Selected Recent LLC Cases

LLCs, Partnerships and Unincorporated Entities Committee
2012 Institute
October 18-19, 2012

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<u>Limited Liability of LLC Members and Managers; Personal Liability under Agency or Other Principles; LLC Veil Piercing</u>

Sun Nurseries, Inc. v. Lake Erma, LLC, 730 S.E.2d 556 (Ga. App. 2012).

Sun Nurseries, Inc. ("Sun") unsuccessfully attempted to collect past due invoices for landscaping services on a golf course and filed suit against Lake Erma, LLC ("Lake Erma") and BEC Properties and Holdings, LLC ("BEC"), two LLCs Sun alleged owned and developed the golf course. BEC disputed any interest in the development. Sun also sued five individual owners, operators, and members of Lake Erma. Three of the five members were also members of BEC. Lake Erma and BEC shared office space, and BEC employees performed work for both companies but were paid by BEC. At trial, the evidence showed that Sun provided landscaping services for the golf course from late 2003 through mid 2005. Sun submitted invoices to BEC, and Lake Erma issued the checks to pay the invoices. Sun filed suit over a series of six unpaid invoices. An accountant for Lake Erma testified that he cut a check for the invoices in question but it was apparently lost in the mail. No replacement check was ever sent to Sun despite the accountant's reassurances that Sun would be paid, and there was conflicting evidence as to whether a replacement check was issued or whether it was issued and held back at the direction of an individual who was a member of both LLCs. Sun threatened to file a lien on the golf course for the unpaid debt prior to a meeting between Sun's owner and two members of the LLCs to discuss the outstanding balance. Whether the meeting was to discuss concerns that Sun was overcharging or that the golf course project was over budget and did not have the funds to pay was disputed. Sun refused an offer of approximately half of what was owed on the outstanding balance. Sun filed suit in February 2006. During 2005, Lake Erma distributed almost $8.3 million to its members in cash and property. In March 2006, two members of the LLCs used the distributed property to obtain loans for Lake Erma and then transferred the proceeds of the loans and the property back to Lake Erma. During the trial, Sun's accounting expert testified that the distribution left Lake Erma insolvent at the end of 2005, but the expert later conceded that using the market value in her analysis (rather than the purchase price plus development costs) Lake Erma was marginally solvent in that it had sufficient funds to pay its existing liabilities with some excess as of the end of 2005. At the close of Sun's case, the trial court granted a directed verdict for the individual defendants and the LLCs on Sun's claim of fraud and for the individual defendants on all other claims. On appeal, Sun argued that the trial court erred in ordering a directed verdict on its fraud claim because there was some evidence to show that statements by Lake Erma's accountant to Sun's owner that Sun would be paid were intended to fraudulently dissuade Sun from filing a lien and that Lake Erma's distribution constituted a fraudulent conveyance designed to defeat the rights of its creditors in violation of state law. Sun also argued that Lake Erma's veil should be pierced so as to hold the members of the LLC liable for the LLC's debts.

The appellate court found that the evidence was insufficient to support Sun's claim of fraud because there was no evidence that the accountant's statements were a willful misrepresentation of a material fact. No evidence showed that the accountant knew his statements regarding Sun being paid were false or that he intended to deceive Sun's owner and prevent him from asserting Sun's lien rights. In addition, Sun failed to establish any culpability of the individual defendants for the accountant's representations regarding the payment of Sun's invoices. No liability existed for the LLC members simply by reason of their status as members of Lake Erma because a member of an LLC is separate from the company and does not have personal liability for the LLC's obligations unless the member personally participates or cooperates in a tort committed by the LLC or directs it to be done. Here, Sun presented no evidence demonstrating that any of the individual defendants personally participated or cooperated in any of the accountant's representations or that they directed him to make representations with the intent to mislead Sun. Therefore, the trial court properly granted a directed verdict on Sun's claim of fraudulent misrepresentation. The appellate court also concluded that the trial court properly granted a directed verdict on Sun's fraudulent conveyance claim because Sun did not present evidence of actual intent to hinder, delay, or defraud Sun in the collection of its debt even assuming there was evidence of insolvency.

Finally, Sun maintained that it presented evidence to support piercing the veil of Lake Erma and that the trial court thus erred in granting a directed verdict in favor of the individual defendants. Sun contended that the March 2006 transfer of property from Lake Erma to two of its members for the purpose of securing a loan demonstrated a use by its members of corporate assets interchangeably without regard to Lake Erma's corporate identity. Since an LLC has a legal existence separate from its members, evidence of an abuse of the LLC form was necessary to pierce the veil. Sun did not show that the members disregarded the separateness of the LLC as a legal entity. There was no evidence of the members commingling or confusing Lake Erma's records, assets, or finances with their own. Although Lake Erma transferred property to two of its members to facilitate a loan for the benefit of the LLC, the loan proceeds and transferred property were immediately returned to Lake Erma. The transaction was not concealed and was properly reflected on the LLC books and in the public record. Sun failed to demonstrate that the distributions were fraudulent or otherwise illegal or improper. The mere existence of transfers or loans between an LLC and its members did not of itself represent an abuse of the LLC form, especially when such transactions were properly reflected on the corporate books and in the public record, as in this case. The appellate court concluded that the distribution and loan transaction were insufficient evidence that the individual defendants disregarded the LLC's separate identity because there was no indication that the individual defendants commingled Lake Erma's finances with their own, appropriated the LLC's assets for their own personal use, or otherwise used Lake Erma as a mere instrumentality for the transaction of their own personal affairs. Accordingly, piercing the veil of the LLC would be improper, and the individual defendants were not liable for the LLC's unpaid debts based on any cause of action.

Grammas v. Lockwood Associates, LLC, 944 N.Y.S.2d 623 (App. Div. 2nd Dept. 2012).

The purchasers of real property filed suit against the seller LLC and the LLC's sole managing member alleging fraud and breach of warranty. The LLC dissolved prior to the commencement of the plaintiffs' suit. The trial court granted the defendants' motion to dismiss the complaint as to the member, holding that the plaintiffs failed to state a cause of action under the doctrine of piercing the corporate veil to justify holding the member personally liable for actions he took as the LLC's sole managing member at the time of and until the dissolution of the LLC. On appeal, the court determined that dismissal of the complaint against the member was error. Generally, a member of an LLC cannot be held liable for the LLC's obligations by virtue of status as a member of the LLC; however, a member of an LLC may be held individually liable for the LLC's debts based on the doctrine of piercing the corporate veil. To state a viable veil-piercing claim, a plaintiff must allege facts that, if proved, indicate that the member exercised complete domination and control over the LLC and abused the privilege of doing business in the LLC form to perpetuate a wrong or injustice. Factors to consider in determining whether a member engaged in such conduct include the failure to adhere to LLC formalities, inadequate capitalization, commingling of assets, and the personal use of LLC funds. The plaintiffs' suit alleged, among other actions, that the member dissolved the LLC shortly after closing title to the property at issue and that the defendants failed to reserve funds for the purposes of contingent liability. The appellate court found that these allegations adequately pled allegations against the member that he engaged in acts amounting to an abuse or perversion of the LLC form to perpetuate a wrong or injustice against the purchasers as required to pierce the veil of an LLC for its alleged fraud and breach of warranty.

Mbahaba v. Morgan, 44 A.3d 472 (N.H. 2012).

The plaintiff sought to recover damages for injuries to her daughter from lead poisoning in an apartment managed by an LLC owned and managed by the defendant. The plaintiff alleged that the defendant was liable on two grounds: (1) the defendant's personal participation in the activity that caused the injury; and (2) veil piercing based on the defendant's transfer of the LLC's business to a new LLC after the plaintiff brought her claims. The trial court dismissed the plaintiff's direct claim and granted the defendant summary judgment on the veil-piercing claim. The New Hampshire Supreme Court concluded that the plaintiff had adequately alleged a direct claim for negligence and that genuine issues of material fact precluded summary judgment on the veil-piercing claim.

The court first analyzed the plaintiff's claim that the defendant had direct liability based on his own tortious conduct. The court acknowledged the statutory liability protection provided members and managers of a New Hampshire LLC but stated that a member remains personally liable for the member's own acts because the statute only protects members and managers from liability "solely by reason" of their status in the LLC, i.e., it only governs vicarious liability for an LLC's debts and obligations. The court stated that a member or manager is protected from liability when making a contract for a disclosed LLC because only the LLC is a party to the contract. The defendant argued that he did not owe any duty to investigate, remedy, or warn the plaintiff about the dangers of flaking lead paint because the owner of the property contractually delegated duties only to the LLC. The court noted that it had abolished specialized tests for landlord negligence and, applying general common law negligence principles, concluded that the defendant had a tort duty independent of any contractual obligation because a reasonable person under these circumstances would exercise a certain degree of care for the protection of a vulnerable tenant. The defendant's management of the apartment and superior knowledge of its hazardous condition sufficed to establish an individual tort duty, and the plaintiff's negligence claim survived the defendant's motion to dismiss.

With respect to the plaintiff's veil-piercing claim, the court noted that it had not yet addressed whether members and managers of an LLC can be held personally liable for the LLC's debts under corporate veil-piercing theory, but the parties had assumed that corporate veil-piercing cases apply to LLCs, so the court did the same. The plaintiff argued that the LLC never had many assets and that the defendant simply decided to cease operations and move his clients to a new LLC with a different name but the same address and telephone number as the original LLC. The defendant's explanation for what the court characterized as "this unusual and ostensibly arbitrary business decision" was that he "'[j]ust wanted to start fresh.'" The court acknowledged that the defendant had every right to establish a new LLC and transfer the original LLC's clients to it but stated that making this "fresh start" when his company was a party to this case could permit a finding that the limited liability entity was used to promote an injustice on the plaintiff. The court stated that it did not need to address the impact of the plaintiff's contention that the LLC failed to insure itself adequately because the fact issues surrounding the LLC's transfer of its accounts made summary judgement improper in any event.

AT&T Advertising, L.P. v. Winningham, 280 P.3d 360 (Okla. App. 2012)

Winningham contracted on behalf of an LLC with AT&T Advertising, L.P. ("AT&T") for yellow pages advertising in 2007 and 2008. AT&T did not receive payment for the advertising and filed suit against Winningham to collect the balance owed on the contracts. Winningham claimed that he signed the contracts on behalf of the LLC and thus was not personally liable for the debt, but AT&T argued that Winningham was personally liable because the LLC had been cancelled by the Secretary of State before Winningham signed the contracts. The trial court found that the LLC was not a legal entity in existence when the contracts were signed due to its cancellation and granted AT&T's motion for summary judgment holding Winningham personally liable for the debt.

The question presented to the appellate court was whether an LLC, which had been cancelled by the Secretary of State for non-payment of fees, provided a liability shield for its agent. Winningham relied on a provision of the Oklahoma Limited Liability Company Act that provides that a member of an LLC is not liable for the LLC's debts solely by reason of the LLC's failure to file annual certificates and pay annual fees to the Secretary of State or by reason of the LLC ceasing to be in good standing or duly registered. Winningham argued that once an LLC is created, its members are free from liability for acts on behalf of the LLC until the LLC voluntarily files for dissolution. AT&T countered that the provision of the statute applied when the LLC was not in good standing and only until the LLC was either dissolved or cancelled, and the LLC in this case had been cancelled. Furthermore, if the court adopted Winningham's interpretation of the provision, an LLC would have no motivation to ever pay the fees or file the required certificate. The appellate court agreed with AT&T. The statute provides that an LLC may be cancelled either by filing a notice of dissolution (voluntary cessation) or by being deemed cancelled for failing to file the annual certificate or pay the annual fee within three years of the due date (involuntary cessation). The provision relied on by Winningham includes express language distinguishing a cancelled LLC from one not in good standing, and Winningham would have been correct had the LLC simply ceased to be in good standing. However, once three years had passed from the due date for the certificate or fee, the statute provided for a more serious penalty, i.e., cancellation of the LLC. Following cancellation, an LLC is no longer required to make the annual filing and pay the annual fee, and the court interpreted this result to indicate that the legislature intended cancellation to mean the LLC no longer existed. That is, once cancelled, an LLC is no longer a separate legal entity. The record here did not dispute that the LLC was cancelled during the time all of the contracts at issue were executed. Because the LLC was cancelled, it was not a legal entity and did not afford its members the liability shield typically in effect for LLC members. The appellate court was also not persuaded by Winningham's claim that the LLC was "suspended" because the Secretary of State record stated the LLC was cancelled and because the statute did not include "suspension" as a status for an LLC. Next, Winningham alleged that the LLC was reinstated after the contracts were executed, which resulted in the liability shield being effective as if the LLC were never cancelled. The appellate court disagreed. The LLC was cancelled July 1, 2007, and it filed articles of conversion to form a corporation on July 14, 2009. The statute was amended effective January 1, 2010, to allow reinstatement as an LLC. Thus, at the time the LLC became a corporation, reinstatement as an LLC was not even possible. The statute also implied no relation back for liability purposes. Nothing in the record showed that the LLC sought reinstatement as an LLC after it was cancelled. When the LLC incorporated, it was not converting, as there was no legal entity in existence to convert from, but rather it was forming an entirely new business entity. In addition, even if the LLC had the ability to convert, the statute provided that conversion of an LLC to another business entity did not affect any liabilities of the LLC or its agents incurred before the conversion. From July 1, 2007, to July 14, 2009, the LLC was not a legally cognizable entity. Thus, the appellate court affirmed the trial court's judgment holding Winningham personally liable for the amount owed on the contracts with AT&T during that time.

16 Jade Street, LLC v. R. Design Construction Co., LLC, 728 S.E.2d 448 (S.C. 2012).

The plaintiff sought to hold a member of an LLC liable for negligent acts the member committed while acting in furtherance of the LLC's construction business, and the member argued that the South Carolina Uniform Limited Liability Company Act shielded the member from personal liability for negligence he committed while working for the LLC. As a matter of first impression in South Carolina, the supreme court concluded that the General Assembly did not intend to abrogate the common law rule that a tortfeasor is liable for the tortfeasor's own actions. The statutory provision at issue provided: "Except as otherwise provided in subsection (c), the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager." Subsection (c) provides that a member is liable for debts, obligations, or liabilities of the company if there is a provision to that effect in the articles of organization and the member has consented in writing to be bound by the provision. The record did not contain the articles of organization, so the court was not able to determine whether subsection (c) would apply in this case. The court noted that a majority of states examining similar language have concluded that a member is always liable for the member's own torts and cannot rely on member status as a shield, but the court cited a few cases in which courts appeared to have concluded otherwise. The court acknowledged that the statute's plain language could be read to shield a member from personal liability for torts committed in furtherance of the LLC's business because the LLC's liability would derive from the acts of a member, manager, or other agent acting in that capacity, and the statute protects a person from liability "solely by reason of being or acting as a member or manager." Additionally, the statute provides that these obligations are "solely" those of the company. Nevertheless, because the right to sue one's tortfeasor is a long-standing right, the court was unwilling to find it was abrogated by statute absent "clear legislative intent." The court was not persuaded that it was the General Assembly's intent to abrogate the common law rule for several reasons. First, the prevailing interpretation of similar language by other courts is that a member is liable for the member's own torts, and this interpretation also comports with the comments to the statute and to the analogous section of the Revised Limited Liability Company Act. More important, said the court, was the fact that this is the rule for shareholders and officers of a corporation, an organizational structure from which LLCs heavily borrow. The court stated that it might appear that its interpretation was eliminating one of the main reasons a person would choose to form an LLC, particularly a single-member LLC, but the court noted that there are myriad other benefits available to those who choose to form an LLC, and the court was not convinced that limiting the shield to vicarious liability would undermine the core of the LLC form of entity. In sum, the court concluded that the statute only protects members from vicarious liability and does not insulate a tortfeasor member from personal liability for his own actions. Thus, the trial court did not err in finding the member in this case personally liable for torts he committed in furtherance of the LLC's business. Two justices dissented, arguing that the clear and unambiguous language of the statute is not amenable to an interpretation that a member tortfeasor is personally liable for torts committed in the furtherance of the LLC's business (emphasizing that the statute protects a member or manager from liability for "a debt, obligation, or liability of the company solely reason of being or *acting as a member or manager*") and citing the principle that the court has no authority to rewrite a statute even though the court may find fault with the wisdom of the statute.

Shook v. Walden, 368 S.W.3d 604 (Tex. App. 2012).

The Waldens entered into two contracts with S & J Endeavors, LLC under which the LLC would convey a residential lot to the Waldens and construct a residence on the lot. Disputes relating to the construction work arose, and there was a protracted delay in transfer of the title to the lot. The Waldens sued the LLC, and its two members/managers, Shook and Jaehne, asserting numerous tort and contract theories. The jury found that the LLC breached the construction contract, that Shook and Jaehne were liable for the LLC's contractual liabilities on the basis of alter ego and single business enterprise, and that the LLC was operated as a sham. The trial court entered judgment against the LLC, Jaehne, and Shook based on these findings. Shook appealed.

On appeal, the Waldens conceded that the single business enterprise finding could not support a judgment against Shook because the Texas Supreme Court rejected the single business enterprise theory in *SSP Partners v. Gladstrong Invs. (USA) Corp*. Thus, the alter ego and sham theories remained as potential bases for the judgment against Shook. Shook did not dispute that the concept of veil piercing applied to an LLC but argued that the Waldens were required to prove that he used the LLC to perpetrate a fraud for his direct personal benefit in order to impose on him the contractual liability of the LLC. The Waldens argued that the common law corporate veil-piercing principles articulated in *Castleberry v. Branscum*, which only required constructive fraud, applied in the absence of any statutory standards in the LLC context.

The court reviewed the development of Texas veil-piercing law going back to the *Castleberry* case. Prior to 1989, Article 2.21 of the Texas Business Corporation Act mandated that the liability of a shareholder of a Texas corporation was limited to the value of the shareholder's shares and did not reference any exception under which a shareholder could be held individually liable for the corporation's obligations. Notwithstanding this statutory language, courts had long held that a corporation's separate existence could be disregarded as a matter of equity in certain circumstances. In 1989, however, the Texas Business Corporation Act ("TBCA") was amended to partially codify and limit judicial application of veil-piercing principles in reaction to the Texas Supreme Court's 1986 decision in *Castleberry*, in which the court stated that piercing the corporate veil on the basis of "sham to perpetrate a fraud" merely required a showing of constructive fraud regardless of whether the underlying claim arose in tort or contract. Article 2.21 of the TBCA was amended in 1989 to provide that a corporation's contractual obligation could not be imposed on a shareholder "on the basis of actual or constructive fraud, or a sham to perpetrate a fraud" except on proof that the shareholder "caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud" on the claimant "for the direct personal benefit of the shareholder." The 1989 amendments also provided that a shareholder had no liability for a contractual obligation of the corporation "on the basis of the failure of the corporation to observe any corporate formality." Article 2.21 was further amended in 1993 and 1997 in several respects, which included broadening the actual fraud requirement to any obligation "relating to or arising from" a corporation's contractual obligation and to claims based on alter ego or any other similar theory. Meanwhile, as these developments regarding corporate veil piercing were taking place, the legislature authorized the creation of LLCs by passing the Texas Limited Liability Company Act ("TLLCA") in 1991. The TLLCA was later recodified in the Business Organizations Code ("BOC"). Article 4.03 of the TLLCA provided that LLC members and managers were not liable for the debts, obligations, or liabilities of the LLC without mention of veil-piercing principles as an exception. This approach was carried forward in the BOC until the legislature added new Section 101.002 of the BOC in 2011 specifying that the BOC provisions applicable to corporate veil piercing (Sections 21.223 and 21.224) also apply to LLCs, their members, and their managers. Shook acknowledged, however, that the 2011 amendment did not impact this case, which was governed by prior law.

Shook relied upon state and federal decisions that have applied corporate veil-piercing standards to LLCs, but the court of appeals pointed out that courts in those cases have done so without analysis of why the corporate standards apply. The Waldens argued that comparison of the corporate and LLC statutes evidenced a legislative intent that the veil-piercing standards applicable to corporations not apply to LLCs (at least prior to 2011) since the legislature conspicuously omitted from the LLC statute the types of restrictions it imposed in the corporate context. In the absence of any statutory standards for veil-piercing of LLCs, the Waldens reasoned that the equitable principles set forth in *Castleberry* applied. The court of appeals noted that its research had revealed a Wisconsin federal district court veil-piercing decision governed by Texas law in which the court had essentially employed the same reasoning advanced by the Waldens. The court of appeals noted as an incidental matter that the legislative history of the 2011 amendments to the LLC statutes reflected that the amendments were in part a response to perceived confusion generated by the Wisconsin federal court's decision. The court of appeals agreed with the Waldens that the veil-piercing restrictions and limitations in the TBCA did not, as a matter of statutory construction, extend to LLCs at any time relevant to this case and that the veil-piercing remedy in this case would be governed by extra-statutory equitable principles. However, the court stated that it did not automatically follow that proper application of those principles to the LLC must track *Castleberry* as the Waldens presumed.

The court discussed the balancing of competing principles required in the application of veil-piercing principles and concluded that the legislative policy judgments made in the aftermath of *Castleberry* and the balancing of interests must necessarily inform judicial application of equitable veil-piercing principles to LLCs. The court stated that it was following the example set by the Texas

Supreme Court in the context of equitable prejudgment interest. In that context, the supreme court overruled prior precedent in deference to legislative policy judgments made and conformed preexisting equitable accrual and compounding methodologies to statutory standards even in cases that the statute did not reach. Although the Waldens stressed that the legislature did not enact a statute to govern veil piercing of LLCs at times relevant to this case, the Waldens offered no reason why the relative equities present with respect to claims to pierce the veil of an LLC with respect to a contract claim would categorically differ from those present in the corporate context. Nor could the court perceive any, and the court concluded that the courts should be guided by the framework provided by the legislature in determining equity with respect to veil-piercing claims against LLCs. The court observed that its conclusion was consistent with the results in other Texas cases although the reasoning was admittedly not made explicit in those cases. The court also noted that a contrary conclusion was not suggested by the fact that the legislature later saw fit to amend the LLC statute to explicitly incorporate the veil-piercing standard prescribed in the corporate statutes. Deferring to and applying the legislative actual fraud standard governing veil-piercing of corporations required reversal of the judgment against Shook because there were no findings or proof that Shook caused the LLC to be used to perpetrate actual fraud for his direct personal benefit.

A dissenting justice argued that the equitable standard set forth in *Castleberry* was the correct approach in this case given the absence of a statutory standard. Because an actual fraud finding is not required under *Castleberry*, the dissenting justice would have affirmed the judgment imposing personal liability on Shook based on the jury's findings (which the dissenting justice considered to be supported by the record) that the LLC was operated as the alter ego Shook and as a sham.

Serio v. Baystate Properties, LLC, 39 A.3d 131 (Md. App. 2012).

Baystate Properties, LLC ("Baystate") entered into a contract with Serio Investments, LLC ("Serio Investments") to build houses on two lots. Serio Investments was to establish an escrow account from which Baystate was to receive scheduled payments, and Baystate was to be paid an additional amount for each house upon the sale of the improved lots. During the course of the work, multiple addenda were presented to Serio Investments. Each of these addenda referenced Serio, the sole member of Serio Investments, individually, but Serio revised these references in each of the addenda and signed them as the managing member of Serio Investments. Serio also obtained from Baystate a signed waiver of any claims of personal liability. When payments began to slow, Serio assured Baystate that the properties would soon be sold. In fact, one of the properties had already sold, and the other sold a few months later. The buyers of one of the houses defaulted on the mortgage, and Serio received only a portion of the sales price. None of the proceeds from either sale were deposited in the Serio Investments account. Serio Investments filed for bankruptcy, and Baystate sought to pierce the veil of Serio Investments and hold Serio personally liable for its obligations to Baystate. The appellate court recognized the liability protection provided members by statute but stated that Maryland "case law has recognized the availability of an action to disregard a limited liability entity congruent with the equitable remedy of piercing the corporate veil." The court noted that the usual articulation of the standard in the corporate context is that "'shareholders generally are not liable for debts or obligations of a corporation unless it is necessary to prevent fraud or enforce a paramount equity.'" The court went on to state that "this standard has been so narrowly construed that neither this Court nor the Court of Appeals has ultimately 'found an equitable interest more important than the state's interest in limited shareholder liability.'" Although the trial court in this case concluded that the evidence did not support a finding of fraud, the trial court found the evidence sufficient to establish a paramount equity. The trial court considered the following evidence: (1) Serio individually owned the lots and conveyed them individually; (2) Serio gave assurances to Baystate regarding settlement of the lots; (3) Serio lied about the sale and settlement of the first lot; (4) Serio Investments had significant debt and no income besides Serio's personal deposits, making Serio Investments "'virtually insolvent;'" and (5) an escrow account was never established as provided for in the agreement with Baystate despite statements by Serio that an escrow account would be created. The appellate court noted that many Maryland cases have addressed fraudulent activity justifying disregard of the corporate entity, but few decisions have explained or applied the concept of a "paramount equity" although the language used in the cases suggests it is a basis to disregard the corporate entity distinct from fraud. The appellate court reviewed Maryland case law and commentary at length and observed that even decisions recognizing alternate grounds for piercing the corporate veil have not done so absent a finding of fraud. What the trial court found most troubling was that Serio misled Baystate regarding the sale of the homes and failed to establish an escrow account. In the trial court's view, the failure to deposit the sale proceeds into Serio Investments and the subsequent bankruptcy filing evidenced an intent to evade the legal obligations to Baystate. However, the appellate court was not convinced that these facts established the "exceptional circumstances" necessary to warrant holding Serio personally liable. The court pointed out that Baystate contracted with Serio Investments, a valid, subsisting LLC at the time, and Baystate apparently was aware that the lots were in Serio's name prior to entering the agreement. There was no evidence that Baystate ever questioned or challenged the failure to establish a funded escrow account, and Serio made it clear (at the outset, with each addendum, and in a waiver of personal liability) that Serio Investments was the party liable on the contract. All payments made to Baystate under the contract were made by checks on the corporate account of Serio Investments or cashier's checks funded by Serio Investments. Transfers by Serio to Serio Investments were documented by confessed judgment promissory notes indicating the payments were loans and not mere commingling of funds. Serio Investments fulfilled its contract until, as Serio testified, the collapse of the housing market caused problems. Baystate was an established building contractor who understood it was dealing with another LLC, and the trial court abused its discretion in holding Serio personally liable for the obligations of Serio Investments.

Restaurant of Hattiesburg, LLC v. Hotel & Restaurant Supply, Inc., 84 So.3d 32 (Miss. App. 2012).

Schafer and Brick formed three LLCs to operate restaurant franchises: (1) Restaurant of Hattiesburg LLC ("Hattiesburg") to operate a franchise in Hattiesburg, (2) Restaurant of Jackson LLC ("Jackson") to operate a franchise in Jackson, and (3) SouthEastern Restaurant LLC ("SouthEastern") to manage the accounting and payroll of both restaurants. Hotel and Restaurant Supply, Inc. ("HRS") established an account to deliver restaurant supplies to Jackson. Jackson was unsuccessful, and after six months it closed and SouthEastern ceased paying HRS on behalf of Jackson. HRS sued Jackson, SouthEastern and John Does 1 though 10 to recover the debt owed by Jackson for the restaurant supplies. The trial court granted summary judgment in favor of HRS and found Jackson and SouthEastern jointly liable to HRS. HRS was unable to collect the debt because of the lack of funds in SouthEastern's bank account. After numerous legal filings by HRS in its attempts to collect, Brick appeared at a judgment-debtor exam on behalf of Jackson and

SouthEastern without bringing requested financial records. Brick testified that SouthEastern managed the payroll and accounting for both Jackson and Hattiesburg. Both LLC restaurants deposited their incomes into SouthEastern's bank account, SouthEastern kept track of the separate incomes and expenses of both restaurants, and SouthEastern paid both restaurants' payroll and bills. Brick also testified that Hattiesburg had opened its own separate bank account after the Jackson restaurant closed because there were no longer multiple restaurants to operate and SouthEastern's consolidated services were not needed. Bank records showed that SouthEastern had issued Brick and Schafer checks as repayment of a loan and reimbursement of expenses. HRS filed suit against Hattiesburg, Schafer, and Brick, requesting that the court pierce the veil of Jackson and SouthEastern and hold the defendants jointly and severally liable for the judgment debt. HRS moved for summary judgment arguing that the parties did not observe corporate formalities, commingled assets, and failed to produce financial document and comply with post-judgment discovery. The trial court granted summary judgment in favor of HRS, and the defendants appealed.

On appeal, the court recognized that an LLC is a different type of entity from a corporation but concluded that the trial court was correct in relying on the three-prong test for piercing the veil of a corporation under Mississippi case law. Thus, the court of appeals held that to pierce the veil of an LLC, the complaining party must prove LLC membership along with the following: (1) some frustration of contractual expectations, (2) flagrant disregard of LLC formalities by the LLC members, and (3) fraud or malfeasance by the LLC members. The court noted that Mississippi has a strong public policy in favor of recognition of corporate entities and avoidance of piercing the corporate veil, and the court found this public policy extends to LLCs as well. The court held that the trial court erred in granting summary judgment because a material disputed fact issue existed as to the first part of the three-prong test. The court found that HRS contracted with Jackson rather than Schafer or Brick individually. As an incorporated business, HRS understood the distinction between an individual and an LLC, and the court stated there was no evidence that HRS believed it was selling restaurant supplies to Schafer and Brick as individuals. HRS's own representative testified that HRS did not deal with Schafer until after HRS attempted to collect unpaid invoices. HRS did not seek a personal guarantee from Schafer or Brick while continuing to tender goods to Jackson, which it knew to be an LLC. In addition, HRS did not name the defendants in the first suit, which undercut HRS's argument that it expected the defendants to be responsible for paying the debt. In relation to Hattiesburg, there was some evidence that a manager of Jackson told HRS that the restaurant was connected to Hattiesburg. Further, SouthEastern, which managed the proceeds from both restaurants' accounts, wrote checks to HRS for Jackson's invoices. These facts could have created some expectation that each restaurant was jointly responsible for the other's debts, but the evidence was clearly not undisputed. HRS's representative testified he thought Hattiesburg already had an account, but he chose to set up a separate account for Jackson. The court emphasized that the common ownership of Jackson, SouthEastern, and Hattiesburg was not itself sufficient to treat the three LLCs as one, and Mississippi has never adopted the "single business enterprise" theory to hold affiliated LLCs jointly liable for each other's debts. A shared bank account alone was not sufficient to show actual frustration of contractual expectations, and HRS's frustration with the performance of Jackson and SouthEastern was not the type of frustration that warranted disregarding the LLC's separate entity and piercing the LLC veil.

Although the failure to conclusively establish the first prong of the test was alone enough to reverse the summary judgment, the court also addressed the evidence in relation to the other two prongs. The court stated that the second prong, flagrant disregard of LLC formalities, is more difficult to prove with an LLC than with a corporation because LLCs impose fewer formalities on its members than do corporations. Importantly, the traditional lack of formalities (e.g., failure to conduct regular meetings, failure to appoint officers and directors) does not necessarily signal abuse. The trial court in this case held that LLC formalities had been flagrantly disregarded because the three LLCs did not maintain separate checking accounts and Brick failed to produce documents at the judgment-debtor exam showing the observance of formalities. The court of appeals stated that the sharing of bank accounts by the LLCs was not a per se abusive practice. Evidence that SouthEastern kept the income and expenses of Jackson and Hattiesburg separate created a factual dispute as to whether the common bank account showed flagrant disregard for the LLCs formalities. As to the failure to produce documents, Brick asserted that they were in the possession of the accountant, which was some evidence that the documents existed. The court held that the trial court erred in holding that Brick's failure to produce financial records at the judgment-debtor exam undisputably proved a flagrant failure to keep LLC records. Finally, the court analyzed the third prong of whether there was a demonstration of fraud or other equivalent malfeasance on the part of the defendants. Failure to pay a debt did not rise to the level of fraud needed to pierce the veil. Some bad action other than the underlying claim must be shown. HRS did not produce evidence that Schafer and Brick committed fraud by trying to use a business entity to shield themselves from personal liability or contracted with HRS for supplies to be used for their personal use with no intention of paying HRS. Evidence did show SouthEastern made payments to Schafer and Brick, but Brick testified those payments were legitimate reimbursements for Jackson expenses. It was also not fraudulent for Schafer and Brick to set up multiple LLCs for their restaurant operations to limit the liabilities of each restaurant to its own debts. The court noted, however, that SouthEastern had claimed the income of Hattiesburg until the judgment was entered against SouthEastern and Jackson, which was somewhat suspicious. The key evidence as to the third prong was the fact that Hattiesburg opened its own bank account following the judgment. HRS argued this action was intended to divert funds from paying the judgment owed to HRS. The defendants contended that they opened the separate account because there was no need for consolidated accounting services without multiple restaurants. Although the court acknowledged the trial court's skepticism of the defendants' explanation, there was a factual dispute on the third prong making summary judgment inappropriate. Because the evidence showed that each part of the three-part veil-piercing test was factually disputed, summary judgment in favor of HRS allowing the LLC veil to be pierced was erroneous.

Martin v. Freeman, 272 P.3d 1182 (Colo. App. 2012).

An LLC contracted with Martin for Martin to construct an airplane hangar, and the LLC sued Martin in 2006 for breach of the construction contract. In 2007, while the litigation was pending, the LLC sold its only asset, an airplane, for $300,000 and distributed the proceeds to the LLC's sole member/manager, who paid the LLC's litigation expenses. In 2008, a judgment was entered in favor of the LLC, and Martin appealed. In that appeal, the court of appeals determined that the LLC's damages were speculative and remanded the case with instructions to enter judgment for Martin. On remand, the court declared Martin the prevailing party and awarded him $36,645 in costs. Martin initiated this action to pierce the veil of the LLC and hold the member personally liable for the costs in the previous case. The trial court pierced the veil, and the court of appeals affirmed on appeal.

The court of appeals stated that, in order to pierce the LLC veil, the court must conclude (1) the corporate entity is an alter ego or mere instrumentality; (2) the corporate form was used to perpetrate a fraud or defeat a rightful claim; and (3) an equitable result would be achieved by disregarding the corporate form. The court addressed the defendants' argument that the first and second prongs were not satisfied. (Although the caption identifies the LLC as a Delaware LLC, there is no indication that any question regarding the governing law was raised, and the court applied Colorado law without discussion of any conflict-of-laws issue.) The court listed nine factors that are considered in determining alter ego status and listed the following findings of the trial court with regard to the alter ego determination: commingling of the LLC's assets with the member's personal assets and the assets of another LLC owned by the member; maintenance of negligible corporate records by the LLC; inadequate records concerning the LLC's substantive transactions; facilitation of misuse by a single individual serving as the sole member and manager; thin capitalization of the LLC; undocumented infusions of cash to pay the LLC's operating expenses, including litigation expenses; the fact that the LLC was never operated as an active business; disregard of legal formalities; the member's payment of the LLC's debts without characterizing the transactions; use of the LLC's assets for non-entity purposes in that the plane was used by the member's other LLC without agreement or compensation; operation of the LLC as a mere assetless shell and diversion of the proceeds of sale of its only significant asset to the member's personal account. The defendants argued that: LLCs have fewer restrictions than corporations concerning maintenance of formal records; member-owners are permitted to fund LLCs; thin capitalization is not a reason to disregard the corporate form; and third-party payment of attorney fees is proper. The court of appeals, however, concluded that the trial court considered the appropriate factors and that its findings supported the conclusion that the LLC was the member's alter ego.

The defendants also argued that the trial court erred in finding that the second prong of veil piercing was satisfied because the court did not find wrongful intent or bad faith. The court of appeals rejected this argument, concluding that showing the corporate form was used to defeat a creditor's rightful claim is sufficient and that further proof of wrongful intent or bad faith is not required to pierce the veil. In finding that the corporate form was used to defeat a rightful claim, the trial court relied upon the LLC's sale of its only asset and diversion of the proceeds to the member during litigation with Martin. The defendants argued that the sale of the airplane in 2007 did not support the second prong because Martin did not have a rightful claim until the cost award in 2009. The court of appeals concluded that defeating a *potential* creditor's rightful claim is sufficient to support the second prong. The court stated that the member drained the LLC of all assets during litigation while the LLC was exposed to liability because it had sued Martin. Without a finding of veil piercing, the court stated that leaving the LLC with no assets would have defeated Martin's potential claims. The defendants further argued that the second prong was not satisfied because the trial court found that all of the known or reasonably possible debts were fully provided for at the time of the distribution. The court of appeals held that this finding was not relevant to the veil-piercing analysis because it was made in analyzing Martin's claim that the defendants violated the Colorado statutory restriction on distributions by an LLC.

A strenuous dissent argued that the majority's decision was contrary to controlling Colorado precedent requiring the party seeking to pierce the veil to prove, at a minimum, wrongful conduct in the use of the corporate form.

Thomas & Thomas Court Reporters, LLC v. Switzer, 810 N.W.2d 677 (Neb. 2012).

The plaintiff sued to recover payment for court reporting services. After concluding that the evidence supported the trial court's finding that the law firm of Hathaway & Switzer, LLC (as opposed to the firm's clients) was liable for the bills on which the plaintiff sued, the Nebraska Supreme Court addressed whether the trial court erred in holding Switzer individually liable. The supreme court recognized that members and managers of LLCs are not generally liable for the debts and obligations of the LLC and stated that a court will disregard a company's identity only where the company's identity has been used to commit fraud, violate a legal duty, or perpetrate a dishonest or unjust act in violation of another's rights. A plaintiff seeking to impose liability must prove that the company's identity should be disregarded to prevent fraud or injustice to the plaintiff. There was no such proof in this case. The evidence did not show that Switzer contracted individually with the plaintiff or that he ever ordered services from the plaintiff other than in his capacity as member of the firm. Nor was there any evidence of fraud or injustice supporting disregard of the firm's identity as an LLC. In sum, there was no evidence to support the trial court's judgment against Switzer individually.

Grand Legacy, LLP v. Gant, 66 So.3d 137 (Miss. 2011).

Gant, an individual, had a letter of intent to purchase property, and Gant offered to sell the property to Grand Legacy, LLP ("Grand Legacy") once Gant purchased the property. Grand Legacy agreed to purchase the property through a partnership to be formed in the future with Gant. Gant executed a contract of sale to purchase the property from its current owner. A second contract of sale, specifying the seller as Gant and the purchaser as a limited partnership to be formed between Grand Legacy and Gant, was executed. Eventually, a limited partnership consisting of Grand Legacy as the general partner and Gant & Shivers, LLC (an LLC owned by Gant and another individual, Shivers) as the limited partner, was formed to purchase the property. Subsequently, the contract of sale with Gant as seller was amended to make the LLC the seller. The purchase of the property closed in simultaneously closings of the sale of the property to the LLC and from the LLC to the limited partnership. Grand Legacy claimed that it did not learn until over two years later that Gant, Shivers, and their LLC profited from the transaction by selling the property to the limited partnership for more than the LLC paid for the property. Grand Legacy and the limited partnership sued Gant, Shivers, and the LLC for fraud and breach of fiduciary duty, but the supreme court upheld the trial court's summary judgment in favor of the defendants. Alleged oral statements made prior to formation of the limited partnership were held to be of no force and effect because of merger clauses in the sales contracts. Further, although the court found that the partners in the limited partnership owed duties of loyalty and care and a duty to account for profits derived from any transaction connected with the formation of the partnership without consent of the other partners, the court concluded that disclosure of the difference in sales price in an acknowledgment provided at closing was sufficient to satisfy the duty of the LLC as a partner in the limited partnership. The court also addressed a separate summary judgment motion on the part of Shivers as to his individual liability. The plaintiffs argued that Shivers had personal liability for his role in the alleged fraud of the LLC. Shivers argued that he was protected from personal liability by the Mississippi LLC statute, but the plaintiffs argued that the LLC shield is inapplicable to a member's own acts or omissions and that the LLC veil may be pierced when fraud is involved. The plaintiffs argued that Shivers' signature on an allegedly false HUD-1 statement should subject him to liability. The court distinguished cases from other jurisdictions in which LLC statutes state that the liability shield does not apply to a person's "own acts or conduct." The court also distinguished a case in which a member was found liable for conduct before formation of the LLC. Here, the court pointed out that all of Shivers' actions took place after the formation of the LLC and that a court applying a statute identical to the Mississippi statute held that the mere act of signing a contract on behalf of an LLC in the capacity of member did not make the individual a signatory in his individual capacity. The plaintiffs further argued that the veil of an LLC may be pierced where fraud or misrepresentation is involved. The court again distinguished case law from other jurisdictions as involving evidence dissimilar to that in this case or law that did not control. The court stated that "[t]he law of Delaware, as applied by its own courts and those of other jurisdictions, 'allows a court to pierce the corporate veil of an entity when there is fraud....'" Since the trial court applied a Mississippi statute, however, the supreme court stated that "Delaware business-association law, however persuasive, does not lead to a finding of error."

Wehlage v. Empres Healthcare Inc., 821 F.Supp.2d 1122 (N.D. Cal. 2011).

A nursing home resident sued the facility where she resided and various other entities, including several Washington LLCs, for violations of California health and safety, unfair competition, and consumer protection statutes. The plaintiff sought to hold the LLCs liable as alter egos of the facility. Applying Washington law to the alter ego allegations (see below under heading "Foreign LLCs–Governing Law" for a discussion of the court's analysis of the governing law issue), the court held that the plaintiff failed to sufficiently plead alter ego liability. For alter ego liability to be imposed under Washington law, the corporate form must be intentionally used to violate or evade a duty, and disregard must be necessary and required to prevent unjustified loss to the injured party. The plaintiff alleged that the defendant entities created a maze of undercapitalized entities, which in reality operated as a single entity, to avoid liability. The plaintiff alleged that the LLCs had financial and operational authority over the facility, but the court held that these allegations were insufficient to meet the test under Washington law. Except for conclusory statements, the plaintiff did not allege that the LLCs intentionally used the corporate form to engage in fraud or misrepresentation. Further, even if the allegations met the first part of the test, the plaintiff did not allege that the LLCs intentionally harmed her by abusing the corporate form. Although the plaintiff alleged that the facility was undercapitalized and understaffed, the plaintiff did not allege that these conditions were created with the intent to harm her or to avoid paying damages.

Walsh v. Kindred Healthcare, 798 F.Supp.2d 1073 (N.D. Cal.2011).

Residents of a skilled nursing facility sued the facility, related facilities, and parent and related corporations, LLCs, and other entities, alleging violations of California health and safety, unfair competition, and consumer protection statutes. The plaintiffs sought to hold the facilities and parent and related entities liable for the acts of one another under the alter ego doctrine. The court discussed and applied corporate alter ego principles under California law (noting that the alter ego doctrine applies equally to LLCs), and the court held that the allegations were insufficient to invoke the alter ego doctrine. To invoke the alter ego doctrine under California law, there must be allegations that (1) there is such a unity of interest and ownership that the separate personalities of the two corporations no longer exist, and (2) if the acts are treated as the acts of only one corporation, an inequitable result will follow. The court found the allegations sufficient to allege unity of interest and ownership with respect to the parent entities and facilities, but not with respect to the relationship between the parent entities or between the facilities, and the court stated that the plaintiffs failed to allege how certain entities fit into the corporate structure and that they should be held liable for the acts of other entities or vice versa. Further, the court stated that allegations of setting up empty shells, siphoning of funds, and promotion of injustice and inequity were sufficient to allege an injustice based on the parent entities' attempt to avoid liability, but the allegations did not clearly show whether the parent entities misused the corporate form to siphon funds from the facilities and did not allege what injustice would result if other facilities and related entities were not held liable. The court gave the plaintiffs leave to amend.

Wilson v. Thorn Energy, LLC, 787 F.Supp.2d 286 (S.D.N.Y. 2011).

The plaintiffs lent money to and invested in several LLCs for the purpose of offshore oil exploration. The plaintiffs sought to pierce the veil of the LLCs to hold the managing member as well as the LLCs liable for repayment of the amounts invested and lent to the LLCs. Based on New York choice-of-law rules, the court applied Delaware law, the law of the state of organization of the LLCs with respect to the veil-piercing claim. Noting that courts have applied the standard for disregarding the corporate form in the LLC context, the court relied upon the Second Circuit's two-prong distillation of Delaware's alter-ego standard as follows: "'(1) whether the entities in question operated as a single economic entity, and (2) whether there was an overall element of injustice or unfairness.'" The court stated that a plaintiff must show a mingling of the operations of the entity and its owner considering various factors, including whether the entity was solvent, whether dividends were paid and other formalities observed, whether the dominant owner siphoned funds, and whether the entity generally functioned as a mere facade for the dominant owner. The court stated that some combination of these factors is required along with an overall element of injustice or unfairness, but actual fraud is not required. Applying this standard to the summary judgment evidence, the plaintiff did not conclusively establish grounds for piercing the veil. With respect to the first prong, i.e., whether the managing member and the LLCs operated as a single economic unit, there were fact issues as to whether the managing member siphoned off funds for his personal use and whether the entities were a mere facade or instrumentality for his personal activities. Because there was a fact issue on the first prong, the court did not need to examine the element of injustice or unfairness.

LLC's Authority/Standing to Sue

418 Meadow Street Associates, LLC v. Clean Air Partners, LLC, 43 A.3d 607 (Conn. 2012).

An LLC brought an action against its commercial tenant seeking to enforce a lease agreement and collect rent. The defendant tenant alleged that the LLC lacked standing because the two members who authorized the lawsuit held only a 50% ownership interest and therefore did not have a majority interest as required to file suit on behalf of the LLC. The remaining 50% interest was held by Levine, a member whose spouse was an owner of the defendant tenant. The operating agreement was silent as to whether and when a member was disqualified from voting his or her interest, so the LLC relied on a provision of the Connecticut LLC statute providing that in determining the vote required to bring suit, the vote of any member who has an interest in the outcome of the suit that is adverse to the interest of the LLC is to be excluded. The LLC alleged that Levine had an adverse interest and that her 50% ownership was thus properly excluded in determining whether a majority interest authorized filing the suit on behalf of the LLC. The defendant tenant claimed the LLC lacked standing because Levine's interest was not adverse and should thus be included in determining whether a majority interest authorized the litigation on behalf of the LLC. The trial court interpreted the meaning of "adverse interest" in the statute and concluded that to be adverse a member must have had a proprietary, or ownership, interest in the defendant. The court found that Levine did not have a proprietary interest in the defendant and she did not have an adverse interest simply because she was the wife of a co-owner of the defendant, so her interest was insufficient to disqualify her as a voting member of the LLC. The court of appeals concluded that the record supported the trial court's finding that Levine had no individual proprietary interest in the outcome of the litigation adverse to the LLC's interest, and her husband's ownership interest in the defendant was not significant enough to attribute to her an interest adverse to the outcome of the action based on their personal relationship alone. At the time the LLC voted on whether to file suit against the defendant, Levine was not facing claims against her by the other members, but the court of appeals noted that a member's exclusion from voting for having an adverse interest in the outcome of the suit had to pertain to the litigation in question for the vote. According to the court of appeals, actions pending with different parties and separate issues were not applicable to the determination of whether an adverse interest existed.

The Connecticut Supreme Court reversed and remanded, holding that the plain meaning of the term "adverse" in the statute excluding a member's vote in the context of authorizing litigation on behalf of the LLC encompassed any interest of a member that was contrary to or opposed to the LLC's interest in the outcome of the litigation. The court stated that an adverse interest is not limited to circumstances in which a member has a direct, adverse proprietary interest and that when a member's spouse holds an interest or maintains a position of control in a defendant company, that member's interest is considered adverse to the outcome of a lawsuit by the LLC against the defendant company. The court noted that the law generally affords a different treatment to spouses than to other parties, and the court concluded that the sweeping scope of the term "adverse" in the provision of the LLC statute at issue requires the interests of a member's spouse to be imputed to the member. The court explained that this categorical rule allows members to be aware of whether their votes will be excluded because of a spouse's interest and reduces litigation among members over whether their votes should be counted. If the members of an LLC do not want to be bound by this rule, the statute allows them to modify the rule in the operating agreement. Based on the interpretation of the statute adopted by the supreme court, the ownership interest of Levine's spouse in the defendant was imputed to Levine such that Levine had an interest adverse to the outcome of the litigation the LLC brought against the defendant. Because Levine's interest was adverse, she was properly excluded from the vote on whether to file suit against the defendant, and the other 50% had a majority ownership interest that could move forward with filing suit.

Alternatively, the defendant contended that the provision of the LLC statute relied upon by the LLC did not apply because the LLC's operating agreement was silent as to whether it adopted or incorporated by reference the provision. The supreme court disagreed. The court stated that the statutory provision governing the exclusion of a member's vote applies to all LLCs unless an LLC's operating agreement provides for a different rule that conflicts with the statute or provides that the statute does not apply. If the operating agreement is silent as to the applicability of the statute in this regard, the statute controls. Here, the LLC's operating agreement did not include any provision concerning how to calculate votes for the purpose of bringing a lawsuit on behalf of the LLC. Because the default rule on this issue was not negated, it controlled.

LLC Derivative Suits

Young v. Bush, 277 P.3d 916 (Colo. App. 2012).

Four LLCs, each having between four and seven members, including Young and Bush, were formed to acquire and develop real estate. Bush was the founder and sole manager of the LLCs. Young began questioning Bush's management of the LLCs, and after an unsuccessful settlement and release, Young filed this action asserting numerous claims, individually and derivatively, against Bush, Bush Development, Inc., and the LLCs. The LLC members held a special meeting attended by Young, the other LLC members (either in person or by proxy), counsel for Young and the LLCs, and special counsel for the LLCs. Bush was not present at the meeting. The special meeting was for the purpose of determining whether the derivative action was in the best interests of the LLCs. All members other than Young agreed the action was not in the LLCs' best interests. The defendants moved for dismissal of the action or for summary judgment arguing that based on the applicable statutory provision dismissal was required because a majority of the independent members had determined that pursing the derivative action was not in the best interests of the LLCs. Young responded that genuine issues of material fact existed as to whether the determination that the action was not in the LLCs' best interests had been made by independent members and whether the determination was based upon an adequate inquiry, two requirements for dismissal under that statute. The trial court interpreted the applicable statute as allowing it to liberally construe a member's vote and his independent status regarding the derivative proceeding, and the court found that the plaintiff had the burden under the statute to prove the lack of independence and inadequate inquiry. The trial court entered summary judgment in favor of the defendants concluding that Young failed to prove the lack of independence of the members agreeing not to pursue the derivative action or the inadequacy of the members' inquiry.

On appeal, Young alleged that the trial court erred in dismissing his derivative claims because it incorrectly applied a cursory "liberal" standard in addressing the independence of the members who voted that the action was not in the best interests of the LLCs rather than applying case law applicable to corporate and limited partnership derivative actions. In addition, Young contended that the trial court erred because there was a genuine issue of material fact as to the independence of those members as well as the adequacy of the inquiry on which their determination was based. The appellate court held that the case was to be remanded to the trial court for the plaintiff to conduct discovery on the issues of independence and adequate inquiry, and the trial court was to then assess, under the standard set by the appellate court, whether the derivative claim should be dismissed based on the applicable statute.

The court of appeals discussed the history of the enactment of the Colorado Limited Liability Company Act and its amendment in 2002 to provide for derivative actions by members. On its face, the provision requires a court to dismiss a derivative action against an LLC if the decision makers described in the provision determine in good faith, after conducting an inquiry upon which the determination was based, that maintenance of the derivative action is not in the best interests of the LLC. The decision makers must be independent, but they are not deemed to lack independence based solely on enumerated circumstances, and the burden is on the plaintiff to prove that the decision makers are not independent, the inquiry was inadequate, or the determination was not made in good faith. No reported appellate cases address the provision, no other states' statutes are identical or substantially identical, and the legislative history does not shed light on the general assembly's intent in enacting the provision. At issue in the present case were the independence of the decision makers and the adequacy of their inquiry. "Independent" and "inquiry" are not defined in the provision, so the court was left to determine these standards. The parties disagreed on the extent to which the appellate court could rely on case law addressing dismissal of derivative actions in the context of other business entities. The appellate court determined that additional standards based on case law were applicable as long as those standards were not inconsistent with the specific language chosen by the general assembly to apply to dismissal of derivative actions against LLCs.

First, the appellate court considered the standard for determining whether a decision maker recommending dismissal of a derivative action was independent. The determination of independence is highly fact-sensitive, but the fundamental question was whether the decision maker had any interest (i.e., not solely pecuniary but also personal interest in the challenged transaction) in the litigation and relationship with the defendant that was likely to interfere with the ability to exercise an independent, unbiased judgment with respect to the litigation. The court determined that substantial business relationships and close personal or family ties, while not necessarily dispositive, could create a material question of fact as to the independence of the decision makers. In deciding Young's challenge to the independence of the LLCs' members who voted against maintaining the derivative action, the trial court did not base its decision on standards developed under case law. Instead, the trial court concluded that the provision, which enumerated circumstances that did not by themselves establish lack of independence, allowed the court to construe "liberally" the vote and the independent status of the LLCs' members, that the business and family relationships cited by Young did not show that the members were incapable of voting independently, and that case law regarding independence in the corporate context were inapplicable and factually inapposite. The appellate court disagreed and held that the provision did not foreclose further analysis under case law on the independence issue. Looking at Colorado case law in the corporate and limited partnership context, case law in other jurisdictions, and the LLC statute itself, the appellate court stated that deference to the substantive decision of the members was required in that both the statute and case law directed courts to defer to the business judgment of an independent person or entity recommending dismissal of a derivative action. However, the appellate court concluded that the provision did not itself establish a lenient standard of review or permit a court to forgo further inquiry into the independence of the persons whose substantive decision regarding maintaining the derivative action would be binding on the court. By identifying circumstances that did not alone cause a person to not be considered independent, the general assembly indicated that independence was a matter of degree rather than an absolute. Unlike case law and other LLC statutes, the provision placed the burden on the plaintiff to show the lack of independence by the decision makers. Placing the burden on the plaintiff to disprove the existence of the statutory requirements could suggest a legislative intent to afford more deference to the decision makers or allow a presumption of the requirements of independence, good faith, and adequate inquiry. However, such deference was not unlimited, and such a presumption was not irrebuttable. If a plaintiff proved that a decision maker was not independent due to having a stake in the litigation or a relationship with a defendant that would interfere with his or her ability to make an unbiased judgment as to what was in the best interest of the LLC, the court would not defer to the decision makers' business judgment and dismiss the derivative action. In sum, the independence of a decision maker within the meaning of the provision depends on whether he or she has a stake in the litigation or a relationship with a defendant that precludes him or her from making an unbiased judgment as to whether dismissal of the derivative action was in the best interest of the LLC. Business, personal, or familial relationships with a defendant raised a question about whether a decision maker was independent, but such relationships were not dispositive. That is, a court could find that the specific relationship at issue would not interfere with the decision maker's independence. Applied to this case, the defendants submitted minutes of the special meetings of the LLCs establishing who was in attendance and that all members other than Young voted that maintaining the derivative action was not in the best interests of the LLCs. Young submitted an affidavit stating that numerous members had familial and business relationships that caused them not to be independent for the determination of whether to proceed with the suit. The affidavit also requested discovery, including taking depositions of some of the members whose independence was in question, to determine their relationships with and financial connections to the defendants Bush and Bush Development for the purpose of assessing their independence. The trial court denied the requested discovery and dismissed the derivative action based on the members' vote. The appellate court reversed the trial court's decision and held that the facts set forth in Young's affidavit showed business and familial relationships sufficient to create a material question of fact as to the independence of the LLC members who made the best interests determination. The appellate court remanded on the issue of independence to allow discovery to establish whether the relationships interfered with the members' ability to exercise independent, unbiased judgments regarding maintenance of the derivative action. On remand, the trial court was to determine the issue of independence based on the facts discovered applying the standards set forth above.

Next, the appellate court considered whether the inquiry on which the decision makers based their decision not to proceed with the derivative action was adequate within the meaning of the provision and applicable case law. Young argued to the trial court that the LLCs' members did not make a reasonable inquiry, if any at all, into the allegations of the complaint. Young noted there was no evidence of any investigation by the members and there was no report. Young requested leave for discovery to depose members regarding their inquiry into the allegations and any parties on whose investigation the LLC members relied, asserting such information was relevant as to whether the best interest determination was based on a sufficient inquiry. The trial court found that the statute did not require a report, that the minutes showed the LLCs' counsel had conducted an inquiry and reported his conclusions to the members, and that Young had not met his burden to show that the inquiry was inadequate. The trial court held there was no issue of material fact regarding the adequacy of the defendants' inquiry and therefore denied Young's request for further discovery on the issue. The appellate court considered the provision and case law and disagreed with the trial court. According to the appellate court, the LLC statute does not appear to contemplate the production of a written report or an investigation as extensive as those required in corporate derivative actions but does require that there be an inquiry to produce facts sufficient to enable LLC members to make an informed and good-faith decision on whether maintenance of the derivative action is in the LLCs' best interests. Although analysis is fact-sensitive, the fundamental principle gleaned from case law was that the focus of the judicial review regarding the adequacy of the inquiry should be on the procedures followed rather than on the substantive conclusion reached by the investigation. Under the business judgment rule, the substantive conclusion was not subject to judicial review, however a court may properly determine the adequacy and appropriateness of the investigative procedures used. There is no single standard for assessing the adequacy of an inquiry or investigation, but some relevant factors include the length and scope of the investigation, the use of experts, the business entity's or defendant's involvement, and the adequacy and reliability of the information supplied to the decision makers. The appellate court noted that the provision referred to an "inquiry" rather than an "investigation" as discussed in many corporate and limited partnership cases. An inquiry is less thorough than an investigation, so its use by the legislators indicates that they intended an inquiry in the context of the provision to be less searching and detailed than an investigation. The use of this term recognizes that LLCs may have fewer members and fewer resources than a large corporation, and an adequate inquiry can be conducted without retaining experts or independent outside counsel, although a lack of outside counsel may relate to issues of the decision makers' independence and good faith. Thus, the appellate court concluded that an inquiry under the provision could be less searching and detailed than investigations described in the case law. However, it did not follow from this that no inquiry was required or that the trial court could undertake only a cursory review of the inquiry on which the LLCs' members based their determination as to whether to maintain the derivative action. In sum, although no written report was required and the members could rely on an independent attorney's bona fide investigation, the record had to show that the investigation produced information bearing on the substance of the allegations made by the plaintiff and that the members had before them sufficient information on which to base their decision of whether maintaining the derivative action was in the best interests of the LLCs. The appellate court determined that the record did not establish whether the inquiry was sufficient. On remand, Young would be entitled to discovery on this issue, and the trial court should then decide based on the facts discovered and the standards set forth above whether the LLCs' decision was based on an adequate inquiry into Young's allegations.

Finally, the appellate court addressed whether Young's claims for relief were direct rather than derivative such that he should have been allowed to pursue them despite the trial court's dismissal of the derivative action. A member of an LLC may assert a direct claim when the member suffered injuries separate and distinct from the injury to the LLC or other members. Although Young's complaint stated that each claim was asserted by him individually and as a member of the LLCs, he argued in response to the defendants' motion to dismiss that his third claim for breach of his settlement agreement with Bush was a direct claim only. The trial court did not address this contention when it dismissed all the claims. After the notice of appeal was filed, the defendants filed a response indicating their willingness to stipulate that Young's third claim was an individual direct claim and asked the court to reinstate that claim against the defendant Bush only. The trial court entered the order so stating, but it lacked jurisdiction to do so because the notice of appeal had been filed. The appellate court affirmed the trial court's ruling that Young's claim for breach of his settlement agreement with Bush was a direct claim that could be maintained regardless of the trial court's decision regarding the dismissal of the derivative action. Although Young did not amend his complaint to clarify this allegation, the defendants were on notice from the substance of the allegations that Young was alleging an injury separate and distinct from any injury suffered by the LLCs or other members of the LLCs. Also, if Young were to prevail on this claim, relief would go to him personally rather than to the LLCs. The appellate court remanded to permit Young to reassert his breach of settlement claim as a direct claim if he chose to do so. The appellate court held that the trial court did not err in dismissing and refusing to reinstate claims for access to records and an accounting where Young failed to clarify prior to judgment that the claims were asserted only directly rather than derivatively.

CML V, LLC v. Bax, 28 A.3d 1037 (Del. 2011).

The Delaware Supreme Court agreed with the chancery court in this case that creditors of an insolvent Delaware LLC do not have standing to sue derivatively for breach of fiduciary duty to the LLC. A creditor of an insolvent LLC asserted derivative claims on behalf of the LLC for breach of fiduciary duty by the managers in connection with certain acquisitions and sales by the LLC. The chancery court dismissed the claims for lack of standing because the Delaware LLC statute states that the plaintiff in a derivative suit must be a member or assignee. The supreme court found the language of the Delaware LLC statute unambiguously limited derivative standing to members and assignees and thus affirmed the chancery court's judgment. The court rejected the argument that the legislature intended to take the corporate rule of derivative standing for creditors of insolvent corporations and apply it to LLCs. Given the unambiguous language of the statute, the court stated that it "must apply the plain language without any extraneous contemplation of, or intellectually stimulating musings about, the General Assembly's intent." According to the court, applying the plain language did not yield an unreasonable or absurd result. The court found it logical for the General Assembly to limit derivative standing and exclude creditors given the contractual freedom provided to interested parties to define their relationships in the LLC context, which "affords creditors significant contractual flexibility to protect their unique, distinct interests." The court also rejected the argument that the statutory limitation of derivative standing to members and assignees is an unconstitutional curtailment of the chancery court's equitable jurisdiction. Based on the historical equity jurisdiction of the High Court of Chancery of Great Britain and the fact that LLCs did not exist at common law, the court concluded that the Delaware constitution only guarantees the chancery court's jurisdiction to extend derivative standing to prevent failures of justice in cases involving corporations. When adjudicating the rights, remedies, and obligations associated with Delaware LLCs, the courts must look to the Delaware Limited Liability Company Act because it is the only statute that creates those rights, remedies, and obligations. Although the statute provides that common law principles of equity supplement the express provisions of the statute, courts cannot interpret the common law to override the express provisions the General Assembly adopted. "Supplementing express provisions is altogether different from displacing them or interpreting them out of existence under the guise of articulating and applying equitable principles." In any event, the court concluded that there was no threat of a failure of justice that would justify application of equity even if the court had the jurisdiction to extend derivative standing (which the court emphatically stated that it did not). The court pointed out that the creditor here chose to lend on what later turned out to be unfavorable terms. As examples of provisions that the creditor could have obtained to protect itself, the court stated that the creditor could have negotiated for a provision that would convert its interests to that of an assignee in the event of an insolvency or a provision that would give the creditor control of the LLC's governing body in an insolvency. The fact that the creditor did not craft its loan documents to adequately protect its legal remedies in the event of the LLC's insolvency did not amount to a threat to the interests of justice that would justify an equitable extension of derivative standing.

George Wasserman & Janice Wasserman Goldsten Family LLC v. Kay, 14 A.3d 1193 (Md. App. 2011).

The plaintiffs, minority investors in two LLCs and five general partnerships (the "investment vehicles"), sued Jack Kay, the managing member of one of the LLCs and de facto managing member or partner of the other investment vehicles, asserting numerous causes of action based on Kay's secret diversion of investment vehicle funds for investment in Bernard Madoff entities. In addition to suing Kay individually, the plaintiffs sued two entities owned and controlled by Kay that were used to facilitate the investments in the Madoff entities. The plaintiffs brought all of their claims directly and derivatively, and the principal issues in this appeal related to the nature of the claims as direct or derivative. In a lengthy analysis of the nature of the plaintiffs' claims, the court concluded that the plaintiffs could bring their claims directly with respect to both the general partnership and LLC investment vehicles. The plaintiffs based their claims on Kay's improper diversion of funds that were required to be held in reserve funds of the investment vehicles and distributed to the plaintiffs directly. The court relied on a Maryland case dealing with a corporate cash-out merger in which minority shareholders claimed that directors/majority shareholders breached their fiduciary duties to the minority shareholders by failing to obtain an appropriate price for the cashed-out shares. The Maryland Court of Appeals held in that case that the directors were subject to direct common law duties of candor and good faith to the shareholders. In distinguishing individual actions from derivative actions in the corporate context, the Maryland Court of Appeals stated that a shareholder may bring a direct action against alleged corporate wrongdoers when either: (1) the shareholder suffers the harm directly; or (2) a duty is owed directly to the shareholder, though such harm may also be a violation of a duty owing to the corporation. Extending the rationale in this case to partnerships and LLCs, the court concluded that the plaintiffs had sufficiently alleged that they suffered harm directly and that Kay, as managing partner/member, violated duties owed directly to the plaintiffs. The court noted that partners are in contractual privity with each other by virtue of the partnership agreement. Further, the Revised Uniform Partnership Act ("RUPA") specifies that partners owe each other (in addition to the partnership) fiduciary duties, and a partner may maintain an action against the partnership or another partner to enforce the partner's rights. With respect to Kay's obligations to other members of the LLCs, the court pointed out that members are in contractual privity because they are parties to an operating agreement, and the court stated that managing members owe fiduciary duties to each other, not just the LLC itself. The court went on to analyze in some depth whether the plaintiffs, as minority partners, could assert claims on behalf of the partnerships given the governance provisions of RUPA. The court concluded that the provisions of RUPA should be tempered when non-plaintiff partners have conflicts of interest so that the partnership claim may be enforced by all of the disinterested partners. In this case, however, the court could perceive no need to permit an action on behalf of the entities since the plaintiffs had adequately alleged individual direct injury. The court rejected the plaintiffs' derivative claims on behalf of the LLCs for the same reasons. Nevertheless, because the parties had briefed the issue and there was no reported opinion addressing the issue, the court proceeded to analyze whether the LLC statutory provision excusing demand before the filing of a derivative suit when a demand is "not likely to succeed" equates to "futility" in the corporate context. The plaintiffs argued that the "not likely to succeed" requirement was less stringent than the test for "futility" in the corporate context. The Maryland LLC statute provides that a member may bring a derivative action to enforce a right of an LLC to the same extent a shareholder may bring an action for a derivative suit under the

Maryland corporation law, and the next subsection of that provision requires demand unless it is "not likely to succeed." Reading these provisions in harmony, the court concluded that the phrase "not likely to succeed" equates to the "futility" exception in the corporate context.

<u>Fiduciary Duties of Members and Managers</u>

Paron Capital Management, LLC v. Crombie, C.A. No. 6380-VCP, 2012 WL 2045857 (Del. Ch. May 22, 2012).

An LLC and two of its members sued the third member, Crombie, for fraud and breach of fiduciary duty. The court concluded Crombie committed fraud by making numerous misrepresentations about his investment track record, employment history, and personal financial situation to induce the other members to go into business with him. The evidence showed that Crombie intended that the plaintiffs rely on his misrepresentations and that the plaintiffs' reliance was justified. The plaintiffs conducted extensive due diligence on Crombie, and the court found that the plaintiffs acted reasonably in their investigation but were nevertheless victimized by his deceit. The court also concluded that Crombie breached his fiduciary duties to the plaintiffs by failing to correct his misrepresentations and continuing to make additional misrepresentations after the formation of the LLC. The LLC agreement specifically provided that Crombie had a duty to "devote and render his diligent best efforts and full-time professional trading and advisory services to the Company," but also stated that the fiduciary duty imposed by that provision "shall not limit or be in derogation of any other fiduciary duties that [Crombie] or any other Manager has or shall have, including but not limited to fiduciary duties of a Manager to the Company and to the other Members pursuant to 6 Del. C. § 18-1104." The plaintiffs interpreted the agreement as implying that Crombie owed them the traditional duties of loyalty and care in addition to the duty to devote his best efforts and full-time trading and advisory services, and the court noted that Delaware law imposes on LLC managers and members traditional duties of loyalty and care to each other and to the LLC absent contrary provisions in the LLC agreement. Crombie did not dispute the plaintiff's interpretation of the agreement but argued that the plaintiffs did not prove he breached these duties. The court concluded that Crombie breached his duty of loyalty to the plaintiffs by preparing fraudulent marketing materials for the LLC and by continuing to conceal material information about his track record, employment history, and personal finances. The court stated that a fiduciary breaches the duty of loyalty under Delaware law if the fiduciary learns that an earlier communication by the fiduciary to the beneficiaries is false and then knowingly and in bad faith remains silent as the beneficiaries continue to rely on the earlier statements. Because Crombie was the manager of the LLC and continued to conceal the truth about his earlier misrepresentations as well as providing and authoring fraudulent materials in conducting the LLC's business, Crombie breached his fiduciary duty to the plaintiffs. The court awarded the plaintiffs reliance, mitigation, and lost earnings damages as well as certain injunctive relief. Because Crombie's conduct was particularly egregious and fraudulent, the court also awarded the plaintiffs their attorneys' fees, litigation expenses, and costs.

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, C.A. No. 5843-VCL, 2012 WL 1869416 (Del. Ch. May 16, 2012).

Affiliates of ASB Capital Management, LLC (collectively "ASB") and affiliates of The Scion Group, LLC (collectively "Scion") were joint venturers in several real estate joint ventures structured as Delaware LLCs, one of which was Dwight Lofts, LLC. After ASB removed Scion as managing member of Dwight Lofts, LLC, and Scion exercised a put right under the LLC agreement, Scion asserted that ASB breached its fiduciary duties by suppressing the summer revenue of Dwight Lofts and failing to inform appraisers of Scion's interest about an alleged oral agreement for extended summer leasing by the college that leased Dwight Lofts. The court assumed for purposes of this claim that ASB became de facto managing member after removal of Scion from that position and took on the fiduciary duties of that position. Under the Dwight Lofts LLC agreement, the managing member was required to exercise its power and authority under the agreement and perform its duties as managing member in good faith, in a manner the managing member reasonably believed to be in the best interest of the LLC and with the care a prudent real estate professional in a like position would use under similar circumstances. The LLC agreement further provided that the managing member was undertaking fiduciary duties and responsibilities to the LLC and its members "identical to those a general partner undertakes in a limited partnership to its limited partners under the statutes and case law of the State of Delaware applicable to a limited partnership form of business organization." The agreement prohibited the managing member from intentional acts or failures to act constituting gross negligence, willful misconduct, a material breach of fiduciary duty, fraud, misapplication of funds, theft, misappropriations of an LLC asset, or intentional misrepresentation. An exculpatory clause provided that a member was not liable for damages arising out of acts or omissions in good faith on behalf of the LLC or members, reasonably believed to be within the scope of authority granted to the member by the agreement, and reasonably believed to be in the best interests of the LLC or the members. The exculpatory clause did not eliminate liability for acts or omissions resulting from fraud, gross negligence, or willful misconduct. The court reviewed the evidence relating to ASB's dealings with the college and concluded that ASB acted reasonably to maximize Dwight Lofts' summer revenue within the constraints of the master lease with the college and participated in the appraisal process in good faith and candor. Thus, ASB did not breach any fiduciary duties that would be owed as de facto managing member.

Scion also argued that ASB breached the implied covenant of good faith and fair dealing based on a failure to maximize summer revenue and failure to disclose the alleged oral agreement with the college regarding extended summer leasing to the appraisers of Scion's interest. The court rejected Scion's claim of breach of the implied covenant because ASB did not suppress the value of Dwight Lofts and participated in good faith in the contractual appraisal process after Scion's exercise of its put right.

Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App. 2012).

This case dealt with a dispute arising from the redemption of a minority interest owned by Allen in a closely held LLC engaged in natural gas exploration and development. The LLC redeemed Allen's interest in 2004 based on a $138.5 million appraisal of the LLC performed in 2003. In 2006, the LLC was sold for $2.6 billion. The increase in value of the LLC was essentially due to advancements made in horizontal drilling. Allen claimed that Rees-Jones and the LLC made misrepresentations and failed to disclose facts regarding the LLC's future prospects and that he would not have sold his interest in 2004 if he had known these material facts. Allen alleged that the LLC and Rees-Jones, the LLC's manager and majority owner, fraudulently induced him to redeem his interest. Allen brought claims for common law and statutory fraud, breach of fiduciary duty, shareholder oppression, and violations of the Texas Securities Act. In a lengthy opinion analyzing numerous issues bearing on the various claims, the court held, inter alia, that there was a formal fiduciary duty owed by Rees-Jones as the majority member/sole manager of the LLC to Allen as a passive minority member in the context of the redemption of Allen's interest, that Rees-Jones did not conclusively establish that he owed no duty of loyalty to members individually under the terms of the exculpation clause in the LLC's articles of organization, and that summary judgment was properly granted on Allen's shareholder oppression claim.

Based on an alleged fiduciary relationship between Allen and Rees-Jones, Allen alleged that the redemption was a breach of fiduciary duty by Rees-Jones. Allen asserted that Rees-Jones owed Allen a formal fiduciary duty on two bases: (1) a fiduciary duty owed to minority shareholders by a majority shareholder who dominates control over a business, and (2) a fiduciary duty owed by a closely held company's officers and shareholders to a shareholder who is redeeming stock. The court recognized that the entity at issue was an LLC, but the court discussed and applied case law addressing closely held corporations because Allen relied on these cases and the LLC was a closely held LLC that operated much like a closely held corporation.

The court noted that the vast majority of intermediate appellate courts in Texas have declined to recognize a formal fiduciary duty by a majority shareholder to a minority shareholder in a closely held corporation while recognizing that an informal fiduciary duty could exist under particular circumstances. Given "this overwhelming weight of authority," the court did not agree with Allen that Texas recognizes a broad formal fiduciary relationship between majority and minority shareholders in closely held companies that would apply to every transaction among them, and the court thus declined to recognize such a fiduciary relationship between members of an LLC on this basis. The court concluded, however, that "there is a formal fiduciary duty when (1) the alleged-fiduciary has a legal right of control and exercises that control by virtue of his status as the majority owner and sole member-manager of a closely-held LLC and (2) either purchases a minority shareholder's interest or causes the LLC to do so through a redemption when the result of the redemption is an increased ownership interest for the majority owner and sole manager." The court noted that the scope of the fiduciary duty is not necessarily the same as for other fiduciary duties, and the court did not decide the scope of the duty. The court based its conclusion on the fact that Rees-Jones had essentially the powers and responsibilities of a general partner, a role in which the law imposes fiduciary obligations. Furthermore, the court relied upon corporate case law applying the "special facts" doctrine and concluded that the "special facts" doctrine supports recognizing a formal fiduciary relationship when an LLC's member-manager communicates a redemption offer to the minority members that may benefit the member-manager individually.

The court also discussed Rees-Jones's fiduciary duty under the LLC's articles of organization. The articles of organization contained a provision largely tracking Section 7.001 of the Texas Business Organizations Code. Since the LLC was an LLC rather than a corporation, the LLC was not covered by the restrictions in Section 7.001 on the limitation and elimination of liability for governing persons, and the court stated that the LLC's members were free under the LLC statute "to expand or eliminate, as between themselves, any and all potential liability of [the LLC's] manager, Rees-Jones, as they saw fit." In the articles of organization, rather than completely eliminate Rees-Jones's potential liability to the LLC or its members, the members eliminated the managerial liability of Rees-Jones except for the categories of liability for which Section 7.001 of the Texas Business Organizations Code does not permit elimination or limitation of liability for a corporate director. One of these categories was expressed in the articles of organization as "a breach of [Rees-Jones's] duty of loyalty to [the LLC] or its members." Allen relied upon this provision in arguing that Rees-Jones owed him a fiduciary duty. Rees-Jones argued that the articles of organization listed the exact duties owed by Rees-Jones as manager and created duties but that the duties ran to the LLC and the members collectively rather than to individual members. The court disagreed with Rees-Jones's argument that the word "members" was intended to refer only to the members as a whole and not to include members individually or in groups of less than all. Furthermore, the court stated that the reference to the LLC or its members was ambiguous at best, thus creating a fact question for the jury. Thus, Rees-Jones did not conclusively establish that he did not owe a duty of loyalty to Allen under the articles of organization, nor did he conclusively establish that his duty of loyalty was not implicated since the redemption resulted in an increase in his ownership percentage and the duty of loyalty places restrictions on a governing person's ability to participate in transactions on behalf of the company when the person has a personal interest in the transaction. The court noted that the LLC did not define or limit Rees-Jones's duty of loyalty in the LLC documents and that the Texas Business Organizations Code does not define the duty of loyalty in the LLC context. The court stated that it typically looks to the common law when the statutes are silent.

The court of appeals upheld the trial court's summary judgment on Allen's shareholder oppression claim. The court stated that the doctrine of shareholder oppression protects a minority shareholder of a closely held corporation from the improper exercise of majority control, citing the two alternative definitions of shareholder oppression commonly relied upon by Texas courts, i.e., (1) majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; and (2) burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standard of fair dealing and a violation of fair play on which each shareholder is entitled to rely. The court concluded, however, that the alleged "wrongful conduct" of fraud by misrepresentations and omissions and breach of fiduciary duty was not similar to the typical wrongdoing in shareholder oppression cases, i.e., termination of employment, denial of access to books and records, wrongful withholding of dividends, waste of corporate funds, payment of excessive compensation, lock-out from corporate offices, or squeeze-out. Further, the court stated that there is little necessity for the oppression cause of action when the minority shareholder has nondisclosure and breach of fiduciary duty claims. The court noted that it was expressing no opinion as to whether a member of an LLC may assert a claim for shareholder oppression.

Kagan v. HMC-New York, Inc., 939 N.Y.S.2d 384 (App. Div. 1st Dept. 2012).

The plaintiff sought to recover amounts allegedly owed in connection with his work in an investment firm and his ownership in two LLCs. He alleged that the managers of the LLCs violated the LLC agreements and breached their fiduciary duties to the plaintiff by failing to properly calculate and pay amounts owed by the LLCs to the plaintiff under the LLC agreements, which were governed by Delaware law. The plaintiff's claims included a claim for breach of the implied covenant of good faith and fair dealing based on the alleged willful refusal of the managers to pay amounts they acknowledged were due and owing under the agreements. Although it was undisputed that the managers were not contractually obligated to the plaintiff to pay the amounts owed by the LLCs, the plaintiff, relying on *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872 (Del. Ch. 2009), argued that the managers were not entitled to dismissal of the breach of contract claims because the managers had the authority to control the LLCs and the agreements did not explicitly exempt them from liability under the circumstances alleged. The court held that the breach of contract claims were precluded by a "limitation of liability" provision in the LLC agreements, which provided that no manager shall have any liability to any member for any loss arising out of any act or omission of the manager if the manager performs its duty in compliance with the standard set forth in another section of the agreements addressing duties. The provision addressing duties set forth duties of the managers and stated that the managers were required to act in good faith and in the best interest of the LLC and with the care that an ordinarily prudent person in a like position would use under similar circumstances. The exculpatory provision did not protect a manager from liability for loss or damage resulting from intentional misconduct, knowing violation of law, gross negligence, or a transaction from which the manager received a personal benefit in violation or breach of the agreement. The court concluded that the plaintiff's allegations of breach of contract did not allege any breach of the managers's duty to act in good faith and in the best interest of the LLC and that absent any such allegation the managers' liability was limited to the specific tortious acts of intentional misconduct, knowing violation of law, gross negligence, or self dealing, none of which was alleged. The court agreed with the managers that a breach of contract claim under Delaware law is not an allegation of intentional misconduct, knowing violation of law, gross negligence, or self dealing. As such, the court stated that neither the willful conduct or bad faith alleged in the breach of contract causes of action constituted the act of intentional misconduct referred to in the exculpatory provision. The court stated that the fiduciary duty claims were based on the same factual allegations as the breach of contract claims and were properly dismissed. According to the court, resurrecting the breach of fiduciary duty claims would impermissibly allow the plaintiff to plead his breach of contract claims under a different guise. The court went on to distinguish the contractual provisions in this case from those at issue in the decision of the Delaware chancery court in *Kelly v. Blum*, and the court stated that *Kelly v. Blum* does not stand for the proposition that contractual provisions cannot eliminate fiduciary duties that would otherwise exist at common law without specific elimination. The court found that the provisions here imposed only specific limited contractual obligations on the managers, thus eliminating the traditional fiduciary duties imposed under Delaware law by virtue of the principle of *expressio unius est exclusio alterius*.

Two justices agreed with the majority's conclusion that the breach of contract and good faith and fair dealing claims against the managers should be dismissed but dissented as to the dismissal of the plaintiff's breach of fiduciary duty claims. The dissent relied upon the similarity between the contractual provisions at issue in this case and those in *Kelly v. Blum* and the holding of the chancery court in *Kelly v. Blum* that the provisions failed to eliminate traditional fiduciary duties because no clause in the agreement "explicitly restricts or eliminates the default applicability of fiduciary duties." According to the dissent, the plaintiff's breach of fiduciary duty claims survived to the extent they did not duplicate a claim for breach of contract or fall within the terms of the exculpatory clause because the LLC agreements in this case did not explicitly eliminate traditional fiduciary duties. The dissent acknowledged the overlap between the breach of contract and breach of fiduciary duty claims in this case but concluded that the plaintiff's factual allegations of acts by the managers amounting to a manipulation of their control to ensure the plaintiff would not be paid and to benefit at the plaintiff's expense went sufficiently beyond the contract to sustain a breach of fiduciary duty claim at this early pleading stage. The dissent then proceeded to address the hurdle presented by the exculpatory provision and concluded that the plaintiff's allegations were sufficient to fit into the intentional misconduct exception because the plaintiff alleged facts suggesting that the managers knew the plaintiff was owed significant amounts but deliberately caused the LLCs to withhold payment and then used the plaintiff's money for themselves and certain other parties. The dissenting justices would have sustained the claims for breach of fiduciary duty because these allegations supported a claim that the managers used their control of the LLCs to enrich themselves at the plaintiff's expense.

Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App. 2012).

This case involved a dispute over the existence and breach of fiduciary duties in a business venture that operated by means of a limited liability company and limited partnership. An individual who was both a minority member of the LLC and a limited partner of the limited partnership sued the individual who was both the controlling member of the LLC and a fellow limited partner to recover withheld profit distributions. The trial court entered a judgment on the jury verdict that found the controlling member breached his fiduciary duties to the minority member. The court of appeals reversed and remanded holding: (1) the LLC agreement imposed fiduciary duties on the controlling member; (2) the limited partner relationship by itself did not give rise to a direct fiduciary duty between the individuals; (3) the trial court committed harmful error by commingling valid and invalid theories in instructing the jury that the controlling member had fiduciary duties with respect to operations of both the LLC and the limited partnership; and (4) any withheld profit distributions originated from the operations of the limited partnership in which the controlling member's fiduciary duties had been contractually disclaimed.

In February 2003, Wimberly and Strebel went into business together. They formed an LLC, and they and their spouses executed an amended and restated LLC agreement effective January 2004 in which they memorialized terms and provided specifics as to the business. Under the amended agreement, Strebel and Wimberly were the members, with 60% and 40% sharing ratios, respectively; Strebel, Wimberly, and their spouses comprised a board of managers who had to be consulted on certain major decisions; and Strebel was designated as the "Managing Manager and CEO" of the LLC with broad decision-making and management powers. In addition, the agreement provided that the managers had fiduciary duties to the LLC and the members equivalent to the fiduciary duties of directors of Delaware corporations, and members had fiduciary duties to the LLC comparable to stockholders of Delaware corporations. Wimberly, Strebel, and their spouses also formed a limited partnership in 2005. Under the limited partnership agreement, the LLC was designated as the general partner with broad authority to control the limited partnership, and Wimberly, Strebel, and their spouses became limited partners who agreed not to act for the limited partnership. The limited partnership agreement provided that the general partner had no duties except those expressly set forth in the agreement, and no provision in the agreement imposed fiduciary duties on the general partner. In 2007, Wimberly and Strebel had a disagreement regarding the profit distributions related to their business ventures. Wimberly sued Strebel to recover profit distributions Strebel allegedly withheld. Wimberly asserted numerous causes of action contending essentially that Strebel acted in bad faith and breached his fiduciary duties to deprive Wimberly of distributions by retroactively reducing Wimberly's distribution percentages and shifting money from profit to bonuses to reduce funds available for profit distributions. The trial court instructed the jury that Strebel owed Wimberly fiduciary duties based on their relationship as co-owners of the LLC (with Strebel as the majority owner and managing manager) and their relationship as partners in the limited partnership. The jury found that Strebel breached his fiduciary duties to Wimberly. Strebel appealed arguing that he did not owe Wimberly any fiduciary duties and that any acts allegedly depriving Wimberly of distributions were permitted based on the parties' contractual agreements. The court of appeals analyzed the existence and application of fiduciary duties Strebel owed Wimberly.

The parties agreed that whether Strebel owed Wimberly fiduciary duties based on their limited liability company relationship depended on the interpretation of the language in the LLC agreement. The LLC agreement was governed by Delaware law. Under the Delaware LLC Act, parties are given broad freedom to contract, and the existence and scope of fiduciary duties must be determined by reference to the LLC agreement. Here, the LLC agreement stated that managers shall have fiduciary duties to the LLC and the members equivalent to the fiduciary duties of directors of Delaware corporations except as otherwise provided in the agreement. Strebel contended that as the managing manager he owed fiduciary duties to the LLC and its members collectively rather than to Wimberly individually. Wimberly responded that such an interpretation was illogical as it was contrary to the plain meaning of the language of the agreement, which included fiduciary duties to members. Wimberly also asserted that, unless default fiduciary duties are specifically disavowed by contract, Delaware courts have treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. The court of appeals sided with Wimberly and held that the trial court correctly interpreted the LLC agreement as imposing fiduciary duties on Strebel as the managing manager to Wimberly as an individual member. The court viewed the reference in the agreement to the duties of corporate directors as describing the type of duties owed, not limiting those to whom the duties are owed. The language of the LLC agreement specified that the managers shall have fiduciary duties to members. According to the court, any other interpretation would render the phrase superfluous. Thus, the trial court did not err in instructing the jury that Strebel owed Wimberly fiduciary duties as the managing manager of the LLC.

In the remainder of the opinion, the court analyzed whether Strebel owed Wimberly fiduciary duties based on their limited partnership relationship, which depended on whether limited partners owe each other fiduciary duties under Texas law. The limited partnership agreement was governed by the Texas Revised Limited Partnership Act, and the agreement here was silent as to any fiduciary duties owed between and among the limited partners. The court concluded that the mere status as a limited partner does not give rise to fiduciary duties despite broad language in some cases to that effect. However, a party's status as a limited partner does not insulate that party from the imposition of fiduciary duties that arise when a limited partner also takes on a nonpassive role by exercising control over the partnership in a way that justifies recognition of such duties or by contract. In this case, the relationship between Strebel and Wimberly as limited partners in the limited partnership did not give rise to a direct fiduciary duty to each other. The trial court's instruction that Strebel owed Wimberly fiduciary duties as partners in the limited partnership was thus erroneous. Furthermore, the instructions were erroneous to the extent they conveyed that Strebel owed Wimberly fiduciary duties in Strebel's capacity as the managing manager of the LLC that served as the general partner of the limited partnership because the limited partnership agreement expressly disclaimed any fiduciary duties owed to the limited partners by the general partner itself. The trial court's jury instruction failed to account for the legal effect of this disclaimer. Thus, the trial court wrongly included in its jury instructions the existence of fiduciary duties owed by Strebel to Wimberly in relation to the limited partnership.

Strebel argued that the trial court committed harmful error in the jury instructions by commingling valid and invalid theories. The trial court instructed the jury that Strebel owed Wimberly fiduciary duties based on the LLC agreement, which was correct, and because of the limited partnership relationship, which was incorrect. Because of the commingling, it was impossible to determine if the jury finding that Strebel breached his fiduciary duties was based on a valid or invalid theory. Furthermore, the court of appeals concluded that Wimberly's recovery under the improper jury question failed on causation grounds. The damages alleged by Wimberly were caused by the actions of the limited partnership's general partner (i.e., the LLC) in exercising its exclusive authority to run the limited partnership and Strebel's alleged control of the general partner. Courts have recognized that general partners in a limited partnership owe fiduciary duties to limited partners, but courts have also acknowledged the importance of honoring parties' contractual terms defining the scope of their obligations and agreement, including limiting fiduciary duties that may otherwise exist. In this case, there was an express contractual disclaimer in the limited partnership agreement of fiduciary duties owed by the Strebel-controlled general partner to the limited partners, and there was no jury question regarding breaches by the general partner. Because Wimberly sought recovery based on actions that were all taken in Strebel's capacity as managing manager of the general partner, the court held that the waiver of fiduciary duties in the limited partnership agreement foreclosed Wimberly's recovery on his breach of fiduciary duty claim. Applying the fiduciary duties Strebel owed Wimberly in the LLC relationship, as Wimberly urged, would render meaningless the express disclaimer of fiduciary duties in the limited partnership agreement under which the parties were operating. Since Wimberly failed to demonstrate that Strebel took actions that caused Wimberly's lost distribution damages while acting within the scope of any fiduciary duties that existed between the parties (inasmuch as the parties had contractually disclaimed the fiduciary duties related to the actions by Strebel at issue) the judgment, which was based on the jury's finding of breach of fiduciary duty, was reversed. The case was remanded for consideration of alternative liability and damages findings.

Auriga Capital Corporation v. Gatz Properties, LLC, 40 A.3d 839 (Del. Ch. 2012).

Minority members of an LLC that held a long-term lease on a golf course sued the LLC's manager and the individual ("Gatz") who controlled the manager. Gatz and his family had majority voting control over the LLC and owned the golf course leased to the LLC and subleased by the LLC to a golf management corporation. When it became apparent that the golf management corporation would not renew the sublease, the LLC's manager did not take any steps to find a new strategic option that would protect the LLC's investors. Rather, the manager eventually conducted a sham auction to sell the LLC at which Gatz, on behalf of the manager, was the only bidder. The manager acquired the LLC at a nominal amount over the debt and then merged the LLC into the manager. Minority members of the LLC sued the manager and Gatz for breach of their contractual and fiduciary duties to the LLC and the minority members based on actions designed to squeeze out the minority members and deliver the LLC to the Gatz family on unfair terms. The court rejected the manager's claims that the operating agreement displaced the traditional fiduciary duties of the manager, that Gatz and his family were able to exercise their voting rights as members to veto any option for the LLC and thus properly use a "chokehold" over the LLC to pursue their own interests, and that the LLC was valueless by the time of the auction.

The court first discussed at some length the principle that managers of a Delaware LLC owe traditional fiduciary duties of loyalty and care as a default rule. The court based this conclusion on the explicit equitable overlay provided by the LLC statute (Section 18-1104 provides that "[i]n any case not provided for" by the statute, "the rules of law and equity...govern"), the manner in which the statute addresses contractual modification of fiduciary duties (Section 18-1101 permits an LLC agreement to expand, restrict, or eliminate fiduciary duties), existing case law, and problems that would arise if the equitable backdrop contained in the statute were to be judicially excised (disruption of expectations of those who crafted LLC agreements in reliance on equitable defaults that supply a predicable basis for assessing whether a business fiduciary has met its obligations and erosion of Delaware's credibility with investors in Delaware entities).

After explaining that an LLC manager owes traditional fiduciary duties of care and loyalty absent contractual provisions altering the duties, the court turned to the provisions of the LLC agreement in this case and concluded that the agreement did not displace the traditional fiduciary duties of care and loyalty. The court interpreted a provision addressing agreements with affiliates as distilling the duty to prove fairness of a self-dealing transaction to its economic essence (i.e., requiring a showing of fair price) but not otherwise affecting the analysis of the manager's conduct giving rise to the dispute. The provision placed the burden on the manager to show that the price term of an affiliate agreement was the equivalent of one in an arms-length agreement, and the court found that the manager failed to meet that burden because there was no effort to determine the price at which a transaction could be effected through a deal with a third party. The court also addressed an indemnification and exculpation provision that the court noted was both stronger and weaker than a charter provision authorized by Section 102(b)(7) of the Delaware General Corporation Law in that the provision at issue preserved liability for a breach of the duty of care (gross negligence) but provided exculpation for a breach of the duty of loyalty to the extent the breach was not committed in bad faith or through willful misconduct. Under the exculpation provision of the LLC agreement, Gatz and the manager had no monetary liability for a good faith breach of default fiduciary duties unless the breach was the result of gross negligence, willful misconduct, or willful misrepresentation. Also, the conduct must be on behalf of the LLC and reasonably believed to be within the scope of authority conferred by the agreement. The court found that the provision did not protect the defendants because the auction and follow-on merger were effected in violation of the arms-length mandate of the LLC agreement and thus not authorized by the LLC agreement. Additionally, the court concluded that the exculpation provision did not apply even if it exculpated conduct in violation of the arms-length provision because the court found that the actions related to the auction and merger were taken in bad faith.

The court described in detail how Gatz and the manager breached their fiduciary duties of loyalty and care by (1) failing to explore strategic options for the LLC for several years after it became clear that the golf course management corporation would not renew its sublease, (2) rebuffing a credible buyer of the LLC's long-term lease, (3) taking advantage of the economic vulnerability of the LLC created by their own loyalty breaches to play "hardball" with the minority members by making unfair buy-out offers on the basis of misleading disclosures, and (4) conducting a sham auction that delivered the LLC to the manager for a bid of $50,000 in excess of the LLC's debt (of which the manager was already a guarantor). As a result of this conduct, the Gatz family re-acquired fee simple ownership of the property, on which the LLC had spent millions of dollars to build a first-rate Robert Trent Jones, Jr.-designed golf course and clubhouse, and the minority members received only $21,000. The court rejected the manager's defense that the voting power held as a member gave it license to exploit the minority. The court acknowledged that the manager was free not to vote its interest for a sale, but the manager was not free to create a situation of economic distress by failing to explore the LLC's market alternatives and then to buy the LLC for a nominal price. The court also rejected the manager's argument that the LLC was worth less than its debt and that thus any surplus over zero was a fair price. The court could not accept this proposition as true on the record before it and stated that the evidence suggested that the LLC was worth more than the manager paid. The lack of concrete evidence of the LLC's value was the fault of the defendants, who fended off a credible third-party purchaser of the leasehold and conducted an unfair auction, and such ambiguities are construed against the self-conflicted fiduciaries who create them. In the course of discussing the flaws in the auction, the court noted that the manager was not protected by the auctioneer's expert advice under Section 18-406 of the LLC statute. The court stated that a fiduciary cannot select an unqualified advisor and then claim it was guided by an expert. Furthermore, the manager's reliance claim was undercut by its full involvement in the development and approval of the marketing plan and terms of sale.

The defendants argued that there should be no damages award because the LLC was insolvent at the time of the sale. The court was not convinced that the golf course had no positive value and pointed to several indicators that the property justified a bid above the debt owed. The most important factor to the court, however, was that the defendants themselves were responsible for the evidentiary uncertainty by their selfishly motivated acts of mismanagement. The manager had no duty to sell its interest but was not free to mismanage the LLC so as to deliver the LLC to itself for an unfair price. The court awarded the minority members the full amount of their capital contributions plus an additional amount, which totaled to slightly less than what would have been produced by a sale in 2007 at $6.5 million (there being evidence that if the defendants wanted to buy the LLC in 2007, they would have had to pay a price in excess of $6 million). The court characterized its award as a "modest remedy" and stated that the record could support a higher amount. The court also concluded that a partial fee shifting was warranted and awarded the minority members half their attorney's fees and costs based on the bad faith exception to the American Rule.

George Wasserman & Janice Wasserman Goldsten Family LLC v. Kay, 14 A.3d 1193 (Md. App. 2011).

The plaintiffs, minority investors in two LLCs and five general partnerships (the "investment vehicles"), sued Jack Kay, the managing member of one of the LLCs and de facto managing member or partner of the other investment vehicles, asserting numerous causes of action based on Kay's secret diversion of investment vehicle funds for investment in Bernard Madoff entities. In addition to suing Kay individually, the plaintiffs sued two entities owned and controlled by Kay that were used to facilitate the investments in the Madoff entities. The plaintiffs brought all of their claims directly and derivatively, and the principal issues in this appeal related to the nature of the claims as direct or derivative.

The court first provided a general overview of governance, fiduciary duties, and derivative suits in the corporate, LLC, and general partnership contexts. With respect to LLCs, the court noted that, unlike the corporate and general partnership statutes in Maryland, the LLC statute does not expressly address members' fiduciary duties. Nevertheless, the court stated that managing members of LLCs owe common law fiduciary duties because managing members are clearly agents of the LLC and the other members, and agents are fiduciaries under common law. The court stated that the underlying fiduciary duties in the corporate and general partnership context pre-existed the statutes so that the duties exist as such unless limited by statute, and the court said the same holds true in the LLC context. Because there is no Maryland statute precluding or even limiting managing members' fiduciary duties under common law, those underlying duties apply. The court recognized that a Maryland statutory provision governing LLC operating agreements suggests that operating agreements can alter existing duties or create duties that would not otherwise exist, but the allegations in this case did not indicate that the operating agreements for the LLC investment vehicles contained any such provisions.

In a lengthy analysis of the nature of the plaintiffs' claims, the court concluded that the plaintiffs could bring their claims directly with respect to both the general partnership and LLC investment vehicles. The plaintiffs based their claims on Kay's improper diversion of funds that were required to be held in reserve funds of the investment vehicles and distributed to the plaintiffs directly. The court relied on a Maryland case dealing with a corporate cash-out merger in which minority shareholders claimed that directors/majority shareholders breached their fiduciary duties to the minority shareholders by failing to obtain an appropriate price for the cashed-out shares. The Maryland Court of Appeals held in that case that the directors were subject to direct common law duties of candor and good faith to the shareholders. In distinguishing individual actions from derivative actions in the corporate context, the Maryland Court of Appeals stated that a shareholder may bring a direct action against alleged corporate wrongdoers when either: (1) the shareholder suffers the harm directly; or (2) a duty is owed directly to the shareholder, though such harm may also be a violation of a duty owing to the corporation. Extending the rationale in this case to partnerships and LLCs, the court concluded that the plaintiffs had sufficiently alleged that they suffered harm directly and that Kay, as managing partner/member, violated duties owed directly to the plaintiffs. The court noted that partners are in contractual privity with each other by virtue of the partnership agreement. Further, the Revised Uniform Partnership Act ("RUPA") specifies that partners owe each other (in addition to the partnership) fiduciary duties, and a partner may maintain an action against the partnership or another partner to enforce the partner's rights. With respect to Kay's obligations to other members of the LLCs, the court pointed out that members are in contractual privity because they are parties to an operating agreement, and the court stated that managing members owe fiduciary duties to each other, not just the LLC itself. The court went on to analyze in some depth whether the plaintiffs, as minority partners, could assert claims on behalf of the partnerships given the governance provisions of RUPA. The court concluded that the provisions of RUPA should be tempered when non-plaintiff partners have conflicts of interest so that the partnership claim may be enforced by all of the disinterested partners. In this case, however, the court could perceive no need to permit an action on behalf of the entities since the plaintiffs had adequately alleged individual direct injury. The court rejected the plaintiffs' derivative claims on behalf of the LLCs for the same reasons. Nevertheless, because the parties had briefed the issue and there was no reported opinion addressing the issue, the court proceeded to analyze whether the LLC statutory provision excusing demand before the filing of a derivative suit when a demand is "not likely to succeed" equates to "futility" in the corporate context. The plaintiffs argued that the "not likely to succeed" requirement was less stringent than the test for "futility" in the corporate context. The Maryland LLC statute provides that a member may bring a derivative action to enforce a right of an LLC to the same extent a shareholder may bring an action for a derivative suit under the Maryland corporation law, and the next subsection of that provision requires demand unless it is "not likely to succeed." Reading these provisions in harmony, the court concluded that the phrase "not likely to succeed" equates to the "futility" exception in the corporate context.

The court then reviewed each of the plaintiffs' counts to determine whether each stated a cause of action. The court concluded that the plaintiffs had adequately alleged claims against Kay for fraud, tortious interference, breach of the investment vehicles' partnership and operating agreements, and for negligence, gross negligence, and reckless misconduct as to the LLC investment vehicles and for gross negligence and reckless misconduct as to the general partnership investment vehicles. The plaintiffs failed to adequately allege various other claims against Kay, including claims for conversion, breach of fiduciary duty, and negligence. The claims for conversion failed because Maryland does not recognize a cause of action for conversion of money that is not "specific, segregated, or identifiable." The breach of fiduciary duty claims failed because an alleged breach of fiduciary duty may give rise to a cause of action under Maryland law, but it does not, standing alone, constitute a cause of action. The allegations here were relevant to other causes of action, such as fraud, tortious interference, breach of contract, and negligence, but they did not constitute a stand-alone nonduplicative cause of action. The court rejected the negligence claim (as opposed to the gross negligence and reckless misconduct claims) with respect to the partnerships because RUPA limits a partner's duty of care to refraining from gross negligence or reckless conduct, intentional misconduct, or a knowing violation of law. The court stated that no such statutory limitation protects members of LLCs, and the plaintiffs adequately alleged that Kay committed negligence, gross negligence, and reckless misconduct in his capacity as an LLC member. The court rejected the plaintiffs' claim for punitive damages because the plaintiffs did not allege facts demonstrating actual malice. The court concluded that some of the plaintiffs' claims against the two entity defendants owned and controlled by Kay survived (such as the aiding and abetting claims with respect to the fraud count) and others did not (such as a beach of contract claim against the management company that contracted with six of the investment vehicles, which the court said could appropriately be brought by the investment vehicles, but not by the plaintiffs directly).

Tully v. McLean, 948 N.E.2d 714 (Ill. App. 2011).

McLean founded an LLC to purchase and develop Piper's Alley, a retail and entertainment complex in Chicago's Old Town. Pursuant to the LLC's operating agreement, the LLC was manager-managed, and the manager had to be a member of the LLC. The member-manager of the LLC had exclusive responsibility for conducting the LLC's business. After the LLC bought Piper's Alley and renovated it, F.P.A., LLC (FPA) invested in the LLC and became a 50% member. McLean-controlled entities owned the other 50% of the LLC. McLean-controlled entities served as the member-manager of the LLC and as the property manager for Piper's Alley. After FPA discovered financial improprieties in the LLC and McLean refused to cease his involvement in running the LLC, FPA and FPA's member-manager filed direct and derivative claims for fraud and breach of fiduciary duty against McLean and the entities he controlled that were owners of the LLC or involved in the management of the LLC or its property. FPA sought injunctive relief, receivership, expulsion of the LLC's member-manager, damages, forfeiture of any compensation received by the defendants during the period of the fraud/breach, and no sharing by any defendant in the damage award. By agreed order, the trial court ordered that McLean and his companies could no longer exercise any control over the LLC's accounts and that the individual in control of FPA would act as sole manager of the LLC for the duration of the litigation. The defendants filed a counterclaim to dissolve the LLC. After a bench trial, the trial court concluded that the defendants had indisputably misappropriated millions of dollars from the LLC, and the court awarded the plaintiffs compensatory and punitive damages and forfeiture of all management fees. The court found that the LLC's member-manager should be judicially expelled but that dissolution was no warranted by the operating agreement or the statute.

On appeal, the defendants did not contest that McLean's practices of moving funds between different entities and projects was improper and that they were liable for actual losses, but the defendants asserted that the relief was excessive and inequitable. With respect to the defendants' claim for dissolution, the court of appeals found that the judicial expulsion of the member-manager as a member triggered a provision of the operating agreement providing for dissolution of the LLC on the removal of a manager since the operating agreement required a manager be a member. With respect to the punitive damages award, the court of appeals found that the trial court did not abuse its discretion in awarding a 3:1 ratio of punitive damages to compensatory damages and in awarding the punitive damages based on the entire amount of compensatory damages even though the amount of compensatory damages actually awarded was reduced by 50% to take into account the defendants' ownership interests. With respect to the fee forfeiture award, the court of appeals found that the trial court did not err in imposing fee forfeiture on the property manager that managed the property owned by the LLC. The defendants argued that the LLC's manager bore the fiduciary duty of overseeing the property manager, and that the property manager's relationship with the LLC was purely contractual and its ministerial duties were not fiduciary in character. The court of appeals concluded that all of the defendants were owned and controlled by McLean and acted in concert so that the property manager was a fiduciary who breached its duty by cooperating in the scheme. The court of appeals also concluded that certain "loan brokerage fees" charged by the LLC's manager were simply another way of hiding inappropriate transfers, and the trial court did not err in ordering forfeiture of these fees. Finally, the court of appeals held that the trial court did not err in awarding prejudgment interest at the equitable rate of 13%.

<u>Power and Authority of Member or Manager to Bind LLC</u>

Orthopedic & Sports Physical Therapy Associates, Inc. v. Summit Group Properties, LLC, 724 S.E.2d 718 (Va. 2012).

Four individuals who owned Orthopedic & Sports Physical Therapy Associates, Inc. ("OSPTA") approached three doctors in Orthopedic Specialty Clinic ("OSC") and five other individuals from Cardiology Associates of Fredericksburg ("CAF") to form Massaponax Medical Properties, LLC ("MMP"). MMP intended to purchase land in the Massaponax area, build a medical office building, and then sell the finished property to a third party with OSPTA, OSC, and CAF as tenants. In October, 2007, the members of CAF submitted an offer to MMP to purchase the property. After submission of that offer, the members of OSC approached CAF and asked to join them in purchasing the property. The members of OSC and CAF then formed Summit Group Properties, LLC ("Summit") in December, 2007, to purchase and operate the building. OSPTA executed a lease with MMP in January, 2008, and OSC and CAF entered into identical leases. Summit eventually purchased the building and assumed the leases in September, 2008. Prior to opening the Massaponax office building, OSC was the largest referral source for OSPTA as OSC did not have its own physical therapy practice. OSPTA made its decision to enter into a long-term lease based on its assumption that it would continue to receive referrals from OSC. During 2007, one of OSC's doctors decided that OSC would begin offering physical therapy services at the new Massaponax office. The opening of OSC's Massaponax office significantly hurt OSPTA's practice, and OSPTA vacated its space, thereby breaching its lease, in 2009. When Summit sued OSPTA and its owners for breach of the lease, OSPTA filed a counterclaim for fraud in the inducement. OSPTA argued that Summit's ordinary course of business was purchasing and leasing the Massaponax office building and that members of OSC who were also members of Summit concealed and misrepresented information to induce OSPTA to sign the lease. Summit's theory of the case was that any misrepresentations or concealment took place before Summit was formed and assumed the leases and was done in the course of OSC's business. OSPTA requested, and the trial court gave, the following instruction: "An act of a member, including the signing of an instrument in the limited liability company name, for apparently carrying on in the ordinary course the limited liability company business or business of the kind carried on by the limited liability company, binds the limited liability company, unless the member had no authority to act for the limited liability company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority." The Virginia Supreme Court characterized this instruction as accurately stating the law applicable where a fraudulent act was committed in the ordinary course of an LLC's business. The trial court also gave the following instruction offered by Summit: "The Plaintiff Summit Group Properties, LLC, is a limited liability company. In order for you to find that Summit Group Properties, LLC, is guilty of fraud, you must find that the fraudulent activity was authorized by the members of Summit Group Properties, LLC." Summit relied upon the part of the LLC statute that provides that an act of a member that is not apparently for carrying on in the ordinary course the LLC business binds the LLC only if authorized by the other members. The Virginia Supreme Court concluded that this instruction was erroneous because it lacked the "not for apparently carrying on in the ordinary course of business" language that would have modeled it after the statute. The court stated that an instruction based on an act in the ordinary course or an act not in the ordinary course may be appropriate depending upon the nature of the act at issue in a particular case. In this case, the alleged fraudulent acts were lies and omissions by OSC, whose members were three of the eight members of Summit. The court said that the dispositive question was thus whether the actions by OSC's members were in the ordinary course of Summit's business. If the fraud was committed in the ordinary course of Summit's business, then fraudulent acts by one member would bind it. If, however, the fraud was not committed in the ordinary course of business, then the jury would have to find that the fraudulent activity was authorized by the other members. The court concluded that the danger of omitting necessary language from Summit's instruction was that the jury might be misled into thinking that the activity must have been authorized by the members of Summit even if the fraudulent act was within the ordinary course of Summit's business. The court could not conclude that the error was harmless because the court could not tell whether the jury believed the act occurred in the ordinary course of OSC's business or the ordinary course of Summit's business. One justice concurred in part and dissented in part, agreeing with the majority that the trial court erred in giving Summit's instruction but arguing that the error was harmless. The dissenting justice argued that there was no evidence that the concealment by OSC of its plans to provide its own physical therapy services occurred in the ordinary course of Summit's business, which was limited to purchasing a building and assuming the leases entered into between MMP and its tenants. Because Summit was a separate and distinct entity from the medical practices operated by its members, the dissenting justice argued that any misrepresentations made by the members of OSC in the course of their medical practice could not have been made in the course of Summit's real estate business.

Uhar & Company, Inc. v. Jacob, 840 F.Supp.2d 287 (D.D.C. 2012).

Jacob, the sole member of a Virginia LLC, entered into a brokerage agreement under which a commission would be paid to the plaintiff for procuring a tenant for the LLC's property. Jacob and the LLC denied that Jacob was acting as the LLC's agent, and the court relied upon corporate case law, the Restatement (Third) of Agency, the Virginia LLC statute, and the LLC's articles of organization and operating agreement to conclude that Jacob was the LLC's agent and that he had actual or apparent authority to enter into contracts on the LLC's behalf. The articles of organization designated Jacob as the LLC's "manager," which amounted to a designation as an agent under the Virginia LLC statute, and the operating agreement authorized Jacob, as the LLC's manager, to act in the name and on behalf of the LLC, including executing any and all agreements, contracts, and documents necessary or convenient for the development, management, maintenance, and operation of any properties in which the LLC had an interest. Jacob and the LLC did not present any evidence showing that Jacob lacked authority to act as the LLC's agent. Although Jacob and the LLC argued that Jacob was a mere "facilities manager," they failed to proffer any evidence that caused the contention to become a genuine factual issue for trial. Turning to the question of whether Jacob had actual or apparent authority to enter the contract at issue on the LLC's behalf, the court relied upon the Restatement (Third) of Agency and the operating agreement to conclude that Jacob "acted squarely within the scope of his actual authority when he entered into a brokerage agreement on [the] LLC's behalf." Thus, the court granted the plaintiff's motion for summary judgment to the extent it argued that Jacob was the LLC's agent and the LLC was a party to the brokerage agreement.

IP of A West 86th Street 1, LLC v. Morgan Stanley Mortgage Capital Holdings, LLC, 686 F.3d 361 (7th Cir. 2012).

A group of LLC borrowers challenged the authority of the vice president of the LLCs (the vice president was itself an LLC managed by an individual, Okun) to consent on the LLCs' behalf to the assignment by Morgan Stanley of Morgan Stanley's obligations under an escrow agreement that was part of a loan transaction between Morgan Stanley and the LLCs. After Morgan Stanley made the loan to the LLCs, it sold the loan, and the vice president executed borrower's escrow instructions on behalf of the LLCs in connection with the sale of the loan. The court held that the LLCs had fostered in the vice president and the vice president's manager, Okun, the authority or apparent authority to consent on the LLCs' behalf because each LLC's operating agreement provided that third parties dealing with the LLC were entitled to conclusively rely on the signature of the vice president as evidence of authority of the vice president to execute the loan documents on behalf of the LLC and to bind the LLC, and the consent of owners executed for each LLC in connection with the loan transaction identified as vice president the entity that consented to the assignment. Thus, the court concluded that Morgan Stanley had the consent of the LLCs to assign both Morgan

Stanley's rights and obligations under the escrow arrangement. Whether or not the vice president was permitted to grant the consent did not alter Morgan Stanley's right to rely on the vice president's representations that it had the power to do so.

Interpretation of Operating Agreement as to Additional Capital Contributions

Clary v. Borrell, 727 S.E.2d 773 (S.C. App. 2012).

In 2004, Clary and Borrell created an LLC to buy and sell residential real estate. Clary and Borrell each made initial contributions of approximately $70,000, and they entered into an operating agreement that contained provisions relating to subsequent capital contributions. Under the operating agreement, a "Required Interest," defined as 100% of the members, was to determine and notify each member of the need for a capital contribution if the LLC needed money to properly operate and discharge its liabilities. The notification was required to contain a statement in reasonable detail of the proposed uses of the capital contributions and a date by which the capital contributions must be made. The operating agreement also provided that if a member advanced funds to or on behalf of the LLC to pay its obligations, the advance constituted a loan from the member and not a capital contribution. The operating agreement provided that profits and losses would be allocated 50% to Clary and 50% to Borrell, and the agreement also stated that with regard to third parties, except as otherwise expressly agreed in writing, no member was liable for the debts, obligations, or liabilities of the LLC. By agreement of the parties, Clary managed the day-to-day operations of the LLC while Borrell acted as a silent partner with no control over such matters. In early 2006, Clary and Borrell mutually agreed to suspend operations due to the LLC's unprofitability and lack of capital to continue operating. In 2008, Clary and the LLC filed suit against Borrell for breach of contract, alleging that Clary and Borrell contributed equally to the LLC for a time but that Borrell later refused to provide a 50% contribution as required by the operating agreement, which caused Clary to provide additional funds to make up for Borrell's shortfall. Clary also alleged that Borrell refused to pay his equitable share of expenses and losses in connection with outstanding obligations of the LLC, relying on the equal allocation of profits and losses under the operating agreement. Borrell filed a motion for summary judgment asserting that there was no evidence he breached the operating agreement. Specifically, Borrell argued that the provision of the operating agreement allocating profits and losses only determined allocations for tax purposes and did not require him to make 50% contributions to the LLC to match funds contributed by Clary. Borrell maintained that he made the required initial contribution and that any subsequent capital contributions to the LLC were governed by the operating agreement, which would have required Borrell's vote and agreement as a prerequisite to mandatory contributions of the members. According to Borrell's interpretation of the agreement, any additional contributions Clary made to the LLC were loans to and liabilities of the LLC and would be owed by the LLC rather than Borrell to Clary, and Borrell pointed out that the obligations of the LLC were only obligations of the LLC based on the provision of the operating agreement that no member was liable for the debts and obligations of the LLC. Borrell also asserted that the LLC was not a proper party to litigate the matter against Borrell because Clary and Borrell were each 50% owners, and a vote regarding the LLC's litigation against Borrell would be deadlocked. Clary responded that Borrell had made additional contributions to the LLC after the initial capital contribution and provided his creditworthiness on behalf of the LLC in connection with several loans for purchases of property.

Clary stated that Borrell agreed to make subsequent contributions to zero out the LLC once they determined they needed to close the business; however, Clary claimed Borrell refused to pay once he was presented with the amount he supposedly owed. Clary submitted as evidence a handwritten document allegedly signed by Borrell which Clary claimed constituted Borrell's vote to contribute to paying the LLC's debts. The document stated, "Jeff, when the accounts are settled if I owe you I will pay you." Borrell countered that Clary produced no evidence that would indicate Borrell voted to approve subsequent capital contributions as required by the agreement, waived his right to do so, or actually made subsequent capital contributions. Borrell contended the documentation regarding the only specific subsequent capital contribution alleged by Clary showed that the funds provided by Borrell for the purchase of a piece of property by the LLC was a loan to the LLC, not a subsequent capital contribution. Borrell argued that acting as a personal guarantor of loans for the LLC did not qualify as a capital contribution in that the guarantees would be liabilities of Borrell rather than the LLC and would add no value to the LLC. As for the handwritten document, Borrell maintained that it could not reasonably be interpreted to constitute a vote or agreement by Borrell to make or call for a subsequent capital contribution, and any money paid by Clary to settle the debts of the LLC was a loan advanced by Clary to the LLC. The trial court granted summary judgment in favor of Borrell, holding that there was no genuine issue of material fact that Borrell failed to make a capital contribution as provided in the operating agreement and that Borrell's personal guarantee for the LLC's loans did not constitute additional capital contributions. The trial court also found there was no evidence that the LLC was a proper plaintiff as there was no legal basis for joining the company in the suit. Clary appealed, arguing that the evidence presented created a genuine issue of material fact as to whether Borrell breached the operating agreement by failing to make subsequent capital contributions. The appellate court stressed the primacy of the operating agreement in governing the relations among the members, managers, and LLC and found that the handwritten document relied on by Clary met none of the requirements set forth in the operating agreement for subsequent capital contributions. For Borrell to be required to make a subsequent capital contribution pursuant to the operating agreement, Borrell had to determine along with Clary that such a contribution was necessary for the operation of the LLC or the discharge of LLC obligations, and Borrell had to be notified of the need by a notice containing a statement in reasonable detail of the proposed uses of the subsequent capital contribution and a date by which the contribution must be made. Clary also argued that the handwritten document at issue was a blanket acquiescence by Borrell for the payment of the LLC's debts that was a contract in and of itself, but because Clary never raised this argument to the trial court it was not preserved for review. The appellate court also found there was no evidence that Borrell contributed more than the initial capital contribution pursuant to the agreement. Even if Borrell did personally guarantee and obtain loans on behalf of the LLC, such actions did not meet the requirements for subsequent capital contributions under the operating agreement. Rather, additional funds advanced to the LLC were considered loans from the member to the LLC under the terms of the operating agreement. In addition, assuming Borrell made contributions to the LLC beyond the required initial capital contribution, the additional contributions had no effect on Clary's allegation that Borrell failed to make subsequent capital contributions and breached the agreement.

Canyon Creek Development, LLC v. Fox, 263 P.3d 799 (Kan. App. 2011).

Fox was a 50% member in two LLCs of which Julian and Horn were the other members. Fox failed to satisfy capital calls made by Julian on behalf of the LLCs, and the LLCs filed this action for breach of contract. The trial court granted summary judgment in favor of the LLCs in the amount of the capital calls.

On appeal, Fox first argued that Julian had no authority to make capital calls to cover the LLC's debt service when Julian and Horn did not hold a majority interest in the LLCs because the operating agreement generally required a decision to make a capital call to be made by a majority of the members. However, the operating agreement provided that, notwithstanding the general requirement of majority member approval, members were required to contribute such additional capital as was required to pay debt service, insurance, and real estate taxes owed by the LLC. Julian held a management position, and the capital calls were made to remain current on real estate loans to the LLCs. Because Fox failed to raise a fact issue as to the amount of additional capital needed or the reasons for the capital calls, there was no factual dispute on this issue. Thus, the trial court was correct in concluding that it was unnecessary for Julian to consult with Fox before making a capital call to satisfy a current obligation on outstanding loans.

The court of appeals then turned to the more difficult issue of the proper remedy for Fox's breach. Fox argued that the trial court erred in holding him personally liable for the capital contribution rather than limiting the remedy to a reduction of his ownership interest as provided for in the operating agreements. The court examined default provisions of the Kansas LLC statute and the provisions of the operating agreement and reached the conclusion that in a case such as this, where the operating agreements prohibited withdrawal from the ventures, subjecting an investor to personal liability for potentially endless capital calls to prop up a failing venture was neither contemplated by the parties nor envisioned by the LLC statutes. The statute insulates the members from liability for debts of the LLC and claims of third parties against the LLC, and the operating agreements of the LLCs also contained clauses limiting the personal liability of a member for debts or losses "beyond" the member's capital contributions. With respect to capital contributions, the operating agreements contained separate provisions regarding the initial capitalization of the LLCs and later increases in capital. The court explained that the provisions of the operating agreements regarding initial contributions were consistent with the provisions of the Kansas statute contemplating that a contribution may consist of cash, property, services rendered, or a promissory note or other obligation to contribute cash or perform services since the operating agreements measured the initial capital contributions by their "net fair market value," a concept that would not be necessary if initial contributions were limited to cash. On the other hand, the provisions of the operating agreements regarding later capital infusions required such contributions to be in cash unless the manager otherwise consented. The court stated that this made perfect sense in that a venture in need of additional resources to meet current obligations such as debt service would need cash for those purposes, and the court concluded that the statutes and operating agreements contemplated different remedies for defaults in the payment of initial capital contributions and additional capital calls. The court noted the statutory default rule that a member is obligated to perform any promise to contribute cash or property or perform services, even if a member is unable to perform, and that a member may be required at the option of the LLC to contribute an amount of cash equal to the agreed value of the contribution that has not been made. This option is available as a default rule under the statute in addition to any other rights the LLC may have against the noncontributing member under the operating agreement or other law. The operating agreements of the LLCs did not contain a contrary provision. However, the court pointed out that the provisions of the operating agreements regarding additional cash capital contributions specifically addressed the remedy available against a member who fails to make an additional contribution. In that case, the operating agreement specified the LLC's remedy was to dilute the interest of the defaulting member to the extent the other members covered by making additional capital contributions. The court pointed out that the Kansas LLC statute provides that a member who breaches an operating agreement is subject to specified penalties and consequences, and the statute specifically permits an LLC operating agreement to provide for a number of remedies for failure to make a required contribution. Although the capital call provisions of the operating agreement did not state that reduction of a noncontributing member's interest was the sole remedy, the provisions also did not state that additional remedies were available. The court found it significant that the remedy of damages, the most fundamental remedy for breach of contract, was conspicuously absent from the provisions of the operating agreement dealing with additional capital contributions. The court contrasted the provisions of the operating agreement regarding withdrawal, which provided that a member who attempted to improperly withdraw would be subject to an action for damages. Thus, the court concluded that the failure to include such a fundamental remedy as damages when a member fails to contribute additional capital was not an oversight but rather expressed a clear intent that damages are not recoverable from a member who fails to contribute additional capital after the venture is up and running.

<u>Interpretation of Operating Agreement as to Method of Vote or Decision of Members</u>

Paul v. Delaware Coastal Anesthesia, LLC, C.A. No. 7084-VCG, 2012 WL 1934469 (Del. Ch. May 29, 2012).

Dr. Leena Paul challenged her removal as a member of an LLC of which she was a 25% member. The other three members voted by written consent to terminate Paul's membership in the LLC and then gave Paul written notice of her termination. The operating agreement provided that a member could be terminated at any time with 90 days written notice by the LLC acting by vote of 75% of the holders of the LLC's shares. Paul claimed the operating agreement only allowed members to vote their shares at a meeting of the members, relying on provisions of the operating agreement addressing notice of meetings and voting of membership shares. The defendant members relied upon Section 18-302 of the Delaware LLC statute, which allows action by written consent of members, without prior notice and without a meeting, unless otherwise provided in an LLC agreement. After examining the operating agreement, the court found that it did not specify the method by which votes terminating membership must be taken, and nothing in the operating agreement specifically disallowed votes by written consent. Thus, the operating agreement did not "otherwise provide" so as to preempt the statutory default rule allowing action by written consent.

<u>Interpretation of Operating Agreement as to Fiduciary Duties</u>

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, C.A. No. 5843-VCL, 2012 WL 1869416 (Del. Ch. May 16, 2012).

See summary above under heading "Fiduciary Duties of Members and Managers."

Allen v. Devon Energy Holdings, L.L.C., 367 S.W.3d 355 (Tex. App. 2012).

See summary above under heading "Fiduciary Duties of Members and Managers."

Kagan v. HMC-New York, Inc., 939 N.Y.S.2d 384 (App. Div. 1st Dept. 2012).
See summary above under heading "Fiduciary Duties of Members and Managers."

Strebel v. Wimberly, 371 S.W.3d 267 (Tex. App. 2012).
See summary above under heading "Fiduciary Duties of Members and Managers."

Auriga Capital Corporation v. Gatz Properties, LLC, 40 A.3d 839 (Del. Ch. 2012).
See summary above under heading "Fiduciary Duties of Members and Managers."

Interpretation of Operating Agreement as to Effect of Assignment and Restrictions on Transfer of Membership Interest

Condo v. Conners, 266 P.3d 1110 (Colo. 2011).

As part of a divorce settlement, a one-third member of an LLC assigned to his wife his right to receive monetary distributions and agreed that he would vote against all matters requiring unanimous consent unless his wife directed him to do otherwise. The operating agreement of the LLC contained provisions prohibiting assignment of any portion of a member's interest and stating that a member who wished to dispose of any part of the member's interest must first obtain written approval of all members. The couple sought approval of the other members, but they refused to approve of the transfer. The couple went ahead with the assignment and submitted it to the divorce court without any reference to the operating agreement or consent of the other members. When the other members learned of the assignment, they expressed to the husband their concern that it violated the terms of the operating agreement and their unease that the assignment would effectively make the husband a noncontributing member and eliminate any incentive he had to assist in the LLC's continued financial success. To resolve these concerns, the other two members offered to buy the husband's interest, and the husband agreed to sell it to the other two members. The wife brought suit against the members for tortious interference with contract and civil conspiracy. The trial court granted summary judgment in favor of the members on the basis that the assignment from the husband to the wife was void, and the court of appeals affirmed. The supreme court likewise affirmed, but each court employed different reasoning in reaching the conclusion that the husband's assignment to the wife was void. The trial court found that the assignment was void as against public policy because the husband's failure to obtain the consent of the other members constituted bad faith in corporate dealings. The court of appeals concluded that the assignment was void because the operating agreement, interpreted in light of general principles of contract law, prevented the assignment of the right to distributions without consent of all members and thus rendered the assignment void. The court of appeals further held that the dispute was governed by what it believed was the supreme court's adoption of the "classical approach" to anti-assignment clauses in a 1994 opinion. The supreme court's analysis and reasoning was similar to that of the court of appeals, but the supreme court clarified that the opinion relied upon by the court of appeals was not a blanket rejection of the modern approach in favor of the classical approach to assignments.

In its analysis, the supreme court addressed as a threshold matter the defendants' argument that the operating agreement, because it serves as an organic document for the LLC, more closely resembles a constitution or charter than a contract and should not be interpreted in accordance with contract law. The members argued that the operating agreement serves as a "super-contract" explicitly restricting the power of a member to transfer any interest without complying with the operating agreement and that any potential exception found in contract law is irrelevant. The supreme court disagreed and held that an LLC operating agreement is a multilateral contract among the members and that it is appropriate to interpret it in light of prevailing principles of contract law.

The court examined the provisions of the operating agreement and rejected two alternative arguments advanced by the wife as to why the unapproved assignment to her was effective. First, the wife argued that the assignment did not violate the anti-assignment clause because it should be narrowly interpreted to prohibit only nonconforming assignments of contractual duties. She claimed that the provision did not apply to her husband's right to receive monetary distributions. The court did not read the provision so narrowly. The court noted that the Colorado LLC statute compelled the court to give "maximum effect" to the terms of the operating agreement. The operating agreement stated that a member shall not transfer "any portion of its interest" in the LLC without prior written approval of all members. Under the Colorado LLC statute, a membership interest in the LLC is defined to include the right to receive distributions of the LLC's assets. The operating agreement further set forth the manner and timing of mandatory distributions, thus creating an enforceable right on the part of members. The court stated that the express limitation on transfer of "any portion" appeared to employ the broadest possible language, unlike sample language in treatises cited by the wife. Thus, like the court of appeals, the supreme court concluded that the right to receive distributions fell within the scope of the anti-assignment clause because the clause applied to "any portion" of the membership interest.

Having determined that the anti-assignment clause in the operating agreement applied to the transfer of both rights and duties, the supreme court addressed whether the unapproved assignment was without any legal effect, i.e., void, or whether the husband had the power but not the right to make the assignment, i.e., the assignment was effective but constituted a breach of the operating agreement. The court again noted that the Colorado LLC statute requires that "maximum effect" be given to the terms of an operating agreement, but the court stated that giving "maximum effect" to the anti-assignment clause did not resolve whether it functioned as a duty not to assign without consent or rendered each member powerless to assign without consent. The court turned to an examination of the classical and modern approaches to anti-assignment clauses to resolve this question. Relying on Colorado case law and the Restatement (Second) of Contracts, the court concluded that the language of the operating agreement and context of the dispute rendered the husband powerless to make the unapproved assignment. The wife urged that the court should apply the modern approach to the anti-assignment clause, under which a prohibition on assignment is treated as a contractual obligation but does not restrict the power to make a nonconforming assignment unless the clause expressly states that a nonconforming assignment is "void" or "invalid." The court pointed out that the Restatement does not adopt the strict "magic words" approach but instead looks to the language used and the context in which the contract is made to determine whether an anti-assignment clause merely creates a duty not to assign. The court discussed its previous application of the classical approach in *Parrish Chiropractic Centers, P.C. v. Progressive Casualty Insurance Co.*, 874 P.2d 1049 (Colo. 1994) and found two of the rationales employed in that case pertinent to the resolution of this case. These two rationales were the strong public policy in favor of freedom of contract and the right of the non-assigning party to deal only with whom it contracted. The court rejected the wife's argument that the strict "magic words" approach provides the best public policy and that other legislative enactments in Colorado evinced a clear preference for free assignability. The court explained, however, that *Parrish Chiropractic* was not a blanket rejection of the modern approach to assignments as the court of appeals had understood it to be. Rather, the supreme court stated that it was "narrowly" holding that the strict "magic words" approach was inapplicable in this case based on the circumstances and terms of the operating agreement. Although the court stated that the statutory directive to give "maximum effect" to the terms of the operating agreement did not resolve the effect of the assignment, it did reflect a legislative preference for freedom of contract over free alienability of membership rights. Thus, in light of the strong public policy in favor of freedom of contract, the court found that the plain language of the operating agreement rendered the husband powerless to made the unapproved assignment. Further, the court noted a clear public policy of allowing the members of a closely held LLC to tightly control who may receive either rights or duties under the operating agreement.

A concurring opinion argued that the statutory directive to give "maximum effect" to the terms of the operating agreement was controlling. According to the concurring justices, giving "maximum effect" to the operating agreement meant that the unapproved assignment was void *ab initio* and left no room for arguments such as the wife's that the member had the power to make an assignment and merely opened himself up to a breach-of-contract action. The concurring justices were troubled by the majority's approach that the determination of whether an assignor has the power to make an assignment in violation of an anti-assignment clause is dependent upon the circumstances and is thus an issue to be determined on a case-by-case basis. According to the concurring opinion, "the majority's opinion leaves LLC law unsettled and open to uncertainty."

Ott v. Monroe, 719 S.E2d 309 (Va. 2011).

Dewey and Lou Ann Monroe formed a Virginia LLC of which Dewey was an 80% member and Lou Ann was a 20% member. Dewey died and bequeathed his entire estate to his daughter, Janet. Janet claimed that she inherited her father's membership in the LLC, but Lou Ann argued that Janet inherited only Dewey's right to share in the profits and losses of the LLC and to receive distributions to which Dewey would have been entitled. Paragraph 2 of the operating agreement prohibited a member from transferring his membership or ownership, or any portion thereof, to any non-member without the written consent of all other members except by death, intestacy, devise, or otherwise by operation of law. Paragraph 10(B) of the operating agreement prohibited the transfer of all or any part of a member's membership interest other than as provided by the operating agreement. Paragraph 10(C) of the operating agreement stated that, notwithstanding Paragraph 10(B), a member may transfer any portion of the member's interest at any time to other members or the spouse, children, or other descendants of the member. The court prefaced its discussion of the specific dispute in this case with a discussion of the background of the Virginia Limited Liability Company Act and the nature of an LLC and explained how the treatment of a membership interest in an LLC is similar to that of a partnership interest, i.e., the interest is divided into a control interest that may not be unilaterally transferred and a financial interest that is assignable. Janet argued that she inherited Dewey's membership by operation of his will because Paragraph 2 of the operating agreement permitted her to inherit it. However, the court stated that Paragraph 2 merely prohibited a member from transferring any part of his membership except where specifically allowed under the terms of the agreement, with consent of all other members, or upon death, intestacy, devise, or otherwise by operation of law. The court stated that the provision did not address statutory dissociation and did not specifically state an intent to supersede the provision of the statute making death a dissociation except as otherwise provided by the operating agreement. Thus, the court concluded that Dewey was dissociated from the LLC upon his death, and Janet became a mere assignee entitled only to his financial interest. The court went on to opine that it is not possible for a member to unilaterally alienate his control interest even if the operating agreement purports to allow it. The court stated that the words "unless otherwise provided in the articles of organization or an operating agreement" make it possible for an LLC to restrict assignment of members' financial interests because they modify the remainder of the sentence in the statute, which states that a membership interest is assignable in whole or in part. According to the court, the proviso does not make it possible for an LLC to allow a member to assign his control interest because the proviso does not modify the separate sentence stating that an assignment does not entitle an assignee to participate in the management and affairs of the LLC or to become or exercise any rights of a member. Additionally, the statute provides that an operating agreement may not contain provisions inconsistent with Virginia laws. Thus, the court concluded that it was not within Dewey's power under the agreement to unilaterally convey to Janet his control interest and make her a member because the agreement could not confer on him that power.

Interpretation of Operating Agreement as to Removal of Manager

Tully v. McLean, 948 N.E.2d 714 (Ill. App. 2011).

McLean founded an LLC to purchase and develop Piper's Alley, a retail and entertainment complex in Chicago's Old Town. Pursuant to the LLC's operating agreement, the LLC was manager-managed, and the manager had to be a member of the LLC. After the LLC bought Piper's Alley and renovated it, F.P.A., LLC (FPA) invested in the LLC and became a 50% member. McLean-controlled entities owned the other 50% of the LLC and served as the member-manager of the LLC and property manager for Piper's Alley. After FPA discovered financial improprieties in the LLC and McLean refused to cease his involvement in running the LLC, FPA sued for various types of relief, including expulsion of the McLean controlled entity that was the member-manager. The defendants filed a counterclaim to dissolve the LLC. After a bench trial, the court found that the LLC's member- manager should be judicially expelled but that dissolution was not warranted by the operating agreement or the statute. The court of appeals disagreed with the trial court's determination that dissolution was not warranted. The operating agreement provided that the LLC would be dissolved on the "death, removal, liquidation, dissolution, withdrawal or bankruptcy of a Manager." The trial court ordered the member-manager "judicially expelled and disassociated from" the LLC based on statutory grounds for expulsion of a member, i.e., wrongful conduct, willful and persistent breach of the operating agreement or a duty owed to the LLC or other members, and conduct making it not reasonably practicable to carry on the business with the member. The trial court declined to apply the dissolution provision of the operating agreement on the basis that the member-manager was not removed as a manager by vote of a majority of the members as provided by the LLC statute. Thus, the question was whether the judicial expulsion of the member-manager as a member under the statute equated to "removal' as a manager under the operating agreement, thus triggering dissolution under the agreement. The operating agreement did not define or explain "removal" of a manager or how "removal" can come about. Because the Illinois LLC statute provides that it governs to the extent the operating agreement does not otherwise provide, the court of appeals looked to the provisions of the statute. The court acknowledged that the manager was not removed by a vote of the members as provided by the only provision of the statute directly addressing removal of a manager, but the court concluded that the judicial expulsion of the member-manager as a member resulted in the removal of the manager because the operating agreement provided that only a member may serve as a manager. Because the operating agreement called for dissolution upon removal of a manager, dissolution of the LLC was required.

<u>**Interpretation of Operating Agreement Fee-Shifting Provision**</u>

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, __ A.3d __, 2012 WL 3027351 (Del. Ch. 2012).

The plaintiffs, affiliates of ASB Capital Management, LLC (collectively "ASB") who prevailed in this action to obtain reformation of three LLC agreements governing real estate joint ventures between ASB and affiliates of The Scion Group (collectively "Scion") (see summary below of opinion granting reformation), sought to enforce fee-shifting provisions in the LLC agreements and recover attorney's fees and costs incurred in this Delaware action and three other suits filed by Scion in federal courts. After ASB notified Scion of erroneous provisions in the three LLC agreements, Scion preemptively filed suit over one of the agreements in federal court in Wisconsin where the real estate that was the subject of that joint venture was located. ASB then filed this action in Delaware, and Scion then filed two more suits in federal court in Illinois and Florida where the real estate for the other two joint ventures was located. The court was critical of Scion's decision to file multiple suits making the litigation as difficult and expensive as possible for ASB and creating "overlapping, redundant, and otherwise unnecessary activities" which could have led to a "multi-jurisdictional train wreck" absent emergency applications to the Delaware court for an expedited decision. In addition to prevailing on the reformation claims, ASB prevailed on counterclaims asserted by Scion for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing. Each of the three LLC agreements at issue contained a fee-shifting provision under which the non-prevailing party in any action to enforce the provisions of the agreement was required to reimburse the prevailing party for all reasonable attorney's fees and costs incurred in connection with such enforcement.

Scion argued that ASB could not recover fees and costs related to Scion's counterclaims for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing (see summary *infra* of the court's opinion on the merits of these claims), but the court found that these causes of action fell within the fee-shifting provision. The breach of fiduciary duty claim asserted by Scion related to ASB's status as de facto managing member of one of the LLCs after ASB removed Scion as managing member. Scion invoked the provisions of the LLC agreement describing the fiduciary duties of the managing member, and Scion's claim thus fell within the scope of the fee-shifting provision. As the non-prevailing party, Scion was responsible for ASB's fees and costs. Scion's implied covenant claim also sought to enforce the LLC agreement. Under Delaware law, an implied covenant claim sounds in contract, not tort. The court described and discussed the implied covenant of good faith and fair dealing at length in concluding that such a claim fell within the fee-shifting provision of the LLC agreement. In particular, the court discussed whether a culpable mental state is required to breach the implied covenant, and the court concluded that proving such a claim does not depend on the breaching party's mental state. Because Scion's counterclaim for breach of the implied covenant sought to enforce an implied term of the LLC agreement, the fees and costs incurred by ASB as prevailing party qualified for reimbursement under the fee-shifting provision.

Scion also argued that ASB was not entitled to recover its costs and fees in the federal cases because ASB failed to plead for recovery of these expenses in the federal cases themselves. Scion relied on Federal Rule of Civil Procedure 9(g), which Scion argued required ASB to plead attorneys' fees as special damages in a federal case. The chancery court noted that Scion appeared to misstate the law but concluded that the procedural rules that could have applied in the federal cases did not govern ASB's recovery in this case. The court stated that all four cases formed one single controversy, and Scion's contract claims in each case sought to enforce the erroneous agreements as drafted. ASB was forced to defend each case to preserve its right to reformation, and a judgment in Scion's favor in any of the federal cases would have had preclusive effect in the Delaware proceeding. ASB thus incurred its fees and costs in the federal actions in connection with an action to enforce the LLC agreements, and the fees and costs fall within the fee-shifting provision.

The court evaluated the reasonableness of the fee award of over $3,000,000 sought by ASB and concluded it was reasonable. With regard to Scion's claim that the fees must be allocated separately such that each Scion affiliate would be liable for a specific amount to each ASB affiliate for each of the three joint ventures, the court concluded that the fees and costs not associated with the breach of fiduciary duty and implied covenant claims (which related to only one of the three entities) need not be allocated and that each of the three Scion affiliates that were members in the three LLCs should be jointly and severally liable for the fees and costs incurred with respect to the litigation over the issues other than the breach of fiduciary duty and implied covenant claims (i.e., the claims relating to the erroneous provisions in the three LLC agreements that resulted from a scrivener's error and were replicated because the first erroneous agreement was used as a template for the other two). The fees and cost related to the breach of fiduciary duty and implied covenant claims related only to one LLC and were to be borne solely by the Scion affiliate that was a party to that LLC agreement.

<u>Reformation of Operating Agreement</u>

ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, C.A. No. 5843-VCL, 2012 WL 1869416 (Del. Ch. May 16, 2012).

Members of three real estate ventures structured as Delaware LLCs sued for reformation of the LLC agreements based on an error in a waterfall distribution provision in each of the agreements. The members seeking reformation were affiliates of ASB Capital Management, LLC (collectively "ASB"). The members resisting reformation and seeking to enforce the provision as written were affiliates of The Scion Group, LLC (collectively "Scion"). The parties negotiated the terms of a sales proceeds waterfall provision in their initial venture essentially providing for distributions in proportion to their equity investments up to a specified preferred return followed by return of the members' invested capital. Only after invested capital was returned would Scion receive a promote payment equal to a percentage of excess profits, with the members continuing to receive the remaining profits pursuant to their equity-ownership ratio. Another venture based on these terms followed closely on the heels of the first. In a subsequent venture, which was ultimately aborted, Scion sought greater compensation through a two-tier promote approach. By email correspondence in May of 2007, the representatives of ASB and Scion agreed to the terms of a two-tier promote (the

"May 2007 Terms") on "a go forward basis." After agreeing to the May 2007 Terms, Scion and ASB worked on the Breckenridge venture. A lawyer for ASB prepared the initial draft of the Breckenridge LLC agreement using the LLC agreement of the previous venture as a template. The first draft of the Breckenridge LLC agreement did not reflect the May 2007 terms. In the course of revising the draft, the missing first-tier promote was placed after the first preferred return but before the return of capital in the sales proceeds waterfall. This placement meant that Scion would begin to earn its first promote immediately after the preferred return and before ASB and Scion received back their capital. Thus, on a money-losing deal, after the initial preferred return, Scion would receive a percentage of each dollar originally invested by ASB. A representative of Scion testified that he noticed the placement of the first-tier promote and recognized its favorable implications but did not say anything. He claimed that it was normal for opposing counsel to give away a significant deal point for nothing. The lead lawyer for ASB testified that she could not recall if she read the draft with this formulation before it was circulated, but she admitted that she did not focus on the language if she did read it, characterizing the language as "just wrong" and a "terrible translation" of the May 2007 terms. The lawyer who prepared the draft said that she lacked the experience at the time to understand the terms of the promote. At the instance of comments of a representative of ASB, some wording of the sales proceeds waterfall provision was revised before the Breckenridge LLC agreement was executed, but the erroneous inverted placement of the first-tier promote and return of capital paragraphs (and a telling awkward misplacement of the word "and" between the paragraphs) was not changed. The ASB Investment Committee approved the Breckenridge deal based on an internal memorandum that described the sales proceeds waterfall provision with the return of capital coming before the first-tier promote as it should have been drafted. In two subsequent joint ventures between ASB and Scion, the same lawyer for ASB that created the Breckenridge LLC agreement electronically copied that agreement and made deal-specific changes. The inverted placement of the first-tier promote and return of capital provision was perpetuated in these agreements. Neither the lead lawyer for ASB nor ASB's representative read the agreements carefully, believing that the Breckenridge LLC agreement accurately reflected the agreed-upon deal structure and that it had been duplicated in these subsequent deals with minor deal-specific changes. In a deal between Scion and ASB that required a new set of documents because Scion could not participate as an equity holder or lender, the lead lawyer for ASB was heavily involved. In drafting these documents to mimic the compensation as a joint venturer under the May 2007 Terms, ASB's lawyer placed the return of capital before the first-tier promote, and Scion's representative did not object to the provision, indicating that Scion's representatives knew that it correctly reflected the deal and that the other LLC agreements were wrong. When Scion exercised a put right under one of the LLC agreements containing the error, ASB's representatives identified the scrivener's error and were very upset. ASB's representative had a "very, very tough conversation" with ASB's law firm, and ASB put the firm on notice of a malpractice claim. ASB brought suit to reform the erroneous waterfall provisions, and Scion sought to enforce the agreements as written.

The chancery court found that all of the requirements for reformation were met and that all of Scion's defenses failed. First, the court concluded that a specific prior contractual understanding existed that conflicted with the terms of the written agreement based on the May 2007 Terms. The evidence showed that a "promoted interest" or "promote" is a term of art that contemplates the return of invested capital when used in the context of a capital event and refers to a share of the profits or upside of a project. Scion's own expert admitted that he had never heard of a deal in the real estate industry in which a promote was paid before the return of capital in a capital-event waterfall provision. In agreeing to the terms, the parties operated based on the established industry meaning of a "promote" as shown by the terms of the agreements in which ASB's lead lawyer was heavily involved. The court found ASB's witnesses credible and coherent in this regard and found the testimony of Scion's witnesses to be self-serving and contradictory. Second, the court found that ASB proved that it entered into the three agreements with the inverted promote and capital return provisions under the mistaken belief that the agreements reflected the May 2007 Terms. Evidence supporting this conclusion included the explanation of the waterfall provision in internal memoranda on which the ASB Investment Committee relied and the shocked reaction of ASB's representatives when they were presented with Scion's put calculation. Finally, ASB proved that Scion knew the terms of the sales proceeds waterfall as written did not reflect the May 2007 Terms but intentionally remained silent. The court was convinced that Scion's representative recognized the scrivener's error and tried to take advantage of the mistake, and the court rejected the contrived testimony of Scion's representative explaining how he did not intentionally remain silent. The court noted that the knowing silence of Scion's vice president and general counsel was imputed to the Scion members based on the basic agency principle that the knowledge of an agent acquired while acting in the scope of the agency is imputed to the principal. The court also rejected each of Scion's affirmative defenses: (1) the failure of ASB's representative to read the agreements; (2) ASB's ratification of the agreements; and (3) ASB's unclean hands. With respect to Scion's argument that ASB's representative failed to read the agreements, the court believed that ASB's representative read the agreement of the initial venture and thereafter relied on ASB's lawyer and others to advise him about changes, brief him on terms, and provide him portions to read. The court stated that Delaware law does not require a senior decision maker to read every agreement *in haec verba*, and the court found that ASB's representative adequately and properly oversaw the negotiation process and was informed about the terms of the ventures as negotiated. Further, even assuming ASB's representative did not read the agreements before approving them, this failure to read the agreements would not foreclose a claim for equitable reformation. As for Scion's argument that ASB ratified the agreements, the court stated ratification for purposes of reformation requires that the ratifying party have actual knowledge of the error. The court concluded that all of the acts on which Scion relied to establish ratification occurred before ASB had actual knowledge of the error. Finally, the court rejected Scion's unclean hands defense. This defense was based on an eight-month delay by ASB in paying the undisputed portion of Scion's put calculation, and the court concluded that this conduct, which was cured by payment plus interest, did not threaten to tarnish the court's good name so as to invoke the doctrine of unclean hands. Because ASB proved by clear and convincing evidence that it was entitled to reformation of the sales proceeds waterfall provisions in the disputed LLC agreements, the court reformed the provisions to place the return of capital and promote provisions in the proper sequence.

Oral Amendment of Operating Agreement as to Buyout on Member's Death

Pastimes, LLC v. Clavin, 274 P.3d 714 (Mont. 2012).

Tim Clavin ("Tim") began attempting to establish a bar and casino business in 1994. Tim's mother, Lila Clavin ("Lila"), and Robert Gilbert ("Gilbert") founded Pastimes, LLC in 1996, and the LLC did business as a gaming parlor. Lila and Gilbert executed an operating agreement in which each was listed as a member of the LLC with a 50% ownership interest. The events of dissolution specified by the operating agreement included the death of a member unless at least two members remained who agreed to continue the business of the LLC. Upon dissolution, the agreement provided that the LLC's assets were to be divided in accordance with each member's capital account and then in proportion to each member's membership interest. Lila died in 2000, and Tim served as the personal representative for her estate. Tim and Gilbert were unable to agree on the value of Lila's share of the LLC at the time of her death. The disagreement led the two men to reach an oral agreement for Gilbert to continue operating the LLC in hopes of realizing a return on their investments. Gilbert served as manager after Lila's death, and he attributed 50% of the LLC's tax liability to the estate on the tax return for the LLC each year. In 2005, Gilbert filed a complaint seeking a declaratory judgment on behalf of the LLC that Lila's interest in the LLC should be valued as of the date of her death. The estate filed counterclaims against the LLC and Gilbert, including a claim regarding the proper valuation of the estate's interest in the LLC. The estate argued that the proper value of the interest was its present-day value as of the date of trial. After a bench trial, the trial court held that the correct value of the interest was the time of trial. The court determined that the estate did not dissociate from the LLC after Lila died, as contemplated in the LLC's operating agreement. That is, no dissolution of the LLC occurred at Lila's death because Tim and Gilbert voluntarily agreed to continue operating the LLC to allow the parties to earn a return on their investments. The oral agreement by the parties modified the LLC operating agreement and eliminated the need for the trial court to determine the value of the estate's interest pursuant to the operating agreement. The trial court acknowledged that following Lila's death Gilbert had contributed to the business while the estate had not. However, without Lila's initial contribution the business would not have existed, and Gilbert had escaped years of tax liability for the LLC by attributing 50% of the income tax of the LLC to the estate. Following expert testimony, the trial court valued the estate's interest in the business at the time of trial to be over $682,000.

On appeal, the LLC contended that the trial court erred in determining the value of the estate's interest as of the date of trial rather than the date of Lila's death. The LLC argued that under the provisions of the LLC's operating agreement the LLC dissolved immediately and automatically upon Lila's death and that the value of the member's interest should be as of the date of her death. Under the Montana Limited Liability Company Act, the LLC's operating agreement controlled which events caused the LLC to wind up. Based on the operating agreement, Lila's death was an event that caused the LLC to automatically dissolve, and Gilbert had a duty as the only remaining member to wind up the LLC. Instead, Tim and Gilbert voluntarily agreed to continue to operate the LLC with the benefit of Lila's investment in the hopes of growing both Lila's and Gilbert's investments in the business and realize a profit. The Montana Supreme Court agreed with the trial court that the dissolution provisions of the operating agreement did not apply due to the parties' decision to continue operating the business. Gilbert's and Tim's agreement and Gilbert's continued operation of the LLC constituted a fully executed oral agreement, as allowed by Montana law to alter a written contract. The LLC statute provides that an estate or personal representative acting as a member dissociates from the LLC once the estate receives its entire right to distributions from the LLC. Thus, nothing in the statute caused an automatic dissociation of the estate at Lila's death. The operating agreement itself allowed for a member's legal representative to have all the rights of the member for the purpose of settling the member's estate. The oral agreement between Tim and Gilbert was fully executed in that the parties performed its terms. Gilbert did not liquidate the LLC, and the estate, acting as a member of the LLC, chose to forgo a payout in order to wait for a potentially higher return on Lila's initial investment. Gilbert continued to manage the LLC after Lila's death. The supreme court held that because the parties had modified the dissolution provisions of the LLC's operating agreement, the trial court properly valued the estate's interest in the LLC at the time of trial rather than at the time of Lila's death and affirmed that portion of the judgment. The supreme court held that the parties did not modify other provisions of the operating agreement such as the applicable interest rate and indemnification provisions in relation to attorney's fees and costs awarded to the estate. The trial court improperly interpreted the indemnification provision in the operating agreement to support an award of attorney's fees and costs to the estate, and the requirements of the LLC statute also did not justify an award of attorney's fees. The estate had to rely on its statutory right to the costs of litigation in the absence of a provision in the operating agreement, and here the estate did not meet the statutory time requirements to recover costs. The interest rate, attorney's fees, and costs were improperly awarded by the trial court and therefore reversed by the supreme court. The supreme court remanded to the trial court for recalculation of the judgment and interest.

Improper Distribution

Sun Nurseries, Inc. v. Lake Erma, LLC, 730 S.E.2d 556 (Ga. App. 2012).

Sun Nurseries, Inc. ("Sun") unsuccessfully attempted to collect past due invoices for landscaping services on a golf course and filed suit against Lake Erma, LLC ("Lake Erma") and BEC Properties and Holdings, LLC ("BEC"), two LLCs Sun alleged owned and developed the golf course. BEC disputed any interest in the development. Sun also sued five individual owners, operators, and members of Lake Erma. Three of the five members were also members of BEC. Lake Erma and BEC shared office space, and BEC employees performed work for both companies but were paid by BEC. At trial, the evidence showed that Sun provided landscaping services for the golf course from late 2003 through mid 2005. Sun submitted invoices to BEC, and Lake Erma issued the checks to pay the invoices. Sun filed suit over a series of six unpaid invoices. An accountant for Lake Erma testified that he cut a check for the invoices in question but it was apparently lost in the mail. No replacement check was ever sent to Sun despite the accountant's reassurances that Sun would be paid, and there was conflicting evidence as to whether a replacement check was issued or whether it was issued and held back at the direction of an individual who was a member of both LLCs. Sun filed suit in February 2006. During 2005, Lake Erma distributed almost $8.3 million to its members in cash and property. In March 2006, two members of the LLCs used the distributed property to obtain loans for Lake Erma and then transferred the proceeds of the loans and the property back to Lake Erma. Sun's accounting expert testified that the distribution left Lake Erma insolvent at the end of 2005, but the expert later conceded that using the market value in her analysis (rather than the purchase price plus development costs) Lake Erma was marginally solvent in that it had sufficient funds to pay its existing liabilities with some excess as of the end of 2005. At the close of Sun's case, the trial court granted a directed verdict for the individual defendants and the LLCs on Sun's claim of fraud and for the individual defendants on all other claims. On appeal, Sun argued that the trial court erred in ordering a directed verdict on its fraud claim because there was some evidence to show that statements by Lake Erma's accountant to Sun's owner that Sun would be paid were intended to fraudulently dissuade Sun from filing a lien and that Lake Erma's distribution constituted a fraudulent conveyance designed to defeat the rights of its creditors in violation of state law. Sun also argued that Lake Erma's veil should be pierced so as to hold the members of the LLC liable for the LLC's debts. The appellate court held that the trial court did not err in entering a directed verdict in favor of the defendants on all the claims. In support of its fraudulent conveyance claim, Sun asserted that Lake Erma made the distributions with the intent to defeat the rights of its creditors, including Sun, because the transfers rendered Lake Erma insolvent and unable to pay its debts. The appellate court determined that there was no evidence that the distributions caused Lake Erma to be insolvent, and even if the initial analysis by Sun's expert, which was calculated with limited documentation, could be considered as some evidence of Lake Erma's insolvency, Sun failed to demonstrate that the distributions were made with an actual intent to hinder, defraud, or delay Sun's collection of its debt as required by the statutory provision relied on by Sun. Sun did not present sufficient evidence of the statutory badges of fraud to support a finding of actual intent, and a directed verdict on the fraudulent conveyance claim was thus proper.

Rev O, Inc. v. Woo, 725 S.E.2d 45 (N.C. App. 2012).

The plaintiff leased a tract of commercial property from an LLC managed by Marilyn Woo ("Woo"). The sole member of the LLC was the Paul W. Woo Revocable Trust. Woo was the widow of Paul Woo, but she was not an owner or member of the LLC. The lease between the LLC and the plaintiff contained a provision that made the plaintiff responsible for obtaining any liquor license for the sale of alcohol on the premises, and the lease was expressly conditioned on the issuance or revocation of such a license. Initially, the plaintiff paid the LLC the required security deposit and rent, but the plaintiff was unable to obtain a liquor license, and the LLC and the plaintiff terminated the lease. A few months later, in September of 2007, the LLC sold its real estate, including the property previously leased by the plaintiff. The plaintiff filed suit against the LLC in August of 2008, seeking reimbursement of the deposit and rent it had paid the LLC. The plaintiff obtained a default judgment against the LLC but was unable to collect the amount of the judgment because the LLC had no assets following the sale of its real estate. The LLC filed articles of dissolution in 2009. In April of 2009, the plaintiff sued Woo claiming that Woo had violated the North Carolina LLC statute by wrongfully assenting to or participating in the sale and distribution of the LLC's assets and that her actions rendered her personally liable to the LLC, which would enable the LLC to pay the debt owed to the plaintiff. The action against Woo was based on claims of unjust enrichment, unfair or deceptive trade practices, and veil piercing. Woo claimed that as the manager of the LLC she did not have liability for its obligations and did not act in violation of the North Carolina LLC statute so as to be liable to the LLC. Woo sought summary judgment supported by an affidavit in which Woo stated that no assets from the LLC had been distributed to her from 2007 forward, she had not been enriched or received anything of value from the LLC from 2007 forward, as manager of the LLC she implemented the policies and directions of the member, and she could not completely control or dominate the LLC since it was solely owned by the member, which had the ability to remove her as the manager at any time. The trial court granted Woo's motion for summary judgment. On appeal, the plaintiff argued that genuine issues of material fact existed as to whether Woo violated the provisions of the North Carolina LLC Act that limit distributions, and whether Woo was unjustly enriched, committed unfair or deceptive practices, or violated public policy.

The provisions of the North Carolina LLC statute at issue prohibit a distribution by an LLC if the LLC would not be able to pay its debts as they become due in the usual course of business or the LLC's total assets would be less than its total liabilities. Additionally, a manager who votes for or assents to a distribution in violation of the statute is personally liable to the LLC for the amount of the distribution that was impermissible. The plaintiff's theory was that Woo approved a distribution to the LLC's member in violation of the statute, Woo was thus liable to the LLC, and the plaintiff would be entitled to benefit from Woo's liability because the liability would enable the LLC to pay plaintiff's judgment against the LLC. The court of appeals was not persuaded that there was any evidence that a violation of the statute occurred or that any violation would support a damage recovery in favor of the plaintiff. The plaintiff did not produce any evidence tending to show that at the time of the sale and related distribution the LLC was unable to pay its debts that became due in the usual course of business or that its liabilities exceeded the value of its assets in violation of the statute. The plaintiff also did not establish that the default judgment entered against the LLC more than a year after the challenged sale and distribution was a debt that had become due in the usual course of business. The plaintiff did not file suit and assert its claim for reimbursement until almost a year after the lease with the LLC had been terminated and all of the LLC's assets had been sold, and there was no evidence the plaintiff had informed the LLC of the existence of its reimbursement claim prior to the sale and distribution in question. Additionally, the plaintiff failed to present any evidence that the LLC should have anticipated, at the time of the distribution, that the plaintiff would have a successful claim for reimbursement for the deposit and rent payments the plaintiff had made prior to the lease being terminated. Although the lease was conditioned on the issuance of a liquor license, the lease contained no provision that the plaintiff would be entitled to reimbursement of any money paid if the lease was terminated due to failure to obtain a liquor license. The plaintiff identified no statutory provision or common law principle giving it the right to reimbursement for payments made prior to the termination of the lease. Thus, there was no basis to hold that the challenged sale and distribution of the LLC's assets violated the LLC statute. Furthermore, even if the distribution of the LLC's assets violated the LLC statute, the court reasoned that any liability on the part of Woo would be a cause of action in favor of the LLC and not the plaintiff. The plaintiff did not argue it had the right to force the LLC to sue or seek recovery from Woo, that the LLC was legally required to seek recovery from Woo pursuant to the statute, or that the plaintiff had the ability to enforce any rights the LLC may have had against Woo. The plaintiff also did not show how any violation of the statutory distribution provisions supported the plaintiff's claims of unjust enrichment and unfair or deceptive trade practices.

With respect to the unjust enrichment claim, the plaintiff failed to provide any evidence that Woo may have received a distribution from the LLC or its member after 2007. Thus, the unjust enrichment claim could not survive summary judgment. Similarly, the plaintiff failed to identify any support in the record for its assertion that Woo's conduct as the LLC's manager constituted unfair or deceptive trade practices. Finally, the court rejected the plaintiff's claim that Woo's approval of the sale of the LLC's assets was against public policy in that it created a windfall for the LLC's member at the expense of the LLC's creditors. The court explained that the plaintiff did not demonstrate it was in fact a "creditor" of the LLC at the time of the challenged sale and distribution or that Woo or the LLC should have foreseen at that time that the LLC might be liable to the plaintiff. The plaintiff also did not show that the LLC had any obligation at the time of the disputed sale and distribution to reimburse it for payments made to the LLC under the lease. Under these circumstances, the court was unable to see what "public policy" was violated when the challenged distribution occurred, and the plaintiff provided no authority or argument explaining why the alleged public policy implications of Woo's actions as manager of the LLC supported overturning the trial court's summary judgment.

<u>Dissolution and Winding Up</u>

LaFond v. Sweeney, __ P.3d __, 2012 WL 503655 (Colo. App. 2012).

This dispute over the distribution of attorney's fees from a contingent-fee case pending at the time of the dissolution of a two-member LLC law firm presented the court with a matter of first impression in Colorado. LaFond and Sweeney formed a law firm as an LLC, and they orally agreed to share equally in all the profits of the firm without regard to who brought the cases into the firm or who did the work on them. LaFond represented a client in a whistle-blower action on a contingency fee basis. After a considerable amount of work was done on the case, LaFond's firm dissolved. Once the firm dissolved, LaFond continued to represent the client in the action. At the time of the dissolution, there was no written agreement describing how the firm's assets should be distributed, and no written agreement existed regarding how the contingent fee generated by the case would be distributed. LaFond and Sweeney were unable to reach an agreement as to the division of the fees that were potentially going to be earned from the whistle-blower case, and LaFond filed a declaratory judgment action seeking a determination by the court as to how the potential fee should be distributed. The trial court determined that the whistle-blower case had been an asset of the law firm, and the value of the case as an asset of the firm was its value at the time the firm dissolved. The oral agreement between LaFond and Sweeney required any profit from the whistle-blower case to be divided equally, so if LaFond recovered a contingent fee from the case, the trial court held that Sweeney would be entitled to one half of the recovery up to a ceiling of an amount calculated based on the work done and costs advanced as of the date of the dissolution. The whistle-blower case then settled, and although LaFond and Sweeney agreed that their oral agreement required them to divide the profits from the case equally, they disagreed on how those profits should be calculated.

On appeal, Sweeney contended that she was entitled to half of the entire contingent fee awarded to LaFond in the whistle-blower case, and LaFond argued that the trial court properly calculated the value of the case recovery awarded to Sweeney, which was based on an hourly valuation of attorney's fees and costs expended by the firm as of the date of its dissolution. The appellate court agreed with Sweeney. In reaching its decision, the court of appeals discussed three principles. First, cases belong to clients, not to attorneys or law firms. Attorneys and law firms must not engage in conduct that would impermissibly interfere with a client's right to choose counsel, and disputes between attorneys over a fee due or that may become due should not affect the client's right to choose counsel. Here, the client did not seek new counsel after dissolution of LaFond's firm, and the client manifested his intention that La Fond fulfill the continuing obligation of the firm. The court found no indication that the client's right to choose his counsel was adversely affected by the dispute between LaFond and Sweeney. Second, when attorneys handle contingent-fee cases to a successful resolution, they have enforceable rights to the contingent fee provided the contingent-fee agreement satisfies the general requirements for contracts and the special requirements of professional ethics. Here, the client was required to pay the fee when the case settled because the agreed upon work was completed, and cases limiting a discharged attorney's recovery to quantum meruit were thus inapposite to the issue presented in this case. The final principle addressed by the appellate court is that a contingent fee may constitute an asset of a dissolved law firm organized as an LLC, and the fee is to be divided among its members once it is earned. The court looked at case law in other states and concluded that the principles of partnership law applied in those cases furnished appropriate guidance for resolution of the issue in this case. Here, a contingent-fee case was brought into the law firm before it dissolved, and LaFond continued to handle the case after dissolution until the case was resolved. Importantly, dissolution did not terminate the LLC law firm. Instead, the entity continued as to all existing matters for the purpose of winding up its unfinished business. The pending whistle-blower case was unfinished business to be completed in the process of winding up the LLC law firm, and dissolution of the firm did not void or negate the contract or release the firm from its obligations to the client. An attorney such as LaFond who carries on the representation of a client and completes an existing case following dissolution does so on behalf of the dissolved firm. Thus, any income received by a member from winding up unfinished business belongs to the dissolved firm, and any attempt by a member to convert such business solely to his or her own business violates the duty owed to the dissolved firm absent a contrary agreement by the members. The contingent fee earned by LaFond was the firm's asset because it constituted the completion of unfinished business of the LLC at its dissolution. As an asset of the dissolved firm, Sweeney also had rights in the contingent fee earned. The court relied on the California case of *Jewel v Boxer* and numerous other out-of-state cases and emphasized that its decision was in line with the great majority of states where courts have concluded that contingent fees ultimately generated from cases that were pending at the time of dissolution of a law firm must be divided among the former partners according to the fee-sharing arrangement that was in place when the firm dissolved, absent a contrary agreement. LaFond owed the dissolved law firm fiduciary duties, including the duty to divide the firm's assets with Sweeney according to the oral fee-sharing agreement in place when the firm dissolved, and the duty extended to the contingent fee. The court of appeals pointed out a distinction (overlooked in many jurisdictions applying the majority rule) between a pending contingent-fee *case* as being unfinished business to be completed in winding up a dissolved firm and the *fee* generated by that pending case as being property of the firm. The court felt it was an important distinction in the context of this appeal. The court noted that the allocation of firm assets generally must be based on their value at the time of dissolution, but the value of an as-yet-unearned contingent fee cannot be ascertained until the case is completed – only then does the asset come into existence. The trial court characterized the whistle-blower case as a firm asset and ascribed to it a value determined by employing a form of quantum meruit analysis based on totaling the hourly attorney's fees and costs as of the date of dissolution. The trial court's ruling attempted to bring finality to the dissolution of the firm, but it did not take into account the fact that the LLC firm did not terminate upon dissolution but instead continued to exist until all pending business was complete. Although most of the court's analysis was based on similarities between partnership and LLC law, the court noted an important difference between the partnership and LLC statutes in Colorado resulting in the conclusion that LaFond was not entitled to compensation beyond his share of the contingent fee for winding up the whistle-blower case on behalf of the dissolved law firm. Unlike the Colorado Uniform Partnership Act, which states that a partner is entitled to reasonable compensation for services in winding up the business of the partnership, the Colorado Limited Liability Company Act does not expressly authorize compensation to former members who wind up the LLC's business. The court found that the exclusion of such language from the LLC statute represented an intentional choice by the legislature. In addition, the court cited *Jewel* and other out-of-state cases rejecting the concept of awarding an attorney extra compensation for winding up a contingent-fee case.

In sum, LaFond had a duty to wind up unfinished business of the dissolved law firm, including continuing to represent the client in the whistle-blower suit, and the contingent fee earned in the case was the dissolved firm's asset, which was subject to an equal division between LaFond and Sweeney based on their pre-dissolution oral agreement to share equally in all the firm's profits. Further, LaFond was not entitled under Colorado LLC law to compensation beyond his share of the contingent fee.

<u>Judicial Dissolution</u>

Venture Sales, LLC v. Perkins, 86 So.3d 910 (Miss. 2012).

As a matter of first impression, the Mississippi Supreme Court held that the evidence supported the trial court's order to dissolve a Mississippi LLC on the ground that it was not reasonably practicable to carry on the LLC in conformity with the operating agreement where the operating agreement stated that the LLC's purpose was to acquire, develop, and sell real estate, but its real estate remained undeveloped ten years later. Perkins, Fordham, and Thompson entered into a business venture to acquire, develop, and sell real estate in 2001. Each man contributed cash and land to an existing LLC previously formed by Fordham and Thompson, and the contributions were structured so that each would own one-third of the LLC. Following the contributions in 2001, the operating agreement of the LLC was amended to reflect a purpose to acquire, develop, and sell commercial and residential properties near a specific area of Mississippi where its land was located and other locations to be decided by the company as well as to conduct any other lawful business, purpose, or activity as decided by the members. When the men entered into their venture, Perkins lived out of state, and he stated at trial that he relied on Fordham and Thompson, who had experience in the mobile home business, to devote their time and energy to developing the LLC property. In early 2009, the LLC negotiated an option contract for the sale of a portion of its land, but the deadline expired before closing. Also in 2009, the LLC listed its property for sale for $5.2 million but was unsuccessful in selling it. Fordham requested approval to list the property for $3.5 million, but Perkins did not approve. Perkins filed an application for judicial dissolution of the LLC in 2010. As of the beginning of trial, the LLC property remained undeveloped and essentially unchanged after ten years. Fordham and Thompson cited several reasons outside of the members' control for the delay in the development, but they had successfully developed at least two other subdivisions with approximately 200 houses within twenty-five miles of the LLC's property. The trial court found that it was not reasonably practicable to carry on the business of the LLC based on the property's history, the LLC's inability to obtain funding for development, and the uncertainty regarding the economic climate in the area. The trial court ordered the LLC to be dissolved.

On appeal, Fordham, Thompson, and the LLC (collectively the "appellants") alleged the trial court erred in ordering the dissolution of the LLC. Specifically, the appellants argued that the trial court erred in ordering the dissolution of a solvent LLC based on the application of one dissatisfied member. The Mississippi Supreme Court affirmed the trial court's order of dissolution holding that the judgment dissolving the LLC was supported by substantial evidence and was not an abuse of discretion. The trial court ordered dissolution on the basis that it was not reasonably practicable to carry on the business in conformity with the LLC operating agreement, a basis for judicial dissolution under the Mississippi Limited Liability Company Act. The statute did not define "not reasonably practicable," and no Mississippi cases had interpreted the standard. Thus, the supreme court examined how other jurisdictions had considered the matter. Although no definitive test existed for determining reasonable practicability, the court recognized it was widely accepted that dissolution was appropriate when an LLC was not meeting the economic purpose for which it was established. The LLC in this case was formed for the purpose of acquiring, developing, and selling commercial and residential property; however, more than 10 years after Perkins became a member, the property remained entirely undeveloped. At trial, the appellants offered numerous reasons as to why the development had been delayed, including zoning and sewage access issues, Hurricane Katrina, city regulations, and the economic downturn and national housing market decline. Despite the alleged hindrances, Fordham and Thompson had successfully formed two other LLCs and developed at least two other subdivisions within twenty-five miles of the property at issue during the ten-year period since Perkins joined the LLC. Furthermore, the appellants presented no evidence that the LLC would have been able to develop the property as intended within the foreseeable future because the LLC was unable to obtain additional funding or bank loans needed to begin development. The appellants maintained that it was reasonably practicable for the LLC to continue operating because its assets exceeded its liabilities and the local economy showed signs of improvement. The court disagreed with the appellants because they failed to show that the LLC could actually meet its stated purpose– developing and selling its property. In addition, the appellants contended that Perkins blocked the LLC from taking advantage of business opportunities such as selling the property at a reduced price or offering lots. The court found that the appellants presented no evidence that buyers were ready to purchase the property or portions of it at those prices. More than ten years after its formation, the LLC had not met, and would not meet in the near future, its purpose of developing and selling property. Substantial evidence existed to support the trial court's finding that it was not reasonably practicable for the LLC to carry on business in conformity with its operating agreement. Therefore, the court held that the trial court did not err by granting the petition for dissolution and remanded to the trial court to address winding up the affairs of the LLC.

Administrative Dissolution or Cancellation

AT&T Advertising, L.P. v. Winningham, 280 P.3d 360 (Okla. App. 2012).

Winningham contracted on behalf of an LLC with AT&T Advertising, L.P. ("AT&T") for yellow pages advertising in 2007 and 2008. AT&T did not receive payment for the advertising and filed suit against Winningham to collect the balance owed on the contracts. Winningham claimed that he signed the contracts on behalf of the LLC and thus was not personally liable for the debt, but AT&T argued that Winningham was personally liable because the LLC had been cancelled by the Secretary of State before Winningham signed the contracts. The trial court found that the LLC was not a legal entity in existence when the contracts were signed due to its cancellation and granted AT&T's motion for summary judgment holding Winningham personally liable for the debt.

The question presented to the appellate court was whether an LLC, which had been cancelled by the Secretary of State for non-payment of fees, provided a liability shield for its agent. Winningham relied on a provision of the Oklahoma Limited Liability Company Act that provides that a member of an LLC is not liable for the LLC's debts solely by reason of the LLC's failure to file annual certificates and pay annual fees to the Secretary of State or by reason of the LLC ceasing to be in good standing or duly registered. Winningham argued that once an LLC is created, its members are free from liability for acts on behalf of the LLC until the LLC voluntarily files for dissolution. AT&T countered that the provision of the statute applied when the LLC was not in good standing and only until the LLC was either dissolved or cancelled, and the LLC in this case had been cancelled. Furthermore, if the court adopted Winningham's interpretation of the provision, an LLC would have no motivation to ever pay the fees or file the required certificate. The appellate court agreed with AT&T. The statute provides that an LLC may be cancelled either by filing a notice of dissolution (voluntary cessation) or by being deemed cancelled for failing to file the annual certificate or pay the annual fee within three years of the due date (involuntary cessation). The provision relied on by Winningham includes express language distinguishing a cancelled LLC from one not in good standing, and Winningham would have been correct had the LLC simply ceased to be in good standing. However, once three years had passed from the due date for the certificate or fee, the statute provided for a more serious penalty, i.e., cancellation of the LLC. Following cancellation, an LLC is no longer required to make the annual filing and pay the annual fee, and the court interpreted this result to indicate that the legislature intended cancellation to mean the LLC no longer existed. That is, once cancelled, an LLC is no longer a separate legal entity. The record here did not dispute that the LLC was cancelled during the time all of the contracts at issue were executed. Because the LLC was cancelled, it was not a legal entity and did not afford its members the liability shield typically in effect for LLC members. The appellate court was also not persuaded by Winningham's claim that the LLC was "suspended" because the Secretary of State record stated the LLC was cancelled and because the statute did not include "suspension" as a status for an LLC. Next, Winningham alleged that the LLC was reinstated after the contracts were executed, which resulted in the liability shield being effective as if the LLC were never cancelled. The appellate court disagreed. The LLC was cancelled July 1, 2007, and it filed articles of conversion to form a corporation on July 14, 2009. The statute was amended effective January 1, 2010, to allow reinstatement as an LLC. Thus, at the time the LLC became a corporation, reinstatement as an LLC was not even possible. The statute also implied no relation back for liability purposes. Nothing in the record showed that the LLC sought reinstatement as an LLC after it was cancelled. When the LLC incorporated, it was not converting, as there was no legal entity in existence to convert from, but rather it was forming an entirely new business entity. In addition, even if the LLC had the ability to convert, the statute provided that conversion of an LLC to another business entity did not affect any liabilities of the LLC or its agents incurred before the conversion. From July 1, 2007, to July 14, 2009, the LLC was not a legally cognizable entity. Thus, the appellate court affirmed the trial court's judgment holding Winningham personally liable for the amount owed on the contracts with AT&T during that time.

<u>Charging Order; LLC Property</u>

Wells Fargo Bank, N.A. v. Continuous Control Solutions, Inc., No. 11-1285, 2012 WL 3195759 (Iowa App. Aug. 8, 2012).

Judgment creditors obtained charging orders against the judgment debtors' interests in three LLCs, and the LLCs objected to provisions of charging orders that ordered the LLCs to provide counsel for the judgment creditors periodic statements specifying "any and all disbursals, distributions, inflows, or payments in order to ensure compliance with this charging order." The LLCs argued on appeal that there was no statutory authority for the disclosure orders, and the court of appeals agreed. The court of appeals explained that a charging order under the Iowa LLC statute is a lien on a judgment debtor's transferable interest in an LLC, and after entry of a charging order, the debtor member no longer has the right to future LLC distributions to the extent of the charging order but retains all other rights that it had before execution of the charging order, including the managerial interest. The judgment creditors relied upon the provision of the charging order statute that authorizes the court to "[m]ake all other orders necessary to give effect to the charging order," but the court of appeals concluded that this statutory provision cannot be read as broadly as the judgment creditors argued. Another provision of the charging order statute permits the court to appoint a receiver "with the power to make all inquiries the judgment debtor might have made." The court explained that this provision, which mirrors a provision in the Revised Uniform Limited Liability Company Act (RULLCA), contemplates a receiver for the distributions and not the LLC. The commentary to the receivership provision of RULLCA states that the primary advantage provided by the provision is an "expanded right to information." However, the court of appeals noted that the provision relied upon by the judgment creditors does not specifically refer to an expanded right to information, and the comments to the comparable RULLCA provision do not mention an expanded right to information as an example of an order necessary to give effect to a charging order. The court stated that the provision relied upon by the judgment creditors authorizes ancillary orders that affect only economic rights rather than governance rights, and the court concluded that the expanded right to information (i.e., the power to make inquiries that the judgment creditor may have) is limited to a receiver appointed under the receivership provision. The court found its conclusion bolstered by the fact that the Iowa LLC statute provides a transferee of a member's interest is generally not entitled to access to records or information. The court did not think that the holder of a lien on the member's economic interest should have access to the LLC's records if a transferee is not entitled to such access. Because the court concluded that the Iowa statute only authorized a court to order an LLC to disclose financial information to a court-appointed receiver, and there was no statutory authority for the district court's disclosure orders, the court of appeals vacated the part of the charging orders requiring disclosure. The court of appeals indicated, however, that the district court had faced a challenging task in view of the absence of case law from which the district court could have drawn guidance.

Weddell v. H2O, Inc., 271 P.3d 743 (Nev. 2012).

In a dispute between the members of two LLCs, the Nevada Supreme Court analyzed the effect of a charging order against the interest of one of the members and concluded that the judgment creditor had only the rights of an assignee of the member's interest. The court also concluded that a party's notice of pendency on an option to purchase an LLC membership interest was unenforceable because the action on which the notice was based concerned an alleged expectancy in the purchase of a membership interest and not a direct legal interest in real property.

Stewart and Weddell were the members of two LLCs, Granite Investment Group, LLC ("Granite") and High Rock Holding, LLC ("High Rock"), and Weddell was initially the manager of each LLC. Stewart, the majority member, purported to remove Weddell as manager of each LLC and elect himself as manager. In an unrelated matter, a judgment creditor of Weddell obtained a charging order against Weddell's membership interests in Granite and High Rock. Subsequently, Stewart purported to purchase Weddell's membership interest in Granite pursuant to buyout provisions of the operating agreement concerning voluntary transfers. The trial court concluded that the charging order divested Weddell of both membership and managerial rights in Granite and High Rock upon the tender of purchase money by Stewart and concluded that Stewart was the sole manager of both LLCs. The supreme court noted that the trial court's language concerning the divestiture of both membership and management right was "troublesome" and stated that it appeared the trial court conflated the purpose of a charging order with the provisions contained in the parties' operating agreements. The court reviewed the general nature of LLCs and the Nevada statutory framework before presenting a historical overview of the charging order remedy. The court concluded that a judgment creditor with a charging order does not unequivocally step into the shoes of a member, and the limited access of a judgment creditor includes only the rights of an assignee. A judgment creditor or assignee is only entitled to the judgment debtor's share of the profit and distributions. Thus, after the entry of a charging order, the debtor member no longer has the right to future distributions to the extent of the charging order but retains all other rights possessed before the charging order, including managerial interests. Applying these principles in this case, the charging order only divested Weddell of his economic rights, not his managerial rights. The court further concluded that the charging order triggered the involuntary transfer provisions of Granite's operating agreement rather than the voluntary transfer provisions. The involuntary transfer provisions explicitly included charging orders, and the court remanded for the trial court to resolve whether Stewart complied with these provisions and whether, as a consequence, Weddell was divested of his membership interest in Granite. The court also directed the trial court to determine whether Weddell retained his managerial rights or whether Stewart had elected himself co-manager pursuant to the Granite operating agreement, which required a unanimous vote of the members to remove a manager. The court agreed with the trial court's conclusion that Weddell was voted out as a manager under the High Rock operating agreement, which did not that specify a unanimous vote was required to remove a manager.

The court concluded that the trial court did not abuse its discretion by canceling Weddell's notice of lis pendens because the filing of a notice of lis pendens is limited under Nevada law to actions directly involving real property. Weddell sought enforcement of an option to purchase the membership interest in a geothermal company that apparently owned real property. However, a membership interest is personal property, and the doctrine of lis pendens therefore did not apply.

Hicks v. Cadle Company, 809 F.Supp.2d 742 (N.D. Ohio 2011).

Hicks sought writs of execution with respect to property of Daniel Cadle in order to collect on a judgment obtained in Colorado. The property sought included Cadle's interests in LLCs and limited partnerships, and Cadle argued that these interests were not stock and were not subject to execution under Ohio law, relying on the charging order provisions of the Ohio LLC and limited partnership statutes. In the absence of Ohio case law addressing whether a judgment creditor may seize a judgment debtor's interest by means of a writ of execution, the court relied upon North Carolina case law holding that a judgment debtor could not subject an LLC membership interest to forced sale by means of a writ of execution in light of the North Carolina charging order statute, which is similar to Ohio's statute. The court stated that the treatment of interests in a limited partnership should be the same in view of the parallel provisions in the limited partnership statute, and Hicks could thus only proceed against the interests in the LLCs and limited partnerships by means of a judicial charging order.

<u>Property of the Estate in LLC Member's Bankruptcy</u>

In re Campbell (Grochocinski v. Campbell), __ B.R. __, 2012 WL 2564720 (Bankr. N.D. Ill. 2012).

Craig and Kim Campbell, the debtors in a Chapter 7 bankruptcy, each owned a 50% interest in OPAR, LLC ("OPAR"), a manager-managed LLC that in turn owned 100% of three member-managed LLCs. The debtors also owned 77% of the limited partnership interests of a limited partnership, the general partner of which was one of the LLCs wholly owned by OPAR. Craig Campbell was the manager of OPAR. The court discussed what was property of the estate with respect to these entities in connection with certain transactions involving the entities that were the basis for an objection to discharge by the trustee. The trustee argued that the chain of ownership enabled the trustee, as successor in interest to the debtors, to exercise all the debtors' economic and non-economic rights in the entities, including the rights to dissolve, wind up, and liquidate the entities. Under the trustee's analysis, that power transformed the entities and their assets into property of the estate. The debtors argued that even if their property rights as members of OPAR passed to the estate, the powers and responsibilities of the manager of OPAR (Craig Campbell) did not pass to the estate because these powers and responsibilities were not interests in property. The court agreed with the debtors that the powers and responsibilities of the debtor as manager were not property of the estate. Thus, OPAR's ownership interests in the three wholly owned member-managed LLCs and the interest of one of those LLCs as general partner in the limited partnership did not automatically become property of the bankruptcy estate. The court acknowledged the broad scope of Section 541(a)(1) and the preemption of state law by Section 541(c) as to the types of property interests that may be transferred, but the court pointed out that state law determines the nature and scope of property interests that comprise the property of the estate in bankruptcy. The court held that the interest of a manager of a manager-managed LLC is not a property interest that can be transferred based on the Illinois LLC statute's provisions on appointing and removing managers. In a footnote, the court stated that the member's management rights in a member-managed LLC would constitute property of the estate under Section 541 based on the provision of the Illinois LLC statute providing that each member in a member-managed LLC has equal rights in the management and conduct of the business and that any matter relating to the management of the LLC may be decided by a majority of the members. The court stated that unless and until the trustee, acting as sole member of OPAR, removed and replaced Craig Campbell as manager, Craig Campbell retained that role after filing his bankruptcy petition. The court explained further in a footnote that the trustee would have to take the preliminary step of replacing the manager of a manager-managed LLC in order to make management decisions pertaining to its winding up and distribution of its assets, and the trustee would have to dissolve and wind up the LLC in accordance with the LLC statute and the operating agreement, while ensuring that obligations to the LLC's creditors were fulfilled, in order to distribute the assets of the LLC to the estate. The court went on to point out that a member is not a co-owner of, and has no transferable interest in, property of an LLC under the Illinois statute. Thus, the debtors' membership interests in OPAR became property of their bankruptcy estate, but OPAR's assets, including the subsidiary LLCs, did not automatically become property of the estate, and the trustee had not yet taken the steps required under Illinois law to bring that property into the estate. Likewise, the court stated that property of real estate LLCs owned by the debtors did not automatically become property of the estate, but their organization as member-managed LLCs would make it easier for the trustee to reach that property. The court also pointed out the distinction between personal bank accounts of the debtors that were property of the estate (and thus subject to the limitations of Section 727(a)(2)) and bank accounts of the LLCs that were not property of the debtors or their estates (and thus not within the scope of Section 727(a)(2)).

Rights of Secured Party as to Pledged Membership Interest in SMLLC; Authority of Member/Manager to File Bankruptcy

In re Crossover Financial I, LLC, __ B.R. __, 2012 WL 2564361 (Bankr. D. Colo. 2012).

A Colorado LLC issued 108 promissory notes, and the LLC's sole member, Yellen, executed a Membership Pledge and Security Agreement in which he pledged a pro rata portion of his membership interest to each note holder. The LLC defaulted on the payment of the notes in 2007, and in 2011, Yellen, acting as sole member and manager of the LLC, adopted a unanimous consent authorizing and directing the filing of the LLC's Chapter 11 bankruptcy petition. Certain note holders challenged Yellen's authority to file the bankruptcy. These note holders asserted that the terms of the security agreement for the pledge of the membership interest divested Yellen of control of the LLC. The note holders argued that the security agreement was self-executing, relying on language in the security agreement that provided that the "rights of the Pledgor to vote and give consents...shall cease in case default shall occur and be continuing" and that the "Secured Party, subsequent to any default, may transfer or cause to be transferred into the names of his nominee or nominees any or all of the Pledged Interest" and "also may vote any or all of the Pledged Interest (whether or not transferred) and give all consents, waivers and ratifications...as though they were the outright owners thereof." The security agreement also gave to the secured party a proxy and power of attorney to act for the pledgor. The court held that the note holders were precluded from taking the position that the security agreement was self-executing as to voting rights because the note holders had taken conflicting positions in other lawsuits in Colorado state courts in which the note holders had argued that Yellen was the sole member of the LLC and that the note holders were not members and had not exercised any rights under the security agreement. The note holders argued next that they did not have to be members of the LLC to exercise their rights per the proxy and power of attorney granted by the security agreement, but the court relied upon a California bankruptcy case and the Colorado LLC statute in concluding that only the members or managers of an LLC are entitled to vote or exercise management rights notwithstanding a pledge of a membership interest. The court relied upon the provision of the Colorado LLC statute that specifies the rights of an assignee or transferee are limited to financial rights and that an assignee or transferee does not have any right to participate in the management of the business and activities of the LLC or to become a member. The note holders argued that the transfer provisions of the operating agreement overrode the provisions of the Colorado LLC statute because the operating agreement permitted a member to transfer his interest in the LLC without consent of any other person. The court stated that this provision of the operating agreement allowed Yellen to transfer his interest if he so chose without consent of any other person, but the provision did not necessarily allow any other person to divest Yellen of his interest. The court stated that it did not appear Yellen had ever divested himself of his "member" interest and, in any event, had not ceased being the manager. Furthermore, even if the transfer provision allowed the involuntary ouster of Yellen, it was undisputed that the note holders had not exercised or foreclosed on their security interests, nor had any additional members been admitted to the LLC. In sum, the court concluded that consistent with various state court rulings in litigation involving the note holders, Colorado law requires a secured creditor to enforce the security agreement and become admitted as a member before voting rights associated with pledged membership interests can be exercised. To hold otherwise, said the court, would permit someone who is not a member or manager to control an LLC.

IRS Authority to Issue Summons to LLC; Inability of LLC to Raise Fourth and Fifth Amendment Rights of Members

United States v. Roe, 421 Fed. Appx. 881 (10th Cir. 2011).

Kelly and Christopher Roe challenged IRS summonses issued to them as members of Roe Ecological Services, LLC. The affidavit of the agent who issued the summonses stated that the summonses were issued to aid in the determination of the LLC's taxable income for specified calendar years and that the members of the LLC would be taxed on the LLC's taxable income because the LLC was a pass-through entity, a purpose the court stated facially fell within the authority of the IRS to examine records and other data that may be relevant to determining the liability of any person for any internal revenue tax. The Roes argued that the summonses were improper because: (1) the LLC was a disregarded entity and thus not the proper object of a summons; and (2) the LLC was not in any event subject to income tax, and the summonses thus could not be for the purpose of investigating its taxable income. The court of appeals characterized the argument that the LLC was a disregarded entity, and as such not subject to an IRS summons, as a "non-starter" because the LLC had more than one member and was thus by default treated as a partnership. The court rejected the Roes' argument that, as a married couple, they should be treated as a single member. The court also rejected the Roes' argument that it was still improper for the IRS to issue summonses to inquire into the income of the LLC as a partnership because the Roes rather than the LLC would be liable for paying the taxes on partnership income, characterizing this argument as inconsistent with the plain wording of the governing statute and case law. Finally, the Roes argued that the IRS summonses violated their Fourth and Fifth Amendment rights. The court of appeals agreed with the district court that the Roes could not assert these personal rights to oppose summonses seeking materials from the LLC, a collective entity. The court compared the LLC in this case to the three-member partnership in *Bellis v. United States*, a United States Supreme Court case in which the court explained that the partners could not object to a grand jury subpoena seeking partnership materials on Fifth Amendment grounds because the partnership had a collective identity distinct from its partners. Here, the LLC had been in existence more than a decade, was organized under Colorado state law giving it special rights and powers, maintained bank accounts, and had its own letterhead, logo, website, and phone. The court acknowledged that the Supreme Court in *Bellis* had speculated that a different case might be presented if it involved a small family partnership, but the court noted that "in the thirty-six years since *Bellis* was decided, the Supreme Court has done nothing to transform this hypothetical musing into a substantive limitation on the applicability of the collective-entity principle, and a number of circuits have expressly declined to do so without further direction from the Court." The court stated that the Roes' objection that they might eventually be required to submit documents and testimony implicating their own Fifth Amendment rights was premature and that the Roes could object to the district court in the event that they were presented with requests for information to which they could validly assert concrete and particularized personal objections under the Fifth Amendment.

Foreign LLC–Governing Law

Wehlage v. Empres Healthcare Inc., 821 F.Supp.2d 1122 (N.D. Cal. 2011).

A nursing home resident sued various entities, including several Washington LLCs, for violations of California health and safety, unfair competition, and consumer protection statutes. The plaintiff sought to hold the LLCs liable as alter egos of the facility where the plaintiff resided. The plaintiff claimed that California law applied to the alter ego claims against the LLCs because the admission agreement between the plaintiff and the licensee had a choice-of-law clause specifying that the agreement was governed by the law of the state where the facility was located, but the court held that the alter ego issue was collateral to the admission agreement. The plaintiff also argued that the California LLC statute, which provides that the law of an LLC's state of organization governs "its organization and internal affairs and the liability and authority of its managers and members," only codified the "internal affairs doctrine" and that it thus does not apply to disputes involving persons or entities not part of the LLC, i.e., external substantive questions. The plaintiff relied upon case law interpreting the California statute and case law outside of California interpreting a similar statute. The defendants relied on other case law applying the law of the state of formation of an LLC or corporation on the basis that alter ego liability is a matter of internal affairs or that the state of incorporation has the greater interest in determining when and if liability protection will be stripped away. The court stated that there is no definitive authority on the issue but found the defendants' authority more persuasive. The court stated that the statutory language providing that the law of the state of formation governs the liability and authority of an LLC's managers and members pointed to the application of Washington law on the alter ego liability of the LLCs. Further, even though alter ego liability involves a suit by a third person, the court characterized the issue as involving an internal affair because it involves the determination of whether the owners are liable in lieu of the LLC based on the structure of the entity.

Walsh v. Kindred Healthcare, 798 F.Supp.2d 1073 (N.D. Cal. 2011).

Residents of skilled nursing facilities sued the facilities and parent corporations and LLCs alleging violations of California health and safety, unfair competition, and consumer protection statutes. The plaintiffs sought to hold the parent entities liable under the alter ego doctrine. The court discussed and applied corporate alter ego principles under California law (noting that the alter ego doctrine applies equally to LLCs), and the court held that the allegations were insufficient to invoke the alter ego doctrine. Without arguing that Delaware law applied, the defendants argued that the allegations were also insufficient under Delaware law. The court noted that a forum will generally apply its own rule of law unless a party timely invokes the law of another state. The court stated that the defendants in this case had failed to make the necessary showing that application of Delaware law would further the interest of Delaware. Further, the court stated that the California governmental interest test would require the court to determine that the laws of Delaware and California were materially different in order to apply Delaware law, and the court stated that it did not appear the laws of Delaware and California were materially different on the issue of alter ego. Thus, the court applied California law.

Wilson v. Thorn Energy, LLC, 787 F.Supp.2d 286 (S.D.N.Y. 2011).

The plaintiffs lent money to and invested in several LLCs for the purpose of offshore oil exploration. The plaintiffs sought to pierce the veil of the LLCs to hold the managing member as well as the LLCs liable for repayment of the amounts invested and lent to the LLCs. Based on New York choice-of-law rules, the court applied Delaware law, the law of the state of organization of the LLCs with respect to the veil-piercing claim.

Merger/Conversion/Reorganization

Wasserberg v. Flooring Services of Texas, LLC, __ S.W.3d __, 2012 WL 3016861 (Tex. App. 2012).

The plaintiff sought to hold Wasserberg and Felt liable as guarantors for amounts owed for goods and services sold by the plaintiff to Waterhill Companies Limited ("WCL"). In 2002, Wasserberg and Felt signed a credit application on behalf of Waterhill Company, LLC, in which Wasserberg and Felt purported to "personally guarantee all indebtedness hereunder" in order to obtain credit from Flooring Services of Texas, L.P. Waterhill Company, LLC converted into WCL in 2003, and Flooring Services of Texas, L.P. merged into Flooring Services of Texas, LLC (the "plaintiff") in 2007. Goods and services were provided on credit before and after these transactions. The guarantors argued that they were not liable for debts incurred after these transactions (i.e., debts incurred by WCL, the converted entity, for goods and services provided by the plaintiff, the survivor of the merger) because the terms of a guaranty must be strictly followed and "'neither the party seeking to enforce the guarant[ies] nor the party whose performance was guaranteed is named in the existing document.'" The court of appeals held that the trial court properly concluded that the guaranties were applicable to debts incurred after Waterhill Company, LLC converted into WCL because the Texas conversion statutes and the articles of conversion filed with the Secretary of State provided that the converting entity continues in existence in the organizational form of the converted entity. (Relying on a statement in the articles of conversion, the court erroneously referred to the Texas Business Corporation Act rather than the Texas Limited Liability Company Act, but the Texas conversion statutes for partnerships, corporations, and LLCs all contained similar language.) The court of appeals also rejected the argument that the guaranties did not apply to indebtedness for goods and services provided by the plaintiff, Flooring Services of Texas, LLC, as the survivor of a merger with Flooring Services of Texas, L.P. The guarantors argued that the guaranties did not cover these post-merger transactions because the guaranties did not name the plaintiff or refer to its "successors or assigns." The court noted that the Texas merger statutes provide that all rights of the parties to the merger are allocated and vested in the surviving entity without the need for any formal transfer or assignment. The court also distinguished other Texas cases relied upon by the guarantors. According to the court, unlike a guaranty that covered payment for goods sold by Ford Marketing Corporation (which was held not to be enforceable by Ford Motor Company for goods sold by it as the post-merger successor), the document in this case referred to "all indebtedness hereunder" and was not limited to goods and services provided by Flooring Services of Texas, L.P.

Additionally, the court rejected the argument that Texas cases have required language extending a guaranty to actions by a successor entity in order for a successor to enforce the guaranty.

<u>Attorney Liability; Securities Fraud</u>

Rosenbaum v. White, __ F.3d __, 2012 WL 3517590 (7th Cir. 2012).

Investors in a real estate LLC asserted fraud claims against the attorneys who drafted the LLC's formation documents based on the participation of one of the attorneys in a presentation by the promoter. The court concluded the attorneys had no attorney-client relationship with the investors and that the attorneys were not liable on any of the theories asserted by the investors.

The promoter of a venture to buy, rehabilitate, and sell or refinance and rent real estate contacted an attorney, White, to form two LLCs (one of which would be owned by the promoter and two other individuals and the other of which would be owned by the first LLC and investors solicited through private offerings), and White brought in a senior partner, Beaman, who had more expertise in corporate law. The promoter held an investment seminar to present the idea to potential investors, and the promoter talked at length about his investment plan. After about an hour, the promoter asked White whether he would like "to add anything on the creation of the company." White began by addressing a concern raised by a prospective investor about potential conflicts of interest with the promoter's other companies, and White explained that these issues could be addressed in the operating agreement. White also noted that he and his firm were looking into how to avoid certain securities-law concerns issues that might arise from the creation of the LLC and generally explained how structuring the investment venture as an LLC would insulate the investors from personal liability. The promoter added comments in which he stated that the attorneys represented the LLC rather than the promoter personally and "[t]hat means they represent you as well." As co-owners of the LLC, the promoter and the other investors all had interests that needed to be protected and that the attorneys "are working for you just like they are working for me." White stood next to the promoter during these comments and did not make any attempt to clarify or correct them. In the following weeks, Beaman drafted, executed, and filed articles of organization and also drafted operating agreements for both LLCs and loan documents. The plaintiffs invested more than $1 million, and a little over a year later the promoter informed the investors that their investments were gone and he was filing bankruptcy due to the downturn in the real estate market. The investors, believing that the promoter had bilked them, filed suit against the promoter and others, including White, Beaman, and their law firm. Eventually, the only defendants remaining were White, Beaman, and the law firm. The district court granted summary judgment in favor of the defendants, and the court of appeals agreed with the district court that the attorneys could not be held liable on claims for legal malpractice, state and federal securities fraud, actual and constructive fraud, or conspiracy. First the court of appeals held that there was no attorney-client relationship between the defendants and the investors, thus precluding their malpractice and constructive fraud claims. The attorneys were hired to prepare the formation documents for the LLCs and had no further involvement with the companies after they completed this task. The court recognized that there was an attorney-client relationship with the two LLCs, but there were no alleged breaches of duty in the drafting of the LLC formation documents. Most of the plaintiffs never met White, Beaman, or any other member of the firm, and the plaintiffs' relied upon White's presence and participation at the investment seminar and the limited interaction between a few of the plaintiffs and White and Beaman. The court found

White's brief, seven-minute presentation at the investment seminar was insufficient for any investor to reasonably believe the attorneys would be involved in the venture beyond the point of the LLCs' formation. The court also concluded that the promoter's monologue was insufficient to imply an attorney-client relationship. Taken in context, the promoter's statements were intended to assure the investors that the attorneys were hired to represent the two LLCs during their formation, and the potential investors could not reasonably believe they had a personal attorney-client relationship for the indefinite future. The court also stressed that the plaintiffs signed an operating agreement that included prominent language (in all caps right above the signature lines) stating that they had been given the opportunity to review the operating agreement with their legal counsel and/or accountant. The court rejected the argument that the defendants owed them a duty even absent an attorney-client relationship under the Indiana Rules of Professional Conduct. The court stated that the rule addressing dealings with unrepresented persons clearly does not create a legal duty. The absence of a legal duty also impacted the plaintiffs' securities fraud claim. The plaintiffs' based their claim on White's silence as to certain matters during the investment seminar, but an omission cannot be fraudulent absent a duty to speak. The plaintiffs' actual fraud claims revolved around future conduct or existing intent as to future matters, which did not support an actual fraud claim. Finally, the court rejected the plaintiffs' claim that the attorneys conspired with the promoter to commit various torts. There was no evidence the work the promoter hired the attorneys to do was unlawful, and the attorneys had no involvement in soliciting or managing investments. The drafting of the formation documents for the LLC was lawful work for a lawful purpose and was completed before the first investment was made. Thus, even if the promoter acted improperly with respect to the investments, the attorneys could not be liable for acting in concert with the promoter ro commit an unlawful act or to accomplish an unlawful purpose through unlawful means.