Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future

By Charles W. Murdock*

INTRODUCTION

Limited Liability Companies (LLCs) are now authorized by statute in all states.1 The decade of the 1990s witnessed an unparalleled explosion of legislative activity in adopting a wide variety of LLC statutes. As one court has recognized: “The allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms—properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.”2

The origins of LLC statutes were the partnership association statutes enacted by some states in the 1800s.3 These statutes never gained popularity, however, and it was not until 1977 that the modern version of the LLC came into existence with the enactment of legislation by Wyoming.4 Five years later, Florida5 followed Wyoming’s lead after the Internal Rev-

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1. See Appendix 1.
4. Wyoming was the first state to adopt legislation recognizing the modern version of the LLC. Wyoming Limited Liability Company Act, ch. 158 (1977) (codified at WYO. STAT. ANN. §§ 17-15-101 to -143 (Michie 1999)).
5. Florida Limited Liability Company Act, ch. 82 (1982) (codified at FLA. STAT. ANN. §§ 608.401-.471 (West 1993)). The Florida statute has since been substantially amended.
venue Service (IRS) issued a revenue ruling that classified a Wyoming LLC as a partnership for tax purposes. But, the IRS then proposed new regulations that would classify as a corporation any entity in which members were not liable for the entity's debts. This stemmed the growth of LLCs until a new IRS ruling in 1988 again recognized that an LLC could be taxed as a partnership, thereby sparking a resurgence of legislative activity creating LLCs. When the IRS promulgated its "check-the-box" regulations in 1996, a flood of LLC organizations occurred and, in many circumstances, the LLC became the entity of choice for those organizing a new business.

In retrospect, it is remarkable that legislation by a sparsely populated state like Wyoming, which is not thought of as a leading commercial state, could have generated a nationwide movement. This surge of legislative activity, in such a short period of time, coupled with changing tax constraints, has militated against uniformity in LLC legislation, and has produced a rather wide variety of statutory provisions. In the mid-1990s, the National Conference of Commissioners on Uniform State Laws (the Uniform Commissioners) promulgated a "model" act, the Uniform Limited Liability Company Act (ULLCA or Model Act), which has received only a lukewarm reception.

Because of the lack of uniformity across the country, there is much to be said for a uniform act. The most significant problem with ULLCA is that its fiduciary duty provisions are poorly conceived, poorly drafted, and do not accord with fiduciary duty law as it now exists. Illinois, however, which adopted many of the other ULLCA provisions, has modified the ULLCA fiduciary duty provisions both to clarify the provisions and to bring them into accord with existing fiduciary duty law. Consequently, ULLCA, as modified by the Illinois fiduciary duty provisions, would be a solid base from which to develop a more uniform body of LLC statutory law.
Several states have adopted some or all of ULLCA, including Illinois, which, as stated above, made significant changes to the fiduciary duty provisions of ULLCA. As with corporate law, many practitioners reflexively organize LLCs in Delaware. Accordingly, the statutory discussion will focus mainly on ULLCA, Illinois, and Delaware, as well as the statutes in the various states that have provided the backdrop to litigation.

To illustrate the rapid pace of change in this area, this past decade has witnessed three generations of LLC statutes. The first generation could be characterized as "bulletproof" statutes, because these statutes were limited in flexibility and assured organizers that the LLC would be treated as a partnership for tax purposes. The Wyoming statute, which was the basis for the 1980 Letter Ruling that LLCs could be taxed as a partnership, would be an example of a bulletproof statute. The second generation statutes could be described as "flexible" since they provided organizers with options as to management, continuity, and transferability, but with the downside that an entity that took advantage of these options might not be taxed as a partnership. Illinois' initial legislation would fall in this category.

The advent of the check-the-box regulations led to the third generation of statutes. It was no longer necessary to negate such characteristics as transferability and continuity. Consequently, ULLCA moved LLC statutes from a partnership model toward a corporate model. In particular, it was no longer necessary that the "events of dissolution," namely, "death, insanity, bankruptcy, retirement, resignation or expulsion," cause dissolution. What ULLCA did, simply stated, is to take these former "events of dissolution" and transfer them to the member in the event of death, insanity, bankruptcy, retirement, resignation or expulsion. What ULLCA did, simply stated, is to take these former "events of dissolution" and transfer them to the member in the event of death, insanity, bankruptcy, retirement, resignation or expulsion. What ULLCA did, simply stated, is to take these former "events of dissolution" and transfer them to the member in the event of death, insanity, bankruptcy, retirement, resignation or expulsion.
dissolution” and convert them into “events of dissociation,”21 with the result that death and other adverse events impacting a member no longer caused dissolution but, generally, entitled the “dissociated” member to obtain payment from the entity for the fair value of her interest.22

As the decade of the 1990s came to a close, litigation involving LLCs had become more frequent—although in most jurisdictions there is little, if any, case law. As we move into a new millennium, this is an appropriate time to review the litigation issues involving LLCs that have risen in the past decade and analyze how these issues interplayed with the various statutory enactments.

The following sections of this Article will each address a different substantive issue. First, this Article will discuss liability issues that have arisen with respect to LLCs. While the courts have given effect to the legislative intent to create an “incorporated partnership,” there are, nonetheless, circumstances in which members may be personally liable. In particular, the doctrine of “piercing the corporate veil” should be renamed “piercing the entity veil” since courts have recognized the application of the “piercing” doctrine to LLCs.

Next, the Article reviews the cases that have dealt with the operating agreement of an LLC. The philosophy behind the current LLC legislation is to create an entity that is essentially contractual in nature, with the statutory provisions providing default rules when the operating agreement does not otherwise provide. Unfortunately, the philosophy of the lawyers who draft statutes is not always implemented by the persons who organize LLCs. Consequently, complicated issues can arise when there is no operating agreement or when neither the operating agreement nor the statute deal with the issue in question.

The most significant portion of the Article, dealing with fiduciary duties, follows. Some statutes have no explicit fiduciary provisions. Other statutes were based upon section 21 of the Uniform Partnership Act which is so bare bones that it affords little guidance. At the other end of the spectrum is ULLCA, which purports to set forth an exclusive list of fiduciary duties. Unfortunately, ULLCA is not only poorly drafted but, if it means what it says, may markedly curtail existing case law on fiduciary duty. The clearest set of statutory provisions is found in the Illinois Act, which substantially modified ULLCA.

The next section of the Article deals with transfer, dissolution, and dissociation. At first, statutes followed a partnership model regarding dissolution because this was generally necessary to provide partnership tax


treatment. With the change in the federal tax regulations, which permitted an LLC to elect partnership tax treatment without meeting stringent tests, such as eliminating continuity of existence, ULLCA (and states adopting its philosophy in this regard), converted events such as withdrawal or death into “events of dissociation” rather than “events of dissolution.” Thus, there is a new concept, “dissociation,” with which lawyers and courts must be familiar.

The last section deals with how voting power is allocated and entitlement to distributions determined. There are essentially two approaches, per capita and per capital. The per capita approach is derived from general partnership law where all members have equal rights in management and to profits. Contrariwise, the per capital approach is more typical of limited partnerships and corporations where voting rights and distributions are basically tied to the amount of the investment.

After analyzing the complex issues generated by the statutes and case decisions, the conclusion points out that the hectic activity in creating a new form of business organization, and the resulting confusion, could have been avoided if Congress had simply amended the Internal Revenue Code to permit non-publicly traded corporations to elect to be taxed as a partnership. If this is not realistic, then states should consider adopting ULLCA, but with the Illinois fiduciary duty provisions.

**LIABILITY ISSUES IN GENERAL**

The driving force for organizing a limited liability company is the desire to achieve pass-through tax treatment, while at the same time enjoying limited liability. When LLCs first came into vogue, in the late 1980s and early 1990s, there was some concern as to whether the limited liability aspect would hold up in court. With every jurisdiction now recognizing such entities by statute, the concern as to whether limited liability will be achieved has abated. In line with the legislative enactments, courts now recognize that the LLC form of organization provides insulation from liability for members of LLCs.

Within the past two years, courts in Connecticut and Arkansas have rejected attempts to hold members personally liable for the obligations of an LLC. In *Anthony v. Blum*, a Connecticut case, Blum had negligently represented Anthony and, in settlement, Blum executed a $10,400 promissory note on behalf of his law firm (an LLC), payable to plaintiff. Plaintiff sued Blum on the note and argued that Blum’s negligence constituted the consideration for the note, thereby entitled plaintiff to hold Blum person-

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23. See supra text accompanying note 2.

24. See supra note 1. The statutes, of course, provide that members are not liable for the obligations of the LLC. See, e.g., UNIF. LTD. LIAB. CO. ACT § 303(a), 6A U.L.A. 454 (1995); 805 ILL. COMP. STAT. ANN. 180/10-10(a); DEL. CODE ANN. tit. 6, § 18-303(a).

ally liable. The court held, however, that "the present action is not a malpractice action but a breach of contract action"26 in which the law firm was the obligor and for which "Blum is not personally liable."27

An Arkansas court considered the potential liability of an LLC member from two different perspectives. In Marina, LLC v. Burton,28 the LLC defaulted on a contract. The Development Institute, which Burton represented, first sought to hold the member of the LLC personally liable on the basis that he had misrepresented that the LLC had members other than himself. The agent for the Institute testified, however: "the financial capability of the individuals listed [as members] was none of his business" and that "he was aware that limited liability companies were designed to limit an investor's liability."29 Consequently, the court held that the Institute did not reasonably rely on the list of members.30

The Institute also sought to hold the member liable by piercing the limited liability veil of the LLC, focusing on the undercapitalization of the LLC. The court pointed out, however, that the Institute knew the LLC was a new entity and that the LLC planned to finance the project through a bank loan which was never closed. These facts "did not justify piercing the veil."31

THEORIES OF MEMBER LIABILITY

On the other hand, there are bases upon which an LLC member can be personally liable. The Blum court recognized that a member qua actor rather than qua member is liable for the member's own negligent acts.32 Similarly, in Burton, the member could have been liable for his personal misrepresentation if the misrepresentation were material and if the other party reasonably relied upon it.33 These situations arise in the corporate setting as well. While a shareholder generally is not liable qua shareholder, if the shareholder is also an officer or employee, she can be personally liable for actions personally taken.34

While the court in Burton did not believe that the facts warranted piercing the veil of the LLC, there is recognition that the "piercing the cor-

26. Id. at *2.
27. Id.
29. Id. at *6.
30. Id.
31. Id. at *7.
32. Anthony, 1999 WL 259726, at *2 (recognizing that Connecticut General Statutes §§ 34-133(a)-(b) specifically prescribe the liability of members qua actor of limited liability companies).
porate veil” doctrine should be renamed “piercing the entity veil.” For example, in Hollowell v. Orleans Regional Hospital, the court stated:

ORH is a limited liability company rather than a corporation. No case has yet explicitly held that the “veil” of protection from liability afforded by the limited liability company form of business in Louisiana may be “pierced” in the same manner as the “veil” of protection afforded Louisiana corporations. However, commentators throughout the nation appear to agree that the limited liability company “veil” may be “pierced” in the same manner as the corporate “veil.”

The court qualified the foregoing by quoting one commentator who observed that “because the Louisiana LLC law requires fewer formalities such as annual elections of directors, keeping minutes, or holding meetings, failure to follow these formalities should not serve as grounds for piercing the veil of an LLC.” By way of comparison, ULLCA and Illinois expressly provide that “[t]he failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.”

Nevertheless, the Louisiana court reserved the following issues, inter alia, for trial:

(3) Whether ORH was the “alter ego” of any or all of the non-ORH defendants . . . in light of the following factors:
   (a) commingling of funds;
   (b) failure to follow statutory formalities for formation and the transaction affairs;
   (c) undercapitalization;
   (d) failure to provide separate bank accounts and bookkeeping records; and
   (e) failure to hold regular required meetings.

(4) Whether ORH’s members acted through ORH to commit fraud or deceit, and whether the shareholders of ORH’s members acted in similar fashion.

Thus, the court opened the litigation to consider issues similar to those involved in piercing the corporate veil, including whether formalities and

36. Id. at *9.
37. Id.
38. UNIF. LTD. LTAB. CO. ACT § 303(b), 6A U.L.A. 454 (1995); 805 ILL. COMP. STAT. ANN. § 180/10-10(c).
procedures were followed. In most states, however, the statutorily mandated procedures are minimal and thus the risk of running afoul of a statutory mandate should also be minimal. For example, unlike corporation statutes, LLC statutes generally do not mandate annual meetings of members or managers. Other states, like Illinois, also explicitly provide that failure to observe formalities is not a ground for imposing liability.

One of the doctrines employed to pierce the corporate veil is the so-called "holding out" or "alter ego" approach, which is used when the shareholder does not make clear that it is the corporation (or entity), and not the shareholder (or owner), who is the party to the contract. This approach, albeit utilizing agency theory, was used by the court in *Water, Waste & Land, Inc. v. Lanham,* to hold a member of an LLC liable. Lanham and Clark were the managers and members of Preferred Income Investors, LLC. Clark contacted plaintiff to do some engineering work for a fast food restaurant but did not clarify for whom he was acting. According to the court:

In the course of preliminary discussions, Clark gave his business card to representatives of Westec. The business card included Lanham’s address, which was also the address listed as the Company’s principal office and place of business in its articles of organization filed with the secretary of state. While the Company’s name was not on the business card, the letters “PI.I.” appeared above the address on the card. However, there was no indication as to what the acronym meant or that PI.I. was a limited liability company.

The court also noted:

Westec directed all correspondence relating to the restaurant project to Lanham, including a written contract and bills. Both the form of contract and correspondence between the two parties were in Lanham's name and did not refer to the Company. Lanham never signed


42. See, e.g., Ditty v. CheckRite, Ltd., Inc., 973 F. Supp. 1320, 1335 (D. Utah 1997) (stating that under the alter ego doctrine, a plaintiff must show both a unity of interest and ownership such that the separate personalities of the corporation and the individual no longer exist, and that if the corporate form were to be observed, fraud, injustice, or inequity would result).

43. 955 P.2d 997 (Colo. 1998) (en banc).

44. Id. at 999.
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Westec's proposed written contract, and the parties do not dispute that the oral agreement is the only binding contract in this case.\(^{45}\)

The issue presented to the court was who was liable for non-performance. The court found that Westec understood that Clark was Lanham's agent, and that Clark was therefore not liable. The court held Lanham liable, however, on the basis of the "partially disclosed principal" doctrine, that is, "a principal whose existence—but not identity—is known to the other party."\(^{46}\) The court concluded that "[i]n light of the partially disclosed principal doctrine, the county court's determination that Clark and Lanham failed to disclose the existence as well as the identity of the limited liability company they represented is dispositive under the common law of agency."\(^{47}\)

In view of the foregoing, it is difficult to understand why Clark was not also liable since he also did not disclose the existence of the LLC, the real principal. Under the partially disclosed principal doctrine, while he made clear he was acting as an agent, he did not identify the real principal and thus, arguably, he also could have been liable. The court apparently treated his misidentification of Lanham as principal as sufficient to let Clark off the hook. But then Lanham should be liable on the undisclosed principal doctrine, not the partially disclosed principal doctrine. Lanham apparently never indicated that he was acting as an agent. Thus, he should be liable as a principal because the "true" principal, the LLC, was never disclosed.

Lanham, in seeking to avoid liability, argued that the Connecticut statute had a constructive notice provision, i.e., that filing the articles of organization was constructive notice that the LLC is an LLC; therefore he should not be liable for the LLC's obligations. The court responded that the statute:

places third parties on constructive notice that a fully identified company—that is, identified by a name such as "Preferred Income Investors, LLC," or the like—is a limited liability company provided that its articles of organization have been filed with the secretary of state. Section 7-80-208 is of little force, however, in determining whether a limited liability company's agent is personally liable on the theory that the agent has failed to disclose the identity of the company.\(^{48}\)

In distinguishing between agency doctrine and the doctrine of piercing the entity veil, the court determined that

\[^{45}\] Id.
\[^{46}\] Id. at 1002.
\[^{47}\] Id.
\[^{48}\] Id. at 1004.
the doctrine of piercing the corporate veil is based in equity so that a failure to disclose must coexist with wrongful conduct or improper purpose or intent for the latter theory to apply and render personal liability.\textsuperscript{49}

Thus, agents of an entity such as an LLC must take care to insure that both the fact of their agency and the identity of the entity is disclosed. Otherwise, they risk liability on agency principles which, as applied by this court, are more draconian in application than the doctrine of piercing the entity veil since equitable considerations cannot relieve a defendant from liability.

**PIERCING THE ENTITY VEIL**

Several cases have presented interesting twists with respect to the doctrine of piercing the entity veil. In *Tom Thumb Food Market, Inc. v. TLH Properties, LLC*,\textsuperscript{50} the court looked to equitable considerations in relieving Hartmann, the individual defendant, from liability on a lease he had executed on behalf of the LLC. Hartmann had represented that he owned the land in question. He had not purchased the land, however, but was operating under an oral agreement with another person, Smith, to purchase the land and develop the site. Hartmann entered into a twelve year lease on behalf of the LLC with Tom Thumb, but when Hartmann sought to obtain financing to purchase the land, the bank countered with a request for information about the financial status of Tom Thumb, in order to determine whether the proposed lease would be adequate security for its mortgage. At first, Tom Thumb delayed sending financial information and, when it did send such information, it indicated that Tom Thumb had a negative net worth.

The trial court pierced the entity veil and held Hartmann liable to Tom Thumb. The appellate court reversed for two reasons, however. First, although Hartmann did misrepresent his ownership of the land, he did form the LLC to develop the land for a Tom Thumb food market and, at one point, did have access to an option to acquire the land. More importantly, the court held that Tom Thumb did not have clean hands, stating:

The record is undisputed that when Hartmann attempted to obtain financing for the project, Tom Thumb delayed sending financial statements to Hartmann's bank. The record is also undisputed that when the bank ultimately received Tom Thumb's financial information, it refused to finance the project because Tom Thumb had a negative net worth. Tom Thumb's conduct contributed to the delay and ultimately caused the bank to refuse financing. This conduct

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\textsuperscript{49} Id.

contributed to breach of the lease and it would be unjust to allow Tom Thumb to recover against Hartmann personally.\textsuperscript{51}

Another piercing the veil case, \textit{Abu-Nassar v. Elders Futures, Inc.},\textsuperscript{52} involved a Lebanese LLC, which raised the issue of piercing the entity veil from the perspective of both New York law and Lebanese law. The entity was organized under Lebanese law and Lebanese law imposed additional obligations on a business. Suit was filed in New York and the court recognized that, while the law of the state of organization normally determines issues related to the internal affairs of an entity, different conflict of laws principles exist where the rights of third parties external to the entity are at issue. Courts have recognized that piercing the entity veil is "generally a creditors remedy."\textsuperscript{53} Consequently, the court discussed the issue under both New York law and Lebanese law. The court’s analysis under New York law was fairly typical. It considered the following:

\begin{enumerate}
\item intermingling of personal and corporate funds and siphoning of corporate funds by a principal;
\item failure to observe corporate formalities and keep proper books and records;
\item failure to pay dividends;
\item inadequate capitalization;
\item insolvency;
\item perpetration of fraud by shareholders in maintaining the corporate form.
\end{enumerate}

In its analysis, the court focused on the issues of commingling and adequate capitalization.

Lebanese law contained several aspects, however, that, from the perspective of U.S. law, were unusual. Under Lebanese law: (i) the capital of the corporation was required to exceed \$50,000 Lebanese pounds; (ii) the amount of the company’s capital was to figure prominently on all printed material and other documents emanating from the company; and (iii) the company was required to hold an annual meeting to review the company’s business before declaring or distributing profits.\textsuperscript{55} In point of fact, a requirement of minimum capital is fairly typical in the LLC statutes of European and other countries.\textsuperscript{56} These statutes reflect and reinforce a generally recognized principle that the price of limited liability is adequately capitalizing the entity. The requirement that such capital be stated on all correspondence and documents, however, was unusual.

\begin{itemize}
\item \textsuperscript{51} \textit{Id.} at *3.
\item \textsuperscript{52} \textit{Abu-Nassar v. Elders Futures, Inc.}, No. 88CIV7906, 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 8, 1991). While the court frequently refers to piercing the corporate veil, the entity Abu-Nassar organized was a Lebanese limited liability company.
\item \textsuperscript{53} \textit{Tom Thumb Food Market, Inc.}, 1999 WL 31168, at *3; \textit{Abu-Nassar}, 1991 U.S. Dist. LEXIS 3794, at *14-*15.
\item \textsuperscript{54} \textit{Id.} at *17.
\item \textsuperscript{55} See, e.g., Germany: GMBH § 5 (50,000 Deutsche Marks), AG § 7 (100,000 Deutsche Marks); Spain: S.A. Art. 4 (10,000,000 pesetas).
\end{itemize}
With respect to the requirement of 50,000 pounds of capital, the court seemed to interpret this as an ongoing requirement. Such an approach really does not make sense, because, in effect, it destroys the whole concept of limited liability. If there is a continuing obligation to replace the capital of the company as it is reduced by losses, the funds of the shareholders would constantly be at risk without limit. The harshness of this approach in the present situation may have been ameliorated by another provision of Lebanese law providing an opportunity for a company to recapitalize within one year before any negative consequences attach. Arguably, if the company dissolves within that period, there would be no further obligation on the shareholders but, if it continued to operate with inadequate capital, the shareholders could be personally liable to replace the depleted capital.

The two core elements in piercing the corporate veil have been: (i) whether there is such a unity of interest and ownership that the separate personalities of a corporation and the individual no longer exist; and (ii) whether recognition of the corporate form would sanction a fraud, promote injustice, or result in inequity. These elements are also considered in piercing an LLC veil. Two cases have reviewed the first part of this test and determined that the evidence was insufficient to establish that the shareholder in question so conducted the entity’s business that it had no separate existence of its own. New Horizon Supply Cooperative v. Haack was a small claims case in which the evidence was very sketchy. Apparently the trial court pierced the entity veil on the basis that the LLC was essentially a partnership because it was taxed as a partnership. The appellate court held that it was an error to consider partnership tax treatment as conclusive of the nature of the entity under state law, reinforcing the recognition that LLCs generally do provide limited liability for their members. In addition, the appellate court found that there was little in the record to support a conclusion that the entity had no separate existence of its own. In fact, there was little in the record period.

In Ditty v. CheckRite, Ltd., plaintiffs sought to hold a lawyer personally liable for a law firm’s unlawful collection practices on the grounds of piercing the entity veil. They argued that the veil should be pierced because he was the “sole shareholder, sole director and president” of the law firm and because he “designed the ‘covenant not to sue’ scheme, trained the firm’s employees, and supervised the firm’s collection practices.” The court disagreed with plaintiffs because the fact that the lawyer “played an active role in the firm’s businesses is, at best, only marginally probative of the

57. Van Dorn Co. v. Future Chem. & Oil Corp., 753 F.2d 565, 569-70 (7th Cir. 1985).
59. Id.
60. Id.
62. Id. at 1336. Even though plaintiff referred to defendant as a shareholder, he was a member of an LLC.
factors considered when determining whether to pierce the corporate veil. The factors that the court determined to be significant in determining whether to pierce the corporate veil included:

Undercapitalization of a close corporation; failure to observe corporate formalities; siphoning of corporate funds by the dominant shareholders; non-functioning of other officers or directors; and the use of the corporation as a facade for the operations of the dominant shareholder.

While the lawyer’s activities may have met the last factor, there was no evidence on the other factors. Parenthetically, nonetheless, the lawyer was held personally liable as a “debt collector” under the Fair Debt Collection Practices Act.

OPERATING AGREEMENTS AND OPERATING ISSUES

Notwithstanding all the care and detail that has gone into drafting LLC statutes around the country this past decade, recent litigation demonstrates that it is impossible for the legislature to so “cover the waterfront” that judicial construction and interpretation will not be necessary. The cases also demonstrate the need for counsel to be familiar with the LLC Act in question and with the other “entity” statutes. In general, counsel is given considerable latitude in drafting the operating agreement, but this latitude makes it all the more critical that counsel provide expert representation and not top-of-the-head reaction when dealing with clients in the formation and operation of LLCs.

Although, in the corporate world, by-laws have become boilerplate with (often) insufficient regard given to them, the operating agreement in the LLC world is the heart of the relationship among the LLC, its members, and managers. Although forms exist, there are not yet “standard forms” that make organization of an LLC a simple and inexpensive task. Moreover, because the statutes anticipate a detailed and specific operating agreement, most sophisticated practitioners craft an operating agreement for an LLC that is specifically tailored to the clients before them. This generally makes formation of an LLC substantially more expensive than formation of a corporation, where boilerplate articles and by-laws are initially used and later (often years later) a more sophisticated and client-specific shareholders’ or buy/sell agreement is proposed.

63. Id. Although the court referred to the corporate veil, the entity in question was an LLC.
64. Id.
But what if there is no operating agreement signed by all the members? In *Advanced Orthopedics, L.L.C. v. Moon*, defendant argued that he did not intend to form an LLC and that, alternatively, his failure to sign a proposed operating agreement constituted a withdrawal, resulting in mandatory dissolution. The court first held that "attaining a certain level of understanding regarding L.L.C.'s is not a prerequisite to the formation and participation in one" and that the certificate of organization is "conclusive evidence" that an LLC has been duly organized. With respect to his argument that his failure to sign the operating agreement worked a dissolution, the court stated "we are aware of no requirement in the law that an L.L.C. have an operating agreement to be viable."

In *Child Care of Irvine, LLC v. Facchina*, the more complex issue was whether or not there was an operating agreement. The members had originally formed a corporation and executed a shareholders' agreement, which provided both for management of the corporation and arbitration of disputes. The agreement provided that "Shareholders agree to have Dante D. Facchina appointed and elected as Chairman of the Board, President, Chief Financial Officer and Secretary of Child Care of Irvine, Inc., as long as he remains a Shareholder and performs faithfully, efficiently, and competently." According to the court, "those provisions would appear to permit the shareholders to terminate Facchina as Child Care Inc.'s manager for not working full time, or without full effort, or for being unprofessional, inefficient, unfaithful, or incompetent."

66. Section 103(a) provides that members of an LLC "may" enter into an operating agreement and that such equipment "need not be in writing." UNIF. LTD. LIAB. Co. ACT § 103(a), 6A U.L.A. 434 (1995). Delaware provides that an operating agreement can be "written or oral." DEL. CODE ANN. tit. 6, § 18-101(7). The Illinois statute would seem to require that the operating agreement be in writing and be signed by all members because it is an agreement or contract. See 805 ILL. COMP. STAT. ANN. 180/15-5(a). If there is only one member, however, the operating agreement need not be in writing and need not contain the elements of a contract. See 805 ILL. COMP. STAT. ANN. 180/15-5(c).


68. In ULLCA, Illinois, and Delaware, withdrawal does not of itself dissolve an LLC. See UNIF. LTD. LIAB. Co. ACT § 601, 6A U.L.A. 471 (1995); 805 ILL. COMP. STAT. ANN. 180/35-1; DEL. CODE ANN. tit. 6, § 18-801(b). In ULLCA and Illinois, withdrawal, however, constitutes dissociation. UNIF. LTD. LIAB. Co. ACT § 601, 6A U.L.A. 471 (1995); 805 ILL. COMP. STAT. ANN. 180/35-45. This, as a result, may give rise to a return of the member's distributional interest. UNIF. LTD. LIAB. Co. ACT § 701, 6A U.L.A. 476 (1995); 805 ILL. COMP. STAT. ANN. 180/35-60; see also infra text accompanying notes 273-81.

69. *Advanced Orthopedics*, 656 So. 2d at 1105.

70. Id. The court did indicate that defendant could challenge its organization but that he would have the burden of proof. Cf 805 ILL. COMP. STAT. ANN. 180/5-40.

71. *Advanced Orthopedics*, 656 So. 2d at 1105-06.


73. Id. at *1.

74. Id.
Because the parties were unable to obtain subchapter S tax status for the corporation, they executed a "shareholder consent" on December 17, 1996, for the corporation to merge into a Delaware LLC. Defendant Facchina had organized a Delaware LLC on December 5 and, as sole officer of the corporation and managing member of the LLC, executed the Merger Agreement on December 24. He filed a Certificate of Merger in Delaware on December 20, 1996, and the Agreement and Plan of Merger with California on January 14, 1997. The Merger Agreement stated that the LLC "would be governed by the operating agreement in effect prior to the effective date of the merger" and that Facchina would be the general manager of the LLC.

Apparently unbeknownst to the other members, Facchina had engaged a law firm to prepare a draft operating agreement, which Facchina received on December 23, 1996. Facchina asserted that he immediately gave the draft agreement to another member but the other member claimed he first saw the draft on January 16 or 17, 1997. Another member claimed he never saw the draft until February 10, 1998. In any event, it was undisputed that the draft agreement was never signed.

At this stage there existed two documents: one was signed by the parties and labeled a shareholders' agreement; the other was unsigned and labeled an operating agreement. The shareholders' agreement authorized Facchina's termination for cause as therein defined, while the draft operating agreement provided no mechanism to terminate the manager. These documents were then put in issue when Facchina allegedly violated California laws relating to child care and the other members (who owned the other two-third interest in the LLC) voted to terminate Facchina's employment.

Plaintiffs, of course, argued that the executed shareholders' agreement was transformed into the operating agreement when the business was transformed from the corporate form to the LLC form. Facchina argued that the unexecuted draft was the operating agreement because the other members knew of its existence or that, alternatively, the Merger Agreement itself (apparently a rather bare bones document) was the operating agreement. He thus argued that there was no authority to remove him and that plaintiffs' sole remedy was to seek judicial dissolution of the LLC.

Plaintiffs also argued that, as majority members, they had a default right to terminate the manager. Unfortunately for plaintiffs, section 18-402 of the Delaware statute provided in part that "a manager shall cease to be a manager as provided in the limited liability company agreement." As stated above, there was no document explicitly identified as an operating agreement.

75. Id. at *2.
76. Id.
77. Id.
78. Id. at *3.
79. Id. at *4.
agreement and signed by all the members. Consequently, plaintiffs focused
on the opening language of the foregoing statute, to wit, that unless
otherwise provided in the operating agreement, members owning a ma-
majority of the profit interests can manage the LLC.

This portion of the statute deals with a member-managed LLC, how-
ever, whereas Child Care was a manager-managed LLC. This being the
case, the Delaware statute merely provides that a manager ceases to be a
manager "as provided in the limited liability company agreement” without
setting forth any default provision in the event that the operating agree-
ment does not deal with this issue or if, as possibly in the case at bar, there
was no operating agreement. The Delaware statute epitomizes “contrac-
tarianism;” while the Delaware bar extols this as a virtue, this can also be
a serious flaw when the statute offers no default provision when the parties,
as in the case at bar, fail to deal with an issue.

The chancellor vacated a preliminary injunction that barred Facchina
from acting as general manager (even though permitting Facchina to con-
tinue as manager might cause plaintiffs to lose their license and franchise
to operate a child care business) and denied each side’s motions for sum-
mary judgment so that he could hear testimony at trial. The court also
stated that “I have not an inkling which side will ultimately prevail.”

Later, Chief Justice Veasey, in a rather gratuitous extolling of the virtues
of Delaware’s statutes and the benefits of organizing in Delaware, may
have explained why the chancellor had no inkling of what to do, pointing
out that “[i]o understand the overall structure and thrust of the [LLC]

80. Id. Section 18-402 provides in its entirety:

Unless otherwise provided in a limited liability company agreement, the management
of a limited liability company shall be vested in its members in proportion to the then
current percentage or other interest of members in the profits of the limited liability
company owned by all of the members, the decision of members owning more than 50
percent of the said percentage or other interest in the profits controlling; provided how-
ever, that if a limited liability company agreement provides for the management, in
whole or in part, of a limited liability company by a manager, the management of the
limited liability company, to the extent so provided, shall be vested in the manager who
shall be chosen by the members in the manner provided in the limited liability company
agreement. The manager shall also hold the offices and have the responsibilities ac-
corded to the manager by the members and set forth in a limited liability company
agreement. Subject to § 18-602 of this title, a manager shall cease to be a manager as
provided in a limited liability company agreement. A limited liability company may
have more than 1 manager. Unless otherwise provided in a limited liability company
agreement, each member and manager has the authority to bind the limited liability
company.

DEL. CODE ANN. tit. 6, § 18-402 (1999).

81. In other areas, the Delaware statute fails to provide a default provision. See id. § 18-
601 (interim distributions).


83. Id. at *6.
Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly.\textsuperscript{84} He extolled the "broadest possible discretion" that Delaware draftsmen have in crafting agreements and the "certainty that their partnership agreement will be enforced in accordance with its terms."\textsuperscript{85} This is true of other jurisdictions as well, however. According to Chief Justice Veasey, the purpose of the LLC Act is merely to furnish default provisions when the members' agreement is silent. The Delaware statute, however, does not always provide default provisions.\textsuperscript{86}

As the \textit{Child Care} case demonstrates, the Delaware statute was flawed in failing to provide a default provision in a critical area. If Delaware is so freedom-of-contract oriented, why did it not enforce a written contract that provided a manager could be removed for cause? True, the contract was labeled a shareholders' agreement. But the purpose of such an agreement was to specify the relations among the parties. An ordinary person would not see any difference between removing the manager of an LLC or the general manager of a corporation. What normal people focus upon is the management of the business. The form of legal entity is irrelevant. Only lawyers can take the obvious and obfuscate it.

By way of comparison, consider how a well-drafted statute, such as ULLCA or Illinois, would provide a workable default mechanism in a case like \textit{Child Care}. Both statutes provide that, in a manager-managed LLC, a manager:

\begin{enumerate}
\item must be designated, appointed, elected, \textit{removed}, or replaced by a vote, approval, or consent of a majority of the members; and
\item holds office until a successor has been elected and qualified, unless the manager sooner resigns or is \textit{removed}.\textsuperscript{87}
\end{enumerate}

This is a provision that could be modified by the operating agreement\textsuperscript{88} but, if not modified, would be dispositive of the issue in \textit{Child Care}. Three possibilities existed in \textit{Child Care}: (i) the executed shareholders' agreement was the operating agreement, (ii) the unexecuted draft was the operating agreement, or (iii) there was no operating agreement. If the shareholders' agreement were the operating agreement, it specifically authorized termination for cause. If the unexecuted draft were the operating agreement, because it was silent on termination, the default provisions of the statutes would apply and, as was set forth above, under ULLCA or in Illinois, a

\begin{itemize}
\item 85. \textit{Id.}
\item 86. See supra note 81 and accompanying text.
\end{itemize}
majority of the members could remove the manager. Both ULLCA and Illinois provide that, "[t]o the extent the operating agreement does not otherwise provide, this [Act] governs relations among members, managers, and company." This means that the statute provides the default rule when a matter is not covered in the operating agreement. Accordingly, under both statutes, the majority of members could remove the manager, because this is the statutory default rule. Finally, if there were no operating agreement, then clearly the default provisions of the statutes would control. In Illinois, and states adopting ULLCA, this matter could be resolved on summary judgment, thereby avoiding the cost, delay, and risk of loss of business that Delaware imposed.

Another approach to resolving the Child Care issue is suggested by the decision of the Supreme Court of Connecticut in *C & J Builders and Remodelers, LLC v. Gersenheimer*, where the issue was whether a contract executed while plaintiff was a sole proprietorship was binding upon defendants, the other party to the contract, when the sole proprietorship was converted to an LLC. The court, in resolving this issue, looked to explicit statutory provisions that governed the conversion of a general or limited partnership to an LLC. In such situations, the statutes provided that all property of the predecessor vested in the successor and all obligations of the predecessor continued as obligations of the successor. While there was no applicable statutory provision to merge a sole proprietorship into an LLC, the court stated:

> We can discern no reason to distinguish between the conversion of a sole proprietorship to a limited liability company and the conversion of a general partnership to a limited liability company pursuant to § 34-200. "Where possible, courts should, as a matter of common law adjudication, 'assure that the body of the law—both common and statutory—remains coherent and consistent.'" We conclude, therefore, that where a sole proprietorship converts to a limited liability company, all of the interests and obligations incurred by, or chargeable against, the sole proprietorship or its assets are transferred to the limited liability company by operation of law. Moreover, like the general partners in a converting general or limited partnership, the sole proprietor retains personal liability for all preconversion debts and obligations incurred by the sole proprietorship.

While the Connecticut court did not see its decision as extraordinary, it certainly was. Heretofore, mergers and conversions of one entity into another have been exclusively within the legislative domain. In effect, the

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90. 733 A.2d 193 (Conn. 1999).

91. Id. at 197 (citations omitted).
court created a common law merger. While, in the product liability area, some courts have determined as a matter of public policy that liabilities follow assets, these cases deal only with particular liabilities and deal not at all with asset transfer.92 Moreover, a sole proprietorship heretofore has not been recognized as an entity separate and apart from the individual operating it. The assets and liabilities are his or hers, not its.

Nevertheless, a sole proprietorship can be identified in many situations (through bank accounts, use of assets, and contracts) as a separate economic entity, just as readily as a partnership and possibly as a corporation. Thus, the decision in the present case is not so much troubling as overkill. Although the court did not deal with this issue, the contract was most likely assignable. The issue in question was whether the contract provision that required disputes to be arbitrated would be binding upon the defendants after the sole proprietor converted his business to an LLC. Because defendants had contractually agreed to arbitrate disputes, why should not the LLC, as the assignee of the contract, be able to enforce the contracts?93

In a similar view, with respect to the Child Care case, should not the shareholders’ agreement of the corporation be binding upon the LLC? After all, there was a statutory merger involved in which liabilities and assets, including contract rights and obligations, were binding upon the successor by operation of law.94

The first question that arises, however, is whether the shareholders’ contract is a contract of the corporation that could be transferred to the LLC. In many shareholder agreements, particularly those embodying buy-sell type provisions, the corporation is a party to the contract. The provision of the agreement dealing with management is akin to an employment agreement and the rights and liabilities under employment agreements are routinely transferred by operation of law pursuant to merger statutes.

There are, however, two difficulties with this approach. The first is that the corporation may not have been a party to the shareholder agreement. The implications of this will be discussed below. The second is that, instead of a merger of two like entities, such as corporations with which we are now familiar and comfortable, Child Care involved a merger of two dissimilar entities, each with its own jargon and peculiarities. By way of illustration, how can a surviving LLC have a “shareholders” agreement when, according to the conventional wisdom, there are no shares issued in an LLC and accordingly (and per the statute) an LLC has “members” and not “shareholders.”

92. See Turner v. Bituminous Cas. Co., 244 N.W.2d 873 (Mich. 1976) and Ray v. Alad Corp., 560 P.2d 3 (Cal. 1977), and their progeny. These cases involve situations where the assets are transferred explicitly by the parties, whereupon the courts hold that liabilities follow assets.


This, however, is exalting form over substance. What difference does it make whether we call investors in an entity "shareholders" or "members?" A similar "dilemma" arises in the corporate world where statutes generally employ the term "president," whereas businesses appoint or elect "chief operating officers" (COOs) and "chief executive officers" (CEOs). Corporate by-laws typically define the president as the chief executive officer. In the corporate world, the name or designation dilemma is no dilemma at all.

Moreover, some LLCs do have shares and issue certificates and some managers are called directors or managing directors. Because LLCs are essentially creatures of contract, with the statute generally only providing default provisions, the organizers of an LLC should be able to create whatever structure, and use whatever nomenclature, they desire. With the proliferation of statutory provisions authorizing mergers between and among partnerships, limited partnerships, limited liability companies, and corporations, it behooves courts to keep an open mind when dealing with the resulting entities and their relations to the predecessor entities. If an investor or manager was contractually obligated to the predecessor, he or she also ought to be obligated to the successor.

But what if the predecessor entity was not a party to the contract? Arguably, a merger does not transfer obligations to which the predecessor was not a party. The question then arises as to what happens to the contract between the shareholders. Is it extinguished? If not, what effect does it have after the merger?

To what does a shareholder agreement generally apply? Typically, it covers the nature and amount of the investment, provisions as to distributions, provisions relating to management including directorships, voting, employment, compensation and termination, and provisions relating to dispute resolution. Other than jargon and the fact that corporation statutes provide more default specificity than do LLC statutes, the essentials of a shareholders' agreement and the essentials of an operating agreement may be very similar. The parties in Child Care, in their shareholders' agreement, had already contracted with respect to their investor and management relationship. Rather than extinguishing the contract on some theory akin to frustration of essential purpose, why not enforce the contract as reformed to make the jargon compatible with the statute under which the successor is organized?

The problem is that lawyers—and often courts at the prodding of lawyers—get caught up in labels and "black magic." The focus is on the form,
the mechanics, and the abstract propositions, rather than substance and reality. Businesspeople typically understand the essence of what they wish to establish concerning their relationship as investors and managers. Lawyers then sometimes convolute these concepts into complicated agreements. This is not to say that there are not reasons for agreements to be complicated, but the essence can be lost in the detail and the detail can mark the essence.

The pragmatic approach taken by the court in *C & J Builders* should support the argument to carry over investor contracts in predecessor entities into the successor entity. While this creates some problems of construction because of the disparity in language, it gives effect to the relevant portion of the parties’ agreement.

The construction of an operating agreement for a law firm which converted from a partnership to an LLC was a major issue before the court in *Goldstein and Price, L.C. v. Tonkin & Mandl, L.C.*, 98 together with the issue of whether there was an oral modification of such agreement. At the time of conversion, in January 1994, the members of the firm agreed that their **partnership agreement** would be the operating agreement of the LLC until a new operating agreement, consistent with the LLC statute could be prepared. For a law firm organized as an LLC not to have an operating agreement is like the cobbler’s children having no shoes. In the author’s experience, however, *Goldstein* does not present a unique situation.

A draft agreement was prepared and discussed on October 22, 1994, but one member, Tonkin, had reservations about it. His concerns were to be addressed at a subsequent meeting on November 22, but ten minutes before the meeting, Tomkin advised the firm that he was withdrawing. His written notice of withdrawal purported to set the effective date on December 21, 1994.

Section 12 of the operating (partnership) agreement provided that “[t]he withdrawal shall become effective on the last day of the calendar month after service of the withdrawal notice hereafter referred to as the ‘date of withdrawal.’” 99 The firm contended that this provision made his withdrawal effective November 30, 1994, and thus Tonkin was not entitled to additional accounts receivable generated in December, nor to his Keough contribution due in December.

To resolve this issue, the court looked to another provision of the operating (partnership) agreement which specified that a withdrawing member (partner) would receive his share of capital in six equal monthly installments, “with the first payment due on the thirtieth day following the service of the notice of withdrawal.” 100 According to the court, it would not make sense to interpret the language of the agreement to mean that

99. *Id.* at 546 n.1.
100. *Id.* at 551.
withdrawal would become effective the last day of the calendar month after service of the withdrawal notice as referring to the last day of December because, under the payment provision, the first payment would be due 30 days after service of the withdrawal notice, or December 22.

According to the court, this interpretation would have the first payment becoming due before the withdrawal became effective. In effect, the court rewrote the language to read that withdrawal would become effective on the last day of the month in which service of the notice was made. This case demonstrates the need to have an operating agreement with provisions that are clear and precise. The ambiguity in the case at bar deprived plaintiff of his share of the December accounts receivable, which may have been equitable but, more importantly, deprived him of his Keough contribution for the year.

**FIDUCIARY DUTIES**

From a case law standpoint, what is surprising about the last decade is the relative absence of litigation relating to the fiduciary duties of members or managers in LLCs. Although there have been several cases in which fiduciary duties were implicated, many of them dealt with collateral issues, and accordingly, there are relatively few cases dealing specifically with whether or not a particular set of facts involved a breach of fiduciary duty.

In the LLC legislation, there have been a variety of statutory provisions dealing with fiduciary duties. Moreover, in some statutes, there are no specific provisions dealing with fiduciary duties. In point of fact, one effective way of dealing with the issue of fiduciary duties is to leave this subject strictly to case law development. A second approach is that adopted by the Uniform Commissioners in ULLCA, and enacted in several states. ULLCA purports to define an exclusive list of fiduciary duties. Illinois has modified the ULLCA approach by making the list non-exclusive and eliminating the conflicts and ambiguities of ULLCA. Several other states have fiduciary duty provisions patterned after section 21 of the Uniform Partnership Act or section 144 of the Delaware General Cor-


103. *See* states listed in Appendix 2.


105. *See* states listed in Appendix 2.

Limited Liability Companies in the Decade of the 1990s

Another unique approach was found in the original Illinois Act, which provided that a member had obligations and duties similar to a shareholder in the corporate context, and a manager had duties and obligations similar to those of a director in the corporate context. The first approach, i.e., not addressing fiduciary duties in the statute itself, is basically the corporate law approach. Corporate statutes in general do not have extensive provisions with respect to fiduciary duties, but rather the development of fiduciary duties has been left to the case law. For example, section 8.60 of Illinois and section 144 of Delaware deal only with one aspect of the duty of loyalty, namely, conflict of interest. Similarly, section 8.65 of Illinois and section 174 of Delaware deal only with a very limited aspect of the duty of care, namely, distributions in violation of statute. Other aspects of fiduciary duty in the corporate context, such as disclosure, the corporate opportunity doctrine and competing with the corporation, have been left solely to case law development. Clearly, factual issues such as fairness and disinterestedness also must be left to the case law.

Moreover, one of the most important fiduciary duty developments in corporate law has been the recognition of the duty of fair dealing by majority shareholders to minority shareholders. This development is entirely a case law development and has been predicated upon partnership principles, that is, that shareholders in a closely held corporation bear the same fiduciary responsibilities to each other as would partners in the partnership context.

113. See, e.g., Weinberger v. UPO, Inc., 457 A.2d 701, 711 (Del. 1983) (holding that fairness includes both fair price and fair dealing), aff'd, 497 A.2d 792 (Del. 1985); Sblensky v. South Parkway Bldg. Corp., 166 N.E.2d 793, 796, 805 (Ill. 1960) (holding that fairness is the key issue and that an employee and a lawyer for a corporation were not disinterested with respect to a transaction between the corporation and an individual who controlled the corporation); Gries Sports Enters., Inc. v. Cleveland Browns Football Co., 496 N.E.2d 959, 967 (Ohio 1986) (holding that an officer and general counsel were not disinterested and that directors had the burden of proving fairness).
In the partnership context, the Uniform Partnership Act does have a provision dealing with certain fiduciary duties, namely, conflict of interest and partnership opportunity.\(^{115}\) Notwithstanding this statutory provision, Illinois courts, for example, when dealing with fiduciary duties in the partnership context, seem to have generally ignored the statutory provision and have dealt with the subject of fiduciary duties by case law.\(^{116}\) Courts in other jurisdictions have done likewise, treating the statute as merely restating the existence of common law fiduciary duties without any extensive analysis of the statutory language.\(^{117}\) Because, in the corporate and partnership context, fiduciary duties have been dealt with essentially by case law, there would not seem to be a compelling need to have a statutory approach to fiduciary duties in the LLC context.

**THE UNIFORM PARTNERSHIP ACT ANALOG**

The majority of states have either no statutory duty provision\(^ {118}\) or have adopted a version of the provision in the Uniform Partnership

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118. Arizona, District of Columbia, Kansas, Maryland, Massachusetts, Mississippi, Montana, Nebraska, Nevada, and New Jersey. See Appendix 2 for citations. Mississippi has a version of § 8.30 of the Model Business Corporation Act which is basically a duty of care type provision and does not deal with the duty of loyalty or other fiduciary duties. Arizona, District of Columbia, Delaware, Kansas, Maryland, Mississippi, and New Jersey have a provision similar to § 107 of the Revised Uniform Limited Partnership Act (amended 1985), 6A U.L.A. 94 (1995), which provides: “Except as provided in the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.”

Because a third party has no fiduciary duty in dealing with the entity, arguably such a provision eliminates fiduciary duties, rather than leaving them to case law. It is highly unlikely a court would so hold, however. Cf. Fleigler v. Lawrence, 361 A.2d 218 (Del. 1976), discussed infra text accompanying notes 200, 206. Moreover, as the comment to § 107 indicates, the purpose of the above language was not to eliminate fiduciary duties:

Section 107 makes a number of important changes in Section 13 of the prior uniform law. Section 13, in effect, created a special fraudulent conveyance provision applicable to the making of secured loans by limited partners and the repayment by limited partnerships of loans from limited partners. Section 107 leaves that question to a state’s general fraudulent conveyance statute. In addition, Section 107 eliminates the prohibition in former Section 13 against a general partner (as opposed to a limited partner) partner’s sharing pro rata with general creditors in the case of an unsecured loan. Of course, other doctrines developed under bankruptcy and insolvency laws may require the subordination of loans by partners under appropriate circumstances.
Section 21 of the Uniform Act provides simply:

Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.120

But the problem is that it is too simple. Fortunately, the provision does not purport to be exclusive. Moreover, possibly because of its curtness, courts have often ignored its provisions or cited them in passing and relied upon common law principles.121

Section 21 has several ambiguities and limitations, and uses what is today rather archaic language. For example, it speaks of accounting for any “benefit” and holding as trustees any “profit” derived without the consent of the partnership. In today’s jargon, this provision seems aimed at what we call a conflict of interest. But to be wrongful, need the benefit or profit be “improper?” The Wisconsin statute so qualifies the kind of benefit that is recoverable by the LLC,122 but the balance of the LLC statutes are not so qualified. Thus, these statutes are a throwback to the turn of the century (to nineteenth, not twentieth century) jurisprudence where directors of a business were considered trustees and thus transactions with the entity were voidable without regard to fairness.123

Today, when a fiduciary deals with the entity, the inquiry is whether the transaction is fair, not whether the fiduciary made a profit. For example, if a person bought some property in 1998 for $100,000, became a member of an LLC in 1999, and sold the property to the LLC in 2000 for $130,000,124 is there anything improper about the transaction? Clearly the person made a profit. But the issue today normally would be whether the price was fair.125 If the fair market value of the property were $130,000 or more, there would be nothing improper. Even if the property were only worth $120,000, the “evil” would be $10,000, not $30,000.

Another area where the section 21 approach is deficient is in the entity opportunity area. The language that the member must “hold as trustee” any profit or benefit is reminiscent of corporate opportunity language

122. WIS. STAT. ANN. 183.0402 (West Supp. 1999).
124. Assume that the LLC needed this or some similar property for its business.
125. See infra notes 184-88, 197-200, and accompanying text.
where the remedy is a constructive trust. But this obligation to hold as trustee only arises from a transaction “connected with the formation, conduct, or liquidation” of the entity. Such language fits well with the conflict of interest situation where, generally, there is a transaction with the entity. In the entity opportunity situation, however, there is no transaction with the entity. The evil in an entity opportunity situation is that there is no transaction with the entity, whereas there ought to have been one. In other words, the fiduciary, for example, buys property for himself whereas he ought to have acquired it for the entity. In such a situation, he should hold the property as constructive trustee. It may be that his purchase for himself is a “transaction connected with the... conduct” of the LLC, but this is hardly the language you would use to clearly define the proscribed conduct.

Finally, can the activity of a member, which otherwise would be wrongful, be “righted” by approval of the members? If so, must such approval be by a mere majority or does it require unanimity? If by a majority, is it a majority in number or a majority in interest? For example, voting in some LLCs is per capita, while in others it is per capital. Moreover, does the requisite approval require that those voting be disinterested? Section 21 did not require disinterestedness, nor does North Carolina, Oklahoma, Pennsylvania, or Tennessee, whereas Arkansas, Idaho, Indiana, Kentucky, Maine, Missouri, Rhode Island, and Wisconsin, which all specify that the requisite approval be by disinterested

127. Id.
129. Assume voting is per capita. A, B, and C contribute $15,000 each and D, C’s brother (or spouse, or mother, or partner in another venture), contributes $55,000. A and B are opposed to the LLC buying property from C but D approves. On a per capita basis, the transaction is approved $70,000 to $30,000. If voting is per capita, a majority of the members in number of members must approve. A majority of 4 is 3. The transaction could not be approved by C and D alone. For discussion of per capita and per capital, see infra notes 342-70 and accompanying text.
130. Supra note 115.
133. 15 PA. CONS. STAT. ANN. §§ 8943, 1715(d)-(g), 1712 (West 1998).
141. R.I. GEN. LAWS § 7-16-17 (1999).
142. WIS. STAT. ANN. § 183.0402 (West Supp. 1999).
members or managers. Using a different approach, North Carolina and Oklahoma require that the consent be "informed."143

These are all issues that a properly drafted fiduciary duty statute should address. Although it deals only with conflict of interest, the Illinois corporate statute144 is a good model in clarifying that fairness is the key, that approvals must be disinterested, that those approving must be fully informed, and that such approvals only change the burden of proof, rather than creating a safe harbor. While some may argue for the safe harbor approach, this generally is not the approach in the corporate world. Moreover, anyone involved with litigation in the fiduciary duty area knows that the name of the game is who has the burden of proof.

SIMPLIFIED STATUTORY APPROACHES TO FIDUCIARY DUTY

If the LLC statute is to address fiduciary duties, one approach is, in effect, to incorporate by reference. For example, the California statute provides that "[t]he fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership."145 Because the initial approach to the creation of LLCs was to create an incorporated partnership, a sensible approach with respect to fiduciary duties was simply to incorporate the fiduciary duty law of partnership into the LLC law.

A different approach to incorporation by reference was adopted by Illinois. When the Illinois legislature first enacted an LLC Act in 1992, it included a section which provided that the duties of members shall be analogous to those of shareholders in the corporate context and the duties of managers shall be analogous to those of directors.146 This provision disturbed some transaction lawyers in the large Chicago law firms, because they feared that it would incorporate the doctrine of piercing the corporate (entity) veil into LLC law. Accordingly, they began, as a matter of course, utilizing the Delaware LLC laws, notwithstanding that this then subjected managers of the Delaware LLC to the jurisdiction of the Delaware Courts,147 and notwithstanding Chief Justice Veasey's characterization of the Delaware statute as containing provisions that are "prolix, sometimes oddly organized, and do not always flow evenly."148 More significantly,
organizing in Delaware does not eliminate the piercing the entity veil problem, because such a doctrine is a creditor's remedy, not a fiduciary duty issue.\textsuperscript{149} Thus, even with respect to a Delaware LLC, Illinois courts should look to Illinois common law principles in determining whether the corporate form has been used as an instrument of fraud or injustice.\textsuperscript{150}

The initial Illinois statute was essentially a limited partnership type approach, because at the time of its enactment, it was necessary that an LLC have more partnership characteristics than corporate characteristics in order to be taxed as a partnership.\textsuperscript{151} When the “check-the-box” regulations were adopted,\textsuperscript{152} however, Illinois reappraised its existing statutory provisions. Subsequent to the initial Illinois enactment of LLC legislation, the ULLCA was promulgated by the Uniform Commissioners, and in the interest of uniformity, there was substantial interest in adopting ULLCA in its entirety to replace the old Illinois statute. Many of ULLCA’s provisions were prudent and were ultimately adopted. There was considerable difference of opinion, however, as to whether the ULLCA approach to fiduciary duty should be adopted in Illinois. Ultimately, the ULLCA provisions on fiduciary duties were substantially modified. In order to appreciate the present Illinois statutory provisions regarding fiduciary duties, first it is necessary to review the ULLCA approach.

**THE FLAWED APPROACH OF THE UNIFORM ACT**

It is surprising that a Model Act adopted by the Uniform Commissioners could be both so poorly drafted and embody such poor public policy. The structure of ULLCA\textsuperscript{153} is to set forth that “[t]he only fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and


\textsuperscript{150} For an extensive discussion of the Illinois cases on piercing the corporate veil, see BUSINESS ORGANIZATIONS, supra note 114, §§ 8.11-8.23.

\textsuperscript{151} See supra text accompanying notes 5-8. See also infra text accompanying notes 262-63.


(c).". Thus, ULLCA provides the exclusive list of fiduciary duties when a business is organized as an LLC.

There are several problems with this approach. First of all, the duty of loyalty and the duty of care are duties owed by fiduciaries to the entity. In their traditional form, they do not cover obligations owed by the members to each other. Yet ULLCA says that the only fiduciary duties a member owes to other members are the duty of loyalty and the duty of care. Because these duties are owed to the entity and not to members, arguably there are no duties that one member owes directly to another under ULLCA.

This approach flies in the face of developments in corporate law over the last two and a half decades which recognize that shareholders (members) in a corporation do owe fiduciary duties to each other akin to those owed by partners in a partnership. This fiduciary obligation in the corporate context between shareholders is referred to as a duty of good faith and fair dealing. ULLCA does provide that "[a] member shall discharge the duties to a member-managed company and its other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing." This provision does not mean, however, that there is a fiduciary obligation of good faith and fair dealing between members, even though that is what the foregoing provision would seem to say, because this provision is in paragraph (d), whereas paragraph (a) states that the only fiduciary duties are found in paragraphs (b) and (c). Unfortunately, the Uniform Commissioners have taken the position that the obligation of good faith and fair dealing in ULLCA is not a fiduciary duty standard but rather a commercial standard.

The differences between a commercial standard and a fiduciary duty standard are substantial. In a fiduciary duty context, the persons in control, who are trying to uphold the actions they are taking, have the burden of proof to establish that such actions were taken in good faith and were fair to the minority members. Usually they will be the defendants and thus, in contrast to the normal situation where the plaintiff has the burden of proof, the defendants will have the burden of proof. On the other hand, under the commercial standard, the plaintiff would have the burden of proving that the other person did not act in good faith. Moreover, good faith in the commercial context is a very minimalist standard.

155. See Effective Remedies, supra note 114, at 433-36.
158. In Froelich v. Erickson, 96 F. Supp. 2d 507, 522 (D. Md. 2000), the court interpreted the good faith and fair dealing commercial standard as follows:

Assuming arguendo that Maryland does recognize a separate cause of action, the duty of good faith and fair dealing is so narrow that it does not apply here. Explaining the duty
Questions may be raised as to which approach, commercial or fiduciary, is more appropriate with respect to relations among members in a limited liability company. In order to resolve this issue, it is necessary to understand the basic nature of a commercial transaction and contrast it with the basic nature of relations among members in a limited liability company. In the classical commercial context, there is: (i) a transaction (ii) between legal strangers (iii) which involves closure. On the other hand, in a business organization there is: (i) a relationship (ii) between legal associates (iii) which is an open, i.e., ongoing, situation. While it is true that some commercial transactions are ongoing and involve longstanding business relationships, nevertheless it is understood in commercial transactions that persons are dealing at arm's length with each other, and that each party to the transaction has interests that are in opposition to those of the other party. For example, the seller wants the highest price with the least warranty exposure, whereas the buyer wants the lowest price with the greatest warranty protection. On the other hand, in a business organization, the members have an aligned interest in which they expect to work together over time for their mutual benefit.

The approach of the contractarians to this issue is that, if the parties want the protections afforded by a fiduciary relationship, let them contract for it. This is unrealistic for several reasons. First of all, there is the matter of cost. Most businesses, at inception, have a financing problem. The most efficient employment of the available finances is for the capital and operating needs of the business, not for attorney's fees. The popularity of books such as, How to Form Your Own Corporation Without a Lawyer for Under $75, demonstrates that business people are not eager to expend any more monies on attorney's fees than is absolutely necessary.

In order to draft an adequate shareholders' agreement in the corporate context, or operating agreement in the LLC context, which would provide the types of protection that fiduciary duties provide on a default basis, one in the context of a loan agreement, the Maryland Court of Special Appeals stated that, "the duty of good faith merely obligates a lender to exercise good faith in performing its contractual obligations; it does not obligate a lender to take affirmative actions that the lender is clearly not required to take under its loan documents."


159. Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1, 28 (1990) (dealing with corporations). Much of Butler and Ribstein's thinking is based upon market discipline and there is no market for closely held interests, whether corporate or LLC.

160. TED NICHOLAS & SEAN P. MELVIN, HOW TO FORM YOUR OWN CORPORATION WITHOUT A LAWYER FOR UNDER $75 (28th ed. 1999).
could expect an attorney's fee in the range of $10,000 or more, at least in the Chicagoland area. One of the reasons for this high cost is the difficulty in drafting such an agreement. Because we are dealing with a relationship, we need to anticipate problems that may not arise until years down the line. If one were to examine the litigated cases, one would find that many of the cases involve problems that have arisen a decade or more after the organization of the business.\(^\text{161}\) This is because, over time, situations change. Personality differences may arise, someone may go through an ego shattering divorce, a spoiled child may enter the business, or the financial misfortunes of one member may lead him or her to make demands that are unacceptable to other members.

In discussing the duty of good faith under ULLCA, the comment to ULLCA states that "a members' refusal to vote for an interim distribution because of negative tax implications to that member does not violate that member's obligation of good faith to the other members."\(^\text{162}\) In point of fact, the refusal by those in control to make distributions in order to enable other members to pay the taxes on the income they constructively receive in a pass-through entity, such as a sub-chapter S corporation, a limited partnership, or an LLC is generally viewed as a breach of fiduciary duty by those in control.\(^\text{163}\)

The Labovitz case is particularly instructive. There, the limited partnership agreement gave unfettered discretion to the general partner to determine when and if distributions were to be made. Notwithstanding this broad grant of authority to the general partner, the Illinois appellate court held that it was a breach of his fiduciary duty to withhold distributions to create cash flow problems for the limited partners.\(^\text{164}\) Because a limited partnership is a pass-through entity for tax purposes, the limited partners were taxed on the income generated by the limited partnership. When the general partner refused to make cash distributions, the limited partners were faced with a cash outflow, namely, the payment of their tax liability, but received no cash from the business to enable them to pay their taxes. This then gave the general partner leverage, because the limited partners had a negative cash flow instead of a positive cash flow, thereby decreasing the attractiveness of their investment and inducing the limited partners to sell to the general at a cheaper price.

\(^{161}\) See, e.g., Battaglia v. Battaglia, 596 N.E.2d 712, 719 (Ill. App. Ct. 1992), appeal denied 602 N.E.2d 446 (Ill. 1992) (involving brothers that had worked together for 40 years); In re Kemp & Beatley, 473 N.E.2d 1173, 1176 (N.Y. 1984) (involving plaintiffs that had worked for the business for 35 and 42 years, respectively); Pedro v. Pedro, 489 N.W.2d 798, 803 (Minn. Ct. App. 1992) (involving a plaintiff that had been employed for 45 years and the defendant brothers employed for 34 and 50 years respectively).


\(^{164}\) See Labovitz, 545 N.E.2d at 313.
The issue of fiduciary duties have been framed by contractarians as embodying a choice between a statutory approach which is paternalistic and one which is contractual. By way of illustration, if a paternalistic approach is chosen, the default provision in the statute would be to provide for the broad and general existence of fiduciary duties and then, if necessary, let the parties contract to limit such duties. On the other hand, in a contractarian approach, the statutes would be silent or would have limited fiduciary duties and would permit the parties, if they chose, by contract to impose additional obligations upon themselves.

Thus, we have two approaches to drafting a statute, one paternalistic, seeking to protect people by leaving fiduciary duties as the default provision in the statute, and the other contractarian, which leaves people free to fend for themselves and create whatever protections they need. To sharpen the issue as to which approach is more appropriate, it is also well to postulate, as caricature, that there are two types of business arrangements as well. One situation would envision sophisticated people engaging in a significant transaction in which substantial funds are involved, including the funds to obtain sophisticated advice. In the other situation, postulate that the investors are less sophisticated, funds in general are limited, and sophisticated advice is less available, not only because of cost but also the nature of legal practice in the area.165

What type of business situation is the most prevalent? To put the issue in perspective, according to the records of the Secretary of State of Illinois, there are about 200,000 corporations in Illinois of which about 170,000 have capital of $25,000 or less.166 Although the amount of money invested in a business does not necessarily say anything about the sophistication of the business owners, it is a fair assumption to conclude that few businesses with capital of less than $25,000 would be eager to pay substantial amounts, in the nature of $10,000 or more, for organizational expenses which would include the drafting of sophisticated and detailed agreements. There does not appear to be any data on the extent to which business owners are sophisticated with respect to legal matters, such as fiduciary obligations. From the generally recognized antipathy of the business world toward lawyers, however, it can be assumed that there is not general appreciation among the public for the advice that lawyers proffer.167

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165. Transactions involving millions of dollars are often negotiated by sophisticated lawyers specializing in business transactions who are members of national law firms. On the other hand, the lawyers for a modest transaction in a small town might do divorce, estate planning, and local government law besides business transactions, because the demographics do not permit her to specialize and still earn a living.


167. In giving talks to bar associations over the years, I have surveyed business lawyers as to how much time they spend in discussing fiduciary obligations with their clients upon the organization of a business. Many report that this is a subject that is not discussed at all and the median time spent would appear to be in the order of ten to fifteen minutes.
As stated earlier, when organizing a business, most businesspeople perceive the most pressing need for the use of funds to be in procuring capital equipment and otherwise providing for operations. Legal fees are not a top priority. Moreover, when entering the business relationship, most businessmen enter the relationship the same as most of us enter the marital relationship: optimistically and ill-prepared. Optimism about the future prospects of the business is not a catalyst to enter into an extensive and expensive contract dealing with all the misfortunes that might occur later on.

What then would seem to be good public policy? Because most businesses are small upon inception, and because, arguably, most businesspeople are not sophisticated about fiduciary relationships, the default provision of a statute should provide for the full range of fiduciary obligations.

The counter argument is that there are many situations in which traditional fiduciary duties ought to be limited. A typical situation is one in which two independent real estate investors combine to form a new project as a joint venture. After the project is completed, they want to be free to continue their own real estate ventures and to develop other projects independent of each other.

The leading case of Meinhard v. Salmon, however, held that two partners in a real estate venture owed each other the fiduciary duty to give each other the opportunity to participate in future ventures. Such fiduciary duty would be inconsistent with the goals of the two real estate developers set forth above and, if not modified, might dissuade them from entering into the joint venture. This, however, is a classic illustration of sophisticated businesspeople dealing with a substantial project in which significant funds will be expended for sophisticated advice, namely, the creation of the joint venture agreement and numerous other contractual and financial documents. Accordingly, these people are well able to fend for themselves and, through contract, could limit what would otherwise be the fiduciary duty not to compete with each other or to afford each other future opportunities.

Thus, a statute which provides for fiduciary duties as a default provision thereby protects smaller or unsophisticated businessmen, but can also provide latitude for sophisticated investors to determine by contract the nature of their relationship.

A statute like ULLCA, which purports to define and then limit fiduciary duties, is flawed in another respect. As stated above, the statute purports to limit the fiduciary duties that a member owes—either to the organi-

zation or other members—to the duty of loyalty and the duty of care. The statute then further limits the duty of loyalty to entity opportunity, conflict of interest, and refraining from competing with the entity.\textsuperscript{170}

But does this exhaust the scope of fiduciary duties? The conflict of interest provision is phrased in terms of refraining from dealing with the company. But failure to deal with the entity can itself be a breach of fiduciary duty. For example, assume two persons, comprising all of the officers and directors of the entity, were conducting a moving and storage business in a warehouse leased from one of them. Further assume that the entity had an option to extend the lease or to purchase the property and that there was no other suitable storage site. In such a situation,\textsuperscript{171} failure to renew the lease or exercise the option to purchase the real estate would mean that the corporation would be out of business and its value would be destroyed. In such a circumstance, action by the shareholder who owned the real estate—either in her capacity as director or as shareholder—to frustrate the exercise of the option or the renewal of the lease would be a breach of fiduciary duty—even though all the shareholder who owns the property need do is simply take no action. By taking no action, the corporation cannot act because, with two shareholders and two directors, it is impossible to get a majority vote if one person opposes the transaction or simply does not act. A majority of two is two. Yet what such shareholder was doing, namely nothing, meets the standard of ULLCA, namely that she is fulfilling her obligation to refrain from dealing with the company.

Another problem in seeking to limit fiduciary duties to those enumerated is that it fails to take into account that fiduciaries have a duty of disclosure and candor to each other. The Delaware supreme court,\textsuperscript{172} as well as the Illinois courts\textsuperscript{173} and courts in other jurisdictions,\textsuperscript{174} have recognized that there is a duty of disclosure and complete candor when a fiduciary deals with those to whom he/she or it owes a fiduciary duty. While, at first blush, the provisions of ULLCA would seem to incorporate this duty,\textsuperscript{175} the obligation to furnish information under ULLCA only applies where "reasonably required for the proper exercise of the member's rights and performance of the member's duties under the operating agreement or this [Act]."\textsuperscript{176} If someone were to negotiate for the purchase

\textsuperscript{173} See Business Organizations, supra note 114, § 14.06.
\textsuperscript{176} Id. § 4.08(b)(1), 6A U.L.A. 463 (1995).
of another member's interest, however, the member, in selling his or her interest would not be exercising her rights or performing her duties under the operating agreement or the statute. Therefore, the informational provisions of ULLCA would not be applicable and, under section 409, there would not be a fiduciary duty between the members. In the corporate context, where one fifty percent shareholder negotiated to sell both his and the other shareholder's shares, and in the process obtained a better deal for himself, the court stated that defendant "stood in a fiduciary relation to Leeb [the other shareholder] . . . that he failed to deal openly and honestly with Leeb, and that, in fact, his conduct was fraudulent."\(^7\)

The ULLCA provisions are flawed for a variety of other reasons: (i) they are poorly drafted and internally inconsistent; (ii) they either dramatically change existing law or fail to accomplish what their proponents sought; and (iii) as an attempt to restate some parts of existing law, they are back in the nineteenth century.

Section 409(b)(2) provides that the duty of loyalty requires a member: "to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company."\(^7\) This is certainly not the duty of loyalty today! It may have been in the nineteenth century. Today, the law generally is that a fiduciary may deal with the entity as an adverse party, that is on opposite sides—the conflict of interest situation—so long as the transaction is fair. For example, in *Winger v. Chicago Citibank*,\(^7\) the Illinois supreme court stated that "directors of a corporation cannot purchase from themselves." This language in the *Winger* decision, however, was rejected by the Illinois supreme court in *Shlensky v. South Parkway Building Corp.*\(^8\) In this later case, the court held that a transaction between a corporation and a director is not presumptively void, but is valid if fair. Unless there is disinterested approval, the proponent of the transaction, the director, has the burden of proof.

This is the same philosophy that is embodied in the Illinois Business Corporation Act.\(^8\) The act provides that a director can deal with a corporation, or, in other words, be on both sides of the transaction, so long as the transaction is fair. Again, the burden is on the director unless there is either a disinterested shareholder or disinterested director approval. It is also the same approach that is embodied in section 144 of the Delaware Act,\(^2\) as interpreted by the Delaware supreme court in *Fliegler v. Law-

\(^{177}\) Illinois Rockford Corp. v. Kulp, 242 N.E.2d 228, 233 (Ill. 1968).
\(^{179}\) Winger v. Chicago City Bank & Trust Co., 67 N.E.2d 265, 276 (Ill. 1946).
where the court, in effect, rewrote the Delaware statute, holding that it is not a safe harbor, but merely changes the burden of proof and that the fiduciary will have the burden of proof unless there is disinterested shareholder approval.

Consequently, a provision prohibiting a member from dealing with the LLC as an adverse party is archaic and is certainly not a restatement of existing law.

The ULLCA provisions are also internally inconsistent. Notwithstanding the seemingly absolute prohibition from dealing with a company in section 409(b)(2) of ULLCA, another section provides that “[a] member of a member-managed company does not violate a duty or obligation under this [Act] or under the operating agreement merely because the member’s conduct furthers the member’s own interest.”184 The implication of this section, were it to be considered in isolation, is that a member could deal “adversely” with the LLC. In other words, furthering the member’s own interests does not violate a duty to the LLC.

If the two provisions are to be reconciled, the keyword is “merely.” For example, if the member sells property to the LLC and thereby generates cash for the member, this is arguably furthering the member’s own interest. But, if the transaction is fair to the entity, there would be no breach under existing law. None of these ULLCA provisions refer to fairness, however. If fairness is the issue, then ULLCA should so state. Instead, ULLCA creates a potential inconsistency.

The morass becomes all the more complicated when one looks at another section of ULLCA which provides:

A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law.185

How can this provision be squared with the provision requiring a member to refrain from dealing with the LLC? It would seem that the first sentence of the above language is in direct conflict with the provision which precludes members from dealing with the LLC as an adverse party. Lending money and transacting other business with the company is “dealing with the company.”

Not only are these provisions confusing and inconsistent, but if they mean what they say, the provisions dramatically change existing law. The second sentence, quoted above, provides that, with respect to each transaction, the rights of a member are the same as those of a person who is not a member. This is in direct conflict with fiduciary duty law in general.

A fiduciary has different obligations than a third party. A third party has no obligation to charge a fair price to the LLC. The third party generally can charge any price she can induce the LLC to pay. When a third party deals with the entity, and the entity sues the third party, the plaintiff entity has the burden of proof. When a fiduciary deals with an entity, however, the defendant fiduciary has the burden of proving that the transaction is fair. Thus, the provision in ULLCA that, when dealing with the LLC, the member has the same obligations as a third party is inconsistent with existing law.

Although it could be argued that this third-party provision was designed to overrule existing law, the picture is further clouded by the very last phrase—that the rights of the member are the same as third parties “subject to other applicable law.” If this last phrase preserves existing law, then it negates the entire provision. It is unparalleled that a piece of proposed legislation could be so confusing and inconsistent.

**THE ILLINOIS MODIFICATIONS TO ULLCA**

The fiduciary duty provisions of the present Illinois Act modify ULLCA in several important respects. The initial provision makes it clear that the enumerated duties are non-exclusive and that there is, thus, room for case law development. This provision provides simply that the “fiduciary duties a member owes . . . include the duty of loyalty and the duty of care . . . .” Accordingly, under the Illinois Act, the duty of good faith and fair dealing is a fiduciary duty, not a commercial standard. ULLCA, on the other hand, states that the duty of care and the duty of loyalty are the only fiduciary duties a member has. In addition, in enumerating certain categories of the duty of loyalty, the Illinois provision similarly provides that the duty of loyalty “includes” the enumerated provisions. Thus, the duty of loyalty provisions that are enumerated are non-exclusive. By way of contrast, ULLCA provides that the duty of loyalty is limited to the enumerated duties.

Equally important is the fact that the provision of ULLCA, which provided that a member’s responsibilities in dealing with the company are the same as a third party, has been dropped in its entirety. The ULLCA provision dealing with conflict of interest has been completely rewritten.

189. Id. 180/15-3(a) (emphasis added).
190. Id. 180/15-3(d).
192. 805 ILL. COMP. STAT. ANN. 180/15-3(b) (West 2000).
194. Id. § 409(f).
195. Id.
Rather than providing that members must refrain from dealing with the LLC, the Illinois provision restates existing law by requiring the member "to act fairly when a member deals with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company." Thus, the conflict of interest provision is consistent with case law around the country. It is also consistent with other entity statutes, such as section 8.60 of the Illinois Business Corporation Act and section 144 of the Delaware General Corporation Law, as modified by Fleigler v. Lawrence, by making fairness the touchstone as to whether a transaction involving a conflict of interest can stand.

In general, the Illinois fiduciary duty provisions stand as a sound model if the subject of fiduciary duties are to be dealt with, at least in part, by statute, rather than being left entirely to common law development. The primary weakness of the Illinois LLC statute is that it follows Delaware's approach in dealing with ratification. It states that the operating agreement may "specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate these duties." ULLCA has a provision that is substantially identical. Thus, although the statute specifies that only disinterested managers may authorize or ratify a transaction, it is open to the interpretation that interested members could so act. It is extremely unlikely, however, that a court would permit an interested member to insulate himself from responsibility in a conflict of interest situation.

As stated above, this provision is patterned after section 144 of the Delaware General Corporation law. The Delaware supreme court, however, interpreting section 144 in Fleigler v. Lawrence, held first that it does not constitute a "safe harbor" but rather merely changes the burden of proof.

200. 361 A.2d 218 (Del. 1976).
204. Statutes in other states require disinterested member approval. See supra notes 135-42 and accompanying text.
205. See DEL. CODE ANN. tit. 8, § 144 (1998). See also Appendix 5.
206. 361 A.2d 218 (Del. 1976).
and in order to effectuate such change in the burden of proof, the vote of the shareholders must be a *disinterested* vote of the shareholders.\textsuperscript{207}

In Illinois, section 8.60 of the Business Corporation Act was drafted after section 144 was, in effect, modified by the court in *Fliegler v. Lawrence.*\textsuperscript{208} Section 8.60 begins by providing that the person seeking to uphold the transaction, namely the fiduciary, has the burden of proof and that this burden is changed to plaintiff only when there is either disinterested director or disinterested shareholder approval.\textsuperscript{209} In view of the decision of the Illinois supreme court in *Shlensky v. South Parkway Building Corp.*,\textsuperscript{210} and the heightened scrutiny which Illinois courts give transactions involving fiduciaries, the present provision in the Illinois LLC Act could well be interpreted (as did the Delaware supreme court in *Fliegler*) as requiring not only disinterested manager approval but also disinterested shareholder approval and holding that such approval, rather than insulating the transaction from judicial review, merely changes the burden of proof.

The logic of section 8.60, and the deficiency in ULLCA and present Illinois provisions, can be illustrated by the following example. Assume a limited liability company has three members, Able, Baker, and Carol. Normally, when the limited liability company engages in a transaction with a third party, the interests of Able, Baker, and Carol will be aligned. They all want to get the best possible deal for the limited liability company and would negotiate vigorously with a third party to accomplish such an advantageous transaction. What if Able and Baker decide, however, to sell an asset which they hold personally to the limited liability company at an inflated price. Because Able and Baker are a majority of the members, they could authorize the transaction from the standpoint of authorization. But should the transaction be insulated from judicial scrutiny, simply because they approve or ratify the transaction?

It can be seen that, in this context, the interests of Able and Baker are aligned but are antithetical to the interest of Carol and the interest of the LLC itself. The contrary argument that is sometimes made is that it is still in the best interest of Able and Baker to benefit the LLC, because they hold a 67% interest in the LLC. To the extent that the price they are charging the LLC for the asset is overstated, however, as members of the limited liability company they bear 67% of such unfairness in price, but they reap 100% of the benefit of the unfairness in their individual capacities. In effect, there is a transfer of value from Carol to Able and Baker.

Take a concrete example. Assume that Able and Baker own real estate worth $200,000, which they propose to transfer to the LLC for $300,000. The LLC, by paying $300,000 for a $200,000 asset, has lost $100,000 in

\textsuperscript{207} See id. at 222.

\textsuperscript{208} See 805 ILL. COMP. STAT. ANN. 5/8.60 (West 2000).

\textsuperscript{209} See id. See also Appendix 6.

\textsuperscript{210} 166 N.E.2d 793 (Ill. 1960).
value, but that $100,000 loss is born equally by Able, Baker, and Carol. Able and Baker in their individual capacities, however, are up $100,000 or $50,000 each. Thus, the net effect of the transaction is that Carol is out $33,333, while Able and Baker have gained $16,667 each. To permit Able and Baker to approve their own self dealing is inconsistent with the basic concept of fiduciary duty.

**CASE LAW DEVELOPMENTS OF FIDUCIARY DUTY**

As stated earlier, it is surprising that there has not been more litigation in the 1990s involving fiduciary duties. The litigation thus far illustrates, however, that courts are having some difficulty in dealing with fiduciary issues in the context of LLCs. One issue which is also troublesome to some courts in the corporate area, is distinguishing whether a fact pattern implicates the duty of care or the duty of loyalty. In fact, this should be a simple matter to resolve. For the duty of care, and the business judgment rule, to be applicable, there must be *no conflicting interest*.211 The difficulty that courts have in determining whether a factual situation implicates the duty of care—with the attendant protection of the business judgment rule—or the duty of loyalty (or related fiduciary duties where the transaction is tainted by self-interest) is illustrated by *Froelich v. Erickson*.212 Froelich, and other employees of a business that Erickson had started, used an LLC as a vehicle to buy the company in a leveraged buy-out. Erickson was not paid up front but received $150 million in preferred interests paying nine percent. The liquidity of the LLC quickly deteriorated and it failed to make its payments to Erickson. The LLC board of directors removed Froelich as CEO and replaced him with Erickson. Erickson also, on two occasions, extended personal guarantees to facilitate financing the LLC's projects.

When additional financing required Erickson to provide a $35 million personal guarantee, Erickson proposed that his preferred interests and the employee's common interests be reclassified into a single class of common interests, based upon an independent appraisal of the value of the company. If the appraisal were equal to or less than the value of Erickson's interests, he would own virtually 100% of the recapitalized LLC. Erickson's proposal was unanimously recommended by the board to the members, and all of the sixteen members, except Froelich, approved the proposal. Erickson did not participate in the Board's recommendation and abstained from voting. The appraisal came in at $155 million, and Erickson received more than 99.9% of the interests. The members then approved a cash-out merger so that Erickson became the only surviving member.

212. *96 F. Supp. 2d 507 (D. Md. 2000).*
Froelich filed suit under various theories, including breach of fiduciary duty. The court granted summary judgment in favor of Erickson on the basis that "the Board's decisions are protected by the business judgment rule."213 Although this would be an appropriate basis upon which to enter summary judgment for a defendant who was an independent director, the independent directors were not sued.214 Erickson, on the other hand, had a conflict of interest as a director of the LLC because he was on both sides of the transaction.215 He was a director of the LLC, and he was dealing with the LLC by exchanging preferred interests for common ones.

The court did state that "Erickson, as a majority interest holder, owed a fiduciary duty to the minority interest holders. In addition, as a director of [the LLC], Erickson owed a fiduciary duty to the Members."216 Based upon the facts of the case, the court concluded that "no reasonable jury could conclude that Erickson breached these duties."217 The court should have stopped there.

Unfortunately, the court went on to state that Froelich's breach of fiduciary theory "fails under the business judgment rule."218 As stated above, however, for the business judgment rule to come into play there must be no conflict of interest.219 Because Erickson did have a conflict of interest, he normally would have the burden of proof. But if there were either disinterested director approval or disinterested shareholder (member) approval—and in this case there were both—the burden of proof would shift back to the plaintiff to show fairness.220 In view of the disinterested approvals and the lack of evidence that the Erickson proposal was unfair, summary judgment was appropriate. But, for the court to analyze this case under the business judgment rule only obfuscates the distinction between the duty of care and the duty of loyalty.

213. Id. at 526.
214. The original board was composed of seven directors, including Erickson and Froelich. Of the other five, three were brought to the Board by Froelich. All were members of the LLC as well. After Froelich was removed as CEO, two-thirds of the members voted to remove him from the board of directors.
215. Froelich phrased the breach of fiduciary duty issue as "usurp[ing] a corporate opportunity" whereas it should have been phrased in terms of a self-dealing conflict of interest. 96 F. Supp. 2d at 526.
216. Id.
217. Id.
218. Id.
220. Both statutory and case law developments around the country in the last quarter century have recognized that while the burden of proof is normally on the fiduciary seeking to uphold a transaction, approval by disinterested directors or disinterested shareholders may shift the burden to plaintiff. See 805 ILL. COMP. STAT. ANN. 5/8.60(b) (West 2000); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976). See also supra notes 180-84, 198-200, and accompanying text.
The court, in *Construction and Environmental Management, LLC v. R & R Handholding, LLC*, also failed to recognize a duty of loyalty issue, this time because of confusion caused by the multiple entities involved and the failure to recognize the real party in interest. The case also illustrates how poorly both the ULLCA fiduciary duty provisions and the Delaware conflict of interest provisions are drafted.

Initially, Michael and Darlene Reed jointly owned 100% of R & R, an LLC organized to acquire and renovate an apartment complex. They applied to Gulf Coast Commercial Mortgage Company (GCCM) for financing. Stephen Bandi was the president and 50% owner of GCCM and, in June 1995, Bandi recommended that R & R get additional partners for financial strength. In August, Bandi (40%) and his mother-in-law (60%) organized Regatta Investment Group LLC (Regatta); Bandi was the managing member of Regatta, and Regatta became a 50% owner in R & R. Regatta contributed capital equal to that of the Reeds. Thereafter GCCM obtained $2.3 million of construction financing for R & R.

R & R then engaged Construction and Environmental Management, LLC (CEM) to act as general contractor. At this time, CEM was owned by Jerry Conrad and his wife, and Conrad was the managing partner. In consideration for obtaining this contract, Conrad transferred a 50% interest in CEM to Regatta. Bandi then began functioning as R & R's managing member. At this point, the relationships among the parties looked like this:

![Relationship Diagram](image.png)

In October 1996, Regatta transferred its interest in CEM to Bandi personally.

The court first addressed the authority issue. Bandi, Mike Reed, and Conrad negotiated a contract based upon plans and specs that were not

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222. The issue of authority, also present in the case, is discussed *infra* notes 228-29 and accompanying text.
very detailed, but no written contract was ever executed. All parties agreed, however, that the maximum cost would be $2.9 million. Work started in November, 1995. Soon afterward, the scope of the work changed and the project went over budget by $300,000 as a result of four oral change orders, made by Conrad on behalf of CEM and approved by Bandi on behalf of R & R. Bandi testified that he was the managing member of R & R and had authority to approve the change orders; however, he acknowledged that the operating agreement did not give him the authority to act as manager. Bandi testified that the Reeds were on the job site frequently and were aware of the changes. On the other hand, the Reeds testified as follows:

Darlene Reed testified that Bandi was not the managing member of R & R, and that all decisions required either an oral or written majority vote of all the members. She stated that Bandi was not authorized to approve change orders without the other members. Michael Reed also testified that all decisions affecting R & R required a majority vote. He admitted that decisions on the "day-to-day" activities of the project were left to Bandi.223

The total costs incurred by CEM was $3,129,888, of which R & R paid $2,852,928. With respect to this excess, R & R contended that (i) change orders had to be in writing, (ii) if not, then Bandi did not have the authority to approve them, or (iii) that the excess was due to cost overruns, not changes to the scope of the work.224 The trial court, after some minor adjustments, entered judgment against R & R for $263,955 on the basis that Bandi "had authorization even though he wore many different hats in this program by representing himself as an owner, representing himself as a contractor."225

The trial court did not appear to deal with the conflict of interest issue but rather treated the case as being determined on the authority issue. The trial court did observe, however, that it "painfully render[ed] ... judgment in favor of the plaintiff, because I just think Mr. Bandi really duped everybody."226

The assignments of error presented to the appellate court included "[t]he trial court erred in failing to hold that La. R.S. 12:1318C invalidated Steve Bandi's modifications to the construction contract on behalf of R & R."227 Section 1318C provides as follows:

No contract or transaction between a limited liability company and one or more of its members, if management is reserved to the mem-

223. R & R, 746 So. 2d at 820.
224. Id. at 821.
225. Id. at 822.
226. Id.
227. Id.
bers, or managers, if management is vested in one or more managers pursuant to R.S. 12:1312, or a person in which such a member or manager has a financial interest, shall be void or voidable solely for this reason, solely because the interested member or manager was present at or participated in the meeting which authorized the contract or transaction, or solely because his or their votes were counted for such purpose, if the material facts as to his interest and to the contract or transaction was disclosed or known to the members and the contract or transaction was approved by a majority vote of the members without counting the vote of the interested member, or if the contract or transaction was fair to the limited liability company as of the time it was authorized, approved, or ratified by the members. Interested members may be counted in determining the presence of a quorum at a meeting which authorized the contract or transaction.228

The foregoing Louisiana LLC statute is modeled after the Delaware corporate conflict of interest statute.229 The problem with the Delaware statute, and thus the Louisiana statute, is that it does not say what it means. It speaks of transaction voidability and repeatedly uses the word "solely." Thus, the focus is on whether or not the transaction is void, rather than the fairness of the transaction.230 Moreover, the verbiage is somewhat obtuse231 and thus obscures the meaning that should be present in the statute. This is what happened in Construction and Environmental Management.232

The court, in rejecting plaintiff's argument that section 1318C applied to the facts at bar, stated:

R & R argues that this article operates to invalidate the change orders made between R & R and CEM. We find that R. S. 12:1318C is inapplicable to the instant case. The contract at issue is not between the corporation, (R & R) and its managing member (Regatta or Mr. Bandi), nor is the contract at issue between CEM and its managing member (Regatta or Bandi). Instead the contract sought to be invalidated is between R & R and CEM.233

What the court failed to recognize was that the contract was between R & R and CEM, and it was alleged, in effect, that CEM was overcharging

228. LA. REV. STAT. § 12:1318(c) (West 2000).
230. As discussed supra, at notes 181-83, 205-07, and accompanying text, however, the Delaware supreme court has interpreted § 144 as requiring that conflict of interest transactions must be fair to the entity and that the proponent has the burden of proof unless there is disinterested shareholder or director approval.
231. The Louisiana version of § 8.60 is obtuse when compared with the clarity of the Illinois version, 805 ILL. COMP. STAT. ANN. 5/8.60 (West 2000), set forth in full text in Appendix 6.
233. Id. at 823.
R & R. Bandi was the representative of R & R in negotiating the contract with CEM, and Bandi owned 50% of CEM. Thus, Bandi had a clear conflict of interest. On the one hand, he had an effective 20% interest in R & R through his 40% interest in Regatta. He also had a financial interest in CEM, first through his interest in Regatta and later directly when Regatta transferred its 50% in CEM to Bandi.\footnote{234. See supra diagram in text accompanying notes 222-23.}

If the Louisiana court had understood the Louisiana statute, it would not have rejected the Reeds' conflict of interest issue. The statute deals with a transaction between an LLC (R & R) and "a person in which such a member or manager (Bandi) has a financial interest (CEM)."\footnote{235. LA. REV. STAT. ANN. § 12-1318(c) (West 2000).} Unfortunately, the quoted language is so buried in the statute that the court did not even address it.

"OPTING OUT" OF FIDUCIARY DUTIES

Thus far, the focus has been upon insuring the existence of fiduciary duties. There are circumstances, however, in which it is appropriate to enable the members to determine for themselves what activities are acceptable and do not constitute a breach of fiduciary duty or to establish standards by which the existence of a duty can be measured. In this regard, ULLCA and the Illinois Act are not substantially dissimilar. With respect to the duty of good faith and fair dealing, ULLCA provides that such duty may not be eliminated, but that the operating agreement "may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable."\footnote{236. UNIF. LTD. LIA. CO. ACT § 103(b)(4) (amended 1996), 6A U.L.A. 434 (Supp. 1999).} The Illinois provision is substantially identical, but provides that the obligation of good faith and fair dealing can neither be eliminated nor reduced.\footnote{237. See 805 ILL. COMP. STAT. ANN. 180/15-5(b)(7) (West 2000).} The Illinois Act does, however, recognize that the operating agreement may set forth standards by which the performance of the obligation is measured, again if the standards are not manifestly unreasonable.

With respect to the duty of loyalty, both acts provide that such fiduciary duty may not be eliminated, but that the operating agreement may "identify specific types or categories of activities that do not violate" these duties, once again if not manifestly unreasonable. The Illinois Act also provides, however, that the duties can neither be eliminated nor reduced, but activities can be identified that do not constitute a breach of a duty. As previously discussed,\footnote{238. See supra notes 170-77 and accompanying text.} there are situations, such as when two independent real estate developers combine to joint venture a new project, when it is appropriate that a traditional duty of loyalty, for example, usurping the entity opportunity, should be limited by defining certain activities, such as en-
gaging in new ventures after completion of the joint venture, that would not give rise to a cause of action. With this background in mind, let us examine the decisions dealing with "opting out."

THE "OPTING OUT" CASES

One of the primary attractions of ULLCA to transactional lawyers is that it explicitly enables them to specify in the operating agreement activities that would not constitute a breach of fiduciary duty. As stated above, Illinois has a similar provision. Litigation lawyers, however, have long been aware that courts will generally respect an agreement of the parties as to their relative rights and responsibilities, including those of a fiduciary nature, so long as the agreement is sufficiently specific and not over-reaching.

In the LLC area, two recent decisions have determined whether the activity of one member competing against another was actionable in light of an agreement defining the responsibility of the member. In McConnell v. Hunt Sports Enterprises, several investors were brought together for the purpose of owning and operating a professional hockey franchise in Columbus, Ohio. Two of the leading investors were John McConnell and Lamar Hunt (who controlled the Hunt Sports Group, L.L.C.). Section 3.3 of the operating agreement provided as follows: "Members May Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company."

After several months of negotiations, a governmental subsidy did not develop and Hunt was not inclined to go forward. Alternative financing for a stadium was offered by an insurance company, however, conditioned upon a satisfactory lease. Hunt, without formally consulting the other members of the LLC, rejected this option. When McConnell was approached by the insurance company, he offered to apply for the hockey franchise and execute the lease himself. Other members joined with him and he did in fact obtain the hockey franchise for Columbus. Hunt then filed suit claiming that McConnell was breaching his fiduciary duty to the LLC that had originally been formed by creating another venture and obtaining the franchise for himself and other investors allied with him. The trial court entered summary judgment in favor of McConnell.

243. Id. at 1206.
244. See id. at 1226.
On appeal, the court first undertook to interpret the contract. Hunt claimed that the reference to "any other business venture" meant a business venture other than a hockey franchise. The court interpreted the word "other" to simply mean that the members could invest in another business venture other than the LLC which was originally formed. The court focused on the words following "any other business venture" namely, "of any nature," and indicated that such words "could not be broader." Moreover the inclusion of the words "any venture which might be competitive with the business of the Company" made it clear that members were not prohibited from engaging in a business that was competitive with the initially formed LLC.

With respect to the fiduciary duty issue, the court stated that, because the act of forming a competing enterprise was specifically approved by the agreement, "these acts in and of themselves would not constitute breach of fiduciary duty because the operating agreement allowed such acts." The trial court did recognize that the method of competing could give rise to a breach of fiduciary duty and the appellate court agreed, stating:

[T]he trial court sustained the objection to such question, stating that competing for a franchise was not a breach of fiduciary duty and that it was "the method of competing for the franchise which might be a breach of fiduciary duty. If in the parlance of the street Mr. McConnell engaged in dirty pool to compete for this contract, then that type of competition could be a breach of fiduciary duty." These rulings were not erroneous.

The appellate court concluded: "[C]ontract provisions may affect the scope of fiduciary duties, and as such, the trial court was correct to indicate that the method of competing, not the competing itself, may constitute a breach of fiduciary duty." A similar, though more complex issue, was presented to the court in *Metro River Boat Associates, Inc. v. Bally's Louisiana, Inc.* Here the issue was whether the merger of Bally into Hilton constituted a breach of the operating agreement's non-competition provisions. Metro and Bally organized Belle of Orleans L.L.C. to own and operate a gambling river boat in Orleans parish. The non-competition section of the operating agreement provided as follows:

[T]he creation of the Company and the assumption by the Members of their duties thereunder shall be without prejudice to the rights of the Members (or the right of their Affiliates) to maintain, expand or

245. *Id.* at 1206.
246. *Id.*
247. *Id.* at 1212.
248. *Id.*
diversify other interests and activities including, but not limited to, gaming interests and activities, and to receive and enjoy profits or compensation therefrom. Notwithstanding the preceding sentence, no Member may engage in any gaming venture (other than [Bally's Casino Lakeshore Resort]) in Orleans Parish or Jefferson Parish. Within the [surrounding] parishes . . . (the "Other Parishes"), (i) Bally Member and its Affiliates can provide management services . . . ; provided that neither Bally Member nor any its Affiliates (as the case may be) may own an equity interest in such ventures . . . .

Hilton Hotels did have an ownership interest in another Orleans Parish river boat casino. Consequently, Metro interpreted the merger between Bally and Hilton to violate the noncompetition provision of the operating agreement. Although some portions of the operating agreement dealt with either a Member or an Affiliate—Hilton was an Affiliate of Bally since it owned stock in Bally—the non-competition provision only prohibited a member (namely Bally) from engaging in another gaming venture in Orleans Parish. Accordingly, the court held that there was no breach of the non-competition provision.

While the decision of the court in interpreting the agreement was arguably hyper-technical, plaintiff's allegation of competition was also hyper-technical. Although the record is not clear on this point, the merger of Bally into Hilton did not create additional competition. Rather Hilton was already operating a competing gaming venture.

The language in the operating agreement with respect to fiduciary duties was critical in another recent case, Lynch Multimedia Corp. v. Carson Communications, L.L.C. This case involved both competing with the entity and the entity opportunity doctrine. CLR Video was a cable TV joint venture with three members, Lynch Multimedia (60%), Rainbow Communications (20%), and the Robert C. Carson Trust (20%). There was a five person board of managers: Lynch named three managers and Rainbow and the Trust one each. Robert C. Carson was the president.

Carson learned in 1996 that other cable systems, Falcon, Westcom, and Galaxy, might be for sale. According to plaintiff, in the fall of 1996 the members approved certain possible acquisitions. In late summer of 1997, Carson informed Lynch representatives of specific opportunities. Lynch suggested further exploration. In April 1998, Carson again met with Lynch representatives. No agreement to purchase was reached and, according to Carson and another witness, Lynch rejected the acquisitions. In May, Carson, through Carson Communications, L.L.C., reached an agreement to acquire Falcon, but Galaxy was unwilling to sell. In October 1998, Carson wrote Lynch, proposing plans to acquire Falcon and Wes-

250. Id. at 559.
251. See id. at 560.
trom. In November, he sent a term sheet on these possible acquisitions to Lynch, and in December sent Lynch another term sheet which also proposed changes in CLR’s operating agreement—in particular that his salary and equity interest in CRL would be increased and he would continue as president.

In Spring 1999, Carson Communications closed on the Falcon and Westcom deals. Prior to closing, Lynch alleged it had sought to exercise its proportionate (60%) interest in the deals. Section 11.4 of the CLR operating agreement provided that an “opportunity . . . to purchase cable television systems . . . shall be first offered to the company.” Carson responded that his duty under section 11.4 was satisfied when he notified the other members that an opportunity existed. On the other hand, Lynch’s position was that Carson could not fulfill his duty unless he presented the other members with a “no-strings-attached” purchase offer at a properly-called special meeting of the members.

Under a typical entity opportunity situation, Lynch’s position might prevail. The court rejected Lynch’s position, however, based upon the language of the agreement:

The court finds that this interpretation must be rejected. First, looking just to the plain language of § 11.4, it would appear that the Operating Agreement does not intend the standard legal definition of “offer.” Under this provision, the member does not offer an “offer” to the other members in the sense that it could be “accepted” or concluded. The member merely offers knowledge of an opportunity.

In addition, the court opined that section 11.4 must be read in light of the entire operating agreement, particularly section 11.2 which provided:

Other Interests. Any Member or Manager may engage independently or with others in other business ventures of every nature and description. Neither the Company nor any Member shall have any right by virtue of this Agreement of the relationship created hereby in or to any other ventures or activities in which any Member or Manager is involved or to the income or proceeds derived therefrom. The pursuit of other ventures and activities by Members or Managers is hereby consented to by the Members and shall not be deemed wrongful or improper.

The court appeared to view the explicit right to compete as watering down the obligations under the entity opportunity doctrine. The court also rejected Lynch’s argument that any tender of an opportunity must be at

253. Id. at 1261-63.
254. Id. at 1264.
255. Id.
256. Id.
a formally called members’ meeting. CLR had consistently operated in an informal manner and Lynch had acquiesced in this approach. The court concluded:

In short, Carson informed the other members of CLR Video of certain opportunities to purchase cable companies. Only after the passage of several months or years, and at one point after the rejection of the proposal, did Carson independently acquire the companies. Under the facts presented to the court, the plaintiff has demonstrated neither a breach of the Operating Agreement nor of the defendants’ fiduciary duties.257

The foregoing cases illustrate that courts are very willing to give effect to the agreement of sophisticated parties who modify their fiduciary responsibility to each other by express provisions in the operating or other agreement. Because courts will parse these agreements carefully, it is important that such agreements be carefully drafted to give effect to the fully informed intentions of the parties. It would be a serious mistake for provisions limiting fiduciary duties to turn into boilerplate. It is also important for courts to scrutinize these agreements all the more carefully when the parties involved are less sophisticated. In my experience, when unsophisticated parties are presented with a long and complex agreement, they often assume that what they are signing embodies standard provisions and rely upon their lawyers to direct them to critical provisions. Lawyers must fulfil this responsibility very carefully.

**TRANSFERABILITY, DISSOLUTION, AND DISSOCIATION**

The concepts of transferability, dissolution, and disassociation are among the more complex issues in LLC statutes. To appreciate the statutory provisions, it is necessary to have an historical perspective. A major reason for organizing an LLC is to avoid an entity level tax and obtain pass-through, or partnership, tax treatment as opposed to corporate tax treatment. At one point, the issue of whether the IRS would recognize that an LLC could be taxed as a partnership hinged upon the extent to which the entity exhibited certain characteristics that are common to corporations, but are usually absent from partnerships.258

The treasury regulations at one time specified that the four characteristics for distinguishing a corporation from a partnership were (i) continuity of life, (ii) limited liability, (iii) free transferability of interest, and (iv) centralization of management.259 In actuality, the treasury regulations iden-
tified six factors that were characteristic of corporations, but two of these characteristics; associates and carrying on a business, were also common to partnerships. Thus, these latter two did not apply in determining whether or not an entity had more corporate characteristics than non-corporate characteristics.

The regulations essentially provided that an unincorporated entity would be taxed as a partnership unless it exhibited three of the four corporate characteristics. Consequently, if a limited liability company possessed fewer than three of the four corporate characteristics, the organization could be taxed as a partnership for tax purposes. Because a primary reason in organizing an LLC was to obtain limited liability treatment, it thus became necessary to negate two of the other three corporate characteristics—centralized management, transferability, or continuity—in order to achieve pass-through tax treatment.

Consequently, the first generation of LLC statutes was designed to facilitate pass-through tax treatment by having default provisions that would negate transferability or continuity of existence. The issue of centralized management was essentially determined by whether the LLC was member-managed or manager-managed. If it were member-managed, then normally it would not have the corporate characteristic of centralized management, but if it were manager-managed, then it was essential to negate both transferability and continuity of existence in order to achieve partnership status and pass-through tax treatment.

**TRANSFERABILITY**

With respect to transferability, the Illinois Act, as originally enacted, provided as follows:

Unless provided otherwise in the articles of organization or the operating agreement, if the members of the limited liability company, other than the member proposing to dispose of the interest, do not approve of the proposed transfer or assignment by *unanimous* consent, the transferee or assignee of the interest shall have no right to participate in the management of the business and affairs of the limited liability company or to become a member.260

This provision is actually a second generation type statute, because it permits the operating agreement to modify the default statutory provision that unanimous consent of the other members is necessary for a particular member to transfer his or her interest and constitute the transferee a mem-

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ber in his or her stead. A first generation statute would preclude transferability unless there was unanimous consent.

The above provision, together with sections 30-10 and 30-15 were repealed by the 1998 amendments to the Illinois act and replaced sections 30-5 and 30-10, which mirror the provisions in ULLCA. The approach in Delaware is similar to ULLCA. Although the new provisions are more complex, they basically do not change the essential statutory scheme that an assignee of a member does not become a member except with the unanimous consent of the other members, unless the operating agreement provides otherwise. The basic operative provision today is section 30-10, patterned after section 503 of ULLCA, which provides: “A transferee of a distributional interest may become a member of a limited liability company if and to the extent that the transferor gives the transferee the right in accordance with authority described in the operating agreement or all other members consent.” The change worked by ULLCA is basically one of emphasis, putting the focus on the operating agreement in the first instance. If there is no specific provision in the operating agreement, however, the default provision is that a transferee does not become a member unless all the other members so agree. The balance of the provisions in section 30-10 basically set forth the rights of a transferee who does not become a member and the obligations of the transferor.

Under the flexibility of the Illinois Act, either as originally enacted or as modified in line with ULLCA, it should be possible to provide in the operating agreement that membership interests are freely transferable. Today this would not be problematic. Prior to the check-the-box regulations,

261. See supra notes 17-20.
262. For example, with respect to transferability, the Wyoming statute, as originally enacted, provided that:

The interest of all members in a limited liability company constitutes the personal estate of the member, and may be transferred or assigned as provided in the operating agreement. However, if all of the other members of the limited liability company other than the member proposing to dispose of his or its interest do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the member’s interest shall have no right to participate in the management of the business and affairs of the limited liability company or to become a member. The transferee shall only entitled to receive the share of profits or other compensation by way of income and the return of contributions, to which that member would otherwise be entitled.


however, such a provision in an operating agreement could have destroyed the opportunity for a manager-managed LLC to be taxed as a partnership. Even today, if the interests are publicly traded, an LLC or partnership will be taxed as a corporation rather than a partnership.267

Because, with regard to transferability, the focus is now on the operating agreement, the question then arises as to what should such agreement provide with respect to transferability. The issue here is not substantially different from the issue under the corporate form of doing business. Some of the same basic principles apply.

If the entity is closely held, providing legal transferability does not necessarily equate to transferability in fact. In providing a common law definition for a closely held corporation, the court in *Galler v. Galler*,268 a frequently cited case, stated: “For our purposes, a close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying and selling.”269

The fact that there is generally no market for interests in an entity does not mean, however, that it is not appropriate to restrict the transfer of interests in such entity. It may be undesirable to have a spouse or a non-employee succeed to an interest. Certainly, you would not want a competitor to have an interest.

Typically, in an LLC, transfer requires the approval of the remaining members. But should such approval require unanimity or mere majority, and if by a majority, is it a majority in number (*per capita*) or a majority in financial interest (*per capital*)? In the corporate form, approval at the board level is generally *per capita* and approval at the shareholder level is generally *per capital*, but if there are three or less members with equal investment, the difference between majority and unanimity is academic.

For ease of illustration, assume a situation where the approval of the remaining members is to be done on a *per capita* basis. If there are three or less members, the remaining members will be two or less, and a majority of two is two. Thus, a majority vote in this circumstance requires unanimity. Similarly, if there are three members with equal investment, the remaining two will each have fifty percent vis-à-vis each other and the affirmative vote of both would be necessary to approve a transfer.

Because relationships in a closely held organization are generally important, it will normally be desirable to require that the remaining members consent before a transferee can become a member. But every general proposition will typically have exceptions. Frequently, there is an exception for transfers to a family member. This facilitates estate planning; it also fulfills the desire of some entrepreneurs to create a family business that can be transmitted to their children. Every coin has two sides, however, and there

268. 203 N.E.2d 577 (Ill. 1964).
269. *See* id. at 583.
is no assurance that members of a second generation will have the talent or personality that made the first generation member a good "partner."

Under ULLCA-type statutory provisions, "[a] transferee who does not become a member is not entitled to participate in the management or conduct of the limited liability company's business, require access to information concerning the company's transactions, or inspect or copy any of the company's records."\(^{270}\) Although a transferee has some limited economic rights,\(^{271}\) the most obvious characteristic of a transferee is impotence. Since powerlessness is not an enviable position, there are few circumstances in which a person would be willing to purchase a member's interest without absolute assurance that the purchaser would become a member.

This situation is particularly acute in the event of death situation. In the corporate context, the spouse of a deceased shareholder succeeds to the shares and, with cumulative voting,\(^{272}\) may be able to obtain a seat on the board of directors. In the LLC context under ULLCA, however, death is a dissociating event, not a dissolving event.\(^{273}\) Accordingly, the surviving spouse or estate is a mere transferee and, unless the operating agreement provides otherwise, under ULLCA there is no right to information or to be bought out until the expiration of the term,\(^{274}\) which arguably could be perpetual.\(^{275}\) In Illinois, dissociation would normally give rise to a buyout at fair value,\(^{276}\) but this right could be circumscribed in the operating agreement.

**CASE LAW UNDER TRANSFERABILITY**

Great care must be exercised both in drafting the transferability provisions of the operating agreement and in drafting any consent to transfer. The default provisions of the statute can create a form of Russian Roulette: last to die wins. This is illustrated by the case of *Lusk v. Elliott*.\(^{277}\) The LLC in question was formed by Lusk, as Trustee for the Citation Realty Trust,\(^{278}\)


\(^{272}\) The mechanics and consequences of cumulative voting are extensively discussed in *Business Organizations*, supra note 114, §§ 9.14–19.

\(^{273}\) See infra notes 277-80 and accompanying text for discussion of problems created by death.


\(^{275}\) ULLCA does not specifically provide that the term could be perpetual but the term could be at least 50 years. See id. § 203 Comment, 6A U.L.A. 445 (1995). Illinois speaks of the "latest date, if any," at which the LLC will dissolve. See 805 Ill. Comp. Stat. Ann. 180/5-5(a)(6) (West 2000) (emphasis added). This implicitly suggests a perpetual term.


which was a one percent owner, and the late Mr. Elliott, who was the manager and owned the other ninety-nine percent interest, to own and operate an airplane. The Trust managed the airplane's daily operations and finances and received a management fee for such services. The operating agreement had an absolute prohibition against the transfer of a member's interest but could be amended by a unanimous vote of the members.

Mr. Elliott was seriously ill and, in anticipation of his imminent death, Lusk and Mrs. Elliott, as attorney-in-fact for Mr. Elliott, executed a "Consent to Assignment" of his "entire and undivided membership interest" to the Elliott Trust and agreed that such assignment "shall not constitute a prohibited assignment" under the operating agreement, and that the intent was "to preserve for Neal M. Elliott the beneficial ownership of his membership interests."278 Mrs. Elliott then assigned on his behalf his membership interest to the Elliott Trust.

Mrs. Elliott wanted to sell the plane, which would end the management contract with the Lusk Trust, and noticed a members meeting. In response, Lusk, purportedly as sole member, amended the operating agreement to specify that the Lusk Trust was the sole member and filed the present suit. Lusk contended that the assignment transferred only Mr. Elliott's beneficial financial interest and not his membership interest, while Mrs. Elliott contended that the assignment transferred the entire membership interest. If Lusk were correct, his trust would be the sole remaining member and would manage the company, and would preserve the existing management contract with his trust. If Mrs. Elliott were correct, her trust would be a ninety-nine percent member and would manage the company.

The court entered summary judgment for Mrs. Elliott. The court first found that the language of the Consent to Assignment amended the operating agreement. Otherwise the assignment would have been a prohibited assignment. Under Delaware law, a mere assignment transfers only a financial interest and not the membership interest.279 Lusk contended that because the document in question was labeled an "Assignment," it only transferred Mr. Elliott's financial interest but did not constitute the Elliott Trust as a member. The court held, however, that the interest assigned was Mr. Elliott's "entire undivided membership interest," and thus transferred "the entirety of Mr. Elliott's membership interest to the Trust."280

At a bare minimum, the litigation in this case teaches that if you want to transfer a membership interest, call the document a "transfer" and not an "assignment." In addition spell out specifically that the transferee becomes a member. But should this nitpicking be necessary? The following section will discuss how the ULLCA approach facilitates continuity by

278. Id. at *2.
279. See DEL. CODE ANN. tit. 6, § 18-702(a) (1999).
changing the partnership "events of dissolution" into events of dissociation. With respect to transfer of an LLC interest, why do we retain the partnership concept that assignment of an interest transfers only a financial interest and not a management interest? Limiting who can manage makes sense in a partnership context where a partner can expose other partners to unlimited liability. It makes less sense in the LLC context where member liability is limited.

**DISSOLUTION**

While the provisions in the third generation statutes with respect to transfer of interests are more complex, they do not work a substantial change in the essence of the statutory provisions. On the other hand, the provisions with respect to dissolution have been dramatically changed as a result of ULLCA. In essence, the circumstances which would automatically cause dissolution have been substantially limited and, in their stead, a new concept, that of "disassociation," has been introduced into the statutory provisions. These changes have been motivated by the fact that it is no longer necessary to "kill" continuity of existence as a characteristic of an LLC in order to obtain partnership tax treatment. Although LLCs can be used for a variety of purposes, from holding real estate to operating a commercial business, most commercial business operations would desire more stability than that afforded by the "events of dissolution" in the earlier statutes.

For purposes of comparison, both the original Illinois Act and the current Illinois Act provided that a limited liability company could be dissolved on the basis of (i) an event specified in the operating agreement or articles of organization, (ii) the consent of the members, (iii) the entry of a decree of judicial dissolution, and (iv) administrative dissolution. The big difference between the two statutes, however, is that the original Act provided that an LLC would be dissolved, unless otherwise provided in the articles of organization or the operating agreement, upon the following "events of dissolution:" "[t]he death, retirement, resignation, bankruptcy, court declaration of incompetence with respect to, or dissolution of, a member or upon the occurrence of any other event that ter-

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281. Even the title of the Illinois chapter has been changed from "Dissolution" alone to "Dissolution and Disassociation." See 805 ILL. COMP. STAT. ANN. 180/35 (West 2000).

282. The original act required these events to be set forth in the articles whereas the current act permits them to be set forth in the operating agreement. See id. 180/35-1(1). Contrast this with section 35-1(1) of the original statute. 1992 Ill. Laws 2529.

283. See 805 ILL. COMP. STAT. ANN. 180/35-1(2), (4)-(6) (West 2000). Compare with § 35-1(2)(4)(5) and § 35-5 (now repealed) of the original act. 1992 Ill. Laws 2529. The new Act also provides that an LLC is dissolved upon the occurrence of an event that makes the continuation of the business unlawful. See 805 ILL. COMP. STAT. ANN. 180/35-1(3) (West 2000).
minates the continued membership of the member in the limited liability company."\textsuperscript{284}

This is no longer true in the current Act. What the foregoing reflects is that new statutes, patterned after ULLCA, take an entity approach to an LLC, whereas the first (and second) generation statutes took a "partnership" type approach. Because a partnership is a "person-oriented" type of business organization, any change in the relation of the partners would result in the dissolution of the partnership. Thus, a partnership lacks continuity of existence, whereas, in the approach introduced by ULLCA, it was sought in general to create greater continuity of existence, and thus more stability, for an LLC as a default condition.

**DISSOICATION**

Although ULLCA-based statutes no longer have the foregoing "events of dissolution," these activities now basically result in a member being "disassociated" from a limited liability company.\textsuperscript{285} When a member disassociates, whether through withdrawal, transfer of the member's interest, expulsion, bankruptcy, death, or incompetency, the member's right to participate in management and the member's fiduciary duties all terminate,\textsuperscript{286} and unless the operating agreement otherwise provides,\textsuperscript{287} the company is obligated to purchase the member's distributional interests for its fair value—assuming that the members disassociation does not result in dissolution.\textsuperscript{288}

Thus, unless the operating agreement eliminates the obligation of the LLC to purchase the member's interest on dissolution, the result under the two Illinois statutes from the member's perspective is fairly similar. Under the original statute, the event of dissolution would give rise to dissolution and the member would receive the value of his distributional interest upon the liquidation of the LLC whereas, under the current statute, the member is entitled to the fair value of such distributional interest.

\textsuperscript{284} 1992 Ill. Laws 2529, § 35-1(3). With respect to the last event of dissolution, namely the termination of membership, the original Act provided that dissolution would be avoided if "within 90 days after the event there are at least two remaining members and all the remaining members agree to continue the business of the limited liability company." Although it is not clear, arguably this language could also prevent dissolution with respect to other events such as death or bankruptcy.


From the company’s perspective under the new act, however, a former “event of dissolution” has no effect on the continued existence of the LLC.

In theory, the value of an interest under the two different approaches outlined above—liquidation and purchase at fair value—should be comparable. The concept of fair value embodies within it the value of a company as a going concern, not just the dead asset or book value. With respect to dissolution of a limited liability company, the persons winding up the limited liability company’s business “may preserve the company’s business or property as a going concern for a reasonable time.” Implicit in this provision is the obligation of the members liquidating the limited liability company business to obtain the going concern value of the business in selling its assets and then making distribution to the members. If there are no ready buyers for the assets, they may not be able to obtain the going concern value of the enterprise. On the other hand, the buyer of the assets often will be the other members. In such a case, there is a conflict of interest for them between their role in buying the assets and their role in liquidating the assets on behalf of the LLC. In this situation it is important for courts to be vigilant to ensure that the members pay “fair value” for the assets.

The dissolution and disassociation provisions in the current Illinois Act are approximately triple the length of such provisions in the original Act. The complexity probably has also tripled. Yet at the core, what is involved here is simply the introduction of a new concept, “disassociation,” for the old, “events of dissolution,” with the result that these events no longer cause a “dissolution” of the enterprise but merely entitle the member to a payout, unless such right is modified in the operating agreement.

If an LLC is dissolved, ULLCA-based statutes provide for the means of dealing with the claims of creditors against a dissolved limited liability company. These provisions are essentially borrowed from recent corporate law statutory developments. Arguably, in dissolving an LLC, it would be a breach of the duty of care for a member, or malpractice, for a lawyer representing an LLC not to take advantage of the opportunity to bar claims against the dissolved company, and derivatively against its members, by complying with the “probate” type procedures that now exist when an LLC is “killed.”

289. See Business Organizations, supra note 114, § 19.2.
290. 805 ILL. COMP. STAT. ANN. 180/35-4(c).
**CASE LAW DEALING WITH DISSOLUTION AND DISSOCIATION**

As discussed above, even statutes that are not as prolix, oddly organized, and unevenly flowing as the Delaware statute\(^2\) are nonetheless fairly complex in dealing with liquidation, dissolution, transfer, and dissociation issues. These are concepts with which courts do not come into contact on a day-to-day basis.

The potential confusion in this area is illustrated by a Georgia case, *Walker v. Virtual Packaging, LLC*,\(^3\) where certain members of the LLC sued other members and the manager to dissolve the LLC and recover damages for breach of contract and breach of fiduciary duty. The members signed both a members' agreement, which included a non-competition covenant, and an operating agreement, which dealt with the management and operations of the LLC. The members' agreement provided that the limited liability company's members could not communicate with any employee of the LLC to solicit the employee either to leave employment or to become employed by a competitor.

The parties first entered into a consent order which provided for the dissolution of the LLC and reserved the issues of breach of the non-competition agreement and breach of fiduciary duty for trial. Thereafter, the defendants moved for summary judgment on these other issues, contending that no issue of damages remained after the dissolution of the LLC. The defendants argued that the plaintiffs were not beneficiaries of the non-compete agreement and therefore could not sue. Plaintiffs responded that when the LLC was dissolved, it implicitly assigned its causes of action for damages to the individual members of the company. Plaintiffs relied on the language of the consent order that distributed, *pro rata*, the assets of the LLC to its members, and reserved any unresolved disputes for later trial after the dissolution of the LLC.

The court set forth the argument of plaintiffs as follows:

> Since the parties expressly reserved this claim unless it was disposed of by the Consent Order and since the Consent Order specifically did not dispose of it and specifically left all undisposed of claims open, the sole remaining issue can only be whether—as a matter of law and independent of the parties expressed agreement—a claim for damages originally belonging to a Limited Liability Company can be distributed pro rata to the members upon dissolution. The claim by [the LLC] against [d]efendants Sucher and Virtual is a "chose in action" belonging to [the LLC] prior to its dissolution. The question therefore must be whether such a chose in action is distributable to

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\(^2\) See *supra* text at note 84 (characterization of the Delaware statute by Chief Justice Veasey).

the owners of [the LLC]. Clearly [the LLC] has attempted an assignment by its agreement to assign its property to its owners.\textsuperscript{296}

In rejecting plaintiffs' contention, the court stated:

Contrary to The Walker Plaintiffs' argument, the record shows that [the LLC] did not assign a chose in action to the Walker Plaintiffs in the Consent Order because [the LLC] did not comply with the terms of the Operating Agreement regarding assignments. According to the Operating Agreement, [the LLC] manager, Sucher could not, "without the express consent" of one of the Walker Plaintiffs, Daniel L. Sessions, execute assignments on behalf of [the LLC]. Neither the Consent Order, nor any other part of the record shows such express consent.\textsuperscript{297}

There are two problems with the court's treatment of this issue. First, the provision in the operating agreement providing that the manager, Sucher, could not make an assignment without the consent of one of the Walker Plaintiffs was designed to protect the Walker Plaintiffs against any inappropriate assignment of actions by Sucher. Apparently Sucher was involved in a competing business and this provision of the operating agreement would, for example, limit his flexibility in dealing with a competing business by requiring the consent of a non-interested party, namely, Sessions. This court, however, used a provision for the protection of the Walker Plaintiffs to deny them the opportunity to be the assignee of the LLC's claim against Sucher. This is a topsy-turvy interpretation of the operating agreement.

But more importantly, when an LLC dissolves after creditors are paid the balance of the assets are distributed to the members, not by virtue of the grace of the operating agreement but rather pursuant to the mandate of the statute. Business organization statutes typically have a survival of remedy provision which provides that dissolution, during the period of the survival of the remedy, shall not take away or impair any remedy available to or against the entity, its managers, or its members for any claim existing prior to the dissolution.\textsuperscript{298} As a matter of logic, the claim against the managers for breaching the non-compete provision was either extinguished upon dissolution or passed to the members.

There is some ambiguity in this area under ULLCA and statutes that mirror it. ULLCA provides:

In winding up a limited liability company's business, the assets of the company must be applied to discharge its obligations to creditors, including members who are creditors. Any surplus must be applied

\textsuperscript{296} Id. at 554.
\textsuperscript{297} Id. at 555.
\textsuperscript{298} See, e.g., 805 ILL. COMP. STAT. ANN. 5/12.80.
to pay *in money* the net amount distributable to members in accordance with their right to distributions under subsection (b).

Because the statute provides that the surplus distributable to the members must be paid in "money," arguably a chose of action is not distributable. The rebuttal to this argument is that the purpose of the foregoing provision is to negate an argument that a member is entitled to receive a distribution in kind. Basically, upon dissolution, the assets of the business are converted to cash, creditors are paid off, and the cash is distributed to the members. If an asset is not readily convertible into cash at the time of dissolution, however, this should not mean that it is not distributable. Escrows and the like have been used for decades when a business is sold and the company liquidated in order to transfer assets which could not then be converted into cash.

Moreover, an interpretation that a chose in action that the company possesses cannot be transferred to its members on liquidation would be inconsistent with the statutory provision that "[e]ach member is entitled to a distribution upon the winding up of the limited liability company's business consisting of a return of all contributions which have not previously been returned and a *distribution of any remainder* in equal shares." Because a chose in action is an asset, to the extent not reduced to cash, it should be distributable to its members in equal shares.

Nevertheless, there may be a systemic problem in the legislation among the states with the ability of an LLC, as opposed to an assignee of an LLC, to pursue a claim after liquidation. When LLC statutes were drafted, the focus was upon limiting liability. When ULLCA was drafted, the Uniform Commissioners borrowed a fairly recent corporate law development, namely a probate-type approach for known claims, and a similar approach, involving notice by publication, for unknown (or contingent) claims. These developments on the corporate side were viewed as "liberalizing," because the predecessor corporate approaches embodied a "survival" approach which, generally, extended the life of a corporation for only two years after dissolution for purpose of suits brought by or against a corporation. With respect to the typical unknown claim, such as a products liability claim, two years was seen as too short a period; thus the extension to five years. In the process of focusing upon liabilities and extending the period to five years for claims brought against the corporation,
however, the provision was not likewise made to continue the survival of claims by the corporation.

Not all states that followed the Model Act approach in extending the period for suits against corporations to five years neglected to cover suits by corporations. Illinois, for example provides:

The dissolution of a corporation either (1) by the issuance of a certificate of dissolution by the Secretary of State, or (2) by a judgment of dissolution by a circuit court of this State, or (3) by expiration of its period of duration, shall not take away nor impair any civil remedy available to or against such corporation, its directors, or shareholders, for any right or claim existing, or any liability incurred, prior to such dissolution if action or other proceeding thereon is commenced within five years after the date of such dissolution. Any such action or proceeding by or against the corporation may be prosecuted or defended by the corporation in its corporate name.304

ULLCA, however, and the states adopting it, have followed the Model Act in dealing solely with claims against the entity. Because an LLC is a creature of statute, arguably the common law precedents dealing with survival in the corporate context would be equally applicable to LLCs. On the corporate side, a federal court summarized the common law background as follows:

We begin with a few general observations on the question of corporate standing after dissolution. At common law, the dissolution of a corporation terminated its legal existence. It could neither sue nor be sued and even pending proceedings abated. See 2 Mod. Business Corp. Act. Ann. S 105, P 2 (2d ed. 1970). Ultimately, every jurisdiction adopted statutes allowing actions to be brought by or against dissolved corporations and preventing actions from abating on dissolution, whether voluntarily or involuntarily or because of charter expiration. Even when a statute continues the existence of a corporation for a certain period, however, it is generally held that the corporation becomes defunct upon the expiration of such period, and, in the absence of a provision to the contrary, no action afterwards can be brought by or against it and must be dismissed. 16A W. Fletcher, Cyclopedia of the Law of Private Corporations s 8144 (1962 Rev. Vol. By M. Wolf).305

Accordingly, unless there is an explicit survival of remedy provision on behalf of claims by the LLC in an LLC statute, any claim by a dissolved LLC may abate.

304. 805 ILL. COMP. STAT. ANN. 5/12.80 (emphasis added).
The operation of the default provisions of a statute in which the “events of dissolution” give rise to dissolution, rather than dissociation, is illustrated by the case of *Gee v. Bullock*.[306] Bullock, the defendant, and her partner, Thow, had organized an LLC, “Thow Pasta” to operate a retail pasta business. Disagreements arose between Bullock and Thow, and she locked him out of the premises. The business was also in financial difficulty, so she induced plaintiffs to invest in a second LLC, the Pasta Shop, with the understanding that some of the funds would be used to pay the rent for Thow Pasta. Bullock represented she was the sole owner of Thow. She allegedly agreed to sign an operating agreement which would give defendants a fifty-one percent controlling interest in the Pasta Shop. Within a month of organizing the second LLC, Bullock refused to sign the operating agreement and this time locked the plaintiffs out of the business. She then obtained another investor to invest in the pasta business and formed a corporation to which assets of the Pasta Shop were transferred.

Plaintiffs sought either an order permitting them to run the Pasta Shop or a decree of dissolution. Because there was no operating agreement, the court was faced with the task of applying the statutory provisions to this set of facts. The Rhode Island statute set forth the classical events of dissolution as a basis to dissolve the entity:

A limited liability company is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:

*d* *d*[sic] the death, resignation, expulsion . . . of a member . . . unless otherwise provided in the articles of organization or a written operating agreement.[307]

The court treated defendant’s lock-out of plaintiffs as a wrongful expulsion of plaintiffs, thereby triggering a dissolution of the Pasta Shop. The court denied plaintiffs’ request for an order permitting them to run the business because “Pasta [Shop] as a business entity ceased to exist for any purpose other than winding-up.”[308]

Because of Bullock’s fraud, however, the court granted plaintiffs an equitable lien on her assets if, upon the winding up of the Pasta Shop, plaintiffs did not recover their investment. Since the assets of the Pasta Shop were transferred to the new corporation, the court then undertook to treat such transfer as a fraudulent conveyance, and plaintiffs as creditors, so that plaintiffs could invoke the Fraudulent Conveyance Act. The court reasoned that a withdrawing member was entitled to a distribution equal to the fair value of the member’s interest as of the date of withdrawal,[309] and

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308. *Id.*
309. R.I. Gen. Laws § 7-16-29 (1992). The statute has since been amended to negate the right to the fair value upon withdrawal unless so provided in the operating agreement.
that a member who is entitled to a distribution "has the status of, and is entitled to all remedies available to, a creditor of the limited liability company." Therefore, plaintiffs, who were expelled, were, in effect, withdrawn and accordingly entitled to a distribution—thereby giving them the status of creditors who could sue under the Fraudulent Conveyance Act to set aside the transfer of the Pasta Shop's assets.

The court certainly manifested an understanding of the intricacies of the LLC statute and reached an equitable result. But the statutory provisions, especially as the court applied them, are themselves inconsistent. Expulsion and withdrawal, although both on an "exit" continuum, are antithetical to each other. Withdrawal is a voluntary act of a member and expulsion is an involuntary act; yet the court treated plaintiffs as being both expelled and withdrawing.

Moreover, because either expulsion or resignation (withdrawing) are "events of dissolution," after which the task of the LLC is to wind-up, that is, convert its assets to cash, pay off creditors, and distribute the balance to its members, it is inconsistent, once dissolution is triggered by expulsion, to initiate an independent fair value proceeding in which one set of members is bought out during the winding-up process and the other members get what is left over.

Parenthetically, in 1997, the Rhode Island Act was amended to reverse the effect of withdrawal. Now, upon withdrawal, a member explicitly is not entitled to a distribution unless the operating agreement so provides. This is part of a trend, which gained momentum after the check-the-box regulations, to move the structure of the LLC from a partnership format to more of a corporate format, particularly with respect to continuity of existence or, more concisely, stability. The third generation statutes, introducing the concept of dissociation, accomplish this by removing the "events of dissolution," i.e., withdrawal, expulsion, death, and the like, from a liquidation trigger and encompassing them within the new concept "dissociation." As previously discussed, an "event of dissociation" does not cause dissolution and the entity continues its legal existence.

Under most dissociation statutes, however, dissociation does provide the dissociated member with a right to recover the fair value of her investment, unless the operating agreement provides otherwise. Thus, were Rhode Island to have had a third generation statute applicable to the facts in Gee, plaintiffs would have been entitled to a fair value distribution, because they were dissociated, whether by expulsion or withdrawal, and there was no operating agreement, so the statutory default requiring purchase of their

310. See id. § 7-16-33.
311. See id. § 7-16-29.
312. See id.
313. See supra note 9 and accompanying text.
314. See supra text accompanying notes 289-90.
315. See supra text accompanying notes 286-88.
interest at fair value would have been applicable. Under the statute as amended in 1997, however, the statutory default position, when there is no operating agreement, is that there is no right to a distribution upon withdrawal. Thus, the statutory analysis upon which the court embarked in *Gee* would come to no avail were it to arise in 1998 when the new statutory provisions would be applicable to all LLCs. Thus, *Gee* is of little vitality today.

The *Gee* court also dealt with the issue of who was entitled to participate in the winding up of Pasta Shop. The statute provided that "members who have not wrongfully dissolved" from LLC can so participate. The court opined that Bullock was not entitled to participate, because her expulsion of plaintiffs was wrongful. The court then appointed a lawyer to wind-up the business, and charged the lawyer's fee to Bullock because of her wrongful actions. This raises the issue of why plaintiffs were not entitled to wind-up the business because they did not wrongfully dissolve it.

Once again, the statutes are not as clear as would appear at first blush on the issue of who is entitled to wind up an LLC. It may be that the *Gee* court believed that the plaintiffs, who were expelled, were no longer members and thus were outside the statutory provision permitting "good" members to wind-up. This same issue, in a slightly different context, arose in *Investcorp v. Simpson Investment Co.*, L.C. Two brothers, and their respective families, each had a fifty percent interest in an LLC that owned 104 acres of land. The four managers were the two brothers and a son of each. A dispute arose as to the development of the land and most of the Alfred Simpson family, with the exception of son Mark as trustee, withdrew. The Donald Simpson family remained as members. Under the Kansas statutes, such withdrawal dissolved the LLC. Because the operating agreement permitted withdrawal after six month's notice (which was given), the withdrawal of most of one branch of the family did not violate the agreement, and so the withdrawal of the Alfred Simpson members was not wrongful. The issue then arose as to who would be entitled to wind-up the LLC.

The Kansas statute then in effect provided that the "managers in office at the time of dissolution" wind-up the business. This arguably is a clear provision that the two brothers and their sons would manage the process.

318. See 267 Kan. 885 (1999), for modification of original opinion.
319. Mark, as trustee, did not withdraw because the unanimous consent of the remaining members was necessary to continue the company. Mark's opposition to continuation assured that the company would be dissolved. Section 17-7622 of the Kansas Annotated Statutes was in force when the LLC was organized. KAN. STAT. ANN. § 17-7622 (1995). This statute was later amended to permit continuation by majority vote and this, in turn, was superceded by a new statute. 1999 Kan. Sess. Laws, ch. 119, § 87.
320. KAN. STAT. ANN. § 17-7627(b).
The remaining Simpsons argued, however, that the withdrawing Simpsons (two of whom were managers) were no longer members (and therefore they arguably were also no longer managers). To resolve this matter, the trial court looked to the operating agreement, section 9.2 of which provided that the “Members” wind-up the business.\textsuperscript{321} The trial court construed this as excluding the withdrawing members from participation.\textsuperscript{322} On appeal, plaintiffs argued that section 9.2 did not discriminate between “remaining members” and “former members,” and as former members with a remaining economic interest, they should be entitled to participate in winding-up. Although this argument might appear to be sophistry, plaintiffs garnered support from other provisions of the operating agreement which at times used the term “Members” and at other times used the phrase “Remaining Members.”\textsuperscript{323}

The Kansas supreme court looked to legislation in other states but found no pattern. For example, Georgia provided that the “members or managers in control prior to dissolution” may wind-up,\textsuperscript{324} whereas Maryland provides that only “remaining members”\textsuperscript{325} may participate in winding up. The court also pointed out that, although ULLCA\textsuperscript{326} excludes managers or members who dissolve wrongfully, “Kansas does not distinguish between wrongful and rightful dissolving members.”\textsuperscript{327}

The court decided that the term “member” included a withdrawing member having a financial interest in the company’s assets. The court found strong support for this position in the provision in the operating agreement that liquidation proceeds should be distributed “to the Members in accordance with their respective positive Capital Account balances.”\textsuperscript{328}

In this context, the term “members” clearly must include “withdrawing members” or withdrawal would work a forfeiture of the withdrawing members’ interest in the LLC.

As the court in \textit{Investcorp} observed, ULLCA provides that “a member who has not wrongfully dissociated” may participate in winding up the LLC after dissolution.\textsuperscript{329} Illinois has the same provision,\textsuperscript{330} while Delaware takes a different tack. The Delaware statute provides that “a manager who has not wrongfully dissolved” an LLC can participate in winding up unless there is no such person.\textsuperscript{331} If that is the case, then the members can choose

\begin{itemize}
\item \textsuperscript{321} \textit{Investcorp}, 983 P.2d at 268.
\item \textsuperscript{322} Id.
\item \textsuperscript{323} Id. at 270.
\item \textsuperscript{324} Id. (citing GA. CODE ANN. § 14-11-604(a) (1994)).
\item \textsuperscript{325} Id. (citing MD. CORP. & ASSOC. CODE ANN. § 4A-904(a) (1998 Supp.)).
\item \textsuperscript{326} UNIF. LTD. LIAB. CO. ACT § 803(a), 6A U.L.A. 484 (1995).
\item \textsuperscript{327} \textit{Investcorp}, 983 P.2d at 265, 270.
\item \textsuperscript{328} Id. at 271 (citing the operating agreement).
\item \textsuperscript{329} UNIF. LTD. LIAB. CO. ACT § 803(a), 6A U.L.A. 484 (1995).
\item \textsuperscript{330} 805 ILL. COMP. STAT. ANN. 180/35-4(a).
\item \textsuperscript{331} DEL. CODE ANN. tit. 6, § 18-803(a) (1999).
\end{itemize}
the person[s] who will wind up the business.\textsuperscript{332} In this latter situation, however, there is no disqualification for a "bad" member to participate. All of these provisions are potentially problematic in their application.\textsuperscript{333}

A basic flaw in both ULLCA and Illinois is the provision that a member who has not wrongfully dissociated may participate in the dissolution process. The typical events of dissociation, including withdrawal and expulsion, do not normally trigger dissolution. In addition, who is a "wrongfully dissociating" person? Very likely, someone who withdraws prior to the terms of an LLC has wrongfully dissociated. Again, however, this activity will not normally trigger dissolution. Another issue would be whether someone who is expelled has wrongfully dissociated. It would not seem that the plaintiffs in \textit{Gee}, who were locked out and thus expelled, acted "wrongfully" in any sense.\textsuperscript{334}

From a different perspective, has someone who has died, gone bankrupt, or been adjudged in need of a conservator, wrongfully dissociated? If not, such a person arguably can participate in winding up. Although a dead person obviously cannot participate, his personal representative may well desire to be involved. Illinois provides that a person wrongfully dissociates only if the dissociation is a "breach of an express provision of the [operating] agreement."\textsuperscript{335} Thus, to preclude a bankrupt or decedent from participating in winding up, the operating agreement must explicitly forbid death or bankruptcy. ULLCA deals with this issue a little more thoughtfully. It provides that bankruptcy or judicial expulsion constitute wrongful dissociation.\textsuperscript{336} Again, though, none of the above dissociating events will normally cause dissolution.

One of the triggers for dissolution is that the members or managers in control have acted oppressively.\textsuperscript{337} Acting oppressively would seem to be wrongful conduct, but acting oppressively does not cause the actor to dissociate.\textsuperscript{338} So here is a situation where, at least initially, a "wrongful" person—i.e., one who oppresses—could participate in winding up—subject to the oppressed member’s right to petition for court supervision "for good cause shown."\textsuperscript{339}

The question then arises: what sort of provision makes sense with respect to who has the authority to wind up an LLC upon dissolution? First of

\textsuperscript{332} \textit{Id.}
\textsuperscript{333} The problematic aspect of each statute is somewhat ameliorated by provisions in each that permit a member or her legal representative, upon a showing of good cause, to have a court oversee the winding up process. \textit{Unif. Ltd. Liab. Co. Act} § 803(a), 6A U.L.A. 484 (1995); 805 Ill. Comp. Stat. Ann. 180/35-4; Del. Code Ann. tit. 6, § 18-803(a).
\textsuperscript{334} \textit{See supra} notes 306-17 and accompanying text.
\textsuperscript{335} 805 Ill. Comp. Stat. Ann. 180/35-50(b) (emphasis added).
all, it does not make sense to tie dissociation into who can wind up in a statutory scheme where dissociation does not lead to dissolution. Second, the right to participate should normally lie with those who were members or managers immediately prior to dissolution, rather than "remaining members," to avoid the Investcorp problem. Because a withdrawing member has an economic interest in the winding up process (assuming withdrawal leads to dissolution), such member should be able to participate unless there are equitable reasons to deny such participation.

Determination of what conduct would exclude a member from participation in winding up should be left to the courts, however, rather than being statutorily defined—unless the statute is phrased very generally. Transaction lawyers abhor litigation and tend to believe that statutory specificity avoids litigation, as generality breeds litigation. If a situation arises in which one group of members seeks to exclude other members from participating in winding up, however, rest assured that there will be litigation. Thus, a statute should simply provide that the members or managers immediately prior to dissolution may wind-up the LLC unless, for good cause shown, a court determines otherwise.

**VOTING AND DISTRIBUTIONS—PER CAPITA OR PER CAPITAL**

In the move from a partnership model to a more corporate approach in LLC statutes generally, in one area there has been almost a reverse trend. Initially most states followed the limited partnership model with respect to voting, profit sharing, and distributions. ULLCA and Illinois, however, now employ a general partnership model. In a general partnership model, all partners have equal rights in management, and disputes are settled by a majority vote of the partners. In addition, the partners share equally in the profits. This is a per capita approach, whereby decisions are reached or profits are distributed from counting heads.

340. See supra notes 317-29 and accompanying text.
341. Id.
343. See UNIF. PARTNERSHIP ACT § 18(e) (1914), 6 U.L.A. 526 (West 1995); UNIF. PARTNERSHIP ACT § 401(f) (1997), 6 U.L.A. 74 (West Supp. 2000); see also 805 ILL. COMP. STAT. ANN. 205/18(e).
345. See UNIF. PARTNERSHIP ACT § 18(a) (1914), 6 U.L.A. 526 (West 1995); UNIF. PARTNERSHIP ACT § 401(b) (1997), 6 U.L.A. 74 (West Supp. 2000); see also 805 ILL. COMP. STAT. ANN. 205/18(a).
On the other hand, in a limited partnership, profit sharing and distributions are based upon the capital contributed.\(^3\)\(^4\)\(^6\) Although management power resides in the general partner,\(^3\)\(^4\)\(^7\) the limited partners do have certain voting rights.\(^3\)\(^4\)\(^8\) Many limited partnership agreements provide that the limited partners exercise these rights in proportion to their capital contributions.\(^3\)\(^4\)\(^9\) This is a per capital approach, because instead of counting heads, one counts dollars.

In essence, the corporate model is a per capital approach, because voting power\(^3\)\(^5\)\(^0\) and right to distributions\(^3\)\(^5\)\(^1\) are functions of the number of shares owned, which, generally, is a function of capital contributed. In the corporate model, however, not only can there be different classes of shares,\(^3\)\(^5\)\(^2\) but also shares can be sold at different prices.\(^3\)\(^5\)\(^3\) Thus, in a closely held corporation, preferred shares are frequently used to create a partnership model. If A contributes $10x and B contributes $90x, they will each receive 10 shares of common stock with voting power. But B would also receive $80x of preferred shares that would have a preference on liquidation of $80x, but no right to vote. Thus, A and B would have equal voting power and equal rights to profits\(^3\)\(^5\)\(^4\) but, upon liquidation, B would receive his excess contribution of $80x before accumulated profits were distributed.


347. See REV. LTD. PARTNERSHIP ACT § 403(a) (1976), 6A U.L.A. 177 (West 1995); see also 805 ILL. COMP. STAT. ANN. 210/403(a).

348. See REV. LTD. PARTNERSHIP ACT § 303(b)(6) (1976), 6A U.L.A. 144-45 (West 1995); see also 805 ILL. COMP. STAT. ANN. 210/303(b)(6).

349. REV. LTD. PARTNERSHIP ACT § 302 (1976), 6A U.L.A. 142 (West 1995) (setting forth the "the right to vote (on a per capita or other basis)") (emphasis added). See also 805 ILL. COMP. STAT. ANN. 210/302.

350. See MODEL BUS. CORP. ACT § 7.21(a) (1999) (stating that in general "each outstanding share . . . is entitled to one vote"); 2 MODEL BUS. CORP. ACT ANN. 7-91 (Aspen 3d ed. 1996 Supp.).

351. See MODEL BUS. CORP. ACT § 6.01(a) (providing that "[a]ll shares of a class must have preferences, limitations, and relative right identical with those of other shares of the same class"); 1 MODEL BUS. CORP. ACT ANN. 6-3 (Aspen 3d ed. 1996 Supp.).

352. Typically, common and preferred shares have different characteristics with the common having the growth potential and more power, and the preferred more security. Frequently, the preferred does not vote.

353. Clearly, preferred and common shares can be sold at different prices, but the value of common shares can change over time as well. In addition, with disclosure the same shares can be sold at different prices though this could, for example, create a tax problem because of the bargain element.

354. The preferred shares generally would have a preferential dividend before profits would be distributed to the common share. This preferential dividend would, however, in the partnership context, be analogous to interest on a loan by a partner. Under the default provision of the Uniform Partnership Act, partners do not receive interest on capital contributions but could on loans. UNIF. PARTNERSHIP ACT § 18(c) (1914), 6 U.L.A. 526 (West 1998). Even with respect to capital, interest could be paid because the default provision is operative. Id.
equally. Thus, as in a partnership, the shareholders (partners) share equally in profits and management, and the shareholders effectively receive a return of their capital contributions before profits are distributed.

The early (i.e., pre-1996 ULLCA) statutes generally used a per capita approach. For example, the default provision in the Illinois statute originally provided, with respect to voting, that “all decisions of the members shall be made by concurrence of the holders of membership interests representing a majority of the book value of the membership interests,” and, with respect to profits and distributions, such shall be made “on the basis of the book value of the member’s membership interest.”

Delaware still provides that profits and losses shall be allocated, and distributions made, “on the basis of the agreed value . . . of the contributions made by each member to the extent . . . not . . . returned.” The default provision with respect to management is also a per capita approach, because the statute provides that “management . . . shall be vested in its members in proportion to the then current percentage . . . of the members in the profits.” As stated above, the default provision for allocating profits is on a per capita basis. With respect to voting, Delaware has a unique provision: “Voting by members may be on a per capita, number, financial interest, class, group, or any other basis.”

ULLCA provides, however, that “each member has equal rights” in management and decisions are made “by a majority of the members.” In addition, “[a]ny distributions . . . must be in equal shares.” Illinois has essentially the same provisions. Thus, there is a return to the general partnership model.

Which approach is better from the perspective of a default provision in a statute? It is important to recognize that the approach which is chosen can have significant impact. Consider the example at the beginning of this section where A invested $10x and B invested $90x. This is a typical “Work/Money” partnership. If per capita is the default, and A and B simply

355. Id. at § 18(a).
356. Id. at § 18(c).
357. In the corporate context, using preferred shares as in the above example, only the “excess” capital contribution is first repaid. The balance of the capital contribution is repaid in connection with distribution of the funds remaining after the preferred gets its first bite.
358. UNIF. PARTNERSHIP ACT § 40(b)(iii) (1914), 6 U.L.A. 901 (West 1995); see also 805 ILL. COMP. STAT. ANN. 205/40(b)(iii). The 1997 Uniform Partnership Act eliminated the distinction between distributions in respect of capital and those in respect of profits.
360. Id. § 20-10, 20-15.
361. DEL. CODE ANN. tit. 6, §§ 18-503, 504.
362. Id. § 18-402.
363. Id. § 18-302(a).
366. 805 ILL. COMP. STAT. ANN. 180/15-1(a)(1), (2); 25-1(a).
assumed that, by forming an LLC, they were partners, we could expect A to be very unhappy. B has absolute control and ninety percent of the profits. On the other hand, a *per capita* approach would provide the equality they arguably desire, having thought of themselves as partners, and would provide equality in sharing profits, but would not compensate B for his “excess” contribution. Nonetheless, in most circumstances, the *per capita* approach achieves greater “equity” and captures more of the likely intended consequences than a *per capital* approach.

To return to an earlier model: if we posit two types of businesses, one well-capitalized with sophisticated investors and the other more modest with unsophisticated investors, using the *per capita* approach as a default role makes the most sense. This gives each member equal rights in management. The *per capita* approach also gives each member equal interests in distributions. Is this fair? With respect to distributions, both *per capita* and *per capital* reach the same result when the capital contributions of the members are equal. If the capital contributions are substantially dissimilar, as in the A/B example above, such as when “x” equals 1000 or more, B has a sufficiently large financial stake that it makes economic sense for him to seek the advice of competent counsel. In such a situation, counsel would likely recommend a combination of common and preferred interests, as would be the case in the corporate example discussed above. This would provide B with an additional return on the extra investment he made so as to restore equity.

Phrased differently, if the capital investments are so substantial as to make a significant difference between the *per capita* and *per capital* approaches, it is likely that the parties are sophisticated and will engage sophisticated counsel to draft a sophisticated agreement. The default provision will pertain only when the operating agreement is silent on these issues. In such a situation, the task of the legislature is to choose a default result which is likely to do the least damage in most situations. Going back to the A/B example, a *per capital* approach leaves A in a totally impotent position. On the other hand, a *per capita* approach not only achieves some basic equity but also provides B with the blocking leverage that a fifty-fifty position holds so as to enhance his negotiating position.

**CONCLUSION**

What the foregoing analysis demonstrates is that the flurry of legislative activity, not just in enacting LLC legislation at the outset but in amending it in response to changes in the tax laws, has created an unstable situation in which counsel must master not only complex and changing legislation

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367. See *supra* note 169 and accompanying text.
368. If A contributes $10x and B $90x, then A would contribute $10,000 and B $90,000 if $x = 1000.$
369. See *supra* notes 357-61 and accompanying text.
but also case law which may or may not be applicable depending upon legislative changes in the interim.

There is something to be said for a moratorium on the constant tinkering or, in some cases, complete overhaul that is going on with LLC statutes. On the other hand, because they were enacted in relative haste, there are glitches and the instinct to tinker may be hard to overcome.

Contractarians are among the strongest proponents of LLCs because of the great flexibility in drafting operating agreements and because of the opportunity to constrain wasteful legal concepts like fiduciary duties.370 But contractarians are also focused upon efficiency. Consider the past decade: A flurry of legislative activity with respect to business organizations, driven largely by tax considerations. A change in the tax regulations, liberalizing the circumstances under which a business organization can be taxed as a partnership. Another flurry of legislative activity to remove what were perceived as glitches in the original legislation and to limit the circumstances under which the entity would be dissolved, in order to make the LLC form a more stable form of organization. Judges, and counsel around the country, are struggling with a new form of business organization and with new procedures and new concepts. Has this been an efficient use of legislative, judicial, and lawyer energy?

On the other hand, post-World War II developments in corporate law have resulted in a Model Act which, for the most part, has been adopted in a majority of states. There have also been case law developments, such as Galler v. Galler371 in Illinois, which empowered shareholders in closely held corporations to adopt wide-ranging and comprehensive shareholder agreements even though such agreements were at odds with some norms of corporate law, and Donohue v. Rodd Electrotype372 in Massachusetts, which recognized that controlling shareholders in a close corporation owe minority shareholders a duty of fairness akin to that which partners owe each other. These decisions have been cited as precedent in many jurisdictions. Accordingly, there is a fairly uniform and flexible body of corporate law throughout the states.

The question then arises: was all this LLC activity necessary or was there a better way that the ends sought by the LLC legislation could have been achieved? The answer is simple. All that needed to have been done was to amend the Internal Revenue Code (IRC) to add one sentence: “A non-publicly traded corporation may elect to be taxed as a partnership by filing an election with . . . .” With the advent of LLCs, any argument that the Treasury had that business entities with limited liability should be precluded from seeking to be taxed as partnerships are long gone.

371. 203 N.E.2d 577 (Ill. 1964).
Will the IRC be so amended? Probably not. Because this would entail legislation, the Republicans and the Democrats would need to come together, whereas the check-the-box regulations were implemented administratively. Moreover, there is now a cadre of lawyers and accountants with expertise in this area who would resist any change because their unique knowledge is now a valuable asset. But there are thousands more lawyers and accountants in small firms and small communities, to say nothing of judges, who would appreciate a simplification of the law regarding business organizations and would prefer the option merely to deal with a form of business organization, namely, the corporation, that is far better understood by a far greater range of people than the LLC.

If returning to the pre-LLC days is not feasible because of the difficulty in amending the IRC, and if the urge to tinker with the existing LLC legislation is irresistible, as it probably is, then there is a definite need for a uniform act that is widely adopted. Business law should have a certain degree of predictability. With numerous statutory models in place, which in turn are amended from year to year, not only does this place a heavy burden on transaction lawyers to master a wide array of statutory provisions, but also it impedes the development of a body of case law which is meaningful across the country.

ULLCA is not a perfect statutory resolution. At a bare minimum, its fiduciary duty provisions should be modified along the line of the Illinois legislation. The perfect is the enemy of the good, however. ULLCA is a good start toward developing a uniform body of legislation. The alternative is a hodge-podge of legislation, borrowing principles from other bodies of law, such as other uniform acts, and existing corporate statutes. The alternative to a uniform approach also presents the spectre of decades before a meaningful body of case law develops. It makes continuing legal education, both for lawyers and judge, more difficult and less efficient. As we move to more of a multi-state practice of law, it makes such practice less efficient.

ULLCA deserves more consideration. It would help if the Uniform Commissioners would revisit the fiduciary duty provision of ULLCA, however, and bring them more in line with existing case law and sound public policy.
APPENDIX 1

Alabama Limited Liability Company Act, ALA. CODE §§ 10-12-1 through 10-12-61 (1994).
Oregon Limited Liability Company Act, OR. REV. STAT. §§ 63.001 through 63.990 (Supp. 1996).


APPENDIX 2

Section 15-3 of the Illinois LLC Act, 805 ILL. COMP. STAT. 180/15-3 (West 2000), provides as follows:

(a) The fiduciary duties a member owes to a member-managed company and its other members include the duty of loyalty and the duty of care referred to in subsections (b) and (c) of this Section.

(b) A member's duty of loyalty to a member-managed company and its other members includes the following:
   (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business or derived from a use by the member of the company's property, including the appropriation of a company's opportunity;
   (2) to act fairly when a member deals with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
   (3) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.

(c) A member's duty of care to a member-managed company and its other members in the conduct of a winding up of the company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A member shall discharge his or her duties to a member-managed company and its other members under this Act or under the operating agreement and exercise any rights consistent with the obligation of good faith and fair dealing.

(e) A member of a member-managed company does not violate a duty or obligation under this Act or under the operating agreement merely because the member's conduct furthers the member's own interest.

(f) This Section applies to a person winding up the limited liability company's business as the personal or legal representative of the last surviving member as if the person were a member.

(g) In a manager-managed company:
   (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;
   (2) a manager is held to the same standards of conduct prescribed for members in subsections (b), (c), (d), and (e) of this Section;
(3) a member who pursuant to the operating agreement exercises some or all of the authority of a manager in the management and conduct of the company's business is held to the standards of conduct in subsections (b), (c), (d), and (e) of this Section to the extent that the member exercises the managerial authority vested in a manager by this Act; and

(4) a manager is relieved of liability imposed by law for violations of the standards prescribed by subsections (b), (c), (d), and (e) to the extent of the managerial authority delegated to the members by the operating agreement.
APPENDIX 3

The following table attempts to break down the fiduciary duty provisions, or lack thereof, for each state, based upon the closest "model" which they approximate. The models used are (i) ULLCA § 409, Uniform Limited Liability Company Act, 6 A U.L.A. 429-508 (App. 4); (ii) Uniform Partnership Act (1914) § 21, 6 U.L.A. 608 (App. 5); (iii) Revised Uniform Limited Partnership Act (1976) § 107, 6A U.L.A. 94 (App. 5); (iv) Delaware General Corporation Law § 144, 8 Del. Code § 18-144 (App. 6); and (v) Model Business Corporation Act § 8.30, 2 Model Bus. Corp. Act Ann. 8-165 (3d ed. 1998, 1999 Supp.) (App. 7). Section 8.30 essentially deals with the duty of care and does not deal with the duty of loyalty or other fiduciary duties. Accordingly, in the text, states having only a § 8.30 type provision are treated as not having a statutory provision on fiduciary duty. States that have a provision similar to RULPA § 107 are also treated as not having a fiduciary duty provision. See supra note 118. Section 107 was not intended to abrogate fiduciary duties. Id.
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<th>Fiduciary Duty Section</th>
<th>ULLCA § 409</th>
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1. By analogy.
2. Articles or operating agreement can exculpate.
3. Fiduciary duties may be expanded or restricted by the operating agreement, inferentially suggesting they exist at common law.
ULLCA § 409, 6A U.L.A. 464-465, provides as follows:

(a) The only fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and (c).

(b) A member’s duty of loyalty to a member-managed company and its other members is limited to the following: (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business or derived from a use by the member of the company’s property, including the appropriation of a company’s opportunity; (2) to refrain from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and (3) to refrain from competing with the company in the conduct of the company’s business before the dissolution of the company.

(c) A member’s duty of care to a member-managed company and its other members in the conduct of and winding up of the company’s business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A member shall discharge the duties to a member-managed company and its other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.

(e) A member of a member-managed company does not violate a duty or obligation under this [Act] or under the operating agreement merely because the member’s conduct furthers the member’s own interest.

(f) A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law.

(g) This section applies to a person winding up the company’s business as the personal or legal representative of the last surviving member as if the person were a member.

(h) In a manager-managed company: (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member; (2) a manager is held to the same standards of conduct prescribed for members in subsections (b) through (f); (3) a member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company’s business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act]; and (4) a manager is relieved of liability imposed by law for violation of the standards prescribed by subsections (b) through (f) to the extent of the managerial authority delegated to the members by the operating agreement.
APPENDIX 5

Section 21 of the Uniform Partnership Act, 6 U.L.A. 608, provides as follows:

Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

Section 107 of the Revised Uniform Limited Partnership Act, 6A U.L.A. 94, provides as follows:

Except as provided in the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.
APPENDIX 6

Section 144 of the Delaware General Corporation Act, 8 Del. Code tit. 6, § 8-144, provides as follows:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.
APPENDIX 7

Section 8.30 of the Model Business Corporation Act, 2 MODEL BUS. CORP. ACT ANN. 8-160 (3d ed. 1999 Supp.), provides as follows:

(b) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

(c) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

(d) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on the performance by any of the persons specified in subsection (e)(1) or subsection (e)(3) to whom the board may have delegated, formally or informally by course of conduct, the authority or duty to perform one or more of the board’s functions that are delegable under applicable law.

(e) In discharging board or committee duties a director, who does not have knowledge that makes reliance unwarranted, is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the persons specified in subsection (e).

(f) A director is entitled to rely, in accordance with subsection (c) or (d), on:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person’s professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.
APPENDIX 8

Section 301.7701-2 (Associations), 26 C.F.R. § 301.7701.2 (1995), provides as follows:

(a) Characteristics of corporations. (1) The term "association" refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divided the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. In addition to the major characteristics set forth in this subparagraph other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust. An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust. See Morrissey et al. v. Commissioner (1935) 296 U.S. 344.

(2) Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association...
depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

(3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association. Although the limited partnership also has associates and an objective to carry on business and divide the gains therefrom, these characteristics are not considered because they are common to both corporations and partnerships.

(4) The rules of this section and §§ 301.7701-3 and 301.7701-4 are applicable only to taxable years beginning after December 31, 1960. However, for any taxable year beginning after December 31, 1960, but before October 1, 1961, any amendment of the agreement establishing the organization will, in the case of an organization in existence on November 17, 1960, be treated for purposes of determining the classification of the organization as being in effect as of the beginning of such taxable year (i) if the amendment of the agreement is made before October 1, 1961, and (ii) if the amendment results in the classification of the organization under the rules of this section and §§ 301.7701-1, 301.7701-3, and 301.7701-4 in the same manner as the organization was classified for tax purposes on November 17, 1960. The third sentence of paragraph (b)(1) of this section is applicable to taxable years beginning on or after June 14, 1993. However, a taxpayer may apply the third sentence of paragraph (b)(1) of this section for taxable years beginning before June 14, 1993.

(5) All references in this section to the Uniform Limited Partnership Act shall be deemed to refer both to the original Uniform Limited Partnership Act (adopted in 1916) and to the revised Uniform Limited Partnership Act (adopted by the National Conference of Commissioners on Uniform State Laws in 1976).

(b) Continuity of life. (1) An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. If the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of a general partner of a limited partnership causes a dissolution of the partnership, continuity of life does not exist; furthermore, continuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be
avoided, upon such an event of withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership. See Glensder Textile Co. v. Commissioner, 46 B.T.A. 176 (1942), acq., 1942-1 C.B. 8.

(2) For purposes of this paragraph, dissolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law. For example, since the resignation of a partner from a general partnership destroys the mutual agency which exists between such partner and his copartners and thereby alters the personal relation between the partners which constitutes the identity of the partnership itself, the resignation of a partner dissolves the partnership. A corporation, however, has a continuing identity which is detached from the relationship between its stockholders. The death, insanity, or bankruptcy of a shareholder or the sale of a shareholder's interest has no effect upon the identity of the corporation and, therefore, does not work a dissolution of the organization. An agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life although the business is continued by the remaining members.

(3) An agreement establishing an organization may provide that the organization is to continue for a stated period or until the completion of a stated undertaking or such agreement may provide for the termination of the organization at will or otherwise. In determining whether any member has the power of dissolution, it will be necessary to examine the agreement and to ascertain the effect of such agreement under local law. For example, if the agreement expressly provides that the organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding such agreement, any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.

(c) Centralization of management. (1) An organization has centralized management if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the manage-
ment decisions necessary to the conduct of the business for which the organization was formed. Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation. The effective operation of a business organization composed of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization, and therefore, centralized management is more likely to be found in such an organization than in a smaller organization.

(2) The persons who have such authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office. See Morrissey et al. v. Commissioner (1935) 296 U.S. 344. Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

(3) Centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.

(4) There is no centralization of continuing exclusive authority to make management decisions, unless the managers have sole authority to make such decisions. For example, in the case of a corporation or a trust, the concentration of management powers in a board of directors or trustees effectively prevents a stockholder or a trust beneficiary, simply because he is a stockholder or beneficiary, from binding the corporation or the trust by his acts. However, because of the mutual agency relationship between members of a general partnership subject to a statute corresponding to the Uniform Partnership Act, such a general partnership cannot achieve effective concentration of management powers and, therefore, centralized management. Usually, the act of any partner within the scope of the partnership business binds all the partners; and even if the partners agree among themselves that the powers of management shall be exclusively in a selected few, this agreement will be ineffective as against an outsider who had no notice of it. In addition, limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners. Furthermore, if all or a specified group of the limited partners may remove a general partner, all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management. A substantially restricted right of the limited partners to remove the general partner
(e.g., in the event of the general partner's gross negligence, self-dealing, or embezzlement) will not itself cause the partnership to possess centralized management.

(d) Limited liability. (1) An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. A member of the organization who is personally liable for the obligations of the organization may make an agreement under which another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for any such liability. However, if under local law the member remains liable to such creditors notwithstanding such agreement, there exists personal liability with respect to such member. In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner. Similarly, in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph (d).

(2) In the case of an organization formed as a limited partnership, personal liability does not exist, for purposes of this paragraph, with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a "dummy" acting as the agent of the limited partners. Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners. Also, if a corporation is a general partner, personal liability exists with respect to such general partner when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the limited partnership. A general partner may contribute his services, but no capital, to the organization, but if such general partner has substantial assets (other than his interest in the partnership), there exists personal liability. Furthermore, if the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization. In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a "dummy" acting as the agent of the limited partners. If the limited partnership agreement provides that a general partner is not personally liable to creditors
for the debts of the partnership (other than debts for which another general partner is personally liable), it shall be presumed that personal liability does not exist with respect to that partner unless it is established that the provision is ineffective under local law.

(c) Free transferability of interests. (1) An organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization. Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization. Furthermore, although the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.

(2) If each member of an organization can transfer his interest to a person who is not a member of the organization only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

(f) Cross reference. See paragraph (b) of § 301.7701-3 for the application to limited partnerships of the rules relating to corporate characteristics.

(g) Examples. The application of the rules described in this section may be illustrated by the following examples.