and BSC: Skandalakis, Procter, and Smith. In April 2015, the members removed Colquitt as managing member and replaced him with Smith and Skandalakis as co-managing members. Then, in May 2015, Colquitt notified the other members of his desire to leave the practice and proposed buyout terms. The members instead voted four days later to terminate Colquitt’s employment for cause and notified Colquitt by letter that same day. He was no longer permitted access to the practice’s premises or computer system. Colquitt filed a complaint against BSA, BSC, and all four remaining doctors asserting claims for breach of fiduciary duty, breach of contract, punitive damages, and attorney’s fees. The trial court entered orders dismissing all claims against McGill and Procter and entered an order granting summary judgment to Smith and Skandalakis as to the breach-of-fiduciary-duty claims. Colquitt appealed both the summary judgment and dismissals.

As to the summary judgment, the court of appeals affirmed and concluded that there was no showing of evidence as to the breach element of Colquitt’s claims for breach of fiduciary duties. To prevail on a claim for breach of fiduciary duty in Georgia requires proof of three elements: (1) existence of a fiduciary duty; (2) breach of that duty; and (3) damage proximately caused by that breach. Colquitt unsuccessfully claimed that Smith and Skandalakis as managing members breached their fiduciary duties to him when they terminated his employment for cause. Under Georgia statutory law, the managing members of an LLC owe fiduciary duties to the company as well as its members, but those duties may be modified or eliminated (with a few exceptions) by the operating agreement. Here, the BSA and BSC operating agreements limited the managing members’ liability for breach of fiduciary duties to “acts or omissions in the management of the Company only in the
Nor did the court of appeals agree with Colquitt’s argument that Smith and Skandalakis breached their fiduciary duties to him based on Colquitt’s purported entitlement to a buyout under the terms of the operating agreements when read in conjunction with his employment contract. First, the court noted that neither the BSA nor the BSC operating agreements contained any mandatory buyout provision; the operating agreements contained an optional offer-to-purchase provision under certain circumstances. Second, upon examining the employment contract, the court concluded that it obligated BSA to a buyout where a buyout is agreed to, but the contract did not mandate such an agreement. Although the employment agreement required BSA to pay to a terminated member a “Buy-Out Amount, as defined in the Practice’s Operating Agreement,” the court stated that there was no buyout amount defined in the BSA operating agreement. The court thus affirmed the summary judgment in favor of Smith and Skandalakis.

As to the dismissal of claims against McGill and Proctor, the appellate court also affirmed the trial court. In order to prevail on his claim for breach of fiduciary duty, Colquitt had to establish the existence of a fiduciary duty. Although Colquitt alleged that McGill and Procter owed him such a duty as members of BSA and BSC, the Georgia LLC statute provides that non-managing members in a manager-managed LLC owe no duties to the LLC or other members. Since the allegations showed that McGill and Procter, as non-managing members of the practice, did not owe Colquitt a fiduciary duty, the trial court properly dismissed the claims for breach of fiduciary duty brought against them.

Marx v. Morris, 925 N.W.2d 112 (Wis. 2019).

The Wisconsin Supreme Court concluded that: (1) corporate principles of derivative standing do not apply to an LLC, and the members of an LLC have standing to assert individual claims against other members and managers of the LLC based on harm to the members or harm to the LLC; (2) common-law claims for breach of fiduciary duty, unjust enrichment, and breach of the covenant of good faith and fair dealing survived summary judgment because the
claims were not displaced by particular provisions of the Wisconsin LLC statute or the LLC’s operating agreement; and (3) genuine issues of material fact existed with regard to the claim that an individual violated Wis. Stat. § 183.0402(1) by willfully failing to deal fairly with the LLC or its members, and potentially with regard to the common-law claims.

North Star Sand, LLC (“North Star”) was formed under Wisconsin law in 2011 to own and mine land containing silica sand (a type of sand used in fracking operations). North Star’s membership consisted of six LLCs, each of which was owned by a different individual. The individual owners of these six LLCs were Marx, Murray, Morris, Johnson, Glorvigen, and Toy. Morris was North Star’s attorney as well as a manager (in his capacity as a “director”) and assisted in drafting its operating agreement. The agreement permitted members to pursue outside business opportunities and transact business with companies who had business relationships with North Star. The agreement also required prior notice of any vote that may occur at a members’ meeting as well as prior notice of any matter to be voted upon at a directors’ meeting.

North Star formed a wholly owned subsidiary, Westar Proppants, LLC (“Westar”), to hold numerous option agreements for the purchase of land with silica sand reserves. As the expiration date of the option agreements approached, the members became concerned that North Star and Westar had too much land under option, and the members discussed the possible cancellation of some of the options. On December 31, 2013, the date the options were set to expire, the members of North Star met by telephone to discuss Westar’s future. Morris informed the other members during this meeting that he and two other individuals, Green and Wesch, had formed DSJ Holdings, LLC (“DSJ”), and that DSJ was interested in purchasing Westar for $70,000. Morris also informed the members that he had an ownership interest in DSJ. Glorvigen made a motion that North Star keep Westar, and the motion passed by a 4-to-2 vote (with Morris and Johnson voting against it). Immediately after the vote, an argument ensued and Morris became “very aggressive” and indicated he might withdraw from North Star. Morris then made a motion to sell Westar to DSJ for $70,000, to which Murray immediately objected, arguing that there had already been a vote, that there was insufficient notice, and that Morris had a conflict of interest. Despite these objections, a second vote occurred, and Morris’s motion passed by a 4-to-2 vote (with Marx and Murray voting against it). DSJ subsequently assigned its membership units in Westar to Morris’s LLC and to Wesch, and they eventually sold Westar to Unimin Corporation in 2015 for an allegedly substantial sum (which was not disclosed due to a confidentiality order). In August 2014, North Star unanimously voted to sell its remaining silica sand land assets in an unrelated transaction in which each member signed a “Member Distribution Receipt and Acknowledgement.” Morris later asked Marx and Murray to sign a separate, all-encompassing release, but each refused to do so.

Marx and Murray alleged five causes of action against Morris and his LLC: (1) violation of Wis. Stat. § 183.0402(1) upon Morris’s willful failure to deal fairly with them while having a material conflict of interest in the transaction; (2) breach of fiduciary duty; (3) breach of fiduciary duty as corporate counsel; (4) unjust enrichment; and (5) breach of implied covenant of good faith and fair dealing. These actions were brought by their LLCs and in their personal capacities rather than in the name of North Star. Morris moved for summary judgment on all claims, arguing that Marx’s and Murray’s claims belonged only to North Star, and that the Wisconsin Limited Liability Company Law supersedes and replaces any common-law duties of LLC members. The motion was denied by the circuit court, which held that there were disputed issues of material fact on the Wis. Stat. § 183.0402 claim. The court of appeals then certified an appeal to the Supreme Court of Wisconsin to answer two questions: (1) Does an LLC member have standing to assert a claim against another member of the LLC based on an injury suffered primarily by the LLC, rather than the individual member asserting the claim? and (2) Does the Wisconsin Limited Liability Company Law preempt an LLC member’s common-law claims against another member based on the second member’s alleged self-dealing? The Wisconsin Supreme Court answered “yes” to the first question, holding that a member has
standing to assert claims against other members and managers because corporate principles of derivative standing do not apply to an LLC. The court answered “no” to the second question, holding that the common-law claims had not been displaced by the LLC’s operating agreement or the LLC statute. The court also concluded that there were genuine issues of material fact as to whether Morris violated the Wisconsin LLC statute by dealing unfairly with Marx and Murray, as well as potential issues of fact regarding the common-law claims. The circuit court’s decision was thus affirmed and remanded.

The Wisconsin Supreme Court provided a general overview of limited liability companies, characterizing LLCs as combining “desirable features of two other business forms, partnerships and corporations.” The court generally traced the development of state LLC statutes and federal income tax treatment and summarized significant provisions of the Wisconsin LLC statute. Turning to specific provisions of North Star’s operating agreement, the court focused on the fact that “the Agreement unambiguously elected that North Star is to be treated as a partnership where all the losses and gains of the LLC flow through to its individual members.” The court explained that this choice and the provisions of the operating agreement assured that all the income, gain, loss, and deductions would pass through to the members as if North Star were a partnership. For that reason, the court concluded that “an injury to North Star is not the same as an injury to a corporation.”

With respect to the issue of standing, the court contrasted the detailed corporate statutes and long history of case law in Wisconsin addressing corporate principles of derivative standing with the law in the LLC context, and the court declined to import corporate principles of derivative standing into the LLC statute. The court stated that the only provision of the Wisconsin LLC statute relating to suits in the name of an LLC is Wis. Stat. § 183.1101, which provides in relevant part:

(1) Unless otherwise provided in an operating agreement, an action on behalf of a limited liability company may be brought in the name of the limited liability company by one or more members of the limited liability company, whether or not the management of the limited liability company is vested in one or more managers, if the members are authorized to sue by the affirmative vote as described in § 183.0404(1)(a).

The court explained that this provision does not require claims against LLC members to be brought in the name of the LLC nor limit the members’ ability to sue members or managers in their individual capacities. According to the court, § 183.1101 “merely requires that if an action of any kind is to be brought in the name of the LLC, against anyone, it must be authorized by a majority vote of disinterested members.” The court reasoned that “Section 183.1101, which is silent on a member’s right to sue on his own behalf, does not abrogate the plain language of Wis. Stat. § 183.0402(1)(a), which prohibits the ‘willful failure to deal fairly with the limited liability company or its members’ by a member or manager.” The court stated that its conclusion was “not driven by who ‘owns’ the claim, but rather by Wis. Stat. § 183.0402 and the partnership-like mode of operation of North Star selected in its Operating Agreement.” The court rejected Morris’s argument that § 183.0402(2) denies a member standing to assert individual claims under § 183.0402(1). Section 183.0402(2) requires a member or manager to account to the LLC and hold as trustee for the LLC any improper personal benefit obtained under various circumstances. According to the court, Morris’s argument mistakenly assumed that injuries to North Star and injuries to individual members were mutually exclusive. Because North Start elected partnership—i.e., flow-through—treatment, the court stated that “there is generally a much closer financial connection between harm to an LLC and harm to its members than between harm to a corporation and harm to its shareholders.” Marx and Murray alleged that Morris, individually and through his LLC, failed to deal fairly with them in connection with a matter in which he had a material conflict of interest, contrary to his statutory and common-law duty as a member and manager, and that Marx and Murray were injured as a result. The court concluded that
Marx and Murray had standing to assert this claim whether North Star was also injured and whether the injury to Marx and Murray was independent of or secondary to North Star.

The court next addressed the issue of whether the common-law claims were preempted by the Wisconsin LLC Act. The court first pointed out that the answer to that question depended on the specific common-law claims brought by a member and the facts attendant to those claims. Here, those claims were breach of fiduciary duty, unjust enrichment, and breach of the covenant of good faith and fair dealing. Second, the court noted that Wis. Stat. §183.1302(2) provides that "[u]nless displaced by the particular provisions of this chapter, the principles of law and equity supplement this chapter." Because this provision had not yet been interpreted by a Wisconsin court, the Wisconsin Supreme Court applied standard statutory interpretation principles to conclude that this provision should be interpreted broadly as permitting common-law claims and defenses that have not been specifically abrogated or displaced. Because the LLC statute does not state or imply that Wis. Stat. §183.0402 reflects the entirety of a member’s or manager’s obligations to other members and the LLC, and because the record did not indicate the full scope of the common-law claims (i.e., whether they included only allegations within the ambit of § 183.0402(2) or something more), the common-law claims survived summary judgment based on the record before the court.

Lastly, the court concluded that the circuit court properly denied Morris’s motion for summary judgment because there were genuine issues of material fact as to whether Morris violated §183.0402(1) by a willful failure to deal fairly with Marx, Murray, and/or North Star in connection with a matter in which he had a material conflict of interest. Specifically, Marx and Murray successfully relied upon the provision of North Star’s operating agreement specifying the requisite notice prior to voting on a matter at a meeting. Marx and Murray raised a genuine issue of material fact by alleging that Morris unfairly influenced the vote by failing to give the required advance notice and by providing false information to the members at the meeting. With regard to the common-law claims, the case had not been sufficiently developed for the court to determine whether genuine disputes as to material facts existed for those claims. The court went on to explain why there were genuine disputes as to material facts regarding the §183.0402(1) claim despite a provision in North Star’s operating agreement permitting pursuit of other business opportunities, a receipt and acknowledgment document signed by the members in connection with another transaction, and consent to the sale of Westar to DSJ by a majority of disinterested members.

The court explained that the “Business Opportunities” clause in North Star’s operating agreement did not unambiguously supplant Wis. Stat. §183.0402(1), but rather was entirely consistent with §183.0402(1). The operating agreement provided:

The individuals serving as Directors, as well as the Members and their respective officers, board of directors, shareholders, partners, and affiliates, may engage independently or with others in other business ventures of every nature and description. Nothing in this Agreement shall be deemed to prohibit any Director, or the Members or their respective officers, board of directors, directors, shareholders, partners, and affiliates, from dealing or otherwise engaging in business with Persons transacting business with the Company. Neither the Company, any Director, or any Member shall have any right by virtue of this Agreement, or the relationship created by this Agreement, in or to such other ventures or activities, or to the income or proceeds derived from such other ventures or activities, and the pursuit of such ventures shall not be deemed wrongful or improper.

According to the court, North Star’s members were “free to engage in business with persons transacting business with North Star, provided that they do so fairly. The claim in this case is that Morris did so
unfairly." The court thus concluded that the clause did not prevent Marx and Murray from asserting their claims against Morris.

Next, the court addressed a document entitled “Member Distribution Receipt and Acknowledgements” signed by Marx and Murray after a transaction in 2014 pursuant to which North Star sold its remaining sand and land assets. The court concluded that the scope of the receipt and acknowledgment document was limited to that particular transaction and did not constitute a release of any member’s claims against Morris in connection with the unrelated Westar transaction.

Finally, the court rejected Morris’s argument that consent to the Westar transaction by a majority of disinterested North Star members precluded a claim under § 183.0402(2). According to the court, “Wis. Stat. § 183.0402(2) does not limit the scope of Morris’s duties to his fellow North Star members under § 183.0402(1). Section 183.0402(2) merely tells Morris what he must do if he derives an improper personal profit without the consent of a majority of disinterested members. It does not state that a violation of § 183.0402(1)(a) is excused so long as a majority of disinterested members consent to the unfair treatment of another member. Therefore, even if a majority of disinterested members were to have voted to approve the sale of Westar to DSJ, this would not affect Marx and Murray’s § 183.0402(1)(a) claim against Morris.”

In sum, the court concluded that (1) corporate principles of derivative standing do not apply to an LLC, and the members of an LLC have standing to assert individual claims against other members and managers of the LLC based on harm to the members or harm to the LLC; (2) Marx’s and Murray’s common-law claims survived summary judgment because the claims were not displaced by particular provisions of the Wisconsin LLC statute or North Star’s operating agreement; and (3) genuine issues of material fact existed with regard to Marx’s and Murray’s claim that Morris violated Wis. Stat. § 183.0402(1), and potentially with regard to the common-law claims. Thus, the court affirmed the order of the circuit court and remanded for further proceedings.

In a partial concurrence/partial dissent, the dissenting justice took issue with the majority’s opinion to the extent the majority established the following propositions: (1) a non-member may sue an LLC’s members based on the LLC’s management decisions; (2) a non-member may sue another non-member based on an LLC’s management decisions; (3) a member of an LLC may sue a non-member for the LLC’s management decisions; and (4) an LLC member may pursue a claim against another LLC member (or a member of the member) without regard to whether the plaintiff actually owns the claim. The dissenting justice explained that these four conclusions all stemmed from a failure to recognize that the distinction between an LLC and its members necessarily affects who may bring what types of actions against which defendants. Further, the dissenting justice argued that the Wisconsin LLC statute necessarily incorporates the concept of derivative standing and that taxation and profit distribution issues do not distinguish LLCs from corporations in any sense relevant to this case. Two additional propositions of the majority with which the dissenting justice disagreed were that: (5) members of an LLC owe each other fiduciary duties; and (6) an attorney owes fiduciary duties not just to the organization it represents, but also to the constituent members of that organization. The dissenting justice argued that fiduciary duties are not owed by members of an LLC to one another, and that an LLC’s attorney has a fiduciary obligation to the LLC, not its members.


The Colorado Court of Appeals affirmed judicial dissolution of four LLCs owned by a mother and son based on circumstances that included inability of the members to get along and misconduct by the managing member (mother).

Paula Gagne and her son Richard Gagne created four LLCs to buy and manage four apartment complexes that would be financed by Paula and managed by Richard. The initial LLC operating agreements provided that each LLC would be owned by Paula and Richard on a fifty-fifty basis, but Richard would have a fifty-one percent voting right in each. Shortly
thereafter, Paula and Richard’s relationship became increasingly acrimonious and litigation ensued. They eventually settled and subsequently entered into new operating agreements under which Paula held the fifty-one percent voting right in each LLC. Again, the business and the relationship turned sour. Richard sued seeking judicial dissolution of the LLCs as well as a declaratory judgment as to his and Paula’s respective rights and obligations. The case eventually went to trial, and both parties appealed the trial court’s judgment. The appellate court in that appeal (Gagne I) held that the district court applied the wrong standard for judicial dissolution and remanded to the district court. After remand, the district court held another trial on the judicial dissolution claim and entered an order. The order concluded that dissolution was appropriate and ordered an in-kind distribution of the LLCs’ assets (adjusting each party’s share of the assets’ values to account for money Paula wrongfully withdrew from the LLCs) pursuant to which Richard and Paula would each receive two of the apartment buildings.

The first contention presented by Paula on appeal was that the court erred in ordering dissolution of the LLCs. Section 7-80-110(2) of the Colorado Limited Liability Company Act provides that “[a] limited liability company may be dissolved in a proceeding by or for a member or manager of the limited liability company if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company.” In Gagne I, the court of appeals held that this standard requires a party seeking judicial dissolution to establish that “the managers and members of the company are unable to pursue the purposes for which the company was formed in a reasonable, sensible, and feasible manner.” The court of appeals in Gagne I specified seven non-exclusive factors to be considered: (1) whether the company’s managers are unable or unwilling to pursue the purposes for which the company was formed; (2) whether a member or manager has committed misconduct; (3) whether it is clear that the members are not able to work with each other to pursue the company’s purposes; (4) whether the members are deadlocked; (5) whether the company’s operating agreement provides a means of resolving any deadlock; (6) whether, in light of the company’s financial condition, there remains a business to operate; and (7) whether allowing the company to continue is financially feasible. No one factor is dispositive, and a party seeking dissolution need not establish every factor. The district court found that the factors weighed heavily in favor of dissolution based on evidence supporting the first five factors, particularly factors (1) and (2), in light of Paula’s substantial misconduct and oppression of Richard, and the court of appeals concluded that the district court did not err in this regard.

With respect to the first factor, the district court found that the LLCs were formed so that Richard “would have an occupation and a means to support his family” despite Paula’s argument that the purpose was merely “to own and operate a single apartment building.” The district court further found that Paula had frustrated the purpose of the LLCs by refusing to work with Richard in any way, shutting him out of any role in decision making, terminating Richard’s corporation’s role as property manager without cause, and giving a primary business role to her other son (Jay), who also refused to work with Richard. The appellate court stated that none of the operating agreements contained a specific purpose clause (or any combination of clauses indicating the limited purpose argued by Paula), that the statement of purpose in the operating agreement is merely a starting point in the analysis, and that the district court’s finding did not contradict anything stated in the operating agreements. Thus, the court of appeals found no basis for concluding that the district court applied the law incorrectly in assessing this factor. Given that the record supported the district court’s additional finding that Paula and Jay were unable and unwilling to allow Richard to have any role in managing the properties, the court of appeals found no error in the district court’s conclusion that the first factor favored dissolution.

With respect to the second factor, Paula unsuccessfully argued that all of the actions characterized by the district court as misconduct on Paula’s part were authorized by the operating agreements, the Colorado Limited Liability Company Act, and/or the business judgment rule. The district court
found numerous instances of improper payments by the LLCs for Paula’s personal benefit or interest without any legitimate business purpose, and the court of appeals stated that there was substantial support in the record to support these findings. The court of appeals acknowledged that it is “true that the operating agreements, the Act, and the business judgment rule would allow a manager of an LLC to do such things as make distributions to members, loan money to the company, pay rent for use of space, hire and fire, seek the advice of professionals, earn reasonable management fees, and obtain reimbursement for expenses incurred while acting on the company's behalf,” but the court stated that “none of these sources of authority immunizes Paula from such acts taken purely for self-interest, in bad faith, and in breach of her fiduciary duties to the LLCs and their members.” The operating agreements in this case required Paula to perform her managerial duties “in good faith, in a manner reasonably believed to be in the best interest of the LLC. The court cited provisions of the Colorado Limited Liability Company Act stating that managers must refrain from “engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law” and requiring managers and members to discharge their duties and exercise their rights “consistently with the contractual obligation of good faith and fair dealing.” The court cited case law for the proposition that “[m]embers of a limited liability company formed under the Act also owe fiduciary duties to each other and to the company.” The district court found, with record support, that Paula breached all these duties and obligations. The court noted that it assumed the corporate business judgment rule applies in the LLC context, but the court concluded that it offered Paula no protection because it does not apply if a manager acts in bad faith or without any reasonable belief that she is serving the company's best interests. In sum, the record supported the district court’s finding that the second factor favored dissolution.

The court of appeals concluded that the third factor—whether the members are unable to work with each other to pursue the LLC’s purposes—supported dissolution despite Paula’s argument that her position as sole manager of the LLCs precluded Richard from complaining about her decisions. Such an argument ignored Paula’s contractual, statutory, and common-law obligations of good faith. Paula did not argue that she could work with Richard to accomplish the LLCs’ purposes, and the court said any argument to that effect would be meritless given the record of prolonged animosity and conflict between Paula and Richard.

The court of appeals concluded that the record also supported the district court’s findings that the members were deadlocked and that the operating agreements did not provide a way around the deadlock. Thus, those two factors also supported judicial dissolution.

Although the final two factors—the LLCs’ financial positions and whether continuation of the LLCs was financially feasible—did not favor dissolution, the appellate court concluded that the district court did not err in ordering dissolution given the evidence supporting the other five factors. The court was particularly concerned about Paula’s operation of the LLCs inconsistently with their primary purpose and her serious misconduct (freezing out Richard from operations and benefitting herself at the LLCs' and Richard's expense), in addition to the fact that the parties simply could not get along. The court cited cases in other jurisdictions in which judicial dissolution was ordered in circumstances similar to this case. Thus, the court of appeals concluded that the district court did not abuse its discretion in ordering dissolution of the LLCs based on the district court’s findings supporting the first five factors.


A retired member brought an action against a New Jersey LLC and its three active members alleging various claims, including modification of the operating agreement by conduct, minority member oppression, and breach of fiduciary duties. The trial court granted summary judgment in favor of the LLC and its active members, holding that: (1) the parties’ course of conduct over a sixteen-year period did not modify the operating agreement; (2) the economic loss doctrine barred the retired member from recovering damages based on a claim of minority member oppression; and
(3) there was nothing to suggest that the active members breached any fiduciary duty owed to the retired member.

Four doctors, Namerow, Zucker, Bienstock, and Chism entered into an operating agreement to form PediatricCare Associates, LLC, a New Jersey limited liability company, in January 2000 with the purpose of owning and operating a medical practice. In March 2001, the parties entered into an Amended and Restated Operating Agreement (the “Agreement”). The Agreement provided members with the right to retire once they had reached the age of sixty and had provided twenty-five years of membership or service to the practice. Furthermore, the Agreement prescribed that the “retirement purchase price” of a retiring member’s interest was calculated according to Section 10 of the Agreement (titled “Determination of Value”) as follows:

The total value of the company (“company value”) shall be the last dated amount set forth on the Certificate of Agreed Value, attached hereto as Exhibit G and made part hereto, executed by the members. The members shall exercise their best efforts to meet not less than once per year for the purpose of considering a new value but their failure to meet or determine a value shall not invalidate the most recently executed Certificate of Agreed Value setting forth the company value then in effect. If the parties fail to agree on a revaluation as described above for more than two (2) years, the company value shall be equal to the last agreed upon value, adjusted to reflect the increase or decrease in the net worth of the company, including collectible accounts receivable, since the last agreed upon value. The value of a member’s interest (“Value”) shall mean the company value multiplied by the percentage interest held by said member and being purchased hereunder, less any indebtedness that the selling or disabled member, the Decedent, or a member departing for any other reason contemplated hereunder may have to the company or to the other members, whichever the case may be.

The most recent Certificate of Agreed Value attached to the Agreement, which stated that the “value of the company” was $2.4 million, was dated January 1, 2000 and signed by Namerow, Zucker, Bienstock, and Chism.

Namerow announced his intention to retire in January 2016, which triggered the application of Section 10. Over the next several months, the parties obtained two appraisals, each using the fair market valuation methodology, for the purpose of reaching a settlement regarding the voluntary negotiated buy-out number. No such number was ever reached and the Agreement was never amended.

Namerow filed this action on October 10, 2017 against Zucker, Bienstock, and Chism (collectively, the “Active Members”) and the LLC, asserting claims for modification of the Agreement by conduct, oppression of a minority member, and breach of fiduciary duty. Both sides filed motions for partial summary judgment.

The first issue that the trial court addressed was whether the parties’ course of conduct over a sixteen-year period modified the terms of the Agreement to require use of a fair market valuation, rather than a net worth valuation as required by Section 10, to value the practice. Namerow argued that the parties had modified the Agreement because they had ignored Section 10 on three prior occasions. The trial court was not persuaded and reasoned that there was no indication that the parties intended to informally modify Section 10 because one such occasion was wholly unrelated to the retirement buyout purchase price of a member and, based on this litigation, the other two occasions did not settle the disagreement. The court then noted that the Agreement stated that it can only be modified by a vote of 80% of the membership interests and there was no evidence that Namerow or the Active Members agreed to formally modify Section 10. Therefore, the trial court granted summary judgment in favor of the LLC and the Active Members on Namerow’s claim that the parties’ conduct modified Section 10 to require the use of a fair market valuation methodology to determine his retirement purchase price.

Next, the trial court addressed Namerow’s claim of minority member oppression under the New Jersey Revised Uniform Limited Liability Company Act (the “New Jersey LLC Act”). Under the New
Jersey LLC Act, judicial recourse is available to minority members who have been “oppressed” by the majority members. New Jersey case law defines “oppression” as “frustrating a [member’s] reasonable expectations” and “is usually directed at a minority [member] personally.” Thus, a minority member has a genuine claim for oppression under the New Jersey LLC Act when their reasonable expectations have been frustrated by the majority members. According to Namerow, he had a reasonable expectation that his 25% membership interest would be purchased using a fair market valuation methodology. In further support of his oppression claim, Namerow referenced an earlier ruling from the court in which it denied the defendants’ motion to dismiss because, at that time, his expectation was reasonable. The trial court pointed out that its earlier ruling was made at a preliminary stage in the litigation and, after discovery and the court’s determination that the net worth methodology applied, it was clear that the defendants’ conduct did not support a claim for oppression under the New Jersey LLC Act. Furthermore, the court cited New Jersey case law for the proposition that the economic loss doctrine prohibits plaintiffs from recovering in tort economic losses to which their entitlement only flows from a contract. Because this claim was contractual in nature and Namerow’s entitlement flowed from the Agreement, the trial court held that his minority member oppression claim failed as a matter of law because it was barred by the economic loss doctrine.

The third issue that the trial court addressed was whether the defendants breached the fiduciary duties owed to Namerow. Under the New Jersey LLC Act, each member of a member-managed LLC owes the company and the other members a duty of care. The court observed that Namerow’s claim for breach of fiduciary duty was based on many of the same recycled allegations from his other claims and were unconvincing for the same reasons. The trial court further reasoned that there was no valid claim for breach of fiduciary duty based on the members of a member-managed LLC acting in conformity with the Agreement. Thus, the trial court granted summary judgment in favor of the LLC and the Active Members on Namerow’s claim for breach of fiduciary duty.

Indemnification and Advancement

**Tangas v. Int’l House of Pancakes LLC, 779 F. App’x 317 (6th Cir. 2019).**

The court of appeals reversed the district court’s summary judgment in favor of a Delaware LLC and its parent corporation on the indemnification claims of a former employee of the LLC. The court held that the employee’s rights vested under the LLC operating agreement before her termination; the business judgment rule did not apply to the LLC’s determination that the employee’s conduct amounted to fraud, willful misconduct, and bad faith; and genuine issues of material fact existed with respect to the employee’s claims that she was entitled to indemnification under the parent corporation’s bylaws and the LLC operating agreement.

Autumn Lee Tangas worked for International House of Pancakes, LLC (“IHOP”), a Delaware LLC, for more than two decades and eventually and became a “franchise bureau consultant.” In that role, Tangas acted as a liaison between IHOP and franchisees to help franchisees improve profits and ensure that they adhered to IHOP operating standards. In 2004, Tangas and her domestic partner were involved in a financial transaction with a franchisee known as Terry Elk, whose operations Tangas oversaw. The purpose of the transaction was unclear, and eventually the money that was exchanged was returned. Years later, in 2011, the FBI raided Elk’s IHOP operations and questioned Tangas. The same day, Tangas informed the in-house counsel of IHOP’s parent company, DineEquity, Inc., a Delaware corporation, about the interview with the FBI even though agents asked her not to discuss the conversation. In 2012, DineEquity’s in-house counsel communicated to Tangas’s lawyer that Tangas was obligated to cooperate with IHOP’s internal investigation under the IHOP code of conduct and a refusal to do so would result in termination. After Tangas’s lawyer responded that Tangas would not answer any questions, IHOP fired Tangas for violating the IHOP code of conduct and refusing to participate in the interview. A federal grand jury subsequently indicted Elk, Tangas, and others. The indictment, which charged Tangas with money laundering and hiring undocumented workers at Elk’s IHOP
locations, essentially alleged that Tangas used her position as a franchise bureau consultant to hide Elk’s criminal activities from IHOP. The criminal case against Tangas proceeded for more than two years until the U.S. Attorney’s Office dismissed the charges without prejudice in 2014. At that time, Tangas had incurred more than $130,000 in legal fees. In 2015, Tangas demanded that IHOP and DineEquity pay these legal fees. The companies refused to pay, and Tangas sued on the basis that DineEquity’s bylaws and IHOP’s LLC agreement entitled her to indemnification. The district court granted summary judgment in favor of DineEquity and IHOP, holding that Tangas was not entitled to indemnification under DineEquity’s bylaws and IHOP’s LLC agreement and that IHOP’s decisions were protected by the business judgment rule. The court of appeals disagreed with the district court’s interpretation of the bylaws and LLC agreement and concluded that there were genuine issues of material fact regarding Tangas’s conduct that affected her rights under the governing documents. Thus, the court of appeals vacated the summary judgment and remanded.

The court of appeals first addressed the indemnification provision of DineEquity’s bylaws, which provided that DineEquity:

shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the Corporation) by reason of the fact that he is or was a director or officer of the Corporation, or is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise, against expenses (including attorneys’ fees) judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

(Emphasis added by the court).

The court of appeals disagreed with the district court’s conclusion that “an employee of a subsidiary company serves ‘at the request of’ its parent company only when the parent company appoints the employee to a specific position” and concluded that there were factual disputes as to whether Tangas was serving IHOP at the request of DineEquity. Additionally, the court concluded that a trier of fact must determine whether Tangas acted in good faith. The court noted that the Delaware corporate indemnification statute articulates a policy favoring indemnity of former officers and directors and that Delaware courts have consistently held that dismissal of criminal charges is by definition success on the merits. However, the court pointed out that this case involved contractual indemnification rather than statutory rights. On remand, the district court would have to conduct a trial to assess whether Tangas was serving IHOP at the request of DineEquity as well as whether she acted in good faith.

The court next turned to the indemnification provision of the IHOP LLC agreement, which provided as follows:

To the fullest extent permitted by law, the Company shall indemnify and hold harmless each Covered Person from and against any and all losses, claims, demands, liabilities, expenses, judgments, fines, settlements and other amounts arising from any and all claims, demands, actions, suits or proceedings, civil, criminal, administrative or investigative (‘Claims’), in which the Covered Person may be involved, or threatened to be involved, as a party or otherwise, by reason of its management of the affairs of the Company or which relates to or arises out of the Company or its property, business or affairs. A Covered Person shall not be
entitled to indemnification under this Section 8.2 with respect to (i) any Claim with respect to which such Covered Person has engaged in fraud, willful misconduct, bad faith or gross negligence or (ii) any Claim initiated by such Covered Person unless such Claim (or part thereof) (A) was brought to enforce such Covered Person’s rights to indemnification hereunder or (B) was authorized or consented to by the Member. Expenses incurred by a Covered Person in defending any Claim shall be paid by the Company in advance of the final disposition of such Claim upon receipt by the Company of an undertaking by or on behalf of such Covered Person to repay such amount if it shall be ultimately determined that such Covered Person is not entitled to be indemnified by the Company as authorized by this Section 8.2.

(Emphasis added by the court).

The agreement defined a “Covered Person” as “the Member, or any officers, directors, stockholders, partners, employees, affiliates, representatives or agents of any of the Member, nor any officer, employee, representative or agent of the Company” (emphasis added by the court). The parties agreed that Tangas was a “Covered Person” until she was terminated, but IHOP argued that she was no longer entitled to indemnity after she was fired.

Because most of Tangas’s legal fees were incurred after her termination, a significant issue bearing on the application of the LLC agreement was whether the indemnification provision included “terminated” or “former” employees. The court discussed this issue but concluded that it was not dispositive because the court concluded that Tangas’s rights vested before her termination. Unlike DineEquity’s bylaws, the LLC agreement did not say anything about “current” versus “former” employees. The court concluded that the district court erred in concluding that the absence of a modifier in the list of “Covered Persons” suggested only current employees were eligible for indemnity and stated that any ambiguity in this regard should be construed against the drafter. The court characterized the question of whether the LLC contemplated indemnity for former employees as a “close one,” but thought the more logical conclusion was that former employees were included in an ambiguous LLC agreement for the policy reasons articulated in Delaware (corporate) statutory and case law. Ultimately, the court stated that it need not resolve the issue in light of its conclusion (discussed below) that Tangas’s rights vested before her termination, but the court made the point that it did not agree with the district court’s method of resolving the issue by comparing DineEquity’s bylaws to IHOP’s LLC agreement. Characterizing the documents as independent, the court did not think that the clearer document informed the more ambiguous.

In concluding that Tangas’s rights to indemnification vested before her employment was terminated, the appellate court relied on two cases distinguished by the district court—Branin v. Stein Roe Inv. Counsel, LLC, No. 8481–VCN, 2014 WL 2961084 (Del. Ch. June 30, 2014), and Salaman v. National Media Corp., No. 92C–01–161, 1992 WL 808095 (Del. Super. Ct. Oct. 8, 1992). The court of appeals acknowledged that “[i]t is true that these cases do not announce that all indemnity provisions everywhere function as rights that vest,” but the court went on to explain that “corporations offering indemnity rights are bound to deliver that benefit when a covered person is targeted, presuming of course that the employee acted in good faith. Otherwise, a corporation could simply fire anyone under investigation, rendering indemnity provisions a nullity. This inequity is exactly what Delaware law guards against. When the FBI came to Tangas’s door, her indemnity rights vested because the LLC Agreement is written expansively to contemplate coverage for threatened and investigative actions. Indemnity is designed for precisely this situation when an employee is sued and is later found not guilty or not liable. The distinction between ‘former’ and ‘current’ employees is irrelevant because Tangas’s rights vested under the Agreement when the FBI began investigating her and before IHOP fired her.”

The court next addressed IHOP’s argument that Tangas’s bad conduct barred
her indemnification claim even if she was entitled to indemnification under the LLC agreement. IHOP argued that Tangas’s failure to report the financial transaction with Elk in 2004 and her failure to cooperate in the internal IHOP investigation in 2011 and 2012 amounted to fraud, willful misconduct, and bad faith under the LLC agreement and that IHOP was entitled to deference on its determination that Tangas engaged in these activities. In its summary judgment ruling, the district court applied the business judgment rule to conclude that no reasonable jury could challenge IHOP’s decision, but the court of appeals rejected the notion that the business judgment rule applied to IHOP’s determination that Tangas was not entitled to indemnification. The court explained that “the business judgment rule is irrelevant to this case because there is no decision over which a corporation’s board could exercise its business judgment. A legal question of contract interpretation is not within a board’s purview.” The court stated that “[t]he business judgment rule might be relevant in an indemnity context if the bylaws or operating agreement make indemnity discretionary. That is not true here because the drafter of the LLC Agreement employed the word ‘shall.’”

Finally, IHOP argued that Tangas was not entitled to indemnity, even if the business judgment rule did not apply, because she broke the rules with regard to the Elk transaction and failed to cooperate with management in 2011 and 2012. However, both of these issues were hotly disputed by the parties, and the court concluded that a trial on the issue of Tangas’s good faith was necessary. The court stated that some case law suggests that expansive contractual language and dismissal of the criminal charges and lack of underlying criminal liability would render the indemnitee’s state of mind irrelevant, but other authority concludes otherwise. Ultimately, the court held that “IHOP is not entitled to deference on the good faith question because its indemnification procedures are directive and broad. But holding that the dismissal of Tangas’s charges satisfies the good faith provision would render the provision of the LLC Agreement discussing misconduct a nullity. Thus, a trial is necessary.”


The Texas Court of Appeals affirmed the trial court’s order that required four limited liability companies to advance to a terminated employee his fees and expenses pursuant to the entities’ governing documents.

Conrad Holt was a member of L Series, L.L.C., CKDH, L.L.C., VUE, L.L.C., and CKDH Investments, L.L.C. (collectively, the “Companies”). He was also employed as the general manager of a group of car dealerships—Arlington Saturn, Ltd., Fort Worth Saturn, Ltd., and Hurst Saturn, Ltd. (collectively, the “Dealerships”). Three of the Companies served as a general partner of one of those Dealerships. CKDH Investments owned and leased the real estate occupied by the Dealerships. Holt had also served as president of each of the Companies and was a manager of CKDH Investments. The other Companies were member-managed.

The Companies and Dealerships terminated Holt’s employment and sued him, claiming in part that he had committed fraud and breached his fiduciary duties to the Companies. Holt counterclaimed, alleging that each of the Companies’ regulations (“regulations” was the statutory term used for the LLC agreement under the LLC statute in Texas before 2006) entitled him to advancement of fees and expenses and indemnity. He alleged that the Companies had breached the regulations by failing to provide him advancement and indemnity and refusing to make distributions to him. After amending his counterclaim, Holt sought partial summary judgment with respect to his advancement claim, and the trial court granted Holt’s motion and ordered the Companies to pay Holt’s past “reasonable attorney fees and expenses” and his “future reasonable attorney fees and expenses” on a monthly basis thereafter upon the submission of “summary invoices.” The Companies filed an interlocutory appeal and alternatively sought mandamus relief.

First, the court of appeals concluded that it did not have jurisdiction over the interlocutory appeal of an order requiring advancement. In its analysis, the court disagreed with the Companies’ argument that Delaware law was more expansive than
Texas law as to advancement claims:

The Companies argue that we should not consider how Delaware treats advancement claims because its law allowing advancement is more expansive than Texas’s. See Del. Code Ann. tit. 6, § 18-108 (allowing indemnification by limited liability company subject only to the standards and restrictions in the company agreement), tit. 8, § 145(e) (allowing corporations to pay defense fees and expenses of officers and directors in advance of final disposition of suit). But Texas law is just as expansive: it provides that a limited liability company’s governing documents may either adopt Texas’s advancement provisions or “may adopt other provisions . . . relating to . . . advancement,” and that those other provisions “will be enforceable.” Tex. Bus. Orgs. Code Ann. § 8.002(b); see also id. § 101.402 (providing that a “limited liability company may ... pay in advance or reimburse expenses incurred by a person,” defined as including a “member, manager, or officer” of the company). Thus, Texas allows a limited liability company the same broad freedom to craft its own advancement provisions as does Delaware. See Bombardier Aerospace Corp. v. SPEP Aircraft Holdings, LLC, No. 17-0578, —— S.W.3d ——, ——, 2019 WL 406075, at *11 (Tex. Feb. 1, 2019) (noting that Texas has “long recognized the strongly embedded public policy favoring freedom of contract” and acknowledging that courts must respect and enforce the terms of a free and voluntary contract “absent a compelling reason”).

Accordingly, although we apply Texas procedure, we have no qualms looking to Delaware law to inform our understanding of the nature of and policies underlying an advancement claim, as did the El Paso Court of Appeals in Aguilar, 344 S.W.3d at 46–47.

The court noted that although Texas may not have a specific procedure to deal with advancement claims in the same manner as Delaware, Texas summary judgment procedures are an appropriate procedure for determining a contractual claim as a matter of law. Because the court concluded that an advancement order does not have the character and function of a temporary injunction, and no Texas statute authorizes an interlocutory appeal of an order requiring advancement, the court dismissed the Companies’ appeal of the advancement order; however, the court proceeded to consider the Companies’ alternative request for mandamus relief.

In seeking mandamus relief, the Companies argued that the trial court abused its discretion when ordering advancement because their suit against Holt did not fall within the scope of the advancement provisions in the Companies’ regulations. The Companies acknowledged that Holt was serving as a member when they sued him but contended that their suit was solely for ultra vires acts outside of his capacity as a member. Section 8.02 of the Companies’ regulations contained the following advancement provision:

The right to indemnification conferred in this Article VIII shall include the right to be paid or reimbursed by the Company the reasonable expenses incurred by a Person of the type entitled to be indemnified under Section 8.01 who was, is or is threatened to be made a named defendant or respondent in a Proceeding [1] in advance of the final disposition of the Proceeding and [2] without any determination as to the Person’s ultimate entitlement to indemnification; provided, however, that the payment of such expenses incurred by any such Person in advance of the final disposition of a Proceeding, shall be made only upon delivery to the Company of a written affirmation by such Person of his or her good faith belief that he has met the standard of conduct necessary for indemnification under this Article VIII and a written undertaking, by
or on behalf of such Person, to repay all amounts so advanced if it shall ultimately be determined that such indemnified Person is not entitled to be indemnified under this Article VIII or otherwise. [Emphasis added.]

Section 8.01 provided “each Person who was or is made a party [to a] pending or completed action, suit[,] or proceeding . . ., by reason of the fact that he or she . . . is or was serving at the request of the Company and an officer, trustee, employee, agent, or similar functionary of the Company shall be indemnified by the Company to the fullest extent permitted by the Act and the TBCA.” Reading these two sections together, the court determined that a person was entitled to advancement if the person was “of the type” entitled to indemnity under section 8.01 and that it was not necessary to determine the right to indemnity.

The Companies argued that Holt was not entitled to advancement under section 8.02 because he would not be entitled to indemnity for his alleged ultra vires acts under section 8.01. Relying on Delaware case law (which refers to the “admittedly maddening” aspect of advancement clauses and “the tsunami of regret that swept over corporate America regarding mandatory advancement contracts”) and distinguishing a Texas case decided in the indemnification rather than the advancement context, the court disagreed with the Companies, concluding that Holt was entitled to advancement because he was “of the type” entitled to indemnity under section 8.01. The court concluded further that requiring Holt to prove that he was ultimately entitled to indemnity, as the Companies argued, would violate the “clear directive” of section 8.02 that the right to advancement was not dependent on a determination of the right to indemnity. The court also determined that the Companies’ allegations of misconduct did not change the nature of the right they bargained to give Holt. Because at least some of the allegations in the suit were based on—and therefore causally connected to—Holt’s service as a member and a manager of the Companies, the court held that the trial court did not abuse its discretion in concluding that Holt was entitled to advancement under the Companies’ regulations.

Information Rights

*Davis v. Highland Coryell Ranch, LLC, 578 S.W.3d 242 (Tex. App. 2019).*

The Texas Court of Appeals held that the definition of “member” in the context of statutory information rights included both a person who was an existing member and a person previously admitted but not presently a member. The court reversed the trial court’s summary judgment in favor of an LLC and remanded, concluding that a former member was not prohibited from accessing LLC information simply because the person was no longer a member at the time of the request.

In 2004, Mark Davis and another individual formed Highland Coryell Ranch, LLC (“Highland”). Davis relinquished his interest in Highland in 2005 and later requested various business records developed by the company while he was still a member. Highland provided some of the records but not others, and Davis sued to obtain those that were not provided. The trial court granted Highland’s motion for summary judgment in which the company argued that Davis had no right to the information because he was a former member. The court of appeals reversed and remanded because the trial court could not hold that Highland established, as a matter of law, that Davis was not entitled to the records since its governing documents were absent from the summary judgment record. On remand, the trial court granted Highland’s second motion for summary judgment to which it attached its company agreement. Davis again appealed.

The issue before the court of appeals involved the right of a former member of an LLC to access company information. The court began its analysis by citing the following three provisions of the Texas Business Organizations Code regarding access to LLC information:

(a) A member of [an LLC]. . . on written request and for a proper purpose, may examine and copy at any reasonable time and at the member’s . . . expense:

(1) records required under Sections 3.151 and 101.501; and
(2) other information regarding the business, affairs, and financial condition of the company that is reasonable for the person to examine and copy.


Each owner or member of a filing entity may examine the books and records of the filing entity maintained under Section 3.151 and other books and records of the filing entity to the extent provided by the governing documents of the entity and the title of this code governing the filing entity.


“Member” means:

(A) in the case of [an LLC], a person who is a member or has been admitted as a member in the [LLC] under its governing documents.


The court distilled these provisions with two observations: first, the right to access LLC records and information is generally dependent upon “member” status in the company; and second, there are two categories of membership because the statutory definition uses “or” in the disjunctive. Interpreting the “is a member” passage to plainly mean that a person is a current member of the LLC, the court concluded that this category did not apply to Davis because he relinquished his interest in Highland prior to his information request.

Turning to the other category, the court acknowledged that the “has been admitted as a member” passage was susceptible to multiple readings: it could mean that the person was admitted in the past and remained a member when the information request was made. According to a canon of statutory construction, the court must give meaning to each passage within the statutory definition of “member.” Thus, the court was required to give individual effect to “is a member” and “has been admitted as a member.” Under Highland’s reading, however, the first passage engulfed and rendered redundant the second passage: a member would be “a person who is a member or has been admitted as a member [and is a member].” Instead, the court interpreted the “has been admitted as a member” passage to mean a person admitted as a member previously but who was no longer a member. Therefore, the court held that the definition of “member” included a person who is presently a member and a person who was previously admitted as a member but not presently a member. The court viewed this interpretation as unambiguous and, thus, determinative. As a result, the court concluded that Davis was not prohibited from accessing Highland’s records and information simply because he was not a member at the time of his request.

The court next reasoned that this interpretation was not absurd because the “proper purpose” language in Section 101.502(a) continued to safeguard against speculative information requests from past members. In addition, the court noted that a “company agreement may not unreasonably restrict a person’s [information rights] under Section 101.502.” Tex. Bus. Orgs. Code § 101.054(e). The court considered this prohibition indicative of a legislative intent to avoid excessive restriction on information rights. The court perceived Highland’s reading as an unreasonable restriction because it prevented a former member from obtaining LLC information even if the former member had a “proper purpose” for the request. The court also observed that Section 101.054(e) contains the word “person,” which the statute defines to include individuals, business organizations, and other entities. Tex. Bus. Orgs. Code § 1.002(69-b). The court pointed to the legislature’s use of this broad term, and not the narrower “member,” as intending to grant access to more than just the current members of the LLC.

The court then addressed the
dissenting opinion. Casting the court’s holding as a “once a member, always a member” concept that was foreign to Texas LLC law, the dissent was largely concerned that the court’s interpretation would allow former members’ voting and decision-making authority to linger under various statutory default rules. Tex. Bus. Orgs. Code §§ 101.103(c), 101.105, 101.251, 101.252. The court’s response included a citation to Section 101.107 (providing, as a modifiable default rule, that “[a] member of [an LLC] may not withdraw or be expelled from the company”) for the proposition that a “once a member, always a member” concept was not as foreign as the dissent asserted. In a footnote, the court pointed to Section 101.111 (which states that the assignment of a membership interest does not itself terminate a member’s membership and that the assignor is not released from any liability the assignor may have to the LLC whether or not the assignee becomes a member) and signaled that such continuing liability could serve as a potential “proper purpose” for a member’s written request. Tex. Bus. Orgs. Code §§ 101.111(a), (b); 101.502(a). The court then observed, however, that a former member could not obtain information to verify that liability under the interpretation of Highland and the dissent. The court also disagreed with the dissent’s assertion that the majority’s reasoning would result in former members being treated as members for all purposes. The majority stated that its decision was limited to the specific issue on appeal, adding that Davis still had to satisfy the “proper purpose” requirement and other statutory criteria.

In sum, the court held that the definition of “member” in the context of statutory information rights included both a person who was an existing member and a person previously admitted as a member but not currently a member. The court concluded that Davis was not prohibited from accessing Highland’s information simply because he was not a member at the time of his request. Because the trial court erred in granting summary judgment in favor of Highland, the court of appeals reversed and remanded for further proceedings.

Interpretation of Operating Agreement or Partnership Agreement


Two ousted members of a Georgia LLC brought a direct action against a third member and several of his entities, alleging that the defendants carried out a takeover scheme by causing a funding crisis. The court of appeals affirmed in part, holding that the ousted members could bring a direct action against the third member and stated claims for breach of the operating agreement, breach of fiduciary duty, and other claims.

Dr. Goldsmith, a neurologist who specialized in complex ear procedures, started ICOT Hearing Systems, LLC (“ICOT Hearing”) to provide low-cost hearing aids. Jason Jue became involved in the early stages of ICOT Hearing and assisted in building the company into a multimillion-dollar enterprise, running the day-to-day operations as its sole manager. ICOT Hearing was wholly owned by ICOT Holdings, LLC (“ICOT Holdings”). Prior to the events at issue in this case, Goldsmith and Jue together held a majority interest in ICOT Holdings and controlled ICOT Hearing and ICOT Holding (collectively, “ICOT”).

In August 2015, Young began personally lending money to ICOT. Goldsmith, Jue, and Young shared the goal of selling ICOT to a third party for upwards of “hundreds of millions of dollars in the near term.” Young encouraged Jue to “put his foot on the gas” regarding ICOT operations and assured Jue and Goldsmith that he would provide more funding.

In March 2016, ICOT Hearing, ICOT Holdings, Jue, Goldsmith, Young, and Young’s limited liability company, TY ICOT Investments (“TY Investments”), entered into a restructuring agreement under which Young loaned additional funds to ICOT Hearing and guaranteed two bank loans (the “Restructuring Agreement”). As part of the restructuring, TY Investments purchased membership units in ICOT Holdings from Goldsmith and minority members and obtained exclusive one-year options to purchase additional units from Goldsmith and minority members. TY Investments’ purchase and its options were memorialized in a Membership Interest and Purchase Option Agreement entered at the time of the restructuring of ICOT Holdings (the
"Goldsmith Agreement"). As an additional part of the restructuring, ICOT Holdings and its members executed an Amended and Restated Operating Agreement (the "Operating Agreement"), which contained provisions placing certain duties on the company’s managers, including the duties to conduct the business in good faith, to not engage in wrongful conduct, and to act in a manner that would not result in improper personal benefit to the managers. The Operating Agreement also provided to TY Investments the power to appoint one of three managers to ICOT Holdings’ board of managers. TY Investments then appointed Young, who agreed to comply with the terms of the Operating Agreement while serving in that position. Following the restructuring and prior to execution of the options, Jue and Goldsmith retained their controlling interest in ICOT Holdings. On the other hand, if TY Investments had executed all of the options it acquired as a result of the restructuring, then Young, through TY Investments, would have a majority interest in ICOT Holdings.

In March 2017, Goldsmith and Jue filed a direct action against Young and TY Investments (collectively, the "Young Defendants") and against other entities controlled by Young. The plaintiffs' amended complaint included claims for breach of the Operating Agreement and breach of fiduciary duties.

The complaint alleged that, after the restructuring, Young orchestrated the following takeover scheme in order to obtain a controlling interest in ICOT Holdings without having to exercise the options: (1) caused an "existential funding crisis" by derailing funding from third-party capital providers; (2) refused to sign the guarantee for a previously negotiated line-of-credit unless he received warrants from Goldsmith and Jue, resulting in short-term cash flow problems; (3) drove away third-party buyer with statements that put the company's financial health in a poor light, disparaged Jue, and threatened to dilute the membership interests of Goldsmith and Jue; (4) initiated an inspection of ICOT’s books and records in preparation for the takeover; (5) leveraged the funding crisis to control ICOT Holdings’ board of managers by appointing an ally, misrepresenting that ally’s appointment was necessary for ICOT Holdings to draw on the line-of-credit; (6) coordinated vote with the ally to terminate Jue as manager of ICOT Hearing; and (7) diluted Goldsmith and Jue and obtained majority control by issuing a capital call when he knew that the line-of-credit was available and that the plaintiffs lacked the funds to make a pro rata contribution pro rata. After Young took control of ICOT Holdings, he contacted the same third-party buyer and proposed a discounted sale. Considering their diluted position and the discounted sale price, neither Goldsmith nor Jue would receive money from the sale. The defendants answered and later moved to dismiss, contending that the plaintiffs were not entitled to bring a direct claim and had failed to state any viable claims against them. The trial court denied the defendants' respective motions. The defendants filed applications for interlocutory appeal, which the court granted, leading to the present companion appeals.

The Young Defendants contended that the plaintiffs failed to state a claim for breach of the ICOT Holdings’ Operating Agreement and breach of fiduciary duties. Specifically, the Young Defendants maintained that neither Young’s failure to provide additional funding beyond what was previously loaned and guaranteed under the Restructuring Agreement nor his vote for a capital call that led to dilution could support a claim for breach of the Operating Agreement or breach of fiduciary duty. The court cited the Georgia LLC Act and case law for the proposition that the managing members of an LLC owe fiduciary duties to the company and its members, but such fiduciary duties may be modified or eliminated by the operating agreement. Under the Operating Agreement, managers were required to act in good faith, refrain from intentional misconduct, and avoid any improper personal benefits. The court disagreed with the Young Defendants, reasoning that Young: (1) derailed additional funding from third-party capital providers solely to implement his takeover scheme; (2) refused to sign the line-of-credit guarantee solely to create a funding crisis; (3) made false representations to a prospective third-party buyer so as to delay any sale and increase his leverage over the plaintiffs; and (4) made false representations to Jue about the provider of the line-of-credit requiring the ally’s appointment to ICOT Holdings’ board of managers and orchestrating the capital
call for the sole purpose of ousting the plaintiffs from control. Therefore, the court concluded that the complaint asserted that Young had acted in bad faith, had engaged in intentional wrongful conduct, and had acted for the purpose of obtaining an improper personal benefit.

**Tangas v. Int’l House of Pancakes LLC, 779 F. App’x 317 (6th Cir. 2019).**

The Sixth Circuit Court of Appeals reversed the district court’s summary judgment in favor of a Delaware LLC and its parent corporation on the indemnification claims of a former employee of the LLC. The court held that the employee’s rights vested under the LLC operating agreement before her termination; the business judgment rule did not apply to the LLC’s determination that the employee’s conduct amounted to fraud, willful misconduct, and bad faith; and genuine issues of material fact existed with respect to the employee’s claims that she was entitled to indemnification under the parent corporation’s bylaws and the LLC operating agreement.

Autumn Lee Tangas worked for International House of Pancakes, LLC (“IHOP”), a Delaware LLC, for more than two decades and eventually and became a “franchise bureau consultant.” In that role, Tangas acted as a liaison between IHOP and franchisees to help franchisees improve profits and ensure that they adhered to IHOP operating standards. In 2004, Tangas and her domestic partner were involved in a financial transaction with a franchisee known as Terry Elk, whose operations Tangas oversaw. The purpose of the transaction was unclear, and eventually the money that was exchanged was returned. Years later, in 2011, the FBI raided Elk’s IHOP operations and questioned Tangas. The same day, Tangas informed the in-house counsel of IHOP’s parent company, DineEquity, Inc., a Delaware corporation, about the interview with the FBI even though agents asked her not to discuss the conversation. In 2012, DineEquity’s in-house counsel communicated to Tangas’s lawyer that Tangas was obligated to cooperate with IHOP’s internal investigation under the IHOP code of conduct and a refusal to do so would result in termination. After Tangas’s lawyer responded that Tangas would not answer any questions, IHOP fired Tangas for violating the IHOP code of conduct and refusing to participate in the interview. A federal grand jury subsequently indicted Elk, Tangas, and others. The indictment, which charged Tangas with money laundering and hiring undocumented workers at Elk’s IHOP locations, essentially alleged that Tangas used her position as a franchise bureau consultant to hide Elk’s criminal activities from IHOP. The criminal case against Tangas proceeded for more than two years until the U.S. Attorney’s Office dismissed the charges without prejudice in 2014. At that time, Tangas had incurred more than $130,000 in legal fees. In 2015, Tangas demanded that IHOP and DineEquity pay these legal fees. The companies refused to pay, and Tangas sued on the basis that DineEquity’s bylaws and IHOP’s LLC agreement entitled her to indemnification. The court of appeals disagreed with the district court’s interpretation of the bylaws and LLC agreement and concluded that there were genuine issues of material fact regarding Tangas’s conduct that affected her rights under the governing documents. Thus, the court of appeals vacated the summary judgment and remanded.

The court of appeals first addressed the indemnification provision of DineEquity’s bylaws, which provided that DineEquity:

> shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the Corporation) by reason of the fact that he is or was a director or officer of the Corporation, or is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation, partnership, joint
venture, trust, employee benefit plan or other enterprise, against expenses (including attorneys’ fees) judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

(Emphasis added by the court).

The court of appeals disagreed with the district court’s conclusion that “an employee of a subsidiary company serves ‘at the request of’ its parent company only when the parent company appoints the employee to a specific position” and concluded that there were factual disputes as to whether Tangas was serving IHOP at the request of DineEquity. Additionally, the court concluded that a trier of fact must determine whether Tangas acted in good faith. The court noted that the Delaware corporate indemnification statute articulates a policy favoring indemnity of former officers and directors and that Delaware courts have consistently held that dismissal of criminal charges is by definition success on the merits. However, the court pointed out that this case involved contractual indemnification rather than statutory rights. On remand, the district court would have to conduct a trial to assess whether Tangas was serving IHOP at the request of DineEquity as well as whether she acted in good faith.

The court next turned to the indemnification provision of the IHOP LLC agreement, which provided as follows:

To the fullest extent permitted by law, the Company shall indemnify and hold harmless each Covered Person from and against any and all losses, claims, demands, liabilities, expenses, judgments, fines, settlements and other amounts arising from any and all claims, demands, actions, suits or proceedings, civil, criminal, administrative or investigative (‘Claims’), in which the Covered Person may be involved, or threatened to be involved, as a party or otherwise, by reason of its management of the affairs of the Company or which relates to or arises out of the Company or its property, business or affairs. A Covered Person shall not be entitled to indemnification under this Section 8.2 with respect to (i) any Claim with respect to which such Covered Person has engaged in fraud, willful misconduct, bad faith or gross negligence or (ii) any Claim initiated by such Covered Person unless such Claim (or part thereof) (A) was brought to enforce such Covered Person’s rights to indemnification hereunder or (B) was authorized or consented to by the Member. Expenses incurred by a Covered Person in defending any Claim shall be paid by the Company in advance of the final disposition of such Claim upon receipt by the Company of an undertaking by or on behalf of such Covered Person to repay such amount if it shall be ultimately determined that such Covered Person is not entitled to be indemnified by the Company as authorized by this Section 8.2.

(Emphasis added by the court).

The agreement defined a “Covered Person” as “the Member, or any officers, directors, stockholders, partners, employees, affiliates, representatives or agents of any of the Member, nor any officer, employee, representative or agent of the Company” (emphasis added by the court). The parties agreed that Tangas was a “Covered Person” until she was terminated, but IHOP argued that she was no longer entitled to indemnity after she was fired.

Because most of Tangas’s legal fees were incurred after her termination, a significant issue bearing on the application of the LLC agreement was whether the indemnification provision included “terminated” or “former” employees. The court discussed this issue but concluded that
it was not dispositive because the court concluded that Tangas’s rights vested before her termination. Unlike DineEquity’s bylaws, the LLC agreement did not say anything about “current” versus “former” employees. The court concluded that the district court erred in concluding that the absence of a modifier in the list of “Covered Persons” suggested only current employees were eligible for indemnity and stated that any ambiguity in this regard should be construed against the drafter. The court characterized the question of whether the LLC contemplated indemnity for former employees as a “close one,” but thought the more logical conclusion was that former employees were included in an ambiguous LLC agreement for the policy reasons articulated in Delaware (corporate) statutory and case law. Ultimately, the court stated that it need not resolve the issue in light of its conclusion (discussed below) that Tangas’s rights vested before her termination, but the court made the point that it did not agree with the district court’s method of resolving the issue by comparing DineEquity’s bylaws to IHOP’s LLC agreement. Characterizing the documents as independent, the court did not think that the clearer document informed the more ambiguous.

In concluding that Tangas’s rights to indemnification vested before her employment was terminated, the appellate court relied on two cases distinguished by the district court—Branin v. Stein Roe Inv. Counsel, LLC, No. 8481–VCN, 2014 WL 2961084 (Del. Ch. June 30, 2014), and Salaman v. National Media Corp., No. 92C–01–161, 1992 WL 808095 (Del. Super. Ct. Oct. 8, 1992). The court of appeals acknowledged that “[i]t is true that these cases do not announce that all indemnity provisions everywhere function as rights that vest,” but the court went on to explain that “corporations offering indemnity rights are bound to deliver that benefit when a covered person is targeted, presuming of course that the employee acted in good faith. Otherwise, a corporation could simply fire anyone under investigation, rendering indemnity provisions a nullity. This inequity is exactly what Delaware law guards against. When the FBI came to Tangas’s door, her indemnity rights vested because the LLC Agreement is written expansively to contemplate coverage for threatened and investigative actions. Indemnity is designed for precisely this situation when an employee is sued and is later found not guilty or not liable. The distinction between ‘former’ and ‘current’ employees is irrelevant because Tangas’s rights vested under the Agreement when the FBI began investigating her and before IHOP fired her.”

The court next addressed IHOP’s argument that Tangas’s bad conduct barred her indemnification claim even if she was entitled to indemnification under the LLC agreement. IHOP argued that Tangas’s failure to report the financial transaction with Elk in 2004 and her failure to cooperate in the internal IHOP investigation in 2011 and 2012 amounted to fraud, willful misconduct, and bad faith under the LLC agreement and that IHOP was entitled to deference on its determination that Tangas engaged in these activities. In its summary judgment ruling, the district court applied the business judgment rule to conclude that no reasonable jury could challenge IHOP’s decision, but the court of appeals rejected the notion that the business judgment rule applied to IHOP’s determination that Tangas was not entitled to indemnification. The court explained that “the business judgment rule is irrelevant to this case because there is no decision over which a corporation’s board could exercise its business judgment. A legal question of contract interpretation is not within a board’s purview.” The court stated that “[t]he business judgment rule might be relevant in an indemnity context if the bylaws or operating agreement make indemnity discretionary. That is not true here because the drafter of the LLC Agreement employed the word ‘shall.’”

Finally, IHOP argued that Tangas was not entitled to indemnity, even if the business judgment rule did not apply, because she broke the rules with regard to the Elk transaction and failed to cooperate with management in 2011 and 2012. However, both of these issues were hotly disputed by the parties, and the court concluded that a trial on the issue of Tangas’s good faith was necessary. The court stated that some case law suggests that expansive contractual language and dismissal of the criminal charges and lack of underlying criminal liability would render the indemnitee’s state of mind irrelevant, but other authority concludes otherwise. Ultimately, the court held that “IHOP is not
entitled to deference on the good faith question because its indemnification procedures are directive and broad. But holding that the dismissal of Tangas’s charges satisfies the good faith provision would render the provision of the LLC Agreement discussing misconduct a nullity. Thus, a trial is necessary.”


In January 2013, Dr. Colquitt and Dr. McGill founded Buckhead Surgical Associates, LLC (“BSA”), a medical practice, and Buckhead Surgery Center, LLC (“BSC”), the practice’s surgery center. Colquitt was the first managing member of the practice, and three other doctors later joined the practice as members of BSA and BSC: Skandalakis, Procter, and Smith. In April 2015, the members removed Colquitt as managing member and replaced him with Smith and Skandalakis as co-managing members. Then, in May 2015, Colquitt notified the other members of his desire to leave the practice and proposed buyout terms. The members instead voted four days later to terminate Colquitt’s employment for cause. Colquitt filed a complaint against BSA, BSC, and all four remaining doctors asserting claims for breach of fiduciary duty, breach of contract, punitive damages, and attorney’s fees. The trial court entered orders dismissing all claims against McGill and Procter and entered an order granting summary judgment to Smith and Skandalakis as to the breach-of-fiduciary-duty claims. Colquitt appealed both the summary judgment and dismissals.

As to the summary judgment, the court of appeals affirmed and concluded that there was no showing of evidence as to the breach element of Colquitt’s claims for breach of fiduciary duties. To prevail on a claim for breach of fiduciary duty in Georgia requires proof of three elements: (1) existence of a fiduciary duty; (2) breach of that duty; and (3) damage proximately caused by that breach. Colquitt unsuccessfully claimed that Smith and Skandalakis as managing members breached their fiduciary duties to him when they terminated his employment for cause. Under Georgia statutory law, the managing members of an LLC owe fiduciary duties to the company as well as its members, but those duties may be modified or eliminated (with a few exceptions) by the operating agreement. Here, the BSA and BSC operating agreements limited the managing member’s liability for breach of fiduciary duties to “acts or omissions in the management of the Company only in the case of gross negligence, willful misconduct or breach of this Agreement by such Managing Partner; but a Managing Partner shall not be liable to the Company or any other Partners for any other acts or omissions.” Therefore, Colquitt had to show that Smith and Skandalakis (1) were acting in the management of the company and that (2) such management acts amounted to gross negligence, willful misconduct, or breach of the operating agreement. The court of appeals explained that the managing members simply participated in a vote—along with the non-managing members—to terminate Colquitt’s employment. The court concluded that participating in such a vote was not an act in the management of the company because management acts, as set forth in the operating agreement, included acts such as expending the income of the company, purchasing insurance for the company, paying taxes, and applying for permits and licenses. The court said that participating in a member vote to terminate another member was not deemed a managerial act or otherwise limited to managerial members; it was an act that required the vote of a specified percentage in interest of all of the members, excluding the terminated member, under the operating agreement. Thus, contrary to Colquitt’s claim, the court concluded that the co-managing members breached no fiduciary duty by voting along with the other members to terminate Colquitt, which the court characterized as “merely taking action expressly authorized by the operating agreement.”

Colquitt then posited that Smith and Skandalakis breached their fiduciary duties to him by setting up their own practices in BSA’s office space in violation of the operating agreement. In his complaint (and amended complaints that followed), however, he claimed that the co-managing members breached their fiduciary duties “by
terminating him, locking him out of the practice's property, preventing him from accessing the practice’s computer system, operating on his patients, exposing him to liability under his personal guarantees, and failing to buy him out.” Because he did not set forth this claim with his enumerated claims in his complaint, the court of appeals refused to review the trial court’s grant of summary judgment on that ground.

Nor did the court of appeals agree with Colquitt’s argument that Smith and Skandalakis breached their fiduciary duties to him based on Colquitt’s purported entitlement to a buyout under the terms of the operating agreements when read in conjunction with his employment contract. First, the court noted that neither the BSA nor the BSC operating agreements contained any mandatory buyout provision; the operating agreements contained an optional offer-to-purchase provision under certain circumstances. Second, upon examining the employment contract, the court concluded that it obligated BSA to a buyout where a buyout is agreed to, but the contract did not mandate such an agreement. Although the employment agreement required BSA to pay to a terminated member a “Buy-Out Amount, as defined in the Practice’s Operating Agreement,” the court stated that there was no buyout amount defined in the BSA operating agreement. The court thus affirmed the summary judgment in favor of Smith and Skandalakis.

As to the dismissal of claims against McGill and Proctor, the appellate court also affirmed the trial court. In order to prevail on his claim for breach of fiduciary duty, Colquitt had to establish the existence of a fiduciary duty. Although Colquitt alleged that McGill and Procter owed him such a duty as members of BSA and BSC, the Georgia LLC statute provides that non-managing members in a manager-managed LLC owe no duties to the LLC or other members. Since the allegations showed that McGill and Procter, as non-managing members of the practice, did not owe Colquitt a fiduciary duty, the trial court properly dismissed the claims for breach of fiduciary duty brought against them.


The Colorado Court of Appeals affirmed judicial dissolution of four LLCs owned by a mother and son based on circumstances that included inability of the members to get along, misconduct by the managing member (mother), and operation of the LLCs inconsistently with the primary purpose of providing the other member (son) an occupation and means to support his family. The court also upheld the district court's order of an in-kind distribution of the four buildings pursuant to a "drop and swap" exchange.

Paula Gagne and her son Richard Gagne created four LLCs to buy and manage four apartment complexes that would be financed by Paula and managed by Richard. The initial LLC operating agreements provided that each LLC would be owned by Paula and Richard on a fifty-fifty basis, but Richard would have a fifty-one percent voting right in each. Shortly thereafter, Paula and Richard’s relationship became increasingly acrimonious and litigation ensued. They eventually settled and subsequently entered into new operating agreements under which Paula held the fifty-one percent voting right in each LLC. Again, the business and the relationship turned sour. Richard sued seeking judicial dissolution of the LLCs as well as a declaratory judgment as to his and Paula’s respective rights and obligations. The case eventually went to trial, and both parties appealed the trial court’s judgment. The appellate court in that appeal (Gagne I) held that the district court applied the wrong standard for judicial dissolution and remanded to the district court. After remand, the district court held another trial on the judicial dissolution claim and entered an order. The order concluded that dissolution was appropriate and ordered an in-kind distribution of the LLCs’ assets (adjusting each party’s share of the assets’ values to account for money Paula wrongfully withdrew from the LLCs) pursuant to which Richard and Paula would each receive two of the apartment buildings. This distribution was to be accomplished by a “drop and swap” exchange. Paula appealed, and the court ultimately held that the district court did not err in any of the ways posited by Paula.

The first contention presented by Paula on appeal was that the court erred in ordering dissolution of the LLCs. Section 7-
80-110(2) of the Colorado Limited Liability Company Act provides that “[a] limited liability company may be dissolved in a proceeding by or for a member or manager of the limited liability company if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company.” In Gagne I, the court of appeals held that this standard requires a party seeking judicial dissolution to establish that “the managers and members of the company are unable to pursue the purposes for which the company was formed in a reasonable, sensible, and feasible manner.” The court of appeals in Gagne I specified seven non-exclusive factors to be considered: (1) whether the company’s managers are unable or unwilling to pursue the purposes for which the company was formed; (2) whether a member or manager has committed misconduct; (3) whether it is clear that the members are not able to work with each other to pursue the company’s purposes; (4) whether the members are deadlocked; (5) whether the company’s operating agreement provides a means of resolving any deadlock; (6) whether, in light of the company’s financial condition, there remains a business to operate; and (7) whether allowing the company to continue is financially feasible. No one factor is dispositive, and a party seeking dissolution need not establish every factor. The district court found that the factors weighed heavily in favor of dissolution based on evidence supporting the first five factors, particularly factors (1) and (2), in light of Paula’s substantial misconduct and oppression of Richard.

With respect to the first factor, the district court found that Paula had frustrated the purpose of the LLCs by refusing to work with Richard in any way, shutting him out of any role in decision making, terminating Richard’s corporation’s role as property manager without cause, and giving a primary business role to her other son (Jay), who also refused to work with Richard. The court of appeals rejected Paula’s argument that the district court violated the parol evidence rule by going beyond the four corners of the LLCs’ operating agreements to determine the LLCs’ purposes when analyzing the first factor. The district court found that the LLCs were formed so that Richard “would have an occupation and a means to support his family,” but Paula argued that the purpose was merely “to own and operate a single apartment building.” The appellate court stated that none of the operating agreements contained a specific purpose clause (or any combination of clauses indicating the limited purpose argued by Paula), that the statement of purpose in the operating agreement is merely a starting point in the analysis, and that the district court’s finding did not contradict anything stated in the operating agreements. Thus, the court of appeals found no basis for concluding that the district court applied the law incorrectly in assessing this factor. Given that the record supported the district court’s additional finding that Paula and Jay were unable and unwilling to allow Richard to have any role in managing the properties, the court of appeals found no error in the district court’s conclusion that the first factor favored dissolution.

With respect to the second factor, Paula unsuccessfully argued that all of the actions characterized by the district court as misconduct on Paula’s part were authorized by the operating agreements, the Colorado Limited Liability Company Act, and/or the business judgment rule. The district court found numerous instances of improper payments by the LLCs for Paula’s personal benefit or interest without any legitimate business purpose, and the court of appeals stated that there was substantial support in the record to support these findings. The court of appeals acknowledged that it is “true that the operating agreements, the Act, and the business judgment rule would allow a manager of an LLC to do such things as make distributions to members, loan money to the company, pay rent for use of space, hire and fire, seek the advice of professionals, earn reasonable management fees, and obtain reimbursement for expenses incurred while acting on the company’s behalf,” but the court stated that “none of these sources of authority immunizes Paula from such acts taken purely for self-interest, in bad faith, and in breach of her fiduciary duties to the LLCs and their members.” The operating agreements in this case required Paula to perform her managerial duties “in good faith, in a manner reasonably believed to be in the best interest of the” LLC. The court cited provisions of the Colorado Limited Liability Company Act stating that managers must
refrain from "engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law" and requiring managers and members to discharge their duties and exercise their rights "consistently with the contractual obligation of good faith and fair dealing." The court cited case law for the proposition that “[m]embers of a limited liability company formed under the Act also owe fiduciary duties to each other and to the company.” The district court found, with record support, that Paula breached all these duties and obligations. The court noted that it assumed the corporate business judgment rule applies in the LLC context, but the court concluded that it offered Paula no protection because it does not apply if a manager acts in bad faith or without any reasonable belief that she is serving the company’s best interests. In sum, the record supported the district court’s finding that the second factor favored dissolution.

The court of appeals concluded that the third factor—whether the members are unable to work with each other to pursue the LLC’s purposes—supported dissolution despite Paula’s argument that her position as sole manager of the LLCs precluded Richard from complaining about her decisions. Such an argument ignored Paula’s contractual, statutory, and common-law obligations of good faith. Paula did not argue that she could work with Richard to accomplish the LLCs’ purposes, and the court said any argument to that effect would be meritless given the record of prolonged animosity and conflict between Paula and Richard.

Because Paula did not have the unilateral right to make all management decisions, the appellate court also rejected Paula’s argument that her role as chief executive manager and her 51% voting right precluded the court from finding that the fourth factor—deadlock of the members—was satisfied. In particular, the district court found that the operating agreement did not give Paula the unilateral right to refuse to renew the management contract between the LLCs and Richard’s management company. This contract was at the heart of the legal dispute between Paula and Richard since the contract was the means by which Richard was active in the LLCs and derived his income. Thus, even though the parties were not deadlocked on all decisions, the record supported a real and material deadlock.

Paula’s argument that the fifth factor was not met depended solely on her argument that there was no deadlock. Because the appellate court rejected that argument and the district court found that the operating agreements provided no way around the deadlock, the record supported the fifth factor.

Although the final two factors—the LLCs’ financial positions and whether continuation of the LLCs was financially feasible—did not favor dissolution, the appellate court concluded that the district court did not err in ordering dissolution given the evidence supporting the other five factors. The court was particularly concerned about Paula’s operation of the LLCs inconsistently with their primary purpose and her serious misconduct (freezing out Richard from operations and benefitting herself at the LLCs’ and Richard’s expense), in addition to the fact that the parties simply could not get along. The court cited cases in other jurisdictions in which judicial dissolution was ordered in circumstances similar to this case. Thus, the court of appeals concluded that the district court did not abuse its discretion in ordering dissolution of the LLCs based on the district court’s findings supporting the first five factors.

Next Paula contended that the district court erred in ordering an in-kind distribution of the LLCs’ assets. The court district court calculated the amounts due each member and allocated two particular buildings to each member. The court ordered the distribution of the apartment buildings through a "drop and swap" whereby the LLCs would distribute all four properties to both members as tenants in common, and each member would convey his or her interest in the two properties he or she was not retaining to the other (or to an entity created by the other to take title to the properties). The parties were allowed to work together to make these transfers in a manner that would qualify for tax advantages under 26 U.S.C. § 1031 (a “1031 exchange”). Paula made several arguments attacking the district court’s in-kind distribution order.

Paula first argued that the court’s order of an in-kind distribution was precluded
by the LLC’s operating agreements based on provisions giving her the “sole right” to sell LLC assets and requiring the members to “to fully cooperate in the use of a 1031 exchange through a qualified intermediary” in the event of a sale of any assets. The court said that Paula was apparently asserting that such a sale and distribution was the only means of distributing assets, but the court pointed out that the provisions of the operating agreements on which she relied applied only to a sale (and arguably only a sale by Paula) and did not purport to limit a court’s options in a judicial dissolution. Further, the court stated that the operating agreements did not need to expressly authorize an in-kind distribution of assets because the Colorado LLC statute contemplates in-kind distributions in the event of a judicial dissolution and winding up. Thus, the court concluded that the operating agreements did not bar in-kind distributions.

The court also rejected Paula’s argument that the district court pierced the corporate veil without making the necessary findings. The court explained that piercing the corporate veil involves holding an individual liable for corporate obligations or liabilities because of disregard or misuse of the corporate form, which the district court did not do when it ordered in-kind distributions as allowed by the LLC statute.

Paula’s final complaint about the in-kind distribution ordered by the district court related to the drop and swap 1031 exchange method specified by the court. According to Paula, even if an in-kind distribution was not barred by the operating agreements, the drop and swap 1031 exchange method was not appropriate because: (1) the statutory provisions allowing for in-kind distribution by a Colorado LLC do not allow a distribution to be accomplished in this way; (2) section 1031 does not allow an exchange of LLC property; and (3) even if section 1031 allows such an exchange, it will not work in this case. The court rejected each of these arguments. First, the court stated that nothing in the LLC statute supported Paula’s argument that an in-kind distribution cannot be ordered through a 1031 exchange. The appellate court stated that a court in this context has substantial discretion in fashioning an equitable remedy, and the court found no abuse discretion here. Paula cited no legal authority for her second argument. While experts testified that swapping membership interests for each other or for real property cannot qualify for section 1031 treatment, at least one expert testified that the properties would qualify for section 1031 treatment once owned by tenants in common. Thus, the district court ordered a process that would allow the parties to take advantage of section 1031 if they chose to do so. In support of her third argument, Paula pointed to a number of contingencies or steps that would need to occur (such as IRS approval, careful planning, and involvement by banks and title companies), but she did not argue that these were insurmountable obstacles. Such an exchange was expressly contemplated in one section of the operating agreement and was merely an option provided by the court to the parties. Although Paula argued that she would suffer negative tax consequences, she offered no legal argument in support of that contention. For these reasons, the appellate court concluded that the district court did not abuse its discretion by ordering an in-kind distribution of the LLCs’ assets.

Next, the court of appeals rejected Paula’s contention that the court erred in ordering various adjustments to each member’s side of the ledger. She based her position on her own testimony and that of her son Jay and certain other professionals. The appellate court emphasized that the district court found both Paula and Jay almost entirely incredible and that her points merely invited the court to improperly reweigh the evidence.

Lastly, the appellate court granted Richard’s request to order Paula to pay his attorneys’ fees incurred on appeal based on a fee-shifting provision in the operating agreements.

Marx v. Morris, 925 N.W.2d 112 (Wis. 2019).

The Wisconsin Supreme Court concluded that: (1) corporate principles of derivative standing do not apply to an LLC, and the members of an LLC have standing to assert individual claims against other members and managers of the LLC based on harm to the members or harm to the LLC; (2) common-law claims for breach of fiduciary duty, unjust enrichment, and breach
of the covenant of good faith and fair dealing survived summary judgment because the claims were not displaced by particular provisions of the Wisconsin LLC statute or the LLC’s operating agreement; and (3) genuine issues of material fact existed with regard to the claim that an individual violated Wis. Stat. § 183.0402(1) by willfully failing to deal fairly with the LLC or its members, and potentially with regard to the common-law claims.

North Star Sand, LLC (“North Star”) was formed under Wisconsin law in 2011 to own and mine land containing silica sand (a type of sand used in fracking operations). North Star’s membership consisted of six LLCs, each of which was owned by a different individual. The individual owners of these six LLCs were Marx, Murray, Morris, Johnson, Glorvigen, and Toy. Morris was North Star’s attorney as well as a manager (in his capacity as a “director”) and assisted in drafting its operating agreement. The agreement permitted members to pursue outside business opportunities and transact business with companies who had business relationships with North Star. The agreement also required prior notice of any vote that may occur at a members’ meeting as well as prior notice of any matter to be voted upon at a directors’ meeting.

North Star formed a wholly owned subsidiary, Westar Proppants, LLC (“Westar”), to hold numerous option agreements for the purchase of land with silica sand reserves. As the expiration date of the option agreements approached, the members became concerned that North Star and Westar had too much land under option, and the members discussed the possible cancellation of some of the options. On December 31, 2013, the date the options were set to expire, the members of North Star met by telephone to discuss Westar’s future. Morris informed the other members during this meeting that he and two other individuals, Green and Wesch, had formed DSJ Holdings, LLC (“DSJ”), and that DSJ was interested in purchasing Westar for $70,000. Morris also informed the members that he had an ownership interest in DSJ. Glorvigen made a motion that North Star keep Westar, and the motion passed by a 4-to-2 vote (with Morris and Johnson voting against it). Immediately after the vote, an argument ensued and Morris became “very aggressive” and indicated he might withdraw from North Star. Morris then made a motion to sell Westar to DSJ for $70,000, to which Murray immediately objected, arguing that there had already been a vote, that there was insufficient notice, and that Morris had a conflict of interest. Despite these objections, a second vote occurred, and Morris’s motion passed by a 4-to-2 vote (with Marx and Murray voting against it). DSJ subsequently assigned its membership units in Westar to Morris’s LLC and to Wesch, and they eventually sold Westar to Unimin Corporation in 2015 for an allegedly substantial sum (which was not disclosed due to a confidentiality order). In August 2014, North Star unanimously voted to sell its remaining silica sand land assets in an unrelated transaction in which each member signed a “Member Distribution Receipt and Acknowledgement.” Morris later asked Marx and Murray to sign a separate, all-encompassing release, but each refused to do so.

Marx and Murray alleged five causes of action against Morris and his LLC: (1) violation of Wis. Stat. § 183.0402(1) upon Morris’s willful failure to deal fairly with them while having a material conflict of interest in the transaction; (2) breach of fiduciary duty; (3) breach of fiduciary duty as corporate counsel; (4) unjust enrichment; and (5) breach of implied covenant of good faith and fair dealing. These actions were brought by their LLCs and in their personal capacities rather than in the name of North Star. Morris moved for summary judgment on all claims, arguing that Marx’s and Murray’s claims belonged only to North Star, and that the Wisconsin Limited Liability Company Law supersedes and replaces any common-law duties of LLC members. The motion was denied by the circuit court, which held that there were disputed issues of material fact on the Wis. Stat. § 183.0402 claim. The court of appeals then certified an appeal to the Supreme Court of Wisconsin to answer two questions: (1) Does an LLC member have standing to assert a claim against another member of the LLC based on an injury suffered primarily by the LLC, rather than the individual member asserting the claim? and (2) Does the Wisconsin Limited Liability Company Law preempt an LLC member’s common-law claims against another member based on the second member’s alleged self-dealing? The Wisconsin
Supreme Court answered “yes” to the first question, holding that a member has standing to assert claims against other members and managers because corporate principles of derivative standing do not apply to an LLC. The court answered “no” to the second question, holding that the common-law claims had not been displaced by the LLC’s operating agreement or the LLC statute. The court also concluded that there were genuine issues of material fact as to whether Morris violated the Wisconsin LLC statute by dealing unfairly with Marx and Murray, as well as potential issues of fact regarding the common-law claims. The circuit court’s decision was thus affirmed and remanded.

The Wisconsin Supreme Court provided a general overview of limited liability companies, characterizing LLCs as combining “desirable features of two other business forms, partnerships and corporations.” The court generally traced the development of state LLC statutes and federal income tax treatment and summarized significant provisions of the Wisconsin LLC statute. Turning to specific provisions of North Star’s operating agreement, the court focused on the fact that “the Agreement unambiguously elected that North Star is to be treated as a partnership where all the losses and gains of the LLC flow through to its individual members.” The court explained that this choice and the provisions of the operating agreement assured that all the income, gain, loss, and deductions would pass through to the members as if North Star were a partnership. For that reason, the court concluded that “an injury to North Star is not the same as an injury to a corporation.”

With respect to the issue of standing, the court contrasted the detailed corporate statutes and long history of case law in Wisconsin addressing corporate principles of derivative standing with the law in the LLC context, and the court declined to import corporate principles of derivative standing into the LLC statute. Based on the provisions of the Wisconsin LLC statute and the LLC’s treatment as a partnership for tax purposes, the court concluded that Marx and Murray had standing to assert their claim that Morris failed to deal fairly them in connection with a matter in which he had a material conflict of interest, regardless of whether North Star was also injured and whether the injury to Marx and Murray was independent of or secondary to North Star.

The court next addressed the issue of whether the common-law claims were preempted by the Wisconsin LLC Act. Because the LLC statute does not state or imply that Wis. Stat. § 183.1302(2) reflects the entirety of a member’s or manager’s obligations to other members and the LLC, and because the record did not indicate the full scope of the common-law claims (i.e., whether they included only allegations within the ambit of § 183.0402(2) or something more), the common-law claims survived summary judgment based on the record before the court.

Lastly, the court concluded that the circuit court properly denied Morris’s motion for summary judgment because there were genuine issues of material fact as to whether Morris violated § 183.0402(1) by a willful failure to deal fairly with Marx, Murray, and/or North Star in connection with a matter in which he had a material conflict of interest. Specifically, Marx and Murray successfully relied upon the provision of North Star’s operating agreement specifying the requisite notice prior to voting on a matter at a meeting. Marx and Murray raised a genuine issue of material fact by alleging that Morris unfairly influenced the vote by failing to give the required advance notice and by providing false information to the members at the meeting. With regard to the common-law claims, the case had not been sufficiently developed for the court to determine whether genuine disputes as to material facts existed for those claims. The court went on to explain why there were genuine disputes as to material facts regarding the § 183.0402(1) claim despite a provision in North Star’s operating agreement permitting pursuit of other business opportunities, a receipt and acknowledgment document signed by the members in connection with another transaction, and consent to the sale of Westar to DSJ by a majority of disinterested members.

The court explained that the “Business Opportunities” clause in North Star’s operating agreement did not unambiguously supplant Wis. Stat. § 183.0402(1), but rather was entirely consistent with § 183.0402(1). The operating
The individuals serving as Directors, as well as the Members and their respective officers, board of directors, shareholders, partners, and affiliates, may engage independently or with others in other business ventures of every nature and description. Nothing in this Agreement shall be deemed to prohibit any Director, or the Members or their respective officers, board of directors, directors, shareholders, partners, and affiliates, from dealing or otherwise engaging in business with Persons transacting business with the Company. Neither the Company, any Director, or any Member shall have any right by virtue of this Agreement, or the relationship created by this Agreement, in or to such other ventures or activities, or to the income or proceeds derived from such other ventures or activities, and the pursuit of such ventures shall not be deemed wrongful or improper.

According to the court, North Star's members were "free to engage in business with persons transacting business with North Star, provided that they do so fairly. The claim in this case is that Morris did so unfairly." The court thus concluded that the clause did not prevent Marx and Murray from asserting their claims against Morris.

In a partial concurrence/partial dissent, the dissenting justice took issue with the majority's opinion in a number of respects.


The Texas Court of Appeals affirmed the trial court's order that required four limited liability companies to advance to a terminated employee his fees and expenses pursuant to the entities' governing documents.

Conrad Holt was a member of L Series, L.L.C., CKDH, L.L.C., VUE, L.L.C., and CKDH Investments, L.L.C. (collectively, the "Companies"). He was also employed as the general manager of a group of car dealerships—Arlington Saturn, Ltd., Fort Worth Saturn, Ltd., and Hurst Saturn, Ltd. (collectively, the "Dealerships"). Three of the Companies served as a general partner of one of those Dealerships. CKDH Investments owned and leased the real estate occupied by the Dealerships. Holt had also served as president of each of the Companies and was a manager of CKDH Investments. The other Companies were member-managed.

The Companies and Dealerships terminated Holt's employment and sued him, claiming in part that he had committed fraud and breached his fiduciary duties to the Companies. Holt counterclaimed, alleging that each of the Companies' regulations ("regulations" was the statutory term used for the LLC agreement under the LLC statute in Texas before 2006) entitled him to advancement of fees and expenses and indemnity. He alleged that the Companies had breached the regulations by failing to provide him advancement and indemnity and refusing to make distributions to him. After amending his counterclaim, Holt sought partial summary judgment with respect to his advancement claim, and the trial court granted Holt's motion and ordered the Companies to pay Holt's past "reasonable attorney fees and expenses" and his "future reasonable attorney fees and expenses" on a monthly basis thereafter upon the submission of "summary invoices." The Companies filed an interlocutory appeal and alternatively sought mandamus relief.

First, the court of appeals concluded that it did not have jurisdiction over the interlocutory appeal of an order requiring advancement. In its analysis, the court disagreed with the Companies' argument that Delaware law was more expansive than Texas law as to advancement claims:

The Companies argue that we should not consider how Delaware treats advancement claims because its law allowing advancement is more expansive than Texas's. See Del. Code Ann. tit. 6, § 18-108 (allowing indemnification by limited liability company subject only to the
standards and restrictions in the company agreement), tit. 8, § 145(e) (allowing corporations to pay defense fees and expenses of officers and directors in advance of final disposition of suit). But Texas law is just as expansive: it provides that a limited liability company’s governing documents may either adopt Texas’s advancement provisions or “may adopt other provisions . . . relating to . . . advancement,” and that those other provisions “will be enforceable.” Tex. Bus. Orgs. Code Ann. § 8.002(b); see also id. § 101.402 (providing that a “limited liability company may . . . pay in advance or reimburse expenses incurred by a person,” defined as including a “member, manager, or officer” of the company). Thus, Texas allows a limited liability company the same broad freedom to craft its own advancement provisions as does Delaware. See Bombardier Aerospace Corp. v. SPEP Aircraft Holdings, LLC, No. 17-0578, —— S.W.3d ———, 2019 WL 406075, at *11 (Tex. Feb. 1, 2019) (noting that Texas has “long recognized the strongly embedded public policy favoring freedom of contract” and acknowledging that courts must respect and enforce the terms of a free and voluntary contract “absent a compelling reason”).

Accordingly, although we apply Texas procedure, we have no qualms looking to Delaware law to inform our understanding of the nature of and policies underlying an advancement claim, as did the El Paso Court of Appeals in Aguilar, 344 S.W.3d at 46–47.

The court noted that although Texas may not have a specific procedure to deal with advancement claims in the same manner as Delaware, Texas summary judgment procedures are an appropriate procedure for determining a contractual claim as a matter of law. Because the court concluded that an advancement order does not have the character and function of a temporary injunction, and no Texas statute authorizes an interlocutory appeal of an order requiring advancement, the court dismissed the Companies’ appeal of the advancement order; however, the court proceeded to consider the Companies’ alternative request for mandamus relief.

In seeking mandamus relief, the Companies argued that the trial court abused its discretion when ordering advancement because their suit against Holt did not fall within the scope of the advancement provisions in the Companies’ regulations. The Companies acknowledged that Holt was serving as a member when they sued him but contended that their suit was solely for ultra vires acts outside of his capacity as a member. Section 8.02 of the Companies’ regulations contained the following advancement provision:

Section 8.01 provided “each Person who was or is made a party [to a] pending or completed action, suit[,] or proceeding . . . ,
by reason of the fact that he or she . . . is or was serving at the request of the Company and an officer, trustee, employee, agent, or similar functionary of the Company shall be indemnified by the Company to the fullest extent permitted by the Act and the TBCA.’ Reading these two sections together, the court determined that a person was entitled to advancement if the person was “of the type” entitled to indemnity under section 8.01 and that it was not necessary to determine the right to indemnity.

The Companies argued that Holt was not entitled to advancement under section 8.02 because he would not be entitled to indemnity for his alleged ultra vires acts under section 8.01. Relying on Delaware case law (which refers to the “admittedly maddening” aspect of advancement clauses and “the tsunami of regret that swept over corporate America regarding mandatory advancement contracts”) and distinguishing a Texas case decided in the indemnification rather than the advancement context, the court disagreed with the Companies, concluding that Holt was entitled to advancement because he was “of the type” entitled to indemnity under section 8.01. The court concluded further that requiring Holt to prove that he was ultimately entitled to indemnity, as the Companies argued, would violate the “clear directive” of section 8.02 that the right to advancement was not dependent on a determination of the right to indemnity. The court also determined that the Companies’ allegations of misconduct did not change the nature of the right they bargained to give Holt. Because at least some of the allegations in the suit were based on—and therefore causally connected to—Holt’s service as a member and a manager of the Companies, the court held that the trial court did not abuse its discretion in concluding that Holt was entitled to advancement under the Companies’ regulations.


The Texas Court of Appeals affirmed the trial court’s summary judgment against two minority interest holders in a Delaware LLC on their claims for breach of contract, noncompliance with Delaware’s implied covenant of good faith and fair dealing, and Delaware statutory violations.

Two brothers, Danial and Stanley Lee (the “Lees”), sued Forgings, Flanges & Fittings, LLC, a Delaware limited liability company (“the LLC”) and the LLC’s majority interest holder, Global Stainless Supply, Inc. (“Global”), alleging Global had breached the parties’ agreements by forcing the sale of the Lees’ membership interests in the LLC for a negative purchase price and by refusing to make distributions to the Lees of more than $6 million. Global characterized the Lees’ suit as an attempt to get a new deal after the LLC’s deteriorating financial performance left them empty-handed. In this summary-judgment appeal, the Lees contended that fact issues precluded summary judgment on their claims against Global and the LLC for breach of contract, noncompliance with Delaware’s implied covenant of good faith and fair dealing, and Delaware statutory violations.

The Lees built a successful business with a German supplier, and eventually the Lees became the majority owners. In 2006, the Lees sold the assets of the business for more than $15 million to the LLC, which was newly formed for purposes of the acquisition by Global, a wholly owned subsidiary of Sumitomo Corporation of Americas (“Sumitomo”). Sumitomo was a master distributor of stainless steel products to the oil-and-gas industry, and Global’s acquisition of the Lees’ business positioned the newly formed LLC to supply a greater variety of steel products and capture additional market share.

As part of the acquisition of the Lees’ business, the parties executed two agreements that were the primary subjects of the appeal: (1) the Limited Liability Company Agreement of Forgings, Flanges & Fittings, LLC (the “LLC Agreement”) between the Lees and Global, and (2) the Put/Call and Members’ Agreement (the “Put/Call Agreement”) among the Lees, Global, and the LLC. While the Put/Call Agreement provided that it was governed by Texas law, the LLC Agreement was governed by Delaware law.

The LLC Agreement provided for voting and non-voting membership interests
and gave Global an 85% voting interest and the Lees each a 7.5% nonvoting interest. Although the Lees were hired to run the LLC, the LLC Agreement did not grant them any special authority to participate in the LLC’s management beyond their role as executives, and the agreement provided that Global was the LLC’s manager.

The LLC Agreement provided for two types of distributions—(1) pro-rata distributions of Net Cash Flow and (2) distributions to cover estimated tax liabilities. An amendment to the LLC Agreement in 2014 clarified the computation and timing of tax liability distributions, but the LLC Agreement continued to provide, as it had from the outset, that Net Cash Flow distributions were to “be paid at such time as determined by the Manager.”

The Put/Call Agreement granted a put option to the Lees and a call option to Global. In the event Global terminated the Lees’ employment without cause and exercised its call option later than the LLC’s third anniversary, the price for the Lees’ membership interests was to be determined using a formula based on the LLC’s EBITDA and “Net Debt” at the “Determination Date.” During negotiations, the Lees proposed adding language to the Put/Call Agreement that would have established a floor price for the Lees’ membership interests, but there was no indication Global accepted this language, and it never became part of the Put/Call Agreement.

According to the Lees, the LLC performed well during the period from 2006 to 2014; according to Global, the LLC’s financial condition had substantially deteriorated due to overexpansion. In 2015, Global terminated the Lees’ employment without cause and gave the Lees notice of its intention to call their interests under the Put/Call Agreement for a purchase price calculated using the LLC’s internally prepared financial statements, which were included in Global’s consolidated financial statements and audited by Global’s auditor KPMG. The calculation yielded a negative value for the Lees’ interests because of the LLC’s substantial debt. Thus, according to Global, it owed no contractual obligation to pay the Lees any amount to purchase their membership interests. Global also took the position that the Lees were not owed any unpaid Net Cash Flow distributions even though Global, as the LLC’s manager, had never paid any such distributions. The only past distributions were for tax liabilities.

The Lees sued Global and the LLC, alleging that Global had improperly refused to pay Net Cash Flow distributions and erroneously calculated the purchase price for their interests. Among the errors asserted by the Lees were inclusion of loans from Sumitomo in Net Debt when the loans should have been excluded as “trade payables” or treated as a cash management system between affiliated companies, and use of the consolidated financial statements instead of basing the calculation on an independent, stand-alone audit of the LLC. According to the Lees, Global’s errors deprived them of unpaid distributions of more than $6 million under the LLC Agreement and almost $10 million under the Put/Call Agreement for their LLC membership interests. Based on these allegations, the Lees asserted numerous causes of action. Global and the LLC denied the allegations and asserted counterclaims, but Global retained the independent accounting firm of Briggs & Veselka (“B & V”) to audit the LLC’s financial statements. The B & V audit was completed almost two years after Global exercised its call option, and, like the consolidated KPMG audit, yielded a negative price for the Lees’ interests. Global and the LLC moved for a traditional and no-evidence summary judgment on all the Lees’ claims, and the trial court granted summary judgment against the Lees on all their claims.

The Lees appealed the dismissal of their claims for breach of the Put/Call Agreement, the LLC Agreement, and Delaware’s implied covenant of good faith and fair dealing, and for violations of the Delaware statutes, but they did not appeal the dismissal of other employment, fiduciary-duty, and declaratory-judgment claims.

The Lees contended on appeal that their summary-judgment response raised a fact issue as to whether Global and the LLC incorrectly calculated the purchase price of their membership interests due to improper inventory charges, miscalculation of certain expenses, erroneous inclusion of the Sumitomo loans as part of Net Debt, and improper calculation of cash equivalents. The court of appeals did not find it necessary to consider whether such discrete fact issues
existed because the court concluded that the contractual obligation of Global and the LLC under the Put/Call Agreement was to draw the “Formula Price” calculation from the LLC’s audited financial statements prepared in accordance with GAAP, and the record conclusively established that they did this. As the court explained:

Under the Put/Call Agreement, the Lees agreed to sell their membership interests to Global for an agreed-to price using a formula of \((\text{EBITDA} \times 4) - \text{Net Debt} \times \text{the Lees’ Interest Percentage}\). The Lees refused to accept Global’s initial calculation of Formula Price because it was not based on audited financial statements of the LLC as a stand-alone entity. Section 3.3(b) of the Put/Call Agreement provides that, “[i]f a Call Exercise Notice is delivered pursuant to the foregoing clause (a) of this section 3.3, then [the LLC] shall cause to be audited its financial statements (i) in the case the Formula Price shall be used to determine the purchase price of the Interests[,]” The contractual definitions of both EBITDA and Net Debt make specific reference to audited financial statements, with the Net Debt definition specifically referencing audited financial statements prepared pursuant to Section 3.3(b). Thus, the Put/Call Agreement memorializes the parties’ unambiguous agreement that the key metrics in the Formula Price (EBITDA and Net Debt) would be based on the LLC’s audited financial statements prepared in accordance with GAAP.

The record conclusively establishes that Global and the LLC adhered to the Put/Call Agreement’s plain text by arranging for an audit to be performed by an independent third-party auditing firm, B & V, and by applying the numbers drawn from the GAAP-audited financial statements directly into the Formula Price calculation. In other words, Global and the LLC followed the contract procedure for exercising the call option. The Lees made no argument in their summary-judgment response that Global and the LLC breached the Put/Call Agreement protocol by failing to act timely. On this record, we find no error in the trial court’s summary judgment on the Lees’ claim for breach of the Put/Call Agreement.

The Lees argue that the audited financial statements cannot be dispositive of their breach-of-contract claim under the Put/Call Agreement because Section 3.3(e) expressly permits them to “object to [Global’s] Call Exercise Notice . . . (whether such objection relates to [Global’s] right to deliver the Call Exercise Notice, the purchase price specified in such Call Exercise Notice or another reason)[,]" (Emphasis added.) Upon a purchase-price objection, Section 3.3(e) obligated Global and the Lees to “negotiate in good faith to resolve such dispute.” And if the dispute was not resolved within ten days after Global delivered the Call Exercise Notice, the Lees and Global had the “right to resort to legal proceedings to resolve the dispute.” There is no allegation or evidence that Global did not negotiate in good faith. Thus, we fail to see how Section 3.3(e) precludes summary judgment on the Lees’ claim for breach of the Put/Call Agreement. The Lees’ competing valuation of the Formula Price may have created a fact issue in a case presenting a different procedural posture—i.e., one where the courts have been asked to render a declaratory judgment as to the correct Formula Price. But that is not the posture in which this case is presented on appeal.

Thus, the court overruled the Lees’ challenge to the summary judgment on their claim for breach of the Put/Call Agreement.

The court next addressed the Lees’ argument that fact issues—as to whether Global improperly refused to make Net Cash Flow distributions of at least $6 million for fiscal years 2006 through 2015 when it exercised its call option—precluded summary judgment on their claims for breach of the LLC Agreement, breach of Delaware’s implied covenant of good faith and fair dealing, and violation of the Delaware Limited Liability Company Act. Global argued that the LLC Agreement conferred Global, as manager, with exclusive discretion as to whether to pay any Net Cash Flow distributions and that Global’s decision to not pay distributions was thus not a breach of any express or implied
With respect to the Lees’ claim for unpaid distributions under the LLC Agreement, the parties disagreed as to how to interpret the distribution provisions in Section 9, which provided in relevant part:

Net Cash Flow of the Company shall be computed and distributed among the Members pro rata in accordance with their respective Membership Interests. Distributions shall be paid at such time as determined by the Manager; provided that Distributions for Estimated Tax Liabilities (as defined below) shall be made quarterly pursuant to Section 9.1. Distribution for Estimated Tax Liabilities shall be subject to a true-up calculation as set forth in Section 9.3. No distributions or returns of capital will be made or paid if they would result in either the Company becoming insolvent or the net assets of the Company becoming less than zero.

Although this clause was followed by detailed provisions addressing the timing and calculation of tax-liability distributions and excesses or shortages as those distributions related to the Lees’ actual tax obligations, there was no additional language regarding Net Cash Flow distributions.

The Lees emphasized the mandatory term “shall” in the first sentence of Section 9 to argue that Global could not decide to never distribute Net Cash Flow, but Global relied on language in the second sentence to assert that its exclusive discretion to never pay Net Cash Flow derived from the disparate treatment of Net Cash Flow and tax-liability distributions. Construing Section 9 as a whole and interpreting its plain text, the court concluded that Section 9 could not reasonably be read as contractually obligating Global to pay Net Cash Flow distributions to the Lees at the time of the call:

Section 9’s first sentence prescribes the manner of any distributions, instructing that Net Cash Flow distributions (if they are made) must be done “pro rata” in accordance with the members’ interests. The “shall” language limits the way in which distributions can be divided (pro rata) when they happen to be made. The sentence’s plain terms do not obligate the payment of distributions. The first clause of Section 9’s next sentence then addresses when Net Cash Flow distributions will be paid—“at such time as determined by the Manager.” Even the Lees acknowledge the discretionary nature of this language.

This language stands in contrast to the language concerning tax-liability distributions. Although Net Cash Flow distributions may be made at such time as determined by the Manager, Global must make tax-liability distributions quarterly. The LLC Agreement’s drafters knew how to require distributions to be made at a specific time, but they refrained from doing so for Net Cash Flow distributions.

Section 9 limits Global’s discretion in only three ways—(1) Global must make tax-liability distributions quarterly, (2) the tax-liability distributions must be reconciled with the Lees’ actual tax obligations annually, and (3) Global may not make any distributions that would cause the LLC to become insolvent or hold less than zero net assets. Other than that part of Section 9 prohibiting Net Cash Flow distributions that would cause the LLC to become insolvent, the LLC Agreement does not impose any restraint against Global’s exercise of its timing discretion for Net Cash Flow distributions. Accordingly, Section 9 does not, as the Lees contend, provide any basis for an obligation to pay distributions beyond the mandatory tax-liability distributions.

The discretionary nature of the Net Cash Flow distributions is made even more plain by consideration of Section 9’s additional provisions for tax-liability distributions. Not only does the LLC Agreement instruct that tax-liability distributions shall be made quarterly, but it also sets forth, in Subsection 9.1, a “minimum quarterly distributions” calculation and, in Subsection 9.3, a method for “true-up...
up” any differences between estimated and actual tax obligations. These detailed, specific provisions for tax-liability distributions stand in contrast to those regarding Net Cash Flow distributions. The parties could have stated that Net Cash Flow distributions, like tax-liability distributions, would be made on a certain schedule or at times when Net Cash Flow exceeded a certain sum. But they did not. Under these circumstances, those omissions must be viewed as intentional in ascertaining the parties’ intent from what they chose to include and what they chose to omit from their agreement.

As the LLC Agreement is written, Global could breach the contract, for example, by paying distributions in a manner other than pro rata or by failing to make quarterly tax-liability distributions. But we find no basis in the LLC Agreement for the Lees’ breach-of-contract claim for unpaid Net Cash Flow distributions at the time Global exercised the call. Accordingly, we overrule that portion of the Lees’ third issue challenging the summary judgment on their breach-of-contract claim for unpaid distributions under the LLC Agreement.

The court next addressed the Lees’ contention that a fact issue nevertheless existed as to whether Global’s refusal to pay Net Cash Flow distributions breached Delaware’s implied covenant of good faith and fair dealing because the implied covenant under Delaware law “‘requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the contract.’” The court explained that the implied covenant is “‘best understood as a way of implying terms in [an] agreement, whether employed to analyze unanticipated developments or to fill gaps in the contract’s provisions.’” Thus, the first step in the court’s analysis was to consider whether a gap existed that must be filled. The implied covenant cannot be used to circumvent the parties’ bargain; therefore, a party generally cannot assert a claim for breach of the implied covenant based on conduct authorized by the terms of the agreement. “As one court explained, ‘For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract’s the thing.’” R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008) (mem. op.)."

Because the court of appeals had already concluded that the LLC Agreement expressly conferred on Global full discretion as to when and if to distribute Net Cash Flow, the court correspondingly concluded that there was no gap to fill using the implied covenant. The contract itself revealed that the parties considered and specifically addressed how and under what circumstances Net Cash Flow distributions would be made, both when the LLC Agreement initially was executed in 2006 and when its distribution provision was amended in 2014. The court stated that it was not permitted by Delaware law “to employ the implied covenant in a manner that would effectively rewrite the contract to afford the Lees a better deal.”

The court addressed post-submission briefing by the Lees in which they cited authority for the proposition that the covenant may operate in equity to restrain the exercise of Global’s timing discretion for Net Cash Flow distributions and prohibit unreasonable or unfair acts or omissions even in the absence of contractual gaps. The court stated that this argument did not present a ground for reversal because the court construed it to be a different argument than the Lees made in their summary-judgment response, which focused on the LLC Agreement’s construction and the implied covenant’s gap-filling function rather than the application of equity to override the LLC Agreement’s express terms. Additionally, the court stated that the authorities cited by the Lees indicated that a party “does not act in bad faith by relying on contract provisions for which that party bargained,” and the summary-judgment record showed Global’s exercise of contractual options for which it bargained and to which the Lees agreed.

Finally, the court addressed the Lees’ argument that the trial court erroneously dismissed their claims under the Delaware Limited Liability Company Act for unpaid distributions. After determining that the Lees adequately pleaded the statutory violations and that the claims were live claims that Global and the LLC did not address in their motion, the court of appeals
concluded that the trial court’s dismissal of the claims was harmless error. The Lees asserted claims for violation of Delaware Limited Liability Company Act § 18-604 (entitled “Distribution upon resignation”) and § 18-606 (entitled “Right to distribution”), but the court pointed out that these statutes expressly contemplate that distribution rights are controlled by the LLC Agreement. Section 18-604 states, in pertinent part, that “upon resignation any resigning member is entitled to receive any distribution to which such member is entitled under a limited liability company agreement.” Section 18-606 states, in pertinent part, that “unless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution.” Thus, the court’s holding that the LLC Agreement imposed no obligation to pay distributions beyond the mandatory tax-liability distributions disposed of this claim.

**Namerow v. PediatriCare Assocs., LLC, 218 A.3d 839 (N.J. Ch. Div. 2018).**

A retired member brought an action against a New Jersey LLC and its three active members alleging various claims, including modification of the operating agreement by conduct, minority member oppression, and breach of fiduciary duties. The trial court granted summary judgment in favor of the LLC and its active members, holding that (1) the parties' course of conduct over a sixteen-year period did not modify the operating agreement; (2) the economic loss doctrine barred the retired member from recovering damages based on a claim of minority member oppression; and (3) there was nothing to suggest that the active members breached any fiduciary duty owed to the retired member.

Four doctors, Namerow, Zucker, Bienstock, and Chism entered into an operating agreement to form PediatriCare Associates, LLC, a New Jersey limited liability company, in January 2000 with the purpose of owning and operating a medical practice. In March 2001, the parties entered into an Amended and Restated Operating Agreement (the “Agreement”). The Agreement provided members with the right to retire once they had reached the age of sixty and had provided twenty-five years of membership or service to the practice. Furthermore, the Agreement prescribed that the “retirement purchase price" of a retiring member’s interest was calculated according to Section 10 of the Agreement (titled “Determination of Value”) as follows:

The total value of the company (“company value”) shall be the last dated amount set forth on the Certificate of Agreed Value, attached hereto as Exhibit G and made part hereto, executed by the members. The members shall exercise their best efforts to meet not less than once per year for the purpose of considering a new value but their failure to meet or determine a value shall not invalidate the most recently executed Certificate of Agreed Value setting forth the company value then in effect. If the parties fail to agree on a revaluation as described above for more than two (2) years, the company value shall be equal to the last agreed upon value, adjusted to reflect the increase or decrease in the net worth of the company, including collectible accounts receivable, since the last agreed upon value. The value of a member’s interest (“Value”) shall mean the company value multiplied by the percentage interest held by said member and being purchased hereunder, less any indebtedness that the selling or disabled member, the Decedent, or a member departing for any other reason contemplated hereunder may have to the company or to the other members, whichever the case may be.

The most recent Certificate of Agreed Value attached to the Agreement, which stated that the “value of the company” was $2.4 million, was dated January 1, 2000 and signed by Namerow, Zucker, Bienstock, and Chism.

Namerow announced his intention to retire in January 2016, which triggered the application of Section 10. Over the next several months, the parties obtained two appraisals, each using the fair market valuation methodology, for the purpose of
reaching a settlement regarding the voluntary negotiated buy-out number. No such number was ever reached and the Agreement was never amended.

Namerow filed this action on October 10, 2017 against Zucker, Bienstock, and Chism (collectively, the “Active Members”) and the LLC, asserting claims for modification of the Agreement by conduct, oppression of a minority member, and breach of fiduciary duty. Both sides filed motions for partial summary judgment.

The first issue that the trial court addressed was whether the parties’ course of conduct over a sixteen-year period modified the terms of the Agreement to require use of a fair market valuation, rather than a net worth valuation as required by Section 10, to value the practice. Namerow argued that the parties had modified the Agreement because they had ignored Section 10 on three prior occasions. The trial court was not persuaded and reasoned that there was no indication that the parties intended to informally modify Section 10 because one such occasion was wholly unrelated to the retirement buyout purchase price of a member and, based on this litigation, the other two occasions did not settle the disagreement. The court then noted that the Agreement stated that it can only be modified by a vote of 80% of the membership interests and there was no evidence that Namerow or the Active Members agreed to formally modify Section 10. Therefore, the trial court granted summary judgment in favor of the LLC and the Active Members on Namerow’s claim that the parties’ conduct modified Section 10 to require the use of a fair market valuation methodology to determine his retirement purchase price.

Next, the trial court addressed Namerow’s claim of minority member oppression under the New Jersey LLC Act when their reasonable expectations have been frustrated by the majority members. According to Namerow, he had a reasonable expectation that his 25% membership interest would be purchased using a fair market valuation methodology. In further support of his oppression claim, Namerow referenced an earlier ruling from the court in which it denied the defendants’ motion to dismiss because, at that time, his expectation was reasonable. The trial court pointed out that its earlier ruling was made at a preliminary stage in the litigation and, after discovery and the court’s determination that the net worth methodology applied, it was clear that the defendants’ conduct did not support a claim for oppression under the New Jersey LLC Act. Furthermore, the court cited New Jersey case law for the proposition that the economic loss doctrine prohibits plaintiffs from recovering in tort economic losses to which their entitlement only flows from a contract. Because this claim was contractual in nature and Namerow’s entitlement flowed from the Agreement, the trial court held that his minority member oppression claim failed as a matter of law because it was barred by the economic loss doctrine.

The third issue that the trial court addressed was whether the defendants breached the fiduciary duties owed to Namerow. Under the New Jersey LLC Act, each member of a member-managed LLC owes the company and the other members a duty of care. The court observed that Namerow’s claim for breach of fiduciary duty was based on many of the same recycled allegations from his other claims and were unconvincing for the same reasons. The trial court further reasoned that there was no valid claim for breach of fiduciary duty based on the members of a member-managed LLC acting in conformity with the Agreement. Thus, the trial court granted summary judgment in favor of the LLC and the Active Members on Namerow’s claim for breach of fiduciary duty.

Distributions


The Colorado Court of Appeals affirmed judicial dissolution of four LLCs
owned by a mother and son based on circumstances that included inability of the members to get along, misconduct by the managing member (mother), and operation of the LLCs inconsistently with the primary purpose of providing the other member (son) an occupation and means to support his family. The court also upheld the district court’s order of an in-kind distribution of the four buildings pursuant to a “drop and swap” exchange.

Paula Gagne and her son Richard Gagne created four LLCs to buy and manage four apartment complexes that would be financed by Paula and managed by Richard. The initial LLC operating agreements provided that each LLC would be owned by Paula and Richard on a fifty-fifty basis, but Richard would have a fifty-one percent voting right in each. Shortly thereafter, Paula and Richard’s relationship became increasingly acrimonious and litigation ensued. They eventually settled and subsequently entered into new operating agreements under which Paula held the fifty-one percent voting right in each LLC. Again, the business and the relationship turned sour. Richard sued seeking judicial dissolution of the LLCs as well as a declaratory judgment as to his and Paula’s respective rights and obligations. The case eventually went to trial, and both parties appealed the trial court’s judgment. The appellate court in that appeal (Gagne I) held that the district court applied the wrong standard for judicial dissolution and remanded to the district court. After remand, the district court held another trial on the judicial dissolution claim and entered an order. The order concluded that dissolution was appropriate and ordered an in-kind distribution of the LLCs’ assets (adjusting each party’s share of the assets’ values to account for money Paula wrongfully withdrew from the LLCs) pursuant to which Richard and Paula would each receive two of the apartment buildings. This distribution was to be accomplished by a “drop and swap” exchange. Paula appealed, and the court ultimately held that the district court did not err in any of the ways posited by Paula.

The first contention presented by Paula on appeal was that the court erred in ordering dissolution of the LLCs. Section 7-80-110(2) of the Colorado Limited Liability Company Act provides that “[a] limited liability company may be dissolved in a proceeding by or for a member or manager of the limited liability company if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company.” In Gagne I, the court of appeals held that this standard requires a party seeking judicial dissolution to establish that “the managers and members of the company are unable to pursue the purposes for which the company was formed in a reasonable, sensible, and feasible manner.” The court of appeals in Gagne I specified seven non-exclusive factors to be considered: (1) whether the company’s managers are unable or unwilling to pursue the purposes for which the company was formed; (2) whether a member or manager has committed misconduct; (3) whether it is clear that the members are not able to work with each other to pursue the company’s purposes; (4) whether the members are deadlocked; (5) whether the company’s operating agreement provides a means of resolving any deadlock; (6) whether, in light of the company’s financial condition, there remains a business to operate; and (7) whether allowing the company to continue is financially feasible. No one factor is dispositive, and a party seeking dissolution need not establish every factor. The district court found that the factors weighed heavily in favor of dissolution based on evidence supporting the first five factors, particularly factors (1) and (2), in light of Paula’s substantial misconduct and oppression of Richard. The court of appeals discussed the district court’s finding on each of the factors and concluded that the district court did not err in ordering dissolution.

After concluding that the district court did not abuse its discretion in ordering dissolution of the LLCs, the court of appeals addressed Paula’s contention that the district court erred in ordering an in-kind distribution of the LLCs’ assets. The court district court calculated the amounts due each member and allocated two particular buildings to each member. The court ordered the distribution of the apartment buildings through a “drop and swap” whereby the LLCs would distribute all four properties to both members as tenants in common, and each member would convey his or her interest in the two properties he or she was not retaining to the
other (or to an entity created by the other to take title to the properties). The parties were allowed to work together to make these transfers in a manner that would qualify for tax advantages under 26 U.S.C. § 1031 (a “1031 exchange”). Paula made several arguments attacking the district court’s in-kind distribution order.

Paula first argued that the court’s order of an in-kind distribution was precluded by the LLC’s operating agreements based on provisions giving her the “sole right” to sell LLC assets and requiring the members to “fully cooperate in the use of a 1031 exchange through a qualified intermediary” in the event of a sale of any assets. The court said that Paula was apparently asserting that such a sale and distribution was the only means of distributing assets, but the court pointed out that the provisions of the operating agreements on which she relied applied only to a sale (and arguably only a sale by Paula) and did not purport to limit a court’s options in a judicial dissolution. Further, the court stated that the operating agreements did not need to expressly authorize an in-kind distribution of assets because the Colorado LLC statute contemplates in-kind distributions in the event of a judicial dissolution and winding up. Thus, the court concluded that the operating agreements did not bar in-kind distributions.

The court also rejected Paula’s argument that the district court pierced the corporate veil without making the necessary findings. The court explained that piercing the corporate veil involves holding an individual liable for corporate obligations or liabilities because of disregard or misuse of the corporate form, which the district court did not do when it ordered in-kind distributions as allowed by the LLC statute.

Paula’s final complaint about the in-kind distribution ordered by the district court related to the drop and swap 1031 exchange method specified by the court. According to Paula, even if an in-kind distribution was not barred by the operating agreements, the drop and swap 1031 exchange method was not appropriate because: (1) the statutory provisions allowing for in-kind distribution by a Colorado LLC do not allow a distribution to be accomplished in this way; (2) section 1031 does not allow an exchange of LLC property; and (3) even if section 1031 allows such an exchange, it will not work in this case. The court rejected each of these arguments. First, the court stated that nothing in the LLC statute supported Paula’s argument that an in-kind distribution cannot be ordered through a 1031 exchange. The appellate court stated that a court in this context has substantial discretion in fashioning an equitable remedy, and the court found no abuse discretion here. Paula cited no legal authority for her second argument. While experts testified that swapping membership interests for each other or for real property cannot qualify for section 1031 treatment, at least one expert testified that the properties would qualify for section 1031 treatment once owned by tenants in common. Thus, the district court ordered a process that would allow the parties to take advantage of section 1031 if they chose to do so. In support of her third argument, Paula pointed to a number of contingencies or steps that would need to occur (such as IRS approval, careful planning, and involvement by banks and title companies), but she did not argue that these were insurmountable obstacles. Such an exchange was expressly contemplated in one section of the operating agreement and was merely an option provided by the court to the parties. Although Paula argued that she would suffer negative tax consequences, she offered no legal argument in support of that contention. For these reasons, the appellate court concluded that the district court did not abuse its discretion by ordering an in-kind distribution of the LLCs’ assets.

Next, the court of appeals rejected Paula’s contention that the court erred in ordering various adjustments to each member’s side of the ledger. She based her position on her own testimony and that of her son Jay and certain other professionals. The appellate court emphasized that the district court found both Paula and Jay almost entirely incredible and that her points merely invited the court to improperly reweigh the evidence.


The Texas Court of Appeals affirmed the trial court’s summary judgment against two minority interest holders in a
Delaware LLC on their claims for breach of contract, noncompliance with Delaware’s implied covenant of good faith and fair dealing, and Delaware statutory violations.

Two brothers, Danial and Stanley Lee (the “Lees”), sued Forgings, Flanges & Fittings, LLC, a Delaware limited liability company (“the LLC”) and the LLC’s majority interest holder, Global Stainless Supply, Inc. (“Global”), alleging Global had breached the parties’ agreements by forcing the sale of the Lees’ membership interests in the LLC for a negative purchase price and by refusing to make distributions to the Lees of more than $6 million. Global characterized the Lees’ suit as an attempt to get a new deal after the LLC’s deteriorating financial performance left them empty-handed. In this summary-judgment appeal, the Lees contended that fact issues precluded summary judgment on their claims against Global and the LLC for breach of contract, noncompliance with Delaware’s implied covenant of good faith and fair dealing, and Delaware statutory violations.

The Lees built a successful business with a German supplier, and eventually the Lees became the majority owners. In 2006, the Lees sold the assets of the business for more than $15 million to the LLC, which was newly formed for purposes of the acquisition by Global, a wholly owned subsidiary of Sumitomo Corporation of Americas (“Sumitomo”). Sumitomo was a master distributor of stainless steel products to the oil-and-gas industry, and Global’s acquisition of the Lees’ business positioned the newly formed LLC to supply a greater variety of steel products and capture additional market share.

As part of the acquisition of the Lees’ business, the parties executed two agreements that were the primary subjects of the appeal: (1) the Limited Liability Company Agreement of Forgings, Flanges & Fittings, LLC (the “LLC Agreement”) between the Lees and Global, and (2) the Put/Call and Members’ Agreement (the “Put/Call Agreement”) among the Lees, Global, and the LLC. While the Put/Call Agreement provided that it was governed by Texas law, the LLC Agreement was governed by Delaware law.

The LLC Agreement provided for voting and non-voting membership interests and gave Global an 85% voting interest and the Lees each a 7.5% nonvoting interest. Although the Lees were hired to run the LLC, the LLC Agreement did not grant them any special authority to participate in the LLC’s management beyond their role as executives, and the agreement provided that Global was the LLC’s manager.

The LLC Agreement provided for two types of distributions—(1) pro-rata distributions of Net Cash Flow and (2) distributions to cover estimated tax liabilities. An amendment to the LLC Agreement in 2014 clarified the computation and timing of tax liability distributions, but the LLC Agreement continued to provide, as it had from the outset, that Net Cash Flow distributions were to “be paid at such time as determined by the Manager.”

The Put/Call Agreement granted a put option to the Lees and a call option to Global. In the event Global terminated the Lees’ employment without cause and exercised its call option later than the LLC’s third anniversary, the price for the Lees’ membership interests was to be determined using a formula based on the LLC’s EBITDA and “Net Debt” at the “Determination Date.” During negotiations, the Lees proposed adding language to the Put/Call Agreement that would have established a floor price for the Lees’ membership interests, but there was no indication Global accepted this language, and it never became part of the Put/Call Agreement.

According to the Lees, the LLC performed well during the period from 2006 to 2014; according to Global, the LLC’s financial condition had substantially deteriorated due to overexpansion. In 2015, Global terminated the Lees’ employment without cause and gave the Lees notice of its intention to call their interests under the Put/Call Agreement for a purchase price calculated using the LLC’s internally prepared financial statements, which were included in Global’s consolidated financial statements and audited by Global’s auditor KPMG. The calculation yielded a negative value for the Lees’ interests because of the LLC’s substantial debt. Thus, according to Global, it owed no contractual obligation to pay the Lees any amount to purchase their membership interests. Global also took the
position that the Lees were not owed any unpaid Net Cash Flow distributions even though Global, as the LLC’s manager, had never paid any such distributions. The only past distributions were for tax liabilities.

The Lees sued Global and the LLC, alleging that Global had improperly refused to pay Net Cash Flow distributions and erroneously calculated the purchase price for their interests. Among the errors asserted by the Lees were inclusion of loans from Sumitomo in Net Debt when the loans should have been excluded as “trade payables” or treated as a cash management system between affiliated companies, and use of the consolidated financial statements instead of basing the calculation on an independent, stand-alone audit of the LLC. According to the Lees, Global’s errors deprived them of unpaid distributions of more than $6 million under the LLC Agreement and almost $10 million under the Put/Call Agreement for their LLC membership interests. Based on these allegations, the Lees asserted numerous causes of action. Global and the LLC denied the allegations and asserted counterclaims, but Global retained the independent accounting firm of Briggs & Veselka ("B & V") to audit the LLC’s financial statements. The B & V audit was completed almost two years after Global exercised its call option, and, like the consolidated KPMG audit, yielded a negative price for the Lees’ interests. Global and the LLC moved for a traditional and no-evidence summary judgment on all the Lees’ claims, and the trial court granted summary judgment against the Lees on all their claims.

The Lees appealed the dismissal of their claims for breach of the Put/Call Agreement, the LLC Agreement, and Delaware’s implied covenant of good faith and fair dealing, and for violations of the Delaware statutes, but they did not appeal the dismissal of other employment, fiduciary-duty, and declaratory-judgment claims.

The Lees contended on appeal that their summary-judgment response raised a fact issue as to whether Global and the LLC incorrectly calculated the purchase price of their membership interests due to improper inventory charges, miscalculation of certain expenses, erroneous inclusion of the Sumitomo loans as part of Net Debt, and improper calculation of cash equivalents. The court of appeals did not find it necessary to consider whether such discrete fact issues existed because the court concluded that the contractual obligation of Global and the LLC under the Put/Call Agreement was to draw the “Formula Price” calculation from the LLC’s audited financial statements prepared in accordance with GAAP, and the record conclusively established that they did this. As the court explained:

Under the Put/Call Agreement, the Lees agreed to sell their membership interests to Global for an agreed-to price using a formula of \(( (\text{EBITDA} \times 4) – \text{Net Debt}) \times \text{the Lees’ Interest Percentage})
. The Lees refused to accept Global’s initial calculation of Formula Price because it was not based on audited financial statements of the LLC as a stand-alone entity. Section 3.3(b) of the Put/Call Agreement provides that, “[i]f a Call Exercise Notice is delivered pursuant to the foregoing clause (a) of this section 3.3, then [the LLC] shall cause to be audited its financial statements (i) in the case the Formula Price shall be used to determine the purchase price of the Interests[.]” The contractual definitions of both EBITDA and Net Debt make specific reference to audited financial statements, with the Net Debt definition specifically referencing audited financial statements prepared pursuant to Section 3.3(b). Thus, the Put/Call Agreement memorializes the parties’ unambiguous agreement that the key metrics in the Formula Price (EBITDA and Net Debt) would be based on the LLC’s audited financial statements prepared in accordance with GAAP.

The record conclusively establishes that Global and the LLC adhered to the Put/Call Agreement’s plain text by arranging for an audit to be performed by an independent third-party auditing firm, B & V, and by applying the numbers drawn from the GAAP-audited financial statements directly into the Formula Price calculation. In other words, Global and the LLC followed the contract procedure for exercising the call option. The Lees made no argument in their
summary-judgment response that Global and the LLC breached the Put/Call Agreement protocol by failing to act timely. On this record, we find no error in the trial court’s summary judgment on the Lees’ claim for breach of the Put/Call Agreement.

The Lees argue that the audited financial statements cannot be dispositive of their breach-of-contract claim under the Put/Call Agreement because Section 3.3(e) expressly permits them to “object to [Global’s] Call Exercise Notice . . . (whether such objection relates to [Global’s] right to deliver the Call Exercise Notice, the purchase price specified in such Call Exercise Notice or another reason)].” (Emphasis added.) Upon a purchase-price objection, Section 3.3(e) obligated Global and the Lees to “negotiate in good faith to resolve such dispute.” And if the dispute was not resolved within ten days after Global delivered the Call Exercise Notice, the Lees and Global had the “right to resort to legal proceedings to resolve the dispute.” There is no allegation or evidence that Global did not negotiate in good faith. Thus, we fail to see how Section 3.3(e) precludes summary judgment on the Lees’ claim for breach of the Put/Call Agreement. The Lees’ competing valuation of the Formula Price may have created a fact issue in a case presenting a different procedural posture—i.e., one where the courts have been asked to render a declaratory judgment as to the correct Formula Price. But that is not the posture in which this case is presented on appeal.

Thus, the court overruled the Lees’ challenge to the summary judgment on their claim for breach of the Put/Call Agreement.

The court next addressed the Lees’ argument that fact issues—as to whether Global improperly refused to make Net Cash Flow distributions of at least $6 million for fiscal years 2006 through 2015 when it exercised its call option—precluded summary judgment on their claims for breach of the LLC Agreement, breach of Delaware’s implied covenant of good faith and fair dealing, and violation of the Delaware Limited Liability Company Act. Global argued that the LLC Agreement conferred Global, as manager, with exclusive discretion as to whether to pay any Net Cash Flow distributions and that Global’s decision to not pay distributions was thus not a breach of any express or implied contractual obligation or statutory violation.

With respect to the Lees’ claim for unpaid distributions under the LLC Agreement, the parties disagreed as to how to interpret the distribution provisions in Section 9, which provided in relevant part:

Net Cash Flow of the Company shall be computed and distributed among the Members pro rata in accordance with their respective Membership Interests. Distributions shall be paid at such time as determined by the Manager; provided that Distributions for Estimated Tax Liabilities (as defined below) shall be made quarterly pursuant to Section 9.1. Distribution for Estimated Tax Liabilities shall be subject to a true-up calculation as set forth in Section 9.3. No distributions or returns of capital will be made or paid if they would result in either the Company becoming insolvent or the net assets of the Company becoming less than zero.

Although this clause was followed by detailed provisions addressing the timing and calculation of tax-liability distributions and excesses or shortages as those distributions related to the Lees’ actual tax obligations, there was no additional language regarding Net Cash Flow distributions.

The Lees emphasized the mandatory term “shall” in the first sentence of Section 9 to argue that Global could not decide to never distribute Net Cash Flow, but Global relied on language in the second sentence to assert that its exclusive discretion to never pay Net Cash Flow derived from the disparate treatment of Net Cash Flow and tax-liability distributions. Construing Section 9 as a whole and interpreting its plain text, the court concluded that Section 9 could not reasonably be read as contractually obligating Global to pay Net Cash Flow distributions to the Lees at the time of the call:

Section 9’s first sentence prescribes the manner of any distributions, instructing that Net Cash Flow distributions (if they are made) must be done “pro rata” in accordance with the members’ interests. The “shall” language
limits the way in which distributions can be divided (pro rata) when they happen to be made. The sentence’s plain terms do not obligate the payment of distributions. The first clause of Section 9’s next sentence then addresses when Net Cash Flow distributions will be paid—"at such time as determined by the Manager." Even the Lees acknowledge the discretionary nature of this language.

This language stands in contrast to the language concerning tax-liability distributions. Although Net Cash Flow distributions may be made at such time as determined by the Manager, Global must make tax-liability distributions quarterly. The LLC Agreement’s drafters knew how to require distributions to be made at a specific time, but they refrained from doing so for Net Cash Flow distributions.

Section 9 limits Global’s discretion in only three ways—(1) Global must make tax-liability distributions quarterly, (2) the tax-liability distributions must be reconciled with the Lees’ actual tax obligations annually, and (3) Global may not make any distributions that would cause the LLC to become insolvent or hold less than zero net assets. Other than that part of Section 9 prohibiting Net Cash Flow distributions that would cause the LLC to become insolvent, the LLC Agreement does not impose any restraint against Global’s exercise of its timing discretion for Net Cash Flow distributions. Accordingly, Section 9 does not, as the Lees contend, provide any basis for an obligation to pay distributions beyond the mandatory tax-liability distributions.

The discretionary nature of the Net Cash Flow distributions is made even more plain by consideration of Section 9’s additional provisions for tax-liability distributions. Not only does the LLC Agreement instruct that tax-liability distributions shall be made quarterly, but it also sets forth, in Subsection 9.1, a “minimum quarterly distributions” calculation and, in Subsection 9.3, a method for “truing-up” any differences between estimated and actual tax obligations. These detailed, specific provisions for tax-liability distributions stand in contrast to those regarding Net Cash Flow distributions. The parties could have stated that Net Cash Flow distributions, like tax-liability distributions, would be made on a certain schedule or at times when Net Cash Flow exceeded a certain sum. But they did not. Under these circumstances, those omissions must be viewed as intentional in ascertaining the parties’ intent from what they chose to include and what they chose to omit from their agreement.

As the LLC Agreement is written, Global could breach the contract, for example, by paying distributions in a manner other than pro rata or by failing to make quarterly tax-liability distributions. But we find no basis in the LLC Agreement for the Lees’ breach-of-contract claim for unpaid Net Cash Flow distributions at the time Global exercised the call. Accordingly, we overrule that portion of the Lees’ third issue challenging the summary judgment on their breach-of-contract claim for unpaid distributions under the LLC Agreement.

The court next addressed the Lees’ contention that a fact issue nevertheless existed as to whether Global’s refusal to pay Net Cash Flow distributions breached Delaware’s implied covenant of good faith and fair dealing because the implied covenant under Delaware law “requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the contract.” The court explained that the implied covenant is “best understood as a way of implying terms in [an] agreement, whether employed to analyze unanticipated developments or to fill gaps in the contract’s provisions.” Thus, the first step in the court’s analysis was to consider whether a gap existed that must be filled. The implied covenant cannot be used to circumvent the parties’ bargain; therefore, a party generally cannot assert a claim for breach of the implied covenant based on conduct authorized by the terms of the agreement. “As one court explained, ‘For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract’s the thing.’ R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008) (mem. op.)."
Because the court of appeals had already concluded that the LLC Agreement expressly conferred on Global full discretion as to when and if to distribute Net Cash Flow, the court correspondingly concluded that there was no gap to fill using the implied covenant. The contract itself revealed that the parties considered and specifically addressed how and under what circumstances Net Cash Flow distributions would be made, both when the LLC Agreement initially was executed in 2006 and when its distribution provision was amended in 2014. The court stated that it was not permitted by Delaware law “to employ the implied covenant in a manner that would effectively rewrite the contract to afford the Lees a better deal.”

The court addressed post-submission briefing by the Lees in which they cited authority for the proposition that the covenant may operate in equity to restrain the exercise of Global’s timing discretion for Net Cash Flow distributions and prohibit unreasonable or unfair acts or omissions even in the absence of contractual gaps. The court stated that this argument did not present a ground for reversal because the court construed it to be a different argument than the Lees made in their summary-judgment response, which focused on the LLC Agreement’s construction and the implied covenant’s gap-filling function rather than the application of equity to override the LLC Agreement’s express terms. Additionally, the court stated that the authorities cited by the Lees indicated that a party “does not act in bad faith by relying on contract provisions for which that party bargained,” and the summary-judgment record showed Global’s exercise of contractual options for which it bargained and to which the Lees agreed.

Finally, the court addressed the Lees’ argument that the trial court erroneously dismissed their claims under the Delaware Limited Liability Company Act for unpaid distributions. After determining that the Lees adequately pleaded the statutory violations and that the claims were live claims that Global and the LLC did not address in their motion, the court of appeals concluded that the trial court’s dismissal of the claims was harmless error. The Lees asserted claims for violation of Delaware Limited Liability Company Act § 18-604 (entitled “Distribution upon resignation”) and § 18-606 (entitled “Right to distribution”), but the court pointed out that these statutes expressly contemplate that distribution rights are controlled by the LLC Agreement. Section 18-604 states, in pertinent part, that “upon resignation any resigning member is entitled to receive any distribution to which such member is entitled under a limited liability company agreement.” Section 18-606 states, in pertinent part, that “unless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution.” Thus, the court’s holding that the LLC Agreement imposed no obligation to pay distributions beyond the mandatory tax-liability distributions disposed of this claim.

Withdrawal of Member


In a case presenting a statutory question of first impression, the Missouri Court of Appeals concluded that an LLC member’s filing of a petition seeking declaratory judgment as to membership status did not constitute an act of withdrawal under Missouri law.

Peter Nicolazzi and Laura Bone formed Young in Spirit Adult Day Care, LLC, an adult daycare business, and executed an operating agreement in September 2005. Although the operating agreement provided that they were the company’s only members, it did not contain any provisions regarding withdrawal. The business expanded but the parties’ business relationship steadily deteriorated. In the spring of 2011, Nicolazzi solicited the purchase of his membership interest from a third-party competitor without first seeking Bone’s consent before he effectively stopped participating in company operations, leaving Bone as the LLC’s sole operator. On June 20, 2011, Bone filed articles of incorporation with Missouri’s Secretary of State for “Young in Spring Adult Day Center, Inc.” and, on the next day, notified Nicolazzi that the business would continue under this new entity and that she
would be dissolving the LLC.

In June of 2011, Nicolazzi filed a petition that included a request for a declaratory judgment to determine Bone’s member status. The trial court entered judgment in favor of Bone based on its determination that, as relevant to this appeal, she was the sole remaining member of the LLC because Nicolazzi withdrew prior to filing his petition. Nicolazzi appealed. The court of appeals reversed in part because it found that Nicolazzi’s actions did not constitute withdrawal under the LLC’s operating agreement and remanded with instructions for the trial court to determine whether Nicolazzi’s filing of his petition constituted a statutory “event of withdrawal” under Section 347.123(4)(c) of the Missouri Limited Liability Company Act. On remand, the trial court held that Nicolazzi’s filing of his petition did constitute a statutory withdrawal. (The court’s opinion includes an observation that the trial court provided its holding on remand “with minimal explanation” and a comment in a footnote that the trial court “improvidently chose to proceed without any hearing, presentation of evidence, argument or discussion before issuing its judgment[.]”) Nicolazzi appealed a second time.

The court of appeals began its analysis by noting that the issue on appeal was purely a question of statutory interpretation, albeit one of first impression: whether the filing of a petition for a declaratory judgment as to LLC member status is an act of withdrawal by the petitioner under Section 347.123(4)(c) of the Missouri Limited Liability Company Act. On remand, the trial court held that Nicolazzi’s filing of his petition did constitute a statutory withdrawal. (The court’s opinion includes an observation that the trial court provided its holding on remand “with minimal explanation” and a comment in a footnote that the trial court “improvidently chose to proceed without any hearing, presentation of evidence, argument or discussion before issuing its judgment[.]”) Nicolazzi appealed a second time.

The court agreed with Nicolazzi’s interpretation and held that the trigger for involuntary withdrawal under Section 347.123(4)(c) is the petitioning to reorganize or otherwise judicially restructure oneself—not the LLC. First, the court followed traditional rules of statutory interpretation to ascertain the meaning of the phrase “for himself” by giving effect to the statutory definitions of person and member. The court observed that the Missouri LLC Act broadly defines “person” to include individuals and entities and clearly provides that a “member” may refer to either a natural person or an entity. Second, the court reasoned that to hold otherwise (i.e. interpreting “for himself” to mean restructuring of the LLC for one’s own benefit) would render the subsection at issue meaningless and incompatible with other provisions of the Missouri LLC Act. The court noted that Bone’s suggested interpretation would preclude a member from ever seeking judicial resolution of LLC member status. If simply filing a petition to seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, or similar relief under any statute, law or regulation or files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him in a proceeding of such nature . . . (emphasis added).

The focus of the parties’ disagreement was the phrase “for himself” in subsection (4)(c). Bone contended that “for himself” means for the member’s own benefit and, thus, Nicolazzi involuntarily withdrew when he petitioned to judicially determine the membership status of the LLC’s two members because he did so for his own benefit. On the other hand, Nicolazzi maintained that “for himself” refers to an entity-member, not a member who is a natural person, as this provision addresses a scenario in which an entity-member files a petition in order to reorganize or otherwise judicially restructure itself. Under Nicolazzi’s reading of the subsection, he did not involuntarily withdraw because he did not, and, as a natural person could not, petition to reorganize or otherwise judicially restructure himself.
determine member status automatically extinguishes membership, then any member who files such a petition loses their standing to bring the petition. This “classic catch-22” and illogical result would eliminate a proper avenue to challenge another member’s status based on their alleged wrongdoing. Furthermore, Bone’s interpretation would contradict other provisions of the Missouri LLC Act, namely a member’s right to seek judicial dissolution of the LLC and the subsequent right to seek liquidation of the LLC’s assets without a lack in standing to bring the action. Third, the court’s interpretation of Section 347.123(4)(c) was supported by consideration of policy, practical and contextual application, and the treatment of comparable statutes in other jurisdictions. The court cited Delaware case law for the proposition that “LLC members have a justifiable and legitimate need to require that fellow members retain certain characteristics or lose their membership status, given that [one] member ‘should not be bound to [another member] with which it never intended or agreed to go into business.’” Section 347.123 reflects such a protective measure because it is concerned with triggering events that change the underlying character of the member. Although the court acknowledged that subsection (4)(c) could apply to either a natural person or an entity as it does not specify a member type, it reasoned that the only practical and contextual application of this subsection is to entity-members because the list of triggering events most naturally affect the structural characteristics of an entity-member. Finally, the court conducted a multi-jurisdictional review in which it found that other courts interpreting similarly worded statutes have rejected the argument that a person automatically relinquishes its membership when the individual member seeks reorganization or dissolution of the LLC rather than for itself.

In sum, based on the court’s interpretation of Section 347.123(4)(c) of the Missouri LLC Act, the court found that Nicolazzi’s filing of a petition for a declaratory judgment to determine LLC member status was not an act of withdrawal under the statute. Thus, the court of appeals reversed the trial court’s judgment on the finding of withdrawal and remanded the case for the trial court to reconsider Nicolazzi’s member status.

Judicial Dissolution

**Dystart v. Dragpipe Saloon, LLC, 933 N.W.2d 483 (S.D. 2019).**

The South Dakota Supreme Court held that judicial dissolution of an LLC was not warranted where the LLC operating agreement contained a broad purpose clause that included the LLC’s activities, the LLC had begun to show a modest profit in recent years, the members’ failure to agree on the sale of the LLC’s property did not prevent the LLC from continuing to operate consistent with its stated purpose or frustrate its economic purpose, and there was no impenetrable deadlock that resulted in one faction of members benefitting to the prejudice of the others.

Four individuals formed Dragpipe Saloon, LLC (“Dragpipe”) in 2003, and each received a 25% membership interest and voting rights. Dragpipe purchased 74 acres of land near Sturgis, South Dakota, and built a bar that is open only during the Sturgis Motorcycle Rally. About eighteen acres were used for the bar, and the remaining acreage was leased to a farmer and later used by the LLC as a campground. Beginning in 2004, Dragpipe was open during the annual motorcycle rallies, selling beverages and t-shirts, hosting food vendors, and providing live entertainment.

After the 2015 rally, two of the members advised the other two members that they wanted to sell their membership interests. The non-selling members did not object, but the members who wanted to sell their interests were unsuccessful. In early 2017, three of the members signed an agreement with a real estate agent intending to offer to sell the Dragpipe property. The fourth refused to sign the agreement.

Two of the four members of Dragpipe sought judicial dissolution and an order authorizing the sale of Dragpipe’s assets. Under the South Dakota Limited Liability Company Act, an LLC is dissolved “on application by a member…upon entry of a judicial decree that (i) the economic purposes of the company is likely to be unreasonably frustrated…[or] (iii) it is not otherwise reasonably practicable to carry on the company’s business in conformity with the articles of organization and its operating
agreement.” Following a trial, the circuit court ordered dissolution and the sale of Dragpipe’s assets. The other members appealed, arguing that the circuit court erred in concluding that it was not reasonably practicable for Dragpipe to continue in accordance with the provisions of its operating agreement and that Dragpipe’s economic purpose was unreasonably frustrated.

Dragpipe’s operating agreement stated that the LLC’s purpose was “to engage in all lawful activities, including, but not limited to, owning, purchasing, taking, leasing, or otherwise holding or acquiring real property and any interest or right in real property and any improvements thereon, and to hold, own, operate, control, maintain, manage and develop such property and interests in any manner that may be necessary, useful or advantageous...[to the] company.” The court noted that Dragpipe’s purpose was very broad, and included purchasing real property and holding, owning, operating, maintaining and managing such property, which was essentially what Dragpipe had done since its formation and continued to do. The court stated that the members who sought dissolution may “have grown weary of Dragpipe’s lukewarm revenue” over the years, but that did not itself indicate the LLC was not carrying on its business in conformity with the operating agreement. In addition, the two members’ desire to sell Dragpipe’s real property and realize the gain from their investments did not mean Dragpipe was unable to continue to operate in accordance with its stated purposes.

The South Dakota Supreme Court also found that the circuit court erred in its determination that the economic purpose of Dragpipe was likely to be unreasonably frustrated. Without judicial dissolution, the court believed Dragpipe would continue to operate as it had in the past. Even if sale of the property was the most likely means of making money for Dragpipe’s members, the members’ failure to agree about the sale of the property did not mean that the economic purpose of Dragpipe was likely to be frustrated. The court noted that the members who sought dissolution had the right under the operating agreement to resign and receive the fair market value of their interests, but they did not attempt to avail themselves of that option.

Finally, the court also noted there was no “impenetrable deadlock” among the members and that it did not appear that one faction of members was benefitting from the disagreement relating to the sale of Dragpipe’s real estate to the prejudice of the other members. Also, the parties worked together at the 2017 rally, suggesting there was no impenetrable deadlock.

In sum, the court concluded that the “drastic remedy” of judicial dissolution was not supported and reversed the circuit court’s judgment.


The Colorado Court of Appeals affirmed judicial dissolution of four LLCs owned by a mother and son based on circumstances that included inability of the members to get along, misconduct by the managing member (mother), and operation of the LLCs inconsistently with the primary purpose of providing the other member (son) an occupation and means to support his family. The court also upheld the district court’s order of an in-kind distribution of the four buildings pursuant to a “drop and swap” exchange.

Paula Gagne and her son Richard Gagne created four LLCs to buy and manage four apartment complexes that would be financed by Paula and managed by Richard. The initial LLC operating agreements provided that each LLC would be owned by Paula and Richard on a fifty-fifty basis, but Richard would have a fifty-one percent voting right in each. Shortly thereafter, Paula and Richard’s relationship became increasingly acrimonious and litigation ensued. They eventually settled and subsequently entered into new operating agreements under which Paula held the fifty-one percent voting right in each LLC. Again, the business and the relationship turned sour. Richard sued seeking judicial dissolution of the LLCs as well as a declaratory judgment as to his and Paula’s respective rights and obligations. The case eventually went to trial, and both parties appealed the trial court’s judgment. The appellate court in that appeal (Gagne I) held that the district court applied the wrong
standard for judicial dissolution and remanded to the district court. After remand, the district court held another trial on the judicial dissolution claim and entered an order. The order concluded that dissolution was appropriate and ordered an in-kind distribution of the LLCs’ assets (adjusting each party’s share of the assets’ values to account for money Paula wrongfully withdrew from the LLCs) pursuant to which Richard and Paula would each receive two of the apartment buildings. This distribution was to be accomplished by a “drop and swap” exchange. Paula appealed, and the court ultimately held that the district court did not err in any of the ways posited by Paula.

The first contention presented by Paula on appeal was that the court erred in ordering dissolution of the LLCs. Section 7-80-110(2) of the Colorado Limited Liability Company Act provides that “[a] limited liability company may be dissolved in a proceeding by or for a member or manager of the limited liability company if it is established that it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company.” In Gagne I, the court of appeals held that this standard requires a party seeking judicial dissolution to establish that “the managers and members of the company are unable to pursue the purposes for which the company was formed in a reasonable, sensible, and feasible manner.” The court of appeals in Gagne I specified seven non-exclusive factors to be considered: (1) whether the company’s managers are unable or unwilling to pursue the purposes for which the company was formed; (2) whether a member or manager has committed misconduct; (3) whether it is clear that the members are not able to work with each other to pursue the company’s purposes; (4) whether the members are deadlocked; (5) whether the company’s operating agreement provides a means of resolving any deadlock; (6) whether, in light of the company’s financial condition, there remains a business to operate; and (7) whether allowing the company to continue is financially feasible. No one factor is dispositive, and a party seeking dissolution need not establish every factor. The district court found that the factors weighed heavily in favor of dissolution based on evidence supporting the first five factors, particularly factors (1) and (2), in light of Paula’s substantial misconduct and oppression of Richard.

With respect to the first factor, the district court found that Paula had frustrated the purpose of the LLCs by refusing to work with Richard in any way, shutting him out of any role in decision making, terminating Richard’s corporation’s role as property manager without cause, and giving a primary business role to her other son (Jay), who also refused to work with Richard. The court of appeals rejected Paula’s argument that the district court violated the parol evidence rule by going beyond the four corners of the LLCs’ operating agreements to determine the LLCs’ purposes when analyzing the first factor. The district court found that the LLCs were formed so that Richard “would have an occupation and a means to support his family,” but Paula argued that the purpose was merely “to own and operate a single apartment building.” The appellate court stated that none of the operating agreements contained a specific purpose clause (or any combination of clauses indicating the limited purpose argued by Paula), that the statement of purpose in the operating agreement is merely a starting point in the analysis, and that the district court’s finding did not contradict anything stated in the operating agreements. Thus, the court of appeals found no basis for concluding that the district court applied the law incorrectly in assessing this factor. Given that the record supported the district court’s additional finding that Paula and Jay were unable and unwilling to allow Richard to have any role in managing the properties, the court of appeals found no error in the district court’s conclusion that the first factor favored dissolution.

With respect to the second factor, Paula unsuccessfully argued that all of the actions characterized by the district court as misconduct on Paula’s part were authorized by the operating agreements, the Colorado Limited Liability Company Act, and/or the business judgment rule. The district court found numerous instances of improper payments by the LLCs for Paula’s personal benefit or interest without any legitimate business purpose, and the court of appeals stated that there was substantial support in the record to support these findings. The court of appeals acknowledged that it is “true that the operating agreements, the Act, and
the business judgment rule would allow a manager of an LLC to do such things as make distributions to members, loan money to the company, pay rent for use of space, hire and fire, seek the advice of professionals, earn reasonable management fees, and obtain reimbursement for expenses incurred while acting on the company's behalf, but the court stated that "none of these sources of authority immunizes Paula from such acts taken purely for self-interest, in bad faith, and in breach of her fiduciary duties to the LLCs and their members." The operating agreements in this case required Paula to perform her managerial duties "in good faith, in a manner reasonably believed to be in the best interest of the" LLC. The court cited provisions of the Colorado Limited Liability Company Act stating that managers must refrain from "engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law" and requiring managers and members to discharge their duties and exercise their rights "consistently with the contractual obligation of good faith and fair dealing." The court cited case law for the proposition that "[m]embers of a limited liability company formed under the Act also owe fiduciary duties to each other and to the company." The district court found, with record support, that Paula breached all these duties and obligations. The court noted that it assumed the corporate business judgment rule applies in the LLC context, but the court concluded that it offered Paula no protection because it does not apply if a manager acts in bad faith or without any reasonable belief that she is serving the company's best interests. In sum, the record supported the district court's finding that the second factor favored dissolution.

The court of appeals concluded that the third factor—whether the members are unable to work with each other to pursue the LLC's purposes—supported dissolution despite Paula's argument that her position as sole manager of the LLCs precluded Richard from complaining about her decisions. Such an argument ignored Paula's contractual, statutory, and common-law obligations of good faith. Paula did not argue that she could work with Richard to accomplish the LLCs' purposes, and the court said any argument to that effect would be meritless given the record of prolonged animosity and conflict between Paula and Richard.

Because Paula did not have the unilateral right to make all management decisions, the appellate court also rejected Paula's argument that her role as chief executive manager and her 51% voting right precluded the court from finding that the fourth factor—deadlock of the members—was satisfied. In particular, the district court found that the operating agreement did not give Paula the unilateral right to refuse to renew the management contract between the LLCs and Richard's management company. This contract was at the heart of the legal dispute between Paula and Richard since the contract was the means by which Richard was active in the LLCs and derived his income. Thus, even though the parties were not deadlocked on all decisions, the record supported a real and material deadlock.

Paula's argument that the fifth factor was not met depended solely on her argument that there was no deadlock. Because the appellate court rejected that argument and the district court found that the operating agreements provided no way around the deadlock, the record supported the fifth factor.

Although the final two factors—the LLCs' financial positions and whether continuation of the LLCs was financially feasible—did not favor dissolution, the appellate court concluded that the district court did not err in ordering dissolution given the evidence supporting the other five factors. The court was particularly concerned about Paula's operation of the LLCs inconsistently with their primary purpose and her serious misconduct (freezing out Richard from operations and benefitting herself at the LLCs' and Richard's expense), in addition to the fact that the parties simply could not get along. The court cited cases in other jurisdictions in which judicial dissolution was ordered in circumstances similar to this case. Thus, the court of appeals concluded that the district court did not abuse its discretion in ordering dissolution of the LLCs based on the district court's findings supporting the first five factors.

Next Paula contended that the district court erred in ordering an in-kind distribution of the LLCs' assets. The court
The district court calculated the amounts due each member and allocated two particular buildings to each member. The court ordered the distribution of the apartment buildings through a “drop and swap” whereby the LLCs would distribute all four properties to both members as tenants in common, and each member would convey his or her interest in the two properties he or she was not retaining to the other (or to an entity created by the other to take title to the properties). The parties were allowed to work together to make these transfers in a manner that would qualify for tax advantages under 26 U.S.C. § 1031 (a “1031 exchange”). Paula made several arguments attacking the district court’s in-kind distribution order.

Paula first argued that the court’s order of an in-kind distribution was precluded by the LLC’s operating agreements based on provisions giving her the “sole right” to sell LLC assets and requiring the members to “to fully cooperate in the use of a 1031 exchange through a qualified intermediary” in the event of a sale of any assets. The court said that Paula was apparently asserting that such a sale and distribution was the only means of distributing assets, but the court pointed out that the provisions of the operating agreements on which she relied applied only to a sale (and arguably only a sale by Paula) and did not purport to limit a court’s options in a judicial dissolution. Further, the court stated that the operating agreements did not need to expressly authorize an in-kind distribution of assets because the Colorado LLC statute contemplates in-kind distributions in the event of a judicial dissolution and winding up. Thus, the court concluded that the operating agreements did not bar in-kind distributions.

The court also rejected Paula’s argument that the district court pierced the corporate veil without making the necessary findings. The court explained that piercing the corporate veil involves holding an individual liable for corporate obligations or liabilities because of disregard or misuse of the corporate form, which the district court did not do when it ordered in-kind distributions as allowed by the LLC statute.

Paula’s final complaint about the in-kind distribution ordered by the district court related to the drop and swap 1031 exchange method specified by the court. According to Paula, even if an in-kind distribution was not barred by the operating agreements, the drop and swap 1031 exchange method was not appropriate because: (1) the statutory provisions allowing for in-kind distribution by a Colorado LLC do not allow a distribution to be accomplished in this way; (2) section 1031 does not allow an exchange of LLC property; and (3) even if section 1031 allows such an exchange, it will not work in this case. The court rejected each of these arguments. First, the court stated that nothing in the LLC statute supported Paula’s argument that an in-kind distribution cannot be ordered through a 1031 exchange. The appellate court stated that a court in this context has substantial discretion in fashioning an equitable remedy, and the court found no abuse discretion here. Paula cited no legal authority for her second argument. While experts testified that swapping membership interests for each other or for real property cannot qualify for section 1031 treatment, at least one expert testified that the properties would qualify for section 1031 treatment once owned by tenants in common. Thus, the district court ordered a process that would allow the parties to take advantage of section 1031 if they chose to do so. In support of her third argument, Paula pointed to a number of contingencies or steps that would need to occur (such as IRS approval, careful planning, and involvement by banks and title companies), but she did not argue that these were insurmountable obstacles. Such an exchange was expressly contemplated in one section of the operating agreement and was merely an option provided by the court to the parties. Although Paula argued that she would suffer negative tax consequences, she offered no legal argument in support of that contention. For these reasons, the appellate court concluded that the district court did not abuse its discretion by ordering an in-kind distribution of the LLCs’ assets.

Next, the court of appeals rejected Paula’s contention that the court erred in ordering various adjustments to each member’s side of the ledger. She based her position on her own testimony and that of her son Jay and certain other professionals. The appellate court emphasized that the district court found both Paula and Jay almost entirely incredible and that her points merely invited the court to improperly reweigh the
Lastly, the appellate court granted Richard’s request to order Paula to pay his attorneys’ fees incurred on appeal based on a fee-shifting provision in the operating agreements.

**Derivative Suits**

*Saunders v. Briner, 221 A.3d 1 (Conn. 2019).*

The court held that an individual who was a 50% member of two LLCs (and co-manager of one of the LLCs) did not have standing under either the Connecticut LLC Act (which was based on the ABA Prototype LLC Act) or common law to bring derivative claims on behalf of the LLCs. The court held that the lower court had discretion to permit the sole member of an LLC to bring a claim that belonged to the LLC as a direct claim, notwithstanding the general rule that the member lacks standing to bring an action for harm suffered only by the LLC, relying on an exception applicable to closely held corporations under the ALI Principles of Corporate Governance.

The plaintiff, a 50% member of two Connecticut LLCs and co-manager of one of the LLCs, brought derivative claims on behalf of the LLCs against the other 50% member, manager, and co-manager. The operating agreements of the LLCs vested management in the managers of the LLCs and did not contain provisions authorizing a member to bring a derivative action. The plaintiff alleged that he adequately represented the interests of the LLCs and had made demands to remedy the issues on which the plaintiff based his claims and that, to the extent he failed to make a formal demand, such a demand was futile.

Although Connecticut adopted the Uniform Limited Liability Company Act in 2017, Connecticut first recognized LLCs in 1993 when it enacted the Connecticut Limited Liability Company Act (CLLCA), which was modeled after the ABA Prototype Limited Liability Company Act (Prototype Act). The CLLCA was in effect when this suit was filed, and the court addressed as a matter of first impression whether the CLLCA provided for member derivative suits absent a provision authorizing such a suit in the operating agreement. On the basis of the plain language of the CLLCA, the court concluded that the CLLCA did not permit members or managers to file derivative actions. Rather, the CLLCA authorized members or managers to collectively commence an action in the name of the LLC upon a requisite vote of disinterested members or managers.

The CLLCA recognized the right of an LLC to sue or be sued and allowed suits to be brought by or against an LLC in its own name. Section 34-187 provided the procedure that members or managers must follow to file a lawsuit in the name of the LLC. Section 34-187(a)(1) and (b) authorized any member, regardless of whether the LLC was member-managed or manager-managed, to bring an action in the name of the LLC upon the vote of a majority of disinterested members. Section 34-187(a)(2) authorized any manager of a manager-managed LLC to bring an action in the name of the LLC upon the vote necessary under § 34-142(a), which required “more than one-half by number of [disinterested] managers ....” The court explained that Connecticut modeled this procedure on § 1102 of the Prototype Act, and the drafters of the Prototype Act made clear that this provision does not permit derivative suits unless they are authorized in the operating agreement. The drafters created a substitute for the derivative action, which they deemed more appropriate “in closely held firms like the typical [limited liability company] ... [in which] members can be expected to be actively interested in the firm, and ... can readily be coordinated for a vote on a suit by the firm.” The court recognized that there may be little difference between the derivative remedy and the one provided by § 1102 of the Prototype Act given the closely held nature of many LLCs, explaining that “[p]ractically, the two types of actions—member initiated and derivative—differ in that, in a derivative action, the parties litigate whether demand was made or whether it was futile and, in a member initiated action, the parties litigate whether a given member’s or manager’s interest was adverse to the company.” Nevertheless, the court concluded that the plaintiff in this case was required to follow the procedure provided by the CLLCA, which was the LLC statute in effect when the action was brought, and the CLLCA required him to allege that he did not need to request a vote
of the other 50% member and manager, whose interests were adverse to that of both LLCs. Thus, the plaintiff failed to allege that he undertook the proper procedure to maintain standing under the CLLCA. “Although the allegations set forth in the plaintiff’s second amended complaint—namely, that he was a member or manager of both companies and that either he made demands on [the other member and manager] or such demands were futile—comport with the procedural requirements for bringing a derivative action under the CLLCA, they do not comply with the requirements for bringing a member initiated action under the CLLCA.”

The plaintiff asked the court to recognize a right on the part of members and managers to sue derivatively under the common law despite the legislature’s omission of a derivative remedy in the CLLCA, but the court concluded that recognition of such a right would conflict with and frustrate the purpose of the CLLCA. The court observed that other Prototype Act jurisdictions have held that members and managers of LLCs must follow the procedure for bringing a member initiated action and lack standing to bring derivative actions under the common law. Thus, the plaintiff did not have standing to sue derivatively under the common law.

Next the court addressed the plaintiff’s direct claims for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing based on the failure to repay a loan made by the plaintiff’s single-member LLC. The defendants argued that the plaintiff lacked standing to bring a direct claim seeking repayment because he lacked a distinct and separate injury from his LLC, and that the claim must be brought by the plaintiff’s LLC. The plaintiff argued that the general rule should not apply because he financed the loan with his personal capital through his wholly owned company.

The court noted that it had not previously addressed the specific question of whether the member of a single-member LLC has standing to bring an action directly on behalf of the company although the court had previously relied on the direct injury requirements imposed on shareholders to derive the general rule that members of LLCs cannot bring a direct action alleging harm to the company. Th court observed that the rule prohibiting shareholders from bringing a direct action to recover for a harm suffered by the corporation addresses the following policy rationales: (1) the protection of other shareholders and creditors of the company; (2) the avoidance of multitudinous litigation; and (3) the equal distribution of recovery to injured parties.

An action brought by one shareholder on behalf of the company or derivative action alleviates the concerns posed by the direct action.

The court discussed exceptions to the corporate rule recognized by courts in some other jurisdictions and the American Law Institute, and those authorities persuaded the court to adopt a “narrowly tailored exception [that] can provide a more flexible mechanism for addressing member standing.” In this regard, the court concluded “that the trial court may permit the member of a single-member limited liability company to bring an action raising derivative claims as a direct action and may order an individual recovery if it finds that to do so will not (1) unfairly expose the company or defendants to a multiplicity of actions, (2) materially prejudice the interests of creditors of the company, or (3) negatively impact other owners or creditors of the company by interfering with a fair distribution of the recovery among all interested parties.” The court determined that the trial court properly exercised subject matter jurisdiction over the plaintiff’s direct claims because the trial court’s exercise of jurisdiction implicitly relied on and was supported by these three factors.

Three justices concurred in part and dissented in part. These justices disagreed with the majority’s decision to adopt the American Law Institute’s approach to close corporation standing to hold that the plaintiff had standing to raise the direct claims relating to his single-member LLC’s loan. The dissent’s reasoning was based on the factual context in which the exception was being applied as well as policy concerns.


Two ousted members of a Georgia LLC brought a direct action against a third member and several of his entities, alleging
that the defendants carried out a takeover scheme by causing a funding crisis. The court of appeals affirmed in part, holding that the ousted members could bring a direct action against the third member and stated claims for breach of the operating agreement, breach of fiduciary duty, fraud, and veil piercing. However, the court reversed in part and held that the third member's alleged breach of fiduciary duties was not a violation of a membership interest purchase agreement.

Dr. Goldsmith, a neurologist who specialized in complex ear procedures, started ICOT Hearing Systems, LLC (“ICOT Hearing”) to provide low-cost hearing aids. Jason Jue became involved in the early stages of ICOT Hearing and assisted in building the company into a multimillion-dollar enterprise, running the day-to-day operations as its sole manager. ICOT Hearing was wholly owned by ICOT Holdings, LLC (“ICOT Holdings”). Prior to the events at issue in this case, Goldsmith and Jue together held a majority interest in ICOT Holdings and controlled ICOT Hearing and ICOT Holding (collectively, “ICOT”). Tracy Young founded and controlled the operations of TMX Finance LLC, TitleMax of Texas, Inc., and TitleMax of Georgia, Inc. (collectively, the “TMX Defendants”), which were a “family of companies” consisting of title pawn companies and other businesses.

In August 2015, Young began personally lending money to ICOT. Goldsmith, Jue, and Young shared the goal of selling ICOT to a third party for upwards of “hundreds of millions of dollars in the near term.” Young encouraged Jue to “put his foot on the gas” regarding ICOT operations and assured Jue and Goldsmith that he would provide more funding.

In March 2016, ICOT Hearing, ICOT Holdings, Jue, Goldsmith, Young, and Young’s limited liability company, TY ICOT Investments (“TY Investments”), entered into a restructuring agreement under which Young loaned additional funds to ICOT Hearing and guaranteed two bank loans (the “Restructuring Agreement”). As part of the restructuring, TY Investments purchased membership units in ICOT Holdings from Goldsmith and minority members and obtained exclusive one-year options to purchase additional units from Goldsmith and minority members. TY Investments' purchase and its options were memorialized in a Membership Interest and Purchase Option Agreement entered at the time of the restructuring of ICOT Holdings (the “Goldsmith Agreement”). As an additional part of the restructuring, ICOT Holdings and its members executed an Amended and Restated Operating Agreement (the “Operating Agreement”), which contained provisions placing certain duties on the company’s managers, including the duties to conduct the business in good faith, to not engage in wrongful conduct, and to act in a manner that would not result in improper personal benefit to the managers. The Operating Agreement also provided to TY Investments the power to appoint one of three managers to ICOT Holdings’ board of managers. TY Investments then appointed Young, who agreed to comply with the terms of the Operating Agreement while serving in that position. Following the restructuring and prior to execution of the options, Jue and Goldsmith retained their controlling interest in ICOT Holdings. On the other hand, if TY Investments had executed all of the options it acquired as a result of the restructuring, then Young, through TY Investments, would have a majority interest in ICOT Holdings.

In March 2017, Goldsmith and Jue filed a direct action against Young and TY Investments (collectively, the “Young Defendants”) and against the TMX Defendants. The plaintiffs’ amended complaint included claims for breach of the Operating Agreement, breach of fiduciary duties, breach of the Goldsmith Agreement, fraud, vicarious liability of the TMX Defendants based on the conduct of their personnel, veil piercing, civil conspiracy, and aiding and abetting a breach of fiduciary duty.

The complaint alleged that, after the restructuring, Young orchestrated the following takeover scheme in order to obtain a controlling interest in ICOT Holdings without having to exercise the options: (1) caused an “existential funding crisis” by derailing funding from third-party capital providers; (2) refused to sign the guarantee for a previously negotiated line-of-credit unless he received warrants from Goldsmith and Jue, resulting in short-term cash flow problems; (3) drove away third-party buyer with statements that put the company's
financial health in a poor light, disparaged Jue, and threatened to dilute the membership interests of Goldsmith and Jue; (4) initiated an inspection of ICOT’s books and records in preparation for the takeover; (5) leveraged the funding crisis to control ICOT Holdings’ board of managers by appointing an ally, misrepresenting that ally’s appointment was necessary for ICOT Holdings to draw on the line-of-credit; (6) coordinated vote with the ally to terminate Jue as manager of ICOT Hearing; and (7) diluted Goldsmith and Jue and obtained majority control by issuing a capital call when he knew that the line-of-credit was available and that the plaintiffs lacked the funds to make a pro rata contribution pro rata. After Young took control of ICOT Holdings, he contacted the same third-party buyer and proposed a discounted sale. Considering their diluted position and the discounted sale price, neither Goldsmith nor Jue would receive money from the sale. The defendants answered and later moved to dismiss, contending that the plaintiffs were not entitled to bring a direct claim and had failed to state any viable claims against them. The trial court denied the defendants’ respective motions. The defendants filed applications for interlocutory appeal, which the court granted, leading to the present companion appeals.

The court first considered the Young Defendants’ argument that the plaintiffs’ claims were derivative in nature because they were not separate and distinct from other members of ICOT Holdings and, thus, had to be brought pursuant to the procedural requirements for filing a derivative action under the Georgia Limited Liability Company Act. The court acknowledged the general rule that dilution claims are derivative because they do not constitute a separate and distinct injury but noted an exception where wrongdoers have seized control of the entity by fraud. Because the plaintiffs’ loss of control resulted from Young’s alleged takeover scheme in breach of his fiduciary duties as a manager and through false representations and omissions about funding, the court determined that the plaintiffs could bring a direct claim against the Young Defendants because the alleged harm to plaintiffs was different from that experienced by the company and its minority members and this special injury was sufficiently pled. Furthermore, the court determined that Goldsmith was entitled to bring a direct action for the alleged breach of the Goldsmith Agreement and Jue was entitled to bring a direct action based on his alleged wrongful termination as manager of ICOT Hearing.

Marx v. Morris, 925 N.W.2d 112 (Wis. 2019).

The Wisconsin Supreme Court concluded that: (1) corporate principles of derivative standing do not apply to an LLC, and the members of an LLC have standing to assert individual claims against other members and managers of the LLC based on harm to the members or harm to the LLC; (2) common-law claims for breach of fiduciary duty, unjust enrichment, and breach of the covenant of good faith and fair dealing survived summary judgment because the claims were not displaced by particular provisions of the Wisconsin LLC statute or the LLC’s operating agreement; and (3) genuine issues of material fact existed with regard to the claim that an individual violated Wis. Stat. § 183.0402(1) by willfully failing to deal fairly with the LLC or its members, and potentially with regard to the common-law claims.

North Star Sand, LLC (“North Star”) was formed under Wisconsin law in 2011 to own and mine land containing silica sand (a type of sand used in fracking operations). North Star’s membership consisted of six LLCs, each of which was owned by a different individual. The individual owners of these six LLCs were Marx, Murray, Morris, Johnson, Glorvigen, and Toy. Morris was North Star’s attorney as well as a manager (in his capacity as a “director”) and assisted in drafting its operating agreement. The agreement permitted members to pursue outside business opportunities and transact business with companies who had business relationships with North Star. The agreement also required prior notice of any vote that may occur at a members’ meeting as well as prior notice of any matter to be voted upon at a directors’ meeting.

North Star formed a wholly owned subsidiary, Westar Proppants, LLC (“Westar”), to hold numerous option agreements for the purchase of land with
silica sand reserves. As the expiration date of the option agreements approached, the members became concerned that North Star and Westar had too much land under option, and the members discussed the possible cancellation of some of the options. On December 31, 2013, the date the options were set to expire, the members of North Star met by telephone to discuss Westar's future. Morris informed the other members during this meeting that he and two other individuals, Green and Wesch, had formed DSJ Holdings, LLC (“DSJ”), and that DSJ was interested in purchasing Westar for $70,000. Morris also informed the members that he had an ownership interest in DSJ. Glorvigen made a motion that North Star keep Westar, and the motion passed by a vote of 4 to 2 (with Morris and Johnson voting against it). Immediately after the vote, an argument ensued and Morris became “very aggressive” and indicated he might withdraw from North Star. Morris then made a motion to sell Westar to DSJ for $70,000, to which Murray immediately objected, arguing that there had already been a vote, that there was insufficient notice, and that Morris had a conflict of interest. Despite these objections, a second vote occurred, and Morris’s motion passed by a vote of 4 to 2 (with Marx and Murray voting against it). DSJ subsequently assigned its membership units in Westar to Morris’s LLC and to Wesch, and they eventually sold Westar to Unimin Corporation in 2015 for an allegedly substantial sum (which was not disclosed due to a confidentiality order). In August 2014, North Star unanimously voted to sell its remaining silica sand land assets in an unrelated transaction in which each member signed a “Member Distribution Receipt and Acknowledgement.” Morris later asked Marx and Murray to sign a separate, all-encompassing release, but each refused to do so.

Marx and Murray alleged five causes of action against Morris and his LLC: (1) violation of Wis. Stat. § 183.0402(1) upon Morris’s willful failure to deal fairly with them while having a material conflict of interest in the transaction; (2) breach of fiduciary duty; (3) breach of fiduciary duty as corporate counsel; (4) unjust enrichment; and (5) breach of implied covenant of good faith and fair dealing. These actions were brought by their LLCs and in their personal capacities rather than in the name of North Star. Morris moved for summary judgment on all claims, arguing that Marx’s and Murray’s claims belonged only to North Star, and that the Wisconsin Limited Liability Company Law supersedes and replaces any common-law duties of LLC members. The motion was denied by the circuit court, which held that there were disputed issues of material fact on the Wis. Stat. § 183.0402 claim. The court of appeals then certified an appeal to the Supreme Court of Wisconsin to answer two questions: (1) Does an LLC member have standing to assert a claim against another member of the LLC based on an injury suffered primarily by the LLC, rather than the individual member asserting the claim? and (2) Does the Wisconsin Limited Liability Company Law preempt an LLC member’s common-law claims against another member based on the second member’s alleged self-dealing? The Wisconsin Supreme Court answered “yes” to the first question, holding that a member has standing to assert claims against other members and managers because corporate principles of derivative standing do not apply to an LLC. The court answered “no” to the second question, holding that the common-law claims had not been displaced by the LLC’s operating agreement or the LLC statute. The court also concluded that there were genuine issues of material fact as to whether Morris violated the Wisconsin LLC statute by dealing unfairly with Marx and Murray, as well as potential issues of fact regarding the common-law claims. The circuit court’s decision was thus affirmed and remanded.

The Wisconsin Supreme Court provided a general overview of limited liability companies, characterizing LLCs as combining “desirable features of two other business forms, partnerships and corporations.” The court generally traced the development of state LLC statutes and federal income tax treatment and summarized significant provisions of the Wisconsin LLC statute. Turning to specific provisions of North Star’s operating agreement, the court focused on the fact that “the Agreement unambiguously elected that North Star is to be treated as a partnership where all the losses and gains of the LLC flow through to its individual members.” The court explained that this choice and the provisions of the operating agreement assured that all the income, gain, loss, and
deductions would pass through to the members as if North Star were a partnership. For that reason, the court concluded that “an injury to North Star is not the same as an injury to a corporation.”

With respect to the issue of standing, the court contrasted the detailed corporate statutes and long history of case law in Wisconsin addressing corporate principles of derivative standing with the law in the LLC context, and the court declined to import corporate principles of derivative standing into the LLC statute. The court stated that the only provision of the Wisconsin LLC statute relating to suits in the name of an LLC is Wis. Stat. § 183.1101, which provides in relevant part:

(1) Unless otherwise provided in an operating agreement, an action on behalf of a limited liability company may be brought in the name of the limited liability company by one or more members of the limited liability company, whether or not the management of the limited liability company is vested in one or more managers, if the members are authorized to sue by the affirmative vote as described in § 183.0404(1)(a).

The court explained that this provision does not require claims against LLC members to be brought in the name of the LLC nor limit the members’ ability to sue members or managers in their individual capacities. According to the court, § 183.1101 “merely requires that if an action of any kind is to be brought in the name of the LLC, against anyone, it must be authorized by a majority vote of disinterested members.” The court reasoned that “Section 183.1101, which is silent on a member’s right to sue on his own behalf, does not abrogate the plain language of Wis. Stat. § 183.0402(1)(a), which prohibits the ‘willful failure to deal fairly with the limited liability company or its members’ by a member or manager.” The court stated that its conclusion was “not driven by who ‘owns’ the claim, but rather by Wis. Stat. § 183.0402 and the partnership-like mode of operation of North Star selected in its Operating Agreement.” The court rejected Morris’s argument that § 183.0402(2) denies a member standing to assert individual claims under § 183.0402(1). Section 183.0402(2) requires a member or manager to account to the LLC and hold as trustee for the LLC any improper personal benefit obtained under various circumstances. According to the court, Morris’s argument mistakenly assumed that injuries to North Star and injuries to individual members were mutually exclusive. Because North Star elected partnership—i.e., flow-through—treatment, the court stated that “there is generally a much closer financial connection between harm to an LLC and harm to its members than between harm to a corporation and harm to its shareholders.” Marx and Murray alleged that Morris, individually and through his LLC, failed to deal fairly with them in connection with a matter in which he had a material conflict of interest, contrary to his statutory and common-law duty as a member and manager, and that Marx and Murray were injured as a result. The court concluded that Marx and Murray had standing to assert this claim whether North Star was also injured and whether the injury to Marx and Murray was independent of or secondary to North Star.

The court next addressed the issue of whether the common-law claims were preempted by the Wisconsin LLC Act. The court first pointed out that the answer to that question depended on the specific common-law claims brought by a member and the facts attendant to those claims. Here, those claims were breach of fiduciary duty, unjust enrichment, and breach of the covenant of good faith and fair dealing. Second, the court noted that Wis. Stat. § 183.1302(2) provides that “[u]nless displaced by the particular provisions of this chapter, the principles of law and equity supplement this chapter.” Because this provision had not yet been interpreted by a Wisconsin court, the Wisconsin Supreme Court applied standard statutory interpretation principles to conclude that this provision should be interpreted broadly as permitting common-law claims and defenses that have not been specifically abrogated or displaced. Because the LLC statute does not state or imply that Wis. Stat.§ 183.1302(2) reflects the entirety of a member’s or manager’s obligations to other members and the LLC, and because the record did not indicate the full scope of the common-law claims (i.e., whether they included only allegations within the ambit of § 183.0402(2) or something more), the common-law claims survived summary judgment based on the record before the court.
Lastly, the court concluded that the circuit court properly denied Morris’s motion for summary judgment because there were genuine issues of material fact as to whether Morris violated § 183.0402(1) by a willful failure to deal fairly with Marx, Murray, and/or North Star in connection with a matter in which he had a material conflict of interest. Specifically, Marx and Murray successfully relied upon the provision of North Star’s operating agreement specifying the requisite notice prior to voting on a matter at a meeting. Marx and Murray raised a genuine issue of material fact by alleging that Morris unfairly influenced the vote by failing to give the required advance notice and by providing false information to the members at the meeting. With regard to the common-law claims, the case had not been sufficiently developed for the court to determine whether genuine disputes as to material facts existed for those claims. The court went on to explain why there were genuine disputes as to material facts regarding the § 183.0402(1) claim despite a provision in North Star’s operating agreement permitting pursuit of other business opportunities, a receipt and acknowledgment document signed by the members in connection with another transaction, and consent to the sale of Westar to DSJ by a majority of disinterested members.

The court explained that the “Business Opportunities” clause in North Star’s operating agreement did not unambiguously supplant Wis. Stat. § 183.0402(1), but rather was entirely consistent with § 183.0402(1). The operating agreement provided:

The individuals serving as Directors, as well as the Members and their respective officers, board of directors, directors, shareholders, partners, and affiliates, may engage independently or with others in other business ventures of every nature and description. Nothing in this Agreement shall be deemed to prohibit any Director, or the Members or their respective officers, board of directors, directors, shareholders, partners, and affiliates, from dealing or otherwise engaging in business with Persons transacting business with the Company. Neither the Company, any Director, or any Member shall have any right by virtue of this Agreement, or the relationship created by this Agreement, in or to such other ventures or activities, or to the income or proceeds derived from such other ventures or activities, and the pursuit of such ventures shall not be deemed wrongful or improper.

According to the court, North Star’s members were “free to engage in business with persons transacting business with North Star, provided that they do so fairly. The claim in this case is that Morris did so unfairly.” The court thus concluded that the clause did not prevent Marx and Murray from asserting their claims against Morris.

Next, the court addressed a document entitled “Member Distribution Receipt and Acknowledgements” signed by Marx and Murray after a transaction in 2014 pursuant to which North Star sold its remaining sand land assets. The court concluded that the scope of the receipt and acknowledgment document was limited to that particular transaction and did not constitute a release of any member’s claims against Morris in connection with the unrelated Westar transaction.

Finally, the court rejected Morris’s argument that consent to the Westar transaction by a majority of disinterested North Star members precluded a claim under § 183.0402(2). According to the court, “Wis. Stat. § 183.0402(2) does not limit the scope of Morris’s duties to his fellow North Star members under § 183.0402(1). Section 183.0402(2) merely tells Morris what he must do if he derives an improper personal profit without the consent of a majority of disinterested members. It does not state that a violation of § 183.0402(1)(a) is excused so long as a majority of disinterested members consent to the unfair treatment of another member. Therefore, even if a majority of disinterested members were to have voted to approve the sale of Westar to DSJ, this would not affect Marx and Murray’s § 183.0402(1)(a) claim against Morris.”

In sum, the court concluded that (1) corporate principles of derivative standing do not apply to an LLC, and the members of an LLC have standing to assert individual
claims against other members and managers of the LLC based on harm to the members or harm to the LLC; (2) Marx’s and Murray’s common-law claims survived summary judgment because the claims were not displaced by particular provisions of the Wisconsin LLC statute or North Star’s operating agreement; and (3) genuine issues of material fact existed with regard to Marx’s and Murray’s claim that Morris violated Wis. Stat. § 183.0402(1), and potentially with regard to the common-law claims. Thus, the court affirmed the order of the circuit court and remanded for further proceedings.

In a partial concurrence/partial dissent, the dissenting justice took issue with the majority’s opinion to the extent the majority established the following propositions: (1) a non-member may sue an LLC’s members based on the LLC’s management decisions; (2) a non-member may sue another non-member based on an LLC’s management decisions; (3) a member of an LLC may sue a non-member for the LLC’s management decisions; and (4) an LLC member may pursue a claim against another LLC member (or a member of the member) without regard to whether the plaintiff actually owns the claim. The dissenting justice explained that these four conclusions all stemmed from a failure to recognize that the distinction between an LLC and its members necessarily affects who may bring what types of actions against which defendants. Further, the dissenting justice argued that the Wisconsin LLC statute necessarily incorporates the concept of derivative standing and that taxation and profit distribution issues do not distinguish LLCs from corporations in any sense relevant to this case. Two additional propositions of the majority with which the dissenting justice disagreed were that: (5) members of an LLC owe each other fiduciary duties; and (6) an attorney owes fiduciary duties not just to the organization it represents, but also to the constituent members of that organization. The dissenting justice argued that fiduciary duties are not owed by members of an LLC to one another, and that an LLC’s attorney has a fiduciary obligation to the LLC, not its members.

Charging Order

Wells Fargo Equip. Fin., Inc. v. Retterath, 928 N.W.2d 1 (Iowa 2019).

The Iowa Supreme Court affirmed the judgment of the district court in favor of a judgment creditor seeking to enforce a charging order against the judgment debtor’s membership interests in an Iowa LLC. The court held that, for the purposes of determining the enforceability of a charging order, a member’s membership interest is located in the LLC’s state of formation.

Jason and Analia Retterath were married and Florida domiciliaries when Jason acquired a membership interest in Homeland Energy Solutions, LLC (“Homeland”), an Iowa LLC, by purchasing a number of membership units. After Jason obtained additional membership units several years later, he transferred all of the units to himself and Analia. Wells Fargo Equipment Finance, Inc. (“WFEFI”) held two Florida judgments against Jason. WFEFI sought to enforce these judgments against Jason’s membership interest in Homeland and obtained a charging order from an Iowa district court. The Retteraths filed a petition to vacate the charging order. Among other claims, the couple asserted that Florida law governed their ownership of the units as tenants by the entireties and made their ownership unavailable to satisfy a judgment debt of one of them individually. WFEFI asserted in its answer that Iowa law governed this dispute and the legal doctrine of tenancy by the entireties did not exempt Jason’s membership interest in Homeland from the judgment. The district court granted summary judgment in favor of WFEFI and dismissed the Retteraths’ petition, concluding that Iowa law applied and a tenancy by the entireties did not exist even if Florida law did apply because the couple did not receive title from the same conveyance. The Retteraths appealed.

The court began its analysis by noting that the location of a member’s membership interest in an LLC was a matter of first impression in Iowa. According to the Retteraths, the situs of their Homeland membership units was their domicile of Florida under Iowa law governing personal property. The court reached a different conclusion and held that, for the purposes of determining the enforceability of a charging order, a member’s membership interest is located in the LLC’s state of formation. The
court did agree that the Retteraths’ interests in Homeland were personal property and acknowledged that it had previously held that the law of the owner’s domicile, not the law of the state of formation, governs the situs of similar forms of intangible person property (e.g., corporate stock). The court reasoned, however, that an interest in an LLC is distinguishable from other forms of intangible personal property because the typical levying procedures available for those forms are unavailable to creditors attempting to levy against a membership interest. The court cited the Iowa Revised Uniform Limited Liability Company Act (the “Iowa LLC Act”) for the proposition that a charging order is the exclusive remedy by which a judgment creditor seeking to enforce a judgment against a member may satisfy that judgment from the judgment debtor’s “transferable interest.” Iowa Code § 489.503(7). The court explained that a charging order requires the LLC to reroute to the judgment creditor any distribution that would otherwise be paid to the judgment debtor, and is premised upon the ability to separate an individual member’s economic interest from LLC operations and the interests of other members. The court emphasized the fact that charging orders are a remedy unique to interests in an LLC and unavailable for other forms of intangible personal property under Iowa law. The court also cited the Iowa LLC Act for the proposition that Iowa law characterizes the LLC as the core of the “transferable interest,” while the individual member and their location are secondary. Iowa Code § 489.102(24). Further, the court reasoned that its holding recognizes Iowa’s authority to govern an LLC’s internal affairs and membership interests, promotes uniformity, avoids the uncertainty that would result if an LLC were subject to charging orders from differing foreign jurisdictions, and creates certainty for creditors by providing a fixed jurisdiction to pursue charging orders. Because Homeland was an Iowa LLC and its membership interests were located in Iowa, the court affirmed the district court’s judgment applying Iowa law and dismissing the Retteraths’ petition because Iowa law does not recognize a tenancy by the entireties.


Because there was an unresolved factual dispute as to whether the judgment debtor in this proceeding was the sole member or one of two members of an LLC, the court of appeals reversed the trial court’s order, which not only granted to the judgment creditor a charging order against the judgment debtor’s LLC interest, but also transferred all of the judgment debtor’s “right, title, and interest” in the LLC to the judgment creditor.

A law firm obtained a judgment against an individual, Pansky, for unpaid fees incurred in a divorce and moved for a charging order against an LLC in which Pansky had an ownership interest. The law firm also sought a transfer of Pansky’s ownership interest in the LLC to the law firm. Pansky conceded that the law firm was entitled to a charging order but objected to a transfer of his ownership interest in the LLC.

At a hearing on the law firm’s motion, the trial court orally ruled, based on Pansky’s concession, that an agreed order granting a charging order would be entered. The court stated that it would reserve ruling on any additional relief beyond a charging order that the law firm requested.

However, when the trial court entered a written order granting the charging order, it also transferred Pansky’s “right, title, and interest” in the LLC. Pansky appealed from that order.

Section 605.0503(3) of the Florida LLC statute provides that, subject to an exception for a single-member LLC, “a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member’s transferee may satisfy a judgment from the judgment debtor’s interest in a limited liability company or rights to distributions from the limited liability company.” In the case of a single-member LLC, § 605.0503(4) provides that, “if a judgment creditor of a member or member’s transferee establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment within a reasonable time . . ., the court may order the sale of that interest in the limited liability company pursuant to a foreclosure sale.” The parties disputed whether the LLC had one or two members (Pansky claiming it had two, and
the law firm claiming it had one), and the trial court commented at the hearing that it did not have enough in front of it to determine whether it could provide all the relief requested by the law firm. The trial court stated that it would enter a charging order based on Pansky's agreement that the law firm was entitled to that much relief.

The court of appeals cited Florida case law regarding the permissible scope of a charging order, and the court reversed and remanded for further proceedings because the trial court's order—which clearly purported to transfer Pansky's "right, title, and interest" in the LLC to the law firm—went beyond granting a charging order, which was the relief agreed to by the parties and authorized by statute.

Series LLCs


The court denied the defendant's motion to dismiss an LLC plaintiff's claims for lack of standing. The defendant argued that the LLC lacked capacity to sue on the claims on behalf of the LLC’s series. The court concluded that Section 18-215(c) of the Delaware Limited Liability Company Act allows an LLC to sue on behalf of its series if the limited liability company agreement permits the LLC to do so.

The plaintiffs, MSP Recovery Claims, Series LLC and MSPA Claims I, LLC, brought two putative class actions against various corporate entities within the Farmers Insurance Group of Companies (collectively, "defendants"). The plaintiffs sought reimbursement and penalties relating to the defendants' alleged failure to reimburse Medicare Advantage Organizations for medical expenses incurred treating Medicare beneficiaries. The plaintiffs alleged that they were the assignees of numerous Medicare Advantage Organizations and related entities. The defendants contended that MSP Recovery Claims, Series LLC lacked standing because it was "not the 'final' assignee per the agreements." The defendants alleged that the signatories to the agreements were "eight other 'series' LLCs . . . namely Series 16-11-509 LLC, Series 17-02-564 LLC, Series 16-08-483 LLC, Series 16-10-504 LLC, Series 15-08-27 LLC, Series 15-09-108 LLC, Series 16-08-483, Series 17-04-631 LLC." The defendants also argued that the assignments were invalid because they were signed on behalf of another entity, Series MRCS, LLC. The plaintiffs argued "that each 'final' assignee is merely a 'subseries' of MSP Recovery Claims, Series LLC and does not need to be a party to these actions."

The court provided the following explanation of series LLCs and the standing issue in this case:

Under Delaware law, an LLC may establish one or more 'series of members, managers or [LLC] interests' which 'may have separate rights, powers or duties with respect to specified property or obligations of the [LLC] or profits and losses associated with specified property or obligations' as well as a 'separate business purpose or investment objective.' Del. Code Ann. tit. 6, § 18-215(a). In order to be entitled to this treatment, the LLC must provide for the series in the LLC agreement, keep separate records for each series and separately hold or account for the assets each series of the LLC, and give notice of the limitation on liabilities of a series in the certificate of formation of the LLC, which constitutes notice of the liability limitation. See id. § 18-215(b). 'Unless otherwise provided in a [LLC] agreement, a series established in accordance with subsection (b) of this section shall have the power and capacity to, in its own name, contract, hold title to assets (including real, personal and intangible property), grant liens and security interests, and sue and be sued.' Id. § 18-215(c).

The Court is unaware of any case law construing these provisions to determine whether an LLC has the capacity to pursue litigation on behalf of its series entities. Section 18-215(c) provides that a series 'shall have the power and capacity' to 'sue and be sued' '[u]nless otherwise provided in a [LLC] agreement.' Id. § 18-215(c). This provision may be interpreted to permit an
LLC to sue on behalf of its series if provided for in the operating agreement. Plaintiffs allege that MSP Recovery Claims, Series LLC “maintains the legal right, by and through its limited liability company agreement, to sue on behalf of each of its designated series LLCs.”

In opposition to the defendants’ motions, the plaintiffs attached an amendment to the operating agreement of MSP Recovery Claims, Series LLC. The amendment provided that “the Company is authorized to pursue or assert any claim or suit capable of being asserted by any designated series arising from, or by virtue of, an assignment to a designated series,” but the defendants argued that this amendment could not confer standing because it was executed and made effective after the lawsuit was filed. The court discussed Ninth Circuit case law regarding deficiencies in standing that are cured after the filing of a lawsuit, and the court declined to dismiss the complaints in the instant case. The court observed that dismissal would likely lead the plaintiffs to simply re-file their complaints in the same district, and dismissal would thus be a “needless formality.” The court construed the plaintiffs’ filing of the amendment to MSP Recovery Claims, Series LLC’s operating agreement as a Rule 15(d) supplemental pleading and found it was sufficient to demonstrate MSP Recovery Claims, Series LLC’s standing to assert claims on behalf of its series assignees.

_**Flaten v. Couture, 912 N.W.2d 330 (N.D. 2018).**_

The court held that the trial court did not abuse its discretion in denying a judgment debtor LLC’s post-judgment motion to limit collection on the judgment to property of a particular series of the judgment debtor LLC.

The plaintiff sued A&M Structuring, LLC (“A&M Structuring”) for failure to perform on a contract between the plaintiff and A&M Structuring 7, LLC (“A&M Structuring 7”). After the plaintiff obtained a judgment against A&M Structuring and levied against its bank accounts, A&M Structuring filed a post-judgment motion arguing that A&M Structuring 7 was part of a Nevada series LLC and that “other A&M Structuring LLCs exist as part of the series and are numbered A&M Structuring 1–13.” A&M Structuring further argued that “under Nevada law each series LLC is considered a separate LLC from the other LLCs in the series, A&M Structuring 7 was the only LLC in the series that was a party to the purchase agreements in this case, and therefore only property from A&M Structuring 7 can be levied to satisfy the judgments.” The North Dakota Supreme Court held that the district court did not abuse its discretion by denying A&M Structuring’s motion because:

A&M Structuring, LLC is registered as a limited liability company in Nevada and is the parent entity of the separate series LLCs, including A&M Structuring 7. See Nev. Rev. Stat. §§ 86.1255 (defining “series”) and 86.296 (authorizing a limited liability company to create a series limited liability company). A&M Structuring, LLC is registered in North Dakota as a foreign limited liability company and none of the individual series LLCs, including A&M Structuring 7, are individually registered in this state. [The plaintiff] sued A&M Structuring, LLC and did not name A&M Structuring 7 as a defendant. A&M Structuring, LLC was named as a defendant in every pleading, and the defendants did not move to join A&M Structuring 7 as a defendant. The defendants did not raise an issue about A&M Structuring, LLC being named a party or argue that A&M Structuring 7 was a separate entity and the only party to the purchase agreements and that it was the only party that could be held liable until after the judgments were entered. The judgments were entered against A&M Structuring, LLC and the sheriff levied on its bank accounts. The district court’s decision was not arbitrary or unreasonable, and we conclude the court did not abuse its discretion.

The defendants also claim A&M Structuring 7’s separate entity status as a series LLC under Nevada law must be recognized by North Dakota courts pursuant to the Full Faith and Credit Clause of the...
United States Constitution. Because the judgments were entered against A&M Structuring, LLC and not A&M Structuring 7, it is unnecessary for us to address the defendants’ arguments about the Full Faith and Credit Clause.

Securities Laws

*S.E.C. v. Arcturus Corp.*, 928 F.3d 400 (5th Cir. 2019).

The Fifth Circuit reversed the district court’s summary judgment in favor of the SEC in this civil enforcement action, holding that the defendants raised issues of material fact as to whether the interests in the oil and gas joint ventures at issue were securities.

Leon Parvizian and two entities formed and controlled by him offered and sold interests in six oil and gas drilling projects. Each of these joint ventures had a managing venturer that supervised and managed the day-to-day operations and earned management fees paid by the project. The two Parvizian entities were the managing venturers on all six projects. Potential investors were contacted through a nationwide cold-calling campaign. Because the interests in the drilling ventures were not registered as securities, the SEC filed a civil enforcement action, alleging violations of the Securities Act of 1933 and the Exchange Act of 1934, against Parvizian and his two entities, as well as other entities and related individuals involved in marketing the projects. The SEC argued that the interests in these drilling projects were securities, and the defendants tried to avoid federal securities laws by labeling the projects as “joint ventures” and the investors as “partners.” The district court concluded that the joint venture interests were securities and granted summary judgment in favor of the SEC. (The district court’s opinion was summarized in the materials provided for the case law update presentation at this conference in 2017.) The defendants appealed.

The court of appeals began its analysis by explaining that the Securities Act broadly defines the term “security” to include a long list of financial instruments, including “investment contracts,” the type of security at issue in this case. Congress left it to the courts to define the term “investment contract,” and the Supreme Court did so in *S.E.C. v. W.J. Howey Co.* Under the Howey test, an investment contract qualifies as a security if it meets three requirements: “(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor.” The parties did not contest that the drilling interests met the first two factors of the Howey test; only the third factor was at issue in this case.

While the Fifth Circuit typically employs a strong presumption that an interest in a general partnership is not a security, the court acknowledged that labeling a partner as a general or limited partner does not always reflect the reality of the allocation of power. The court explained:

To guide courts in applying the third Howey factor to these in-between situations, this court set forth the three Williamson factors—the primary source of contention here. These factors flesh out situations where investors depend on a third-party manager for their investment’s success, and each factor is sufficient to satisfy the third Howey factor. Under the Williamson factors, a partner is dependent solely on the efforts of a third-party manager when:

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise
meaningful partnership or venture powers.

The court then proceeded to analyze each Williamson factor in the context of this case.

When examining the first Williamson factor—whether the drilling projects left the investors so little power “that the arrangement in fact distributes power as would a limited partnership”—the court examined the legal documents setting up the arrangement and how the arrangement functioned in practice, including any barriers to the investors’ use of their powers. The court identified six critical issues that were relevant with respect to this factor: (1) the managers' formal powers as compared to the investors' formal powers; (2) whether the investors exercised their formal powers; (3) the voting structure of the drilling projects; (4) information available to the investors; (5) communication among the investors; and (6) the number of investors. Although the managers had a significant amount of formal power, the investors had certain countervailing powers, such as the power to remove the managers upon a 60% vote. The investors also had veto powers as well as the power to demand a meeting, develop rules and procedures governing meetings and voting, amend the joint venture agreement, receive financial information and information about third-party transactions, and inspect the project’s books. In addition to having formal powers, the investors actually voted and took actions to manage the drilling projects, which distinguished this case from others where summary judgment was appropriately granted. The court disagreed with the SEC regarding the effect of the voting structure and financial participation regarding drilling projects, stating that the structure did not present investors with a Hobson's choice as argued by the SEC, but rather must be viewed in the context of an inherently speculative investment such as drilling. The court explained the structure as allowing investors to “stand aside, incur no further costs, and allow the ‘consenting owners’ to proceed with any completion activities desired.” With respect to available information, the court stated that the record suggested that investors were provided email updates on numerous occasions. Also, the record indicated that investors actually communicated by telephone and email. Finally, the court did not view the number of investors—from 35 to 108 in each project—as stripping the investors of their power absent further factual development.

The second Williamson factor examined by the court was whether the drilling project investors were “so inexperienced and unknowledgeable in business affairs” that they were “incapable of intelligently exercising” their powers. An interest in a partnership is more likely to be a security if it is sold to “inexperienced and unknowledgeable members of the general public.” The SEC argued that the investors were inexperienced because the defendants engaged in an indiscriminate cold-calling campaign that did not seek out experienced investors, and there were statements from four investors that they were inexperienced in drilling investments. The court did not find these arguments to be dispositive at the summary-judgment stage, declining to make an inference about a group of over 340 investors based on this limited evidence. Furthermore, the record showed that many investors actually did have experience in oil and gas drilling. Analysis of this factor required consideration of both investors and offerees, but the court could not determine whether offerees were experienced or not based on the limited record at the summary-judgment stage and concluded that this factual determination was better left to the fact finder.

The third Williamson factor examined by the court was whether the investors were so “dependent on some unique entrepreneurial or managerial ability” of the managers that the investors were not able to “replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.” The SEC argued that the managers were irreplaceable as a practical matter not because of some special skill, but because they had the sole ability to enforce drilling contracts with the subcontractors and unfettered control over the drilling projects’ assets. According to the SEC, the structure of the ventures created two problems: (1) if the investors removed the managers, the managers would still be party to the contracts with the subcontractors, making the investors reliant on them because the managers would still have the power to enforce, or not enforce, the drilling contracts; and (2) the managers
controlled all of the investors’ funds. The court was not convinced by the SEC’s arguments. The first argument was unconvincing because the record was “not clear enough to say, as a matter of law, that the web of contracts between the projects, Managers, and subcontractors made the Managers irremovable.” The court stated that the SEC merely assumed that the right to enforce the contracts with drilling subcontractors rested solely with the managers, but no evidence showed that the investors would be unable to enforce a drilling contract upon removal of a manager. Additionally, while the managers made contractual promises to find subcontractors to do the drilling, the court stated that more than contractual promises are required to find that managers are irreplaceable. The SEC’s argument that the managers were irremovable because the managers controlled all the funds failed to convince the SEC because the investors never expected to recover their funds unless the wells became productive, and the investment was segmented into the phases of drilling, completion, and subsequent operations. Thus, on the third Williamson factor, the defendants put forth enough evidence to raise a genuine issue of material fact.

In sum, the court concluded that the defendants raised genuine issues of material fact as to each of the Williamson factors, and the court reversed and remanded for trial.

**Masel v. Villarreal, 924 F.3d 734 (5th Cir. 2019).**

The court of appeals held that the plaintiff adequately alleged that interests in several limited partnerships were investment contract securities, and the district court erred in dismissing those securities-fraud claims because those claims satisfied the heightened pleading requirements under federal securities law.

Intraoperative monitoring (“IOM”) is a method of monitoring a patient’s nervous system during surgery. Adrianna Villarreal owned Medical Practice Solutions, L.L.C. (“MPS”), a medical services billing company that specialized in billing for IOM services. Anthony Casarez was certified to operate IOM machinery and had worked with David Masel, a neurosurgeon with more than thirty years of experience. Casarez informed Masel that the IOM business was very profitable and proposed a meeting between Masel, Casarez, and Villarreal to discuss investment opportunities within the industry. At the meeting, Villarreal told Masel that MPS was capable of generating the highest payouts for IOM procedures because she had developed a special algorithm—or “secret sauce,” in her words—that enabled her to collect more money for each claim. Villarreal also represented that the reimbursement cycle for such claims was around six months. Casarez agreed with and confirmed the veracity of these statements for Masel. The meeting ended with a proposal: if Masel set up businesses that provided IOM procedures, Villarreal and Casarez would manage them, and through Villarreal’s signature billing practices, they could make Masel a substantial profit. In reliance on Villarreal’s pitch, Masel and his business partner (collectively, “Masel”) agreed to her proposal. Instead of writing a check to Villarreal and Casarez, however, Masel established and invested in fifteen entities, each founded for the purpose of providing IOM services, and then hired Villarreal’s companies to operate these entities in exchange for a financial interest.

The first of these entities, Neuron Shield, LLC, contracted with CGR Investments, LLC (“CGR”), a company solely owned by Villarreal, to provide management and billing services in exchange for a 35% non-voting net-profits interest in the company. Masel then formed four limited partnerships, each with “Neuron Shield” and a number in the name. Each Neuron Shield limited partnership agreement listed a corresponding Neuron Shield LLC as the general partner and CGR as a limited partner holding a 35% interest. The limited partnership agreements also provided that the general partner could not make certain decisions, such as receiving a capital contribution or winding up the partnership, without the approval of each partner holding a 20% or greater. CGR’s interest in three of these LPs was later transferred to IOS Management Services, LLC (“IOS”), of which Villarreal was a principal member.

Villarreal’s proposal did not go according to plan. The entire arrangement between the parties collected only $11 million of the $190 million billed for IOM services, the reimbursement cycle lasted
longer than six months, and Villarreal and Casarez redirected business to other clients. Masel sued Villarreal, MPS, CGR, IOS, and Casarez in federal district court, asserting claims under the Securities Exchange Act of 1934 (the “1934 Act”), among others. As to his securities-fraud claims, Masel alleged that Villarreal made various misrepresentations and omissions, that Casarez was liable because he adopted some of Villarreal’s misrepresentations as his own, and that the entity defendants were liable because Villarreal and Casarez made them while acting as their agents. The district court dismissed each of these claims for failure to state a claim, finding that the allegations of securities fraud were either not pleaded with sufficient particularity or nonactionable. The court did not consider the threshold question, which the defendants had raised, whether Masel had adequately pleaded the existence of a security. Masel appealed.

First, the court of appeals addressed the predicate issue of whether Masel had successfully pleaded the existence of a security. Masel sought relief under § 10(b) of the 1934 Act. To successfully state a cause of action under § 10(b), a plaintiff must plead fraud in connection with the purchase or sale of a “security,” which the 1934 Act defines broadly to include an “investment contract.” Based on the United States Supreme Court’s interpretation of “investment contract” in SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946), the Fifth Circuit applies a three-factor test that requires a plaintiff to show “(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor.” Williamson v. Tucker, 645 F.2d 404, 417 (5th Cir. 1981). The third Howey factor was the only one in dispute in this case. The court noted that typically under Howey’s third factor, interests in a general partnership are not securities while limited partnership interests typically are securities. Even so, the type of partnership is not determinative: a limited partnership interest may not be a security when limited partners are given such managerial control that they are no longer dependent on the skills of a promoter or third party.

The court concluded that the limited partnership interests were investment contract securities and that Masel had adequately pleaded the existence of a security. Securities-fraud cases generally involve the investment of money by a plaintiff either directly with the defendant or in an entity controlled by the defendant, i.e., a purchase of securities by a plaintiff from a defendant. Here, by contrast, the roles were reversed: Masel’s investment went into entities he set up, and Masel argued that the agreement conveying interests to defendants as limited partners in those entities was a sale of securities in relation to which the defendants made fraudulent representations. Though the defendants exercised day-to-day managerial control, it was Masel who held controlling interests. As a result, the court focused on determining whether the defendants exercised sufficient managerial control such that the third Howey factor was satisfied, and Masel’s case depended on demonstrating that the defendants were passive investors. The defendants argued that they had too much control and extensive participation in the day-to-day work of the limited partnerships for their interests to be securities. The court disagreed and reasoned that, at this stage in the litigation, not enough was known about the defendants’ formal powers under the limited partnership agreements to say whether their powers were akin to those of a general partner. Although the defendants did take on significant responsibilities within the limited partnerships, they did so pursuant to what was essentially a service agreement that was subservient to Masel’s formal powers under the limited partnership agreements. The court declined to state that the defendants’ formal powers under the limited partnership agreements to say whether their powers were akin to those of a general partner. Although the defendants did take on significant responsibilities within the limited partnerships, they did so pursuant to what was essentially a service agreement that was subservient to Masel’s formal powers under the limited partnership agreements. The court declined to state that the defendant limited partners’ veto powers to block certain decisions, standing alone, sufficed to negate the existence of an investment contract with respect to the limited partnership interests.

Next, the court of appeals addressed the merits of Masel’s securities-fraud claims. In Rule 10b-5, the SEC has interpreted § 10(b) to prohibit the making of “any untrue statement of a material fact or [omission of] a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading” in connection with the sale of a security. The Private Securities Litigation Reform Act (“PSLRA”) requires plaintiffs in 10b-5 actions to satisfy a pleading requirement higher than the
standard under Rule 12(b)(6). For the first element—a misstatement or omission—plaintiffs must "specify each statement alleged to have been misleading [and] the reason[s] why the statement is misleading." To plead an omission with sufficient particularity, a plaintiff must specifically plead when a given disclosure should have been made. As to scienter, a plaintiff must plead "with particularity facts giving rise to a strong inference that the defendant acted with" scienter. In 10b-5 actions, "scienter" ranges from intentional deception to severe recklessness, the latter being defined as "an extreme departure from the standards of ordinary care, [presenting] a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."

The court of appeals held that the district court properly dismissed Masel’s claims for some of the alleged misrepresentations and omissions against Villarreal, MPS, CGR, IOS, and Casarez, but erred in dismissing certain claims against Villarreal and the entity defendants because Masel adequately stated a 10b-5 claim for those other misrepresentations. The court of appeals also addressed the scienter requirement and concluded that Masel adequately pleaded that the defendants possessed the required scienter.

In sum, the court of appeals held that: (1) the pleadings adequately alleged that the limited partnership interests in this case were securities; (2) the district court did not err in dismissing securities-fraud claims stemming from some of the alleged misrepresentations and omissions; and (3) the district court did err in dismissing securities-fraud claims based on other alleged misrepresentations.


The court of appeals affirmed the district court’s summary judgment in favor of the SEC based on material misstatements knowingly made by the defendant in connection with the sale of joint venture interests, which the court held were investment contract securities under the federal securities laws.

Sameer Sethi sold interests in an oil and gas joint venture through his company, Sethi Petroleum, LLC. Sethi, with the help of twenty salespersons, sought out investors using purchased lead lists in a broad cold-calling campaign. If a potential investor expressed interest and Sethi determined that the investor was "accredited," then Sethi would send a private placement memorandum ("PPM") and a copy of the joint venture agreement ("JVA"). Sethi raised over $4 million from ninety investors.

The SEC alleged that Sethi failed to register the joint venture interests as securities and materially misrepresented his relationships with large oil companies. The SEC filed claims against Sethi under Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The district court granted the SEC’s motion for summary judgment, holding that Sethi offered securities and committed securities fraud. (The district court’s opinion was summarized in the materials provided for the case law update presentation at this conference in 2017.) Sethi appealed.

The court of appeals first addressed Sethi’s argument that the district court erred when it held that interests in his drilling projects were securities. The court analyzed whether the interests were “investment contracts,” and thus securities as defined by federal securities laws, by applying the Howey test. Under the Howey test, an investment contract must meet three requirements: “(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor.” In this case the parties disputed the third factor.

The court explained that the critical inquiry under this factor is “whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.” While there is a “strong presumption” that an interest in a general partnership is not a security, the Fifth Circuit in Williamson v. Tucker articulated three factors that overcome this presumption. Each factor is sufficient to satisfy the third Howey factor. Under the Williamson factors, a partner is
dependent solely on the efforts of a third-party manager when: “(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.”

When examining the first Williamson factor—whether the drilling projects left the investors so little power “that the arrangement in fact distribute[d] power as would a limited partnership”—the court examined the legal documents setting up the arrangement and how the arrangement functioned in practice. In this case, the governing venture documents gave investors some theoretical power to control the drilling projects, such as the power to remove Sethi as manager and the power to call meetings and propose amendments with a 20% vote, develop rules for meetings with a 50% vote, and veto Sethi’s decisions. According to the court, however, “[t]hese powers . . . were illusory in practice. Sethi blocked investors from using their powers on numerous occasions.” Although Sethi was responsible for calling meetings and soliciting votes, he never did, and the investors never held a meeting or voted on any matter. The SEC provided evidence that Sethi took numerous actions without informing investors or soliciting approval as required or promised by the JVA or PPM. Further, Sethi provided the investors little to no information. Because Sethi provided no evidence to rebut the evidence provided by the SEC that the investors could not use their legal powers, the court of appeals held that the district court correctly concluded that Sethi’s drilling projects distributed power as if they were limited partnerships. The court did not address the second and third Williamson factors since the court concluded that the first factor was met.

Next the court addressed Sethi’s claim that the district court erred in granting summary judgment on the SEC’s securities fraud claims. Proof of a violation of Rule 10b-5 based on material representations or misleading omissions requires proof of three elements: “(1) material misrepresentations or materially misleading omissions, (2) in connection with the purchase or sale of securities, (3) made with scienter.” Proof of a violation of Section 17(a)(2) or (a)(3) requires proof of the same elements as for Rule 10b-5 except that negligence on the part of the defendant is sufficient. The parties disputed the first and third elements. The court reviewed evidence of statements by Sethi that suggested Sethi Petroleum had relationships with some of the largest oil companies in the world—relationships that Sethi would leverage in the venture’s favor—when, in reality, these relationships did not exist. The court of appeals concluded that the district court correctly found that Sethi made material misstatements and that they were made knowingly. Accordingly, the court affirmed the district court’s judgment in favor of the SEC.
PLANNING AHEAD

The Committee on LLCs, Partnerships and Unincorporated Entities will meet three times in 2020: at the Spring Meeting of the Section on Business Law, at the Annual Meeting of the Section of Business Law, and at the 2020 LLC Institute. Looking forward:

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<tr>
<td>2020 ABA BLS Annual Meeting</td>
<td>September 10-12, 2020</td>
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<td>2020 LLC Institute</td>
<td>November 12-13, 2020</td>
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<td>2021 ABA BLS Spring Meeting</td>
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<td>2021 ABA BLS Annual Meeting</td>
<td>September 9-11, 2021</td>
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The detailed schedules for Committee meetings and programs at these meetings will be announced in future issues of the LLC & Partnership Reporter.