THE LAW OF LIMITED LIABILITY COMPANIES AND PUBLIC AUTHORITIES

SUPPLEMENTAL READINGS

Class 12

Professor Robert T. Farley, JD/LLM

WIKIPEDIA

New York state public-benefit corporations

New York state **public benefit corporations** and **authorities** operate like quasi-private corporations, with boards of directors appointed by elected officials, overseeing both publicly operated and privately operated systems. Public authorities share characteristics with government agencies, but they are exempt from many state and local regulations. Of particular importance, they can issue their own debt, allowing them to bypass limits on state debt contained in the New York State Constitution. This allows public authorities to make potentially risky capital and infrastructure investments without directly putting the credit of New York State or its municipalities on the line. As a result, public authorities have become widely used for financing public works, and they are now responsible for more than 90% of the state's debt. The growing influence of public authorities over state and local financing, coupled with their ability to avoid regulations applicable to government agencies, has led to calls for reform. Some reforms were passed in the Public Authorities Accountability Act of 2005.[1] The New York State Authorities Budget Office, in their 2018 annual report, noted that there were 47 state authorities and 531 local authorities - including 109 IDAs and 292 not-for-profit corporations created locally - that they provided oversight for in New York State.[2] According to this same ABO report, the operating expenses in 2017 for the 47 state authorities was $34.82 billion.[3] Additionally, the 47 state authorities carried a total of $160.4 billion in outstanding debt.[4]

Contents

Origins
Incorporation and dissolution
Public authority financing
Public authority governance
Types of public authorities
List of New York state public-benefit corporations
- Class A public benefit corporations in the New York City Metropolitan Area
- Class A public benefit corporations in Greater New York State
- Class B public authorities
- Class C public authorities
- Class D public authorities

Controversy
See also
References
External links

Origins

Public benefit corporations in New York State have origins in mercantile capitalism. A shared tradition of English common law and Dutch law may explain their origins.

The New York Court of Appeals provided a thorough history of state laws regarding public authorities in the 1994 case *Schulz v. State*, 84 N.Y.2d 231 (https://www.law.cornell.edu/nyctap/I94_0127.htm). As the court explained, state debt limits were first enacted as a reaction to fiscal crises caused by the state's lending of its credit to "irresponsible" canal and railroad corporations in the early nineteenth century. The state was forced to assume these obligations, which amounted to more than three-fifths of the state's entire debt. In 1846, a referendum requirement was added to the state constitution, prohibiting the state from contracting long term debt without approval by the voters.

As early as 1851, the legislature began to search for ways to evade the constitutional debt limit in order to finance public works projects. Canal certificates, which would be repaid through canal revenues, and which by their terms were not state obligations, were nevertheless held to be unconstitutional in *Newell v. People*, 7 N.Y. 9 (1852) (http://www.courts.state.ny.us/reporter/archives/newell_people.htm). The court held that the state had a moral obligation to repay the debts if canal revenues proved insufficient, and thus the certificates were deemed "an evasion if not a direct violation of the constitution".

In 1921, the legislature chartered the first state public authority, the Port of New York Authority, as a new vehicle for financing public projects while insulating the state from long term debt obligations. In 1926, the Court of Appeals held in *Williamsburgh Savings Bank v. State*, 243 N.Y. 231, that the state could disclaim any moral obligation for public authority debts. However, amendments to the 1938 Constitution overruled this case and completely disclaimed the state's responsibility for any public authority debt.

The widespread use of public authorities in New York State was pioneered by Robert Moses in the 1930s and 40s. Much of Moses' power base resulted from his tight control of the Triborough Bridge Authority, which allowed him to earmark revenues from tolls on the bridge for other projects in New York City and around the state. He also served as president of the Jones Beach Parkway Authority (1933–1963), president of the Bethpage State Park Authority (1933–1963), and chairman of the New York Power Authority (1954–1962). Moses, through his control of these authorities, was able to build some of New York's most important public works projects, including the Cross Bronx Expressway, the Brooklyn-Queens Expressway, and various bridges and parkways. The public authority model allowed Moses to bypass many of the legal restrictions placed on state agencies, allowing him to expedite development but also allowing him to hide project financing, contracting and operational information from public scrutiny. Because of this, he has been criticized for wasteful spending, patronage, and refusing to consider public opposition to his projects.

The 1938 constitutional amendments attempted to limit the proliferation of public authorities by specifying that they could be created only by special act of the state legislature. By 1956, 53 public authorities had been created. In 1990, the Commission on Government Integrity concluded that "At present, so far as Commission staff has been able to determine, no one has even an approximate count of how many of these organizations exist, where they are, much less an accounting of what they do." By 2004, the Office of the State Comptroller had identified at least 640 state and local authorities.[5] The current count stands at 1,098.[6]

Some of the most well known major public benefit corporations in New York State include the Port

Authority of New York and New Jersey (actually a bi-state authority created by interstate compact), the Metropolitan Transportation Authority, and the Empire State Development Corporation. New York has hundreds of lesser-known public benefit corporations, including Industrial Development Agencies and local development corporations.

The Public Authorities Accountability Act of 2005 created the Authority Budget Office in order "to provide the governor and the legislator with conclusions and opinions concerning the performance of public authorities and to study, review and report on the operations, practices and finances of public authorities...."[1] The ABO is intended to promote transparency and accountability and to improve authority governance.

Incorporation and dissolution

The New York State Constitution, Art. X, sec. 5, provides that public benefit corporations may only be created by special act of the legislature. *In City of Rye v. MTA*, 24 N.Y.2d 627 (1969), the court of appeals explained that "The debates of the 1938 Convention indicate that the proliferation of public authorities after 1927 was the reason for the enactment of section 5 of article X.... Abbott Low Moffat, who supported this proposal, told the convention that its purpose was 'to require the Legislature to pass directly itself upon the establishment of each new authority, and to prevent the enactment of general laws pursuant to which a municipal corporation can itself create a corporation of the authority type'".

While major public authorities can only be created by special legislation, many local development corporations have been created under the general Not-For-Profit Corporation Law. These LDCs function in much the same way as other public benefit corporations and public authorities, but do not need to be established by specific state legislation. Additionally, many public authorities have the power to create subsidiary authorities without additional legislative authorization. An example is the Empire State Development Corporation, which decided in 2007 to dissolve 13 subsidiaries and merge 25 others into a single holding company.[7] ESDC still encompasses many subsidiary organizations.[8]

Public authority financing

The 1938 Constitution "expressly empowered public authorities to contract debt independently of the State".[9] Because of this, the Court of Appeals has repeatedly affirmed that public authorities are distinct from the state and that the state carries no moral obligation to repay their debts. Although the Constitution prohibits the state from lending its credit to public authorities, it does allow the state to make gifts of money to authorities. As a practical result, this has resulted in some authorities receiving annual funding from the state on a consistent basis. Despite the fairly obvious moral obligation that the state carries to continue funding these authorities, which provide incredibly important public services such as road maintenance and transit operations, the Court of Appeals has continued to approve the fiction created by the Constitution's ban on moral obligation debt. As the Court of Appeals stated in *Schulz v. State*, 84 N.Y.2d 231 (1994), if "modern ingenuity, even gimmickry, have in fact stretched the words of the Constitution beyond the point of prudence, that plea for reform in State borrowing practices and policy is appropriately directed to the public arena".[9] *See also Wein v. State*, 39 N.Y.2d 136 (1976); *Wein v. Levitt*, 42 N.Y.2d 300 (1977).

Financing public projects through public authorities is also attractive because their independent corporate structure theoretically makes them more flexible and efficient than state agencies. Many

restrictions placed on state agencies do not apply to public authorities, including, for example, general public bidding requirements (some public bidding requirements do apply under the Public Authorities Law). *See Plumbing, Heating, Piping & Air Conditioning Contr. Ass'n v. N.Y.S. Thruway Auth.*, 5 N.Y.2d 420 (1959). Most public authorities may also make contracts, and because of public authorities' corporate status, there is generally, no remedy against the state for the breach of such contracts. *John Grace & Co. v. State University Constr. Fund*, 44 N.Y.2d 84 (1978). Many public authorities, such as Industrial Development Agencies and the Empire State Development Corporation, can also condemn property.

The New York State Public Authorities Control Board was created in 1976 to provide oversight for some of the state's most powerful authorities.[10] Sections 50 and 51 of the Public Authorities Law currently require 11 authorities to receive approval from the PACB prior to entering into contracts for project-related financing. There are five members on the PACB board, all of whom are appointed by the governor and serve year-long terms.[11]

Public authorities are currently responsible for more than 90% of the state's debt and 80% of the state's infrastructure, leading some to refer to them as the "shadow government."[12]

Public authority governance

Public benefit corporations and public authorities are controlled by boards of directors made up of political appointees. Board members have fixed terms and are, at least in theory, considered to be more independent of political influence than elected politicians and appointed agency heads.[13]

Board members and employees of public authorities usually are not considered to be state employees, but are rather employees of the authority. *Ciulla v. State*, 77 N.Y.S.2d 545 (N.Y. Ct. Cl. 1948). However, public authority employees are covered by the ethics regulations included in section 74 of the Public Officers Law, and the Public Authorities Accountability Act of 2005 imposed additional ethics requirements on board members of some public authorities. Importantly, authority board members are now required to attend training sessions on ethics and governance issues.[13]

Types of public authorities

The New York State Comptroller's Office lists four types of public benefit corporations and authorities:

- Class A — these authorities and public benefit corporations have regional or statewide significance
- Class B — according to the Comptroller's office, these "[e]ntities affiliated [are] with a State agency, or entities created by the State that have limited jurisdiction but a majority of Board appointments made by the Governor or other State officials; entities that would not exist but for their relationship with the State."[6]
- Class C — these public authorities have local application.
- Class D — these authorities and public benefit corporations have interstate or international jurisdiction.

List of New York state public-benefit corporations

For a more complete list, see a list of New York State public-benefit corporations

Class A public benefit corporations in the New York City Metropolitan Area

Below are some of the authorities operating in and around the New York City metropolitan area.

Battery Park City Authority

Fully titled the Hugh L. Carey Battery Park City Authority, according to its official website, the authority is:

> a New York State public benefit corporation whose mission is to plan, create, co-ordinate and maintain a balanced community of commercial, residential, retail, and park space within its designated 92-acre site on the southern tip of Manhattan.

Long Island Power Authority

The Long Island Power Authority or LIPA ["lie-pah"], a municipal subdivision of the State of New York, was created under the Long Island Power Act of 1985 to acquire the Long Island Lighting Company (LILCO)'s assets and securities. A second Long Island Power Authority (LIPA), a wholly owned subsidiary of the first, acquired LILCO's transmission and distribution system in June 1998.

Lower Manhattan Development Corporation

The Lower Manhattan Development Corporation (LMDC) was formed after the September 11 attacks to plan the reconstruction of Lower Manhattan. It was founded by Governor George Pataki and then-Mayor Rudolph Giuliani. The LMDC is a joint State-City corporation governed by a 16-member Board of Directors, half appointed by the Governor of New York and half by the Mayor of New York City.

The development corporation is a subsidiary of the Empire State Development Corporation.

Metropolitan Transportation Authority

The Metropolitan Transportation Authority manages public transportation in the New York metropolitan area (this includes the New York City Subway and MTA Regional Bus Operations systems, as well as the Long Island Rail Road and the Metro-North Railroad).

The MTA includes the following subsidiaries:

- Excess Loss Trust Fund
- First Mutual Transportation Assurance Company
- MTA Capital Construction Company
- MTA Capital Program Review Board
- Long Island Rail Road Company
- Metro-North Commuter Rail Road Company
- New York City Transit Authority & Manhattan & Bronx Surface Transit Operating Authority

- Staten Island Rapid Transit Operating Authority
- Triborough Bridge and Tunnel Authority — famously once a fiefdom of Robert Moses, it had performed, as an independent entity, the collection of tolls and the maintenance of the Triborough Bridge. It today operates all intrastate toll bridges in New York City, and is now a subsidiary of the Metropolitan Transportation Authority.

New York City Economic Development Corporation

The New York City Economic Development Corporation was founded in 1966 as the New York City Public Development Corporation. It is New York City's official economic development corporation.[14]

Overcoat Development Corporation

The Overcoat Development Corporation was founded in the 1980s to lure a men's outerwear company to New York City. It continues to exist today due to a favorable real estate lease it got.

Roosevelt Island Operating Corporation

The Roosevelt Island Operating Corporation's[15] responsibility is to develop Roosevelt Island, a small strip of land in the East River, part of the borough of Manhattan.

Class A public benefit corporations in Greater New York State

Some of the public benefit corporations outside of New York City's metropolitan area, or serving the entire state, are listed below.

Agriculture and New York State Horse Breeding Development Fund

The Agriculture and New York State Horse Breeding Development Fund serves equine interests in New York State and provides education concerning certain agricultural development.

A 2004 audit[16] of the fund found problems with its management.

Dormitory Authority of the State of New York

The Dormitory Authority of the State of New York (DASNY) provides construction, financing, and allied services that serve the public good, to benefit specifically universities, health care facilities, and court facilities.

Empire State Development

The Empire State Development, also known as the Urban Development Corporation, maintains various programs and subsidiaries to encourage economic development in New York State.

Natural Heritage Trust

The Natural Heritage Trust supports natural resource conservation and historic preservation within New York State through the reception and administration of donations and grants. It partners with several state agencies, including the New York State Office of Parks, Recreation and Historic Preservation, New York State Department of Environmental Conservation, and the New York State Department of State; partners also include other public and private entities. The trust was established in 1968.[17] In 2017, it had operating expenses of $1.54 million and a staff of 76 people. Its staffing compensation exceeded its operating expenses in 2017 by almost $1.5 million in the 2018 New York State Authorities Budget Office report.[18]

New York State Thruway Authority

The New York State Thruway Authority maintains the New York State Thruway, a system of limited-access highways within New York State.

New York State Environmental Facilities Corporation

The New York State Environmental Facilities Corporation (EFC) provides low-cost capital, grants, and expert technical assistance for environmental projects in New York State. The EFC has issued more than $13 billion in both tax-exempt and taxable revenue bonds. In 2017, the EFC had operating expenses of $442.35 million, an outstanding debt of $5.917 billion, and a staffing level of 115 people.[19] The EFC's 2009-2010 budget was in excess of $500 million. The statutory basis for substantially all EFC activity stems from Title 12 of Article 5 of the NYS Public Authorities Law (also called the "EFC Act") in 1970.

Capital District Transportation Authority

The Capital District Transportation Authority (CDTA) is a public benefit organization which provides transportation services to the Capital District of New York State (Albany, Schenectady, and Rensselaer counties plus part of Saratoga). The function of CDTA is to operate public transportation as well as to operate the Amtrak stations in the service area (Albany-Rennselaer, Schenectady, and Saratoga Springs).

It includes the following subsidies:

- Access Transit Services
- Capital District Transit System
- Capital District Transit System, Number 1
- Capital District Transit System, Number 2
- CTDA Facilities, Inc.

Central New York Regional Transportation Authority

The Central New York Regional Transportation Authority manages most public transportation in four Central New York counties - Onondaga, Oneida, Oswego and Cayuga. This includes bus service serving the cities of Syracuse, Utica, Rome, Oswego and Auburn. The CNYRTA includes the following subsidiaries:

- CNY Centro, Inc.
- Centro of Cayuga
- Centro of Oswego
- Centro of Oneida
- Call-A-Bus Paratransit Services (operates demand-responsive paratransit service in Onondaga County)
- Centro Parking (operates two state-owned parking garages and various surface lots in the city of Syracuse)
- ITC, Inc. (operates the William F. Walsh Regional Transportation Center in Syracuse)

New York State Bridge Authority

The New York State Bridge Authority owns and operates five bridges on the Hudson River.

Olympic Regional Development Authority

The Olympic Regional Development Authority was designed to administer and manage the Whiteface Mountain Ski Center and the other Winter Olympic venues used during the Lake Placid 1980 Winter Olympics.

New York Power Authority

The New York Power Authority provides electricity throughout New York State.

New York State Canal Corporation

The New York State Canal Corporation is a subsidiary of the New York Power Authority (it was a subsidiary of the Thruway Authority before 2017).[20] It is responsible for the oversight, administration and maintenance of the New York State Canal System,[21] which consists of the Erie Canal, Cayuga-Seneca Canal, Oswego Canal and Champlain Canal. It is also involved with the development and maintenance of the New York State Canalway Trail and with the general development and promotion of the Erie Canal Corridor as both a tourist attraction and a working waterway.

Rochester-Genesee Regional Transportation Authority

The Rochester-Genesee Regional Transportation Authority consists of numerous subsidiaries, including:

- Batavia Bus Service, Inc.
- Genesee Transportation Service Council Staff, Inc.
- Lift Line, Inc.
- Livingston Area Transportation Service, Inc.
- Orleans Area Transit System, Inc.
- Regional Transit System, Inc.

- Renaissance Square Corp.
- RGRTA Maritime Development Corporation
- Seneca Transport Systems, Inc.
- Wayne Area Transportation Service, Inc.
- Wyoming Transportation Service, Inc.

United Nations Development Corporation

The United Nations Development Corporation was designed to assist the United Nations with its real estate and development needs.

Class B public authorities

- Adirondack Park Institute[22]
- New York Racing Association
- Erie County Medical Center Corporation

Class C public authorities

Class C public authorities have local jurisdiction and very few are of significance outside of economic development within towns, villages, and small cities.

New York City School Construction Authority (SCA)

The New York City School Construction Authority's mission is to design and construct public schools for children throughout New York City.

Class D public authorities

Class D public authorities have interstate and international jurisdiction. This is the complete list.

- Buffalo and Fort Erie Public Bridge Authority — an international authority that maintains the Peace Bridge link between Buffalo, New York, and Fort Erie, Ontario.
- Niagara Falls Bridge Commission — international public authority controlling various bridges in the Niagara Falls. The Board of Commissioners has eight members, four appointed by the Ontario Premier and four by the Governor of New York State.
- Port Authority of New York and New Jersey — bi-state agency regulates interstate commerce around the ports of New York and New Jersey; owns bridge and tunnel connections between the two states south of the Tappan Zee Bridge; maintains New York City's airports and Newark International Airport; built the World Trade Center; includes the following subsidiaries:
  - New York and New Jersey Railroad Corporation (operates the Port Authority Trans-Hudson commuter railroad system)[23]
  - Newark Legal and Communications Center Urban Renewal Corporation
  - Port Authority Trans-Hudson Corporation Transitcenter, Inc.

- WTC Retail LLC

Controversy

Some of these corporations, particularly the "authorities," are criticized as being wasteful or overly secretive. There were more than 640 as of 2004 according to a *New York Times* editorial. Some attempts at reform have been made. According to the editorial:

> [New York State Comptroller Alan] Hevesi has offered a comprehensive bill that incorporates some of the best ideas in other legislation circulating in Albany [to reform the authorities]. It would also create a commission to assess whether all 640 authorities set up over the last 80 years still need to exist. The Overcoat Protection Authority, for one, would seem to have had its day.[24]

The Overcoat Protection Authority actually is not the correct name of the entity in question. The correct name of the entity the *Times* was speaking of is the Overcoat Development Corporation,[25] which was designed to lure a clothing manufacturer to New York from Indiana in the 1980s.(Berry, Dan. "The Cold Facts Of Officialdom, Albany-Style," The New York Times, March 20, 2004)

Lack of oversight is a major concern with New York's authorities. According to the Associated Press:

> Out of 643 state and local authorities in New York, only 11 need approval by the Public Authorities Control Board before selling bonds. The comptroller's office gets financial reports from just 53. (Johnson, Mark. "Hevesi proposes reforms for state authorities," Associated Press, February 24, 2004)

In 2004, the New York State Comptroller's Office, headed at the time by Alan Hevesi, became concerned about the debt public authorities were generating:

> Most public authorities have the ability to borrow funds by issuing debt. Total public authority debt reached more than $120.4 billion in 2004, and continues to grow. $37 billion of this debt is State-supported, accounting for more than 90 percent of total outstanding State-supported debt.[26]

See also

- New York's political subdivisions are considered municipal corporations. This includes counties, towns, villages, and cities.
- Public-benefit corporation
- List of New York City lists

References

1. "Archived copy" (https://web.archive.org/web/20121224141416/http://www.abo.ny.gov/abo/Chapter766of2005.pdf) (PDF). Archived from the original (http://www.abo.ny.gov/abo/Chapter766of2005.pdf) (PDF) on 2012-12-24. Retrieved 2012-07-24.
2. "ABO's Annual Report on Public Authorities in New York State" (https://www.abo.ny.gov/reports/annualreports/ABO2018AnnualReport.pdf) (PDF). July 1, 2018. p. 2.

3. "ABO's Annual Report on Public Authorities in New York State" (https://www.abo.ny.gov/reports/annualreports/ABO2018AnnualReport.pdf) (PDF). July 1, 2018. p. 16.
4. "ABO's Annual Report on Public Authorities in New York State" (https://www.abo.ny.gov/reports/annualreports/ABO2018AnnualReport.pdf) (PDF). July 1, 2018. p. 26,28.
5. "Archived copy" (https://web.archive.org/web/20110823204408/http://osc.state.ny.us/press/releases/feb04/publicauthorityreform.pdf) (PDF). Archived from the original (http://www.osc.state.ny.us/press/releases/feb04/publicauthorityreform.pdf) (PDF) on 2011-08-23. Retrieved 2009-11-24.
6. "Archived copy" (https://web.archive.org/web/20051206033429/http://www.osc.state.ny.us/pubauth/byclass.htm). Archived from the original (http://www.osc.state.ny.us/pubauth/byclass.htm) on 2005-12-06. Retrieved 2005-12-09.
7. "Archived copy" (https://web.archive.org/web/20110719063952/http://www.empire.state.ny.us/press/press_display.asp?id=819). Archived from the original (http://www.empire.state.ny.us/press/press_display.asp?id%3D819) on 2011-07-19. Retrieved 2009-12-02.
8. "Archived copy" (https://web.archive.org/web/20110716152435/http://www.osc.state.ny.us/pubauth/data/authorities/UDC_files/UDCSubsidiaries033107.pdf) (PDF). Archived from the original (http://www.osc.state.ny.us/pubauth/data/authorities/UDC_files/UDCSubsidiaries033107.pdf) (PDF) on 2011-07-16. Retrieved 2009-12-02.
9. "Robert L. Schulz, Et Al. V. State Of New York, Et Al" (https://www.law.cornell.edu/nyctap/I94_0127.htm). *Law.cornell.edu*. Retrieved 2016-11-29.
10. "Office of the New York State Comptroller - Thomas P. DiNapoli - Home" (http://www.osc.state.ny.us/pubauth/whatisboard.htm). *Osc.state.ny.us*. Retrieved 2016-11-29.
11. "Nys Dob: About Pacb" (http://www.budget.ny.gov/agencyGuide/pacb/aboutPACB.html). *Budget.ny.gov*. 2014-11-07. Retrieved 2016-11-29.
12. Associated, The (September 3, 2009). "New York's 'shadow government' debt rises to $140 billion" (https://archive.today/20120910185649/http://www.syracuse.com/news/index.ssf/2009/09/new_yorks_shadow_government_de.html). *syracuse.com*. Archived from the original (https://www.syracuse.com/news/2009/09/new_yorks_shadow_government_de.html) on September 10, 2012. Retrieved July 22, 2019.
13. "Archived copy" (https://web.archive.org/web/20110727191122/http://www.publicauthority.org/files/Topic_1_Selection_of_PA_Board_Members.doc). Archived from the original (http://www.publicauthority.org/files/Topic_1_Selection_of_PA_Board_Members.doc) on 2011-07-27. Retrieved 2009-12-02.
14. "History" (https://www.nycedc.com/about-nycedc/history). *NYCEDC*. Retrieved July 22, 2019.
15. "Roosevelt Island Operating Corporation" (http://rioc.ny.gov). *Rioc.ny.gov*. 2014-11-07. Retrieved 2016-11-29.
16. "Agriculture and New York State Horse Breeding Development Fund - Internal Controls Over Financial Operations [Issued 2/15/05] [NY]" (http://www.osc.state.ny.us/audits/allaudits/093005/04s56.htm). *Osc.state.ny.us*. Retrieved 2016-11-29.
17. "Natural Heritage Trust" (http://parks.ny.gov/natural-heritage-trust/). NYS Office of Parks, Recreation & Historic Preservation. Retrieved December 2, 2016.
18. "NYSABO 2018 Report" (https://www.abo.ny.gov/reports/annualreports/ABO2018AnnualReport.pdf) (PDF). November 5, 2018. pp. 16, 44.
19. "NYSABO 2018 Report" (https://www.abo.ny.gov/reports/annualreports/ABO2018AnnualReport.pdf) (PDF). November 5, 2018. pp. 16, 29, 44.
20. "N.Y. POWER AUTHORITY TO ASSUME OWNERSHIP OF CANAL CORPORATION ON NEW YEAR'S DAY" (https://www.nypa.gov/news/press-releases/2017/20170102-nypa-canal-corporation). *NY Power Authority*. Retrieved February 18, 2019.

21. "New York State Canals" (http://www.canals.ny.gov/index.shtml). *Canals.ny.gov*. 2014-11-07. Retrieved 2016-11-29.
22. "Adirondack Park Institute" (https://web.archive.org/web/20051225230219/http://www.adirondackparkinstitute.org/). Archived from the original (http://www.adirondackparkinstitute.org/) on 2005-12-25.
23. "PATH - The Port Authority of NY & NJ" (http://www.panynj.gov/path). *Panynj.gov*. 2013-03-03. Retrieved 2016-11-29.
24. "Everybody Wants Reform" (https://www.nytimes.com/2004/02/28/opinion/28SAT4.html?ex=1132808400&en=6ccb632081463bb2&ei=5070). *The New York Times*. Retrieved 2016-11-29.
25. "Archived copy" (https://web.archive.org/web/20060521203151/http://www.osc.state.ny.us/press/releases/feb05/debtact.htm). Archived from the original (http://www.osc.state.ny.us/press/releases/feb05/debtact.htm) on 2006-05-21. Retrieved 2005-11-22.
26. "Office of the New York State Comptroller - Thomas P. DiNapoli - Public Authorities" (http://www.osc.state.ny.us/pubauth/index.htm). *Osc.state.ny.us*. Retrieved 2016-11-29.

External links

- NYS Office of the State Comptroller list of Public Authorities (https://web.archive.org/web/20180704103915/http://www.osc.state.ny.us/pubauth/data/index.htm)
- NYS Authorities Budget Office list of Public Authorities (https://www.abo.ny.gov/paw/paw_weblistingST.html)
- NYS Authorities Budget Office website (https://www.abo.ny.gov/)

Retrieved from "https://en.wikipedia.org/w/index.php?title=New_York_state_public-benefit_corporations&oldid=996844852"

This page was last edited on 28 December 2020, at 21:58 (UTC).

Text is available under the Creative Commons Attribution-ShareAlike License; additional terms may apply. By using this site, you agree to the Terms of Use and Privacy Policy. Wikipedia® is a registered trademark of the Wikimedia Foundation, Inc., a non-profit organization.

New York State's

Public Authorities

Reform for the 21st Century

New York State Senate

Standing Committee on Corporations, Authorities and Commissions

Senator Vincent L. Leibell, Chair

New York State's

Public Authorities

- *What are they ?*
- *What is their role?*
- *What is their history ?*
- *What have they done ?*

What is a *Public Authority?*

A "public authority" is a public benefit corporation organized by the State of New York to construct, operate or perform a public improvement or public service.

What is the role of *Public Authorities?*

Public Authorities were created to:

**** Finance and Bond;***

**** Build and Construct; and***

**** Operate Things***

What is the history of *Public Authorities?*

***1921:** New York creates the Port of NY Authority – First in NYS;*

***1930's:** Robert Moses employs Public Authorities to battle the great depression, building many New York trademark Bridges, Buildings, Parks and Highways;*

***1938:** NY Constitution amended to require that Public Authorities be established by enactment of the State Legislature;*

***1940's:** Legislature creates dozens of Public Authorities to develop post World War Two New York;*

***1950's:** Constitution amended to provide for debt reform while Legislature creates more Authorities to perform major projects like the Thruway;*

***1960's and 70's:** Legislature tasks Authorities to perform expand transportation education, health care, economic development and urban renewal;*

***1976:** Legislature creates the Public Authorities Control Board to oversee accumulated debt of certain large Public Authorities;*

***1980's and 90's:** New York State expands the use of state and local Public Authorities to perform a number of state public projects.*

What has been done by *Public Authorities?*

Public Authorities have become The Work Horse of State Government

SCHENECTADY
METROPLEX
DEVELOPMENT AUTHORITY

What has been done by *Public Authorities?*

Public Authorities perform and indispensable and irreplaceable role

What has been done by *Public Authorities?*

With out them, so many of the things that make New York the Empire State …

NEW YORK STATE THRUWAY

What has been done by *Public Authorities?*

Without Public Authorities, these things simply might not exist today.

February 9, 2021 | 1:25 pm

COVID-19 Updates

COVID-19 is still spreading, even as the vaccine is here. Wear a mask, social distance and stay up to date on New York State's vaccination program.

GET THE FACTS >

Charitable Organization Financial Report Filings with the Department of State

Forming a Limited Liability Company in New York

Forming a Limited Liability Company in New York State

New York recognizes many business forms including the limited liability company (LLC), corporation, limited partnership, sole proprietorship, general partnership and other less familiar forms. Each has its own advantages and disadvantages. For any particular venture, personal and business circumstances will dictate the business form of choice. The Department of State cannot offer advice about the choice of business form and strongly recommends consulting with legal and financial advisors before making the choice. Forming an LLC should only be done after careful analysis. The following information has been developed to answer your questions regarding formation of an LLC and to assist in the filing of the Articles of Organization.

Department of State staff cannot provide legal advice, however, they are available to assist in answering questions about filing LLC documents. Please contact the Department of State, Division of Corporations, State Records and Uniform Commercial Code, One Commerce Plaza, 99 Washington Avenue, Albany, NY 12231 or a representative at (518) 473-2492 or email us with any questions you may have.

What is a Limited Liability Company?

An LLC is an unincorporated business organization of one or more persons who have limited liability for the contractual obligations and other liabilities of the business. The Limited Liability Company Law governs the formation and operation of an LLC. An LLC may organize for any lawful business purpose or purposes.

The LLC is a hybrid form that combines corporation-style limited liability with partnership-style flexibility. The flexible management structure allows owners to shape the LLC to meet the needs of the business. The owners of an LLC are "members" rather than shareholders or partners. A member may be an individual, a corporation, a partnership, another limited liability company or any other legal entity.

How Do I Form a Limited Liability Company?

Organizers form an LLC by filing the Articles of Organization, pursuant to Section 203 of the Limited Liability Company Law, with the Department of State. Organizers prepare, sign and file the Articles of Organization that creates the LLC. Any person or business entity may be an organizer. Organizers may be, but need not be, a member of the LLC formed.

What is a Professional Service Limited Liability Company?

One or more professionals may form, or cause to be formed, a professional service limited liability company (PLLC) for pecuniary profit for the purpose of rendering the professional service or services that the professionals are authorized to practice. A PLLC is formed by filing Articles of Organization pursuant to Section 1203 of the Limited Liability Company Law. "Profession," as defined in Section 1201(b) of the Limited Liability Company Law, includes any practice as an attorney and counselor-at-law, or as a licensed physician, and those occupations designated in Title Eight of the Education Law. For a listing of professional services, please see NYS Department of Education, Office of the Professions.

Are There Any Special Responsibilities Associated With Forming a Limited Liability Company?

The members of an LLC are required to adopt a written Operating Agreement. See Section 417 of the Limited

Liability Company Law. The Operating Agreement may be entered into before, at the time of, or within 90 days after the filing of the Articles of Organization. The Operating Agreement is the primary document that establishes the rights, powers, duties, liabilities and obligations of the members between themselves and with respect to the LLC. The Operating Agreement is an internal document of the LLC and is not filed with the Department of State. The law is silent on the consequences of not adopting an Operating Agreement. The Department of State cannot provide legal advice regarding the preparation of the Operating Agreement.

What are the Publication Requirements Associated with the Formation of an LLC?

Section 206 of the Limited Liability Company Law requires a copy of the Articles of Organization or a notice related to the formation of most limited liability companies to be published in two newspapers for six consecutive weeks. The newspapers must be designated by the county clerk of the county in which the office of the LLC is located. The newspapers charge a fee for the publication of the notice. The information in the published notice, including the name of the LLC, must match the Department of State's records exactly as set forth in the initial articles of organization. The printer or publisher of each newspaper will provide you with an affidavit of publication. A Certificate of Publication, with the affidavits of publication of the newspapers annexed thereto, must be submitted to the Department of State, with a $50 filing fee. Failure to publish and file the Certificate of Publication with the Department of State within 120 days will result in the suspension of the LLC's authority to carry on, conduct or transact business. Note the exemption in Section 23.03 of the Arts and Cultural Affairs Law.

Do I Need a Lawyer?

Articles of Organization have legal effect and Operating Agreements create legally enforceable rights and responsibilities. Anyone forming an LLC should consider utilizing a lawyer. However, there is no requirement to use a lawyer when forming an LLC.

Where Do I Get a Seal?

The Limited Liability Company Law does not refer to a seal of an LLC. Nevertheless, seals are available from commercial sources and legal stationery stores. The Department of State does not supply seals.

How is a Limited Liability Company Taxed?

Federal tax regulations allow an LLC to elect to be taxed as a corporation or partnership for income tax purposes. Consult a tax adviser about these regulations and any changes. For income tax purposes, state law follows federal law. Additionally, state law imposes a tax based on the number of members of the LLC. Also, depending on the nature of the business it undertakes, the LLC may have to pay or collect sales taxes, withholding taxes and other taxes.

The LLC will need a taxpayer identification number, obtainable from the Internal Revenue Service (http://www.irs.gov/). The IRS can answer questions about paying or withholding federal income tax, social security taxes and other federal taxes.

Questions concerning New York State taxes should be directed to the New York State Department of Taxation and Finance (https://www.tax.ny.gov/), Taxpayer Assistance Bureau, W.A. Harriman Campus, Albany, NY 12227.

Does an LLC Need Licenses and Permits?

Some business activities require licenses or permits from state or local governments, or both. For assistance in identifying whether your business requires any New York State licenses or permits, contact New York Business Express.

Contact the county clerk and the clerk of the city, town or village in which the business will operate with questions regarding local licenses or permits.

Other agencies with useful information include the New York State Department of Labor (https://www.labor.ny.gov/home/) and the New York State Workers' Compensation Board (http://www.web.ny.gov/)

Choosing a Name

First, the name of an LLC must include the words "Limited Liability Company" or the abbreviation "LLC" or "L.L.C." Second, the name of the LLC must be distinguishable from the names of other LLC's, corporations or limited partnerships on file with the Department of State. Third, Section 204 of the Limited Liability Company Law contains a list of words and phrases that are prohibited or restricted in the name of an LLC. In addition, certain words and phrases require the consent or approval from other state agencies prior to filing the Articles of Organization with the Department of State.

To determine whether a proposed limited liability company name is available prior to filing the Articles of Organization with the Department of State, you may submit a name availability inquiry or reserve a name by filing an Application for Reservation of Name. Note that a finding that the name is available or the filing of an Application for Reservation of Name is not an approval of the name by the Department of State. A final determination is not made until the Articles of Organization are reviewed and filed by the Department of State. No expenditure or other commitment should be made in reliance upon the name availability inquiry or the filing of an Application for Reservation of Name.

Instructions for Completing the Articles of Organization

The Department of State must make a reproducible official record from the completed Articles of Organization offered for filing. The Department will not accept papers incompatible with its recording technology. All entries and signatures should be typewritten or in black ink on white paper. Avoid dark paper, small or light type, outline or condensed fonts, colored inks, etc.

Name

There are three instances on the form where you are required to provide the name of the LLC. The name MUST be typed exactly the same in all three places. Enter the name of the LLC in the space in the title. Also enter the name in Article First and in the title of the document on the last page of the form. The name must be exactly the same in all three places.

County Location

The Articles of Organization must designate the county within New York State where the LLC's office will be located. Enter only the name of a county in New York State. Do not include the street address. In New York City, the borough of Manhattan is in New York County, the borough of Brooklyn is in Kings County and the borough of Staten Island is in Richmond County. Bronx and Queens are both a borough and a county.

Designation for Service of Process

The LLC must designate the Secretary of State as its agent for service of process. Provide an address to which the Secretary of State may mail a copy of any process received. "Process" means the papers that acquire jurisdiction of the LLC in a legal action.

Signature

The organizer must sign the Articles of Organization and print their name in the space provided opposite the signature.

Filer

Provide the name and address of the filer of the Articles of Organization. The Department of State will issue an official filing receipt to the filer of the Articles of Organization.

Additional Information

Filing Fee

The fee for filing the Articles of Organization is $200. The fee may be paid by cash, check, money order, MasterCard, Visa or American Express. Checks and money orders should be made payable to the "Department of State." Do not send cash through the mail. To pay the filing fee using a credit/debit card complete and sign the Credit Card/Debit Card Authorization Form (pdf). Expedited Handling Services and certified copies are available for an additional fee.

Filing the Articles of Organization

• By mail, send the completed Articles of Organization with the filing fee of $200 to the New York State Department of State, Division of Corporations, State Records and Uniform Commercial Code, One Commerce Plaza, 99 Washington Avenue, Albany, New York 12231.

• In person, deliver the Articles of Organization to the above address. The Division of Corporations, State Records and Uniform Commercial Code is on the 6th floor and is open from 9:00 a.m. to 4:30 p.m., Monday through Friday.

• By fax, you may fax the Articles of Organization along with a Credit Card/Debit Card Authorization Form to the Division of Corporations, State Records and Uniform Commercial Code at (518) 474-1418.

• Online filing

Filing Receipt

The Department of State issues an official filing receipt to the filer of the Articles of Organization. The filing receipt reflects the date of filing, the name of the LLC, an extract of information provided in the Articles of Organization, and an accounting of the fees paid. Filers should verify that this information is correct. The filing receipt is your proof of filing. The Department of State does not issue duplicate filing receipts to replace those lost or destroyed.

Please note that the filing receipt and certified copy, if requested, will be returned by first class mail by the United States Postal Service. The filing receipt and certified copy, if requested, are mailed separately. We do not provide these documents by fax. You may request that your filing receipt and certified copy be returned to you by overnight delivery service by including a prepaid shipping label with your request. The Department of State will not accept prepaid shipping labels with the Department of State listed as the sender. The prepaid shipping label must list yourself as the sender and the receiver.

Filing receipts and related documents for online filings are emailed to the email address provided at the time of filing.

Contacting the Division of Corporations

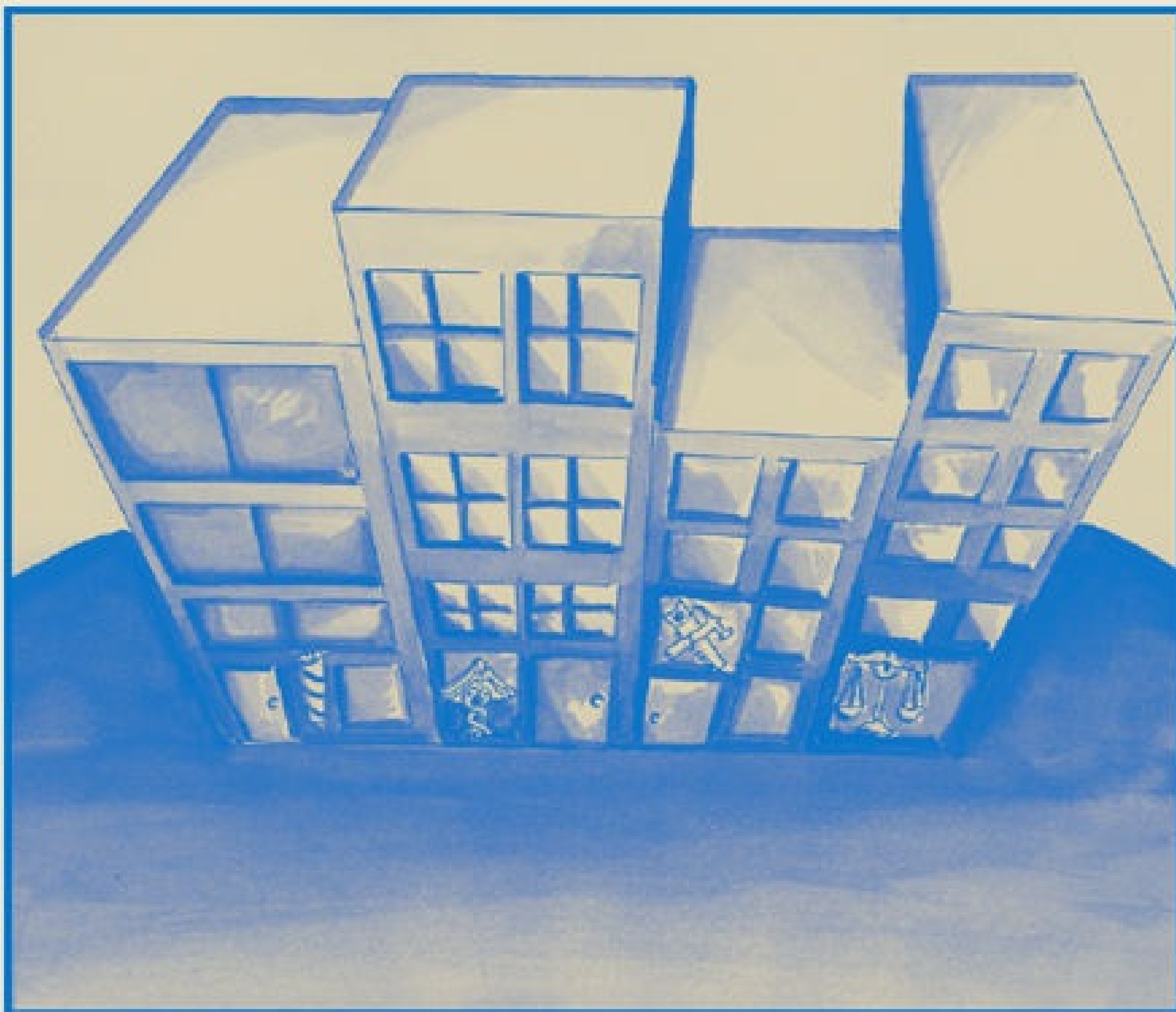
If you require technical advice or have any questions regarding the filing of your Articles of Organization, please contact the New York State Department of State, Division of Corporations, State Records and Uniform Commercial Code, One Commerce Plaza, 99 Washington Avenue, Albany, NY 12231. The telephone number of the Division is (518) 473-2492, or contact us via email.

EXAMPLES & EXPLANATIONS

Agency, Partnerships, and LLCs

Fifth Edition

Daniel S. Kleinberger



Wolters Kluwer

EXAMPLES & EXPLANATIONS

Agency, Partnerships, and LLCs

CHAPTER 13

Introductory Concepts in the History and Law of Limited Liability Companies, LLPs, and LLLPs

§13.1 THE CONTEXT

§13.1.1 The Modern Landscape for Unincorporated Business Organizations

Before 1988, the U.S. world of unincorporated business organizations had two main players:[1] ordinary general partnerships and ordinary limited partnerships.[2] Today, most general partnerships should be limited liability partnerships (LLPs), and many states have revised their limited partnership statutes to provide for limited liability limited partnerships (LLLPs). Even more fundamentally, an entirely new form of entity dominates the world of unincorporated businesses and has outpaced the corporation as the vehicle of choice for businesses whose ownership interests are not publicly traded.

The limited liability company (LLC) is a hybrid form of business entity that combines the liability shield of a corporation with the federal tax classification of a partnership. A creature of state law, each LLC is organized under an LLC statute that creates the company, gives it a legal existence separate from its owner or owners (called "members"), shields those

members from partner-like vicarious liability for the entity's obligations, and governs the company's structure, management, and operations (subject in most respects to the members' "operating agreement"). The essence of an LLC is the coexistence of partnership tax status with corporate-like limited liability.

§13.1.2 The Driving Force: The Tax-Shield Conundrum

The driving force behind the development and spread of the limited liability company has been the desire to solve the "the tax-shield conundrum," that is, to create an entity that:

- as a matter of non-tax, state law shields all the entity's owners from the automatic personal liability of a general partner; while
- as a matter of tax law is classified as a partnership with each owner treated as a partner.

To understand the tax-shield conundrum requires understanding the characteristics of the corporate liability shield and the advantages of partnership tax classification.

a.Corporate Liability Shield

In a corporation, the owners (called "shareholders" or "stockholders") are not, merely on account of ownership status, liable for the obligations of the corporation. They are thus "shielded" from the automatic liability by status which comes with being a partner in an ordinary general partnership[3] or a general partner in an ordinary limited partnership.[4]

Example

> Athos, Porthos, and Aramis form a corporation ("Fencing, Inc.") to teach fencing. They are its shareholders, and, as shareholders, they elect themselves to the corporation's board of directors.[5] The board elects Athos as Chief Executive Officer, Porthos as Executive Vice President, and Aramis as Chief Financial Officer. Acting through one of its duly authorized officers, the corporation then rents a building to

serve as its headquarters and teaching center. Under agency law principles, the corporation is bound to the lease.[6] Athos, Porthos, and Aramis, in contrast, are not. Shareholders *qua* shareholders are not personally liable for corporate obligations. ◄◄◄

Example

Same facts, except Athos, Porthos, and Aramis form an ordinary general partnership. They are each personally liable on the lease. ◄◄◄

Example

Same facts, except Athos, Porthos, and Aramis form an ordinary limited partnership, with Aramis as the sole general partner. Athos and Porthos do not involve themselves in managing the business, although they are employed as fencing instructors.[7] Aramis is personally liable on the lease; Athos and Porthos are not.◄◄◄

The shield does not protect a shareholder from liability resulting from the shareholder's own conduct, and the "shield" protects the shareholders, not the corporation. Nonetheless, common usage refers to "the corporate shield" or "the corporation's shield" or "the corporate liability shield."

Example

Acting as an employee of Fencing, inc., Porthos gives fencing lessons to individual students. Distracted by personal concerns, he negligently inflicts a leg wound. The corporate shield is irrelevant to the student's tort claim against Porthos, which has nothing to do with Porthos's status as a shareholder but rather arises from his own tortious conduct. Likewise, the shield is irrelevant to the student's *respondeat superior*[8] and direct liability claims against the corporation.[9] ◄◄◄

The corporate shield is not completely impermeable. When a dominant shareholder has abused the corporate form, in the interests of justice courts will "pierce the veil" and impose on the shareholder personal liability for the corporation's debts. Piercing claims are rarely successful, however, and the corporate shield is a fundamentally important advantage of the corporate

form of business organization.[10]

b. Partnership Tax Classification

All business organizations are subject to the provisions of the internal Revenue Code concerning income tax.[11] A threshold question under those provisions is whether a business organization will be classified (and therefore taxed) as a partnership or a corporation.

In most situations partnership tax status is preferable, because corporate shareholders face "double taxation" on any dividends they receive. An ordinary C corporation[12] is a taxable entity; it pays corporate income tax on any profits it earns. Dividends to shareholders are therefore made in "after-tax" dollars. Nonetheless, dividends are also taxable as received by the shareholders. Thus the profits comprising corporate dividends are taxed twice.

Partners do not suffer double taxation, because a partnership is not a taxable entity. For income tax purposes, partnerships are "pass-through" structures, with the business' profits (whether distributed or not) allocated and taxable directly to the partners. Partnership losses also "pass through" and can serve as deductions on each partner's own tax return. In contrast, the losses of an ordinary corporation stay with the entity and are useful only if the entity later enjoys a profit.

Example

> In its most recent taxable year, Fencing, Inc., a C corporation, made a profit of $100,000 and would like to distribute all its profits to its shareholders. Assuming a corporate income tax rate of 25 percent, an individual tax rate of 20 percent, and that Athos, Porthos, and Aramis own the same number of shares of stock (and therefore share dividends equally), the calculations and results are:

Taxable Corporate Profit	100,000
Less Corporate Income Tax	(25,000)
Available for Distribution	75,000
Dividend to Each Shareholder	25,000
Less Individual Income Tax	(5,000)

Net to Each Shareholder	20,000
The Federal Government's "Take" (Corp. 25,000; Ind. 3 × 5,000)	**40,000**
"After Tax" Net to the Shareholders	**60,000 ◄◄◄**

Example

> Same facts, including the intent to distribute all its profits to the owners, except that Athos, Porthos, and Aramis have formed a partnership.[13] The calculations and results are:

Profit	100,000
No Partnership Income Tax	(0)
Profits Available for Distribution	100,000
Profits Allocated and Distributed to Each Partner	33,333[14]
Less Individual Income Tax	(6,667)[15]
Net to Each Partner	26,666
The Federal Government's "Take" (Ind. 3 × 6,667)	**20,001**
"After Tax" Net to Partners	**79,998[16]**

13.1 Comparison of Examples

	Corporation	Partnership
Federal government's "take"	40,000	20,001
Owners' "after tax" net	60,000	79,998 ◄◄◄

A partnership's "pass-through" character brings other advantages as well; the disadvantage has always been on the non-tax side, that is, personal liability. Before the invention of limited liability companies,[17] the cost of obtaining partnership tax classification was having at least one partner automatically liable for the business's debts. Put another way, entrepreneurs who wanted the full corporate shield had to pay some form of tax cost for the protection. In its simplest manifestation, that cost consisted of double taxation of a business's profits. Thus: the tax-shield conundrum.

§13.1.3 Dealing with the Conundrum — Pre-LLC

Before the advent of the LLC, entrepreneurs could resort to an ordinary limited partnership with a corporate general partner in order to achieve partnership tax status while minimizing liability risk.[18] To obtain a full corporate shield while achieving some of the advantages of partnership tax status, entrepreneurs could use an S corporation[19] or try to "zero out" the profits of a C corporation. None of these approaches were fully satisfactory.

a.Ordinary Limited Partnerships with a Corporate General Partner

Typically under this approach, a corporation would be formed for the sole purpose of serving as a limited partnership's general partner. This approach had a number of disadvantages, including: (i) complexity; (ii) a significant risk of "piercing" for the corporate general partner, unless that corporation had assets of its own (thereby diverting capital from use in the limited partnership's business); (iii) tax classification issues, unless the corporate general partner had assets of its own; (iv) difficult questions of fiduciary duty pertaining to the officers of the corporate general partner (because, as a formal matter, those officers owed duties to the corporation, but as a practical matter they were managing and typically controlling the limited partnership); and (v) before ULPA (2001), the "control rule," which impeded power-sharing by limited partners, even when "the deal" could be made only on that basis.[20]

b. S Corporations

An S corporation provides a full corporate liability shield with some of the benefits of pass-through tax status. Like a partnership, an S corporation generally pays no tax on its earnings, and its profits and losses are passed through and taxed directly to its shareholders.[21] However, S corporations face significant constraints that do not apply to partnerships.

1. Restrictions on Owners

For most practical purposes, all shareholders in an S corporation must be either U.S. citizens or resident aliens. Subchapter S therefore rules out a long list of potential owners and investors, including corporations, investment banks, venture capital firms, and most foreign nationals. Moreover, an S corporation may not have more than 100 shareholders.

2. Restrictions on Businesses

Subchapter S also rules out a long list of business types and structures. For example, a corporation may not obtain or retain S status if it is a foreign corporation, a bank or savings and loan association, or an insurance company.

3. Restrictions on Financial Structure

An S corporation may have only one class of stock. This requirement precludes flexible allocations of profits, restricts the type of debt the corporation may issue, hampers efforts to gradually shift control of family-owned businesses, and, in general, makes passive investment very difficult to structure.[22]

4. Untoward Consequences for Owners

Unlike a partnership, an S corporation is not a complete pass-through entity. As a result, S corporations contain a number of traps for the unwary. For example, distributions to shareholders of appreciated property trigger a gain to the corporation and hence to the shareholders.[23]

c. C Corporations and “Zeroing Out”

A corporation that cannot elect S status, or chooses not to do so, can try to avoid double taxation by “zeroing out.” To “zero out,” the C corporation makes ostensibly deductible payments to shareholder-employees, thereby reducing or eliminating corporate profits. These payments can be made in a number of ways; the simplest are salaries and bonuses.

This approach is not risk-free, however. The IRS may view the payments as disguised dividends, especially where: (i) the payments are excessive

compared with the value of the services rendered to the corporation;[24] (ii) the payments are proportional to the shareholders equity interests;[25] or (iii) capital is a material income-producing factor for the business and the corporation is not paying reasonable dividends.[26] Even when successful, zeroing-out techniques provide none of the other advantages of passthrough tax status.

§13.1.4 Invention and Development of the LLC

a.Wyoming Starts a Revolution

Wyoming began the LLC revolution by taking seriously the IRS's "Kintner" Regulations on tax classification. Before January 1, 1997, those regulations determined how to classify unincorporated business organizations and were biased toward finding partnership status. The regulations identified four key corporate characteristics (limited liability, continuity of life, free transferability of ownership interests, centralized management), and classified an unincorporated organization as a corporation only if the organization had three or more of the corporate characteristics.

Although limited liability may seem to be the hallmark corporate characteristic, the Kintner Regulations contained no "super" factor. Each characteristic was as significant as each other.

In 1977, the Wyoming legislature sought to exploit that aspect of the Kintner Regulations in order to resolve the "tax-shield conundrum." The Wyoming LLC Act provided for a new form of business organization, with a full, corporate-like liability shield and partnership-like characteristics as to entity management, continuity of life, and transferability of ownership interests. Like a general partnership, a Wyoming LLC was managed by its owners (not centralized management). Like a limited partnership, a Wyoming LLC risked dissolution if one of its owners ceased to be an owner (no corporate-like continuity of life). As with any partnership, Wyoming LLC ownership interests were not freely transferable; absent a contrary agreement, an LLC member had the right to transfer only the economic aspect of the ownership interest (no free transferability of ownership interests).

The corporate-like liability shield was the sole characteristic pointing to corporate tax status. If the Kintner Regulations meant what they said, then a

Wyoming LLC would be accorded partnership tax status.

b.IRS Response to Wyoming; Common Characteristics of Early LLCs

The IRS took more than 10 years to acknowledge the consequences of its own tax classification regulations. Revenue Procedure 88-76 classified a Wyoming LLC as a partnership, and caused legislatures around the country to consider seriously the LLC phenomenon. For the most part, Wyoming's early emulators were faithful copiers, imposing through their LLC statutes the same basic structure as ordained in the Wyoming statute. The major innovation was to establish an alternative governance template for manager-management (modeled on the limited partnership structure), while continuing to set the "default mode" as member-management.

Fidelity to the Wyoming model gave the earliest LLCs some common characteristics—at least to the extent they followed the default blueprint of their respective LLC statutes. In the default mode, an LLC:

- was managed by its members in their capacity as members
  —under the Kintner Regulations—no centralized management (like a general partnership)
- was threatened with dissolution each time a member dissociated
  —under the Kintner Regulations—no continuity of life (like a limited partnership with respect to the dissociation of any general partner)
- allowed its members to freely transfer the economic rights associated with membership, but prohibited them from transferring their membership interest in toto (or any management rights associated with membership) without the consent of all the other members
  —under the Kintner Regulations—no free transferability of interests (like both a general and limited partnership)

c.Increasing Flexibility of Form; IRS Bias Toward Manager-Managed LLCs

This characteristic picture began to lose focus in 1989 as the IRS began to loosen its approach to tax classification. In a series of public and private rulings, the IRS allowed for increasing flexibility of form, especially as to the continuity of life characteristic (i.e., the nexus between member dissociation and at least the threat of entity dissolution). This characteristic had done much to keep a "family resemblance" among LLCs because, until 1989, every LLC "blessed" by the IRS had lacked that characteristic. Beginning in 1989, the IRS began to accept both: (i) a shrinking of the categories of

member dissociation that threatened dissolution; and (ii) a decrease in the quantum of member consent necessary to avoid dissolution following member dissociation. As a result, LLC organizers had a greater variety of structures from which to choose.

At the same time, however, the IRS's pronouncements on continuity of life and free transferability of interests were conducing toward a new characteristic LLC structure. Beginning with Private Letter Ruling 9210019, the IRS revealed a bias toward manager-managed LLCs.[27] In contrast to a member-managed LLC, a manager-managed LLC could achieve partnership tax status while enjoying significant protection from business disruption and significant control over member exit rights. In both official and unofficial ways, the IRS suggested that, for purposes of tax classification, LLCs were properly analogized to limited partnerships rather than to general partnerships.

In 1994, the IRS issued Revenue Procedure 95-10 and made its suggestion a matter of policy. Revenue Procedure 95-10 purported to provide guidelines for LLCs seeking advance assurance of partnership tax status under the Kintner Regulations, but in essence merely provided a series of safe harbors. Those safe harbors rested heavily on the limited partnership analogy.

d. "Check the Box" and the End to Family Resemblance

Revenue Procedure 95-10 might well have pushed LLCs into the limited partnership mold if the IRS had not subsequently decided to do away with the Kintner Regulations entirely. Effective January 1, 1997, the Treasury Department adopted a "check-the-box" tax classification regime under which, in general:

- a business organization organized under a corporate or joint stock statute is taxed as a corporation;
- any other business organization:
  - with two of more owners is taxed as a partnership; and with one owner is disregarded for income tax purposes;
- unless the organization elects to be taxed as a corporation (by "checking the box").[28]

Thus, "check the box" severed the connection between tax classification and organizational structure and invited entrepreneurs (and their attorneys) to specially tailor the structure of an LLC as each "deal" might require.[29]

"Check the box" also resulted in widespread changes to LLC statutes, as states moved quickly to take advantage of the newly permitted flexibility. These changes included:

- eliminating the requirement that an LLC have at least two members (like a general or limited partnership) and authorizing one-member LLCs;
- authorizing operating agreements in one-member LLCs;[30]
- allowing LLCs to have perpetual existence;
- changing the default rule on member dissociation to make dissociation more difficult, either by:
  - — depriving members of the power to dissociate; or
  - — freezing in the economic interest of dissociated members; and
- changing the default rule on the relationship between member dissociation and entity dissolution, either by:
  - — providing that member dissociation does not even threaten dissolution; or
  - — changing the quantum of consent necessary to avoid dissolution following a member's dissociation.

States did not, however, change the default rules on transferability of ownership interests.

§13.1.5 Common Elements of Contemporary LLCs; Range of Variations

a.Common Elements

Despite the great flexibility brought on by the "check-the-box" regulations, it is possible to identify some essential LLC characteristics and to describe a range of possibilities for other important attributes. Even after "check the box," every LLC:

- is organized under a state statute other than a corporation statute, which:
  - —allows the LLC to exist as a legal person separate from each of its members (owners); and
  - —provides rules (most of them "default" rules) for structuring, governing, and operating the entity;
- comes into existence through the filing of a specified public document with a specified state agency;
  - —the document's name varies from state to state; however, almost without exception the name refers to the document either as "articles" or a "certificate" of"organization" or "formation"; but
  - —the difference in nomenclature neither reflects nor implies a difference in legal meaning;[31]
- exists as a legal entity, separate from its owners;

- need not have a specified term of existence and may instead have “perpetual” existence;
- may participate in mergers and other similar “entity” transactions;
- has a full, corporate-like liability shield to protect its owners against automatic, vicarious liability for the debts of the enterprise; and
- refers to the fundamental governing agreement among members as the “operating agreement” and gives that the agreement powers and a permissible scope parallel to those of a partnership agreement.[32]

Example—Formalities of Formation

Three individuals, Voltaire, Rousseau, and Marat, go into business with the expressed intention of forming a limited liability company under the law of State X. They draft and sign articles of organization, and Marat is given the task of actually submitting the document to the Secretary of State of State X. Unfortunately, Marat drops the document in his bath, is too embarrassed to tell Voltaire or Rousseau, and never submits the document. The business is conducted as if the papers had been submitted, accepted, and filed. In all its dealings with third parties, the business styles itself VRM, LLC. The business is not an LLC. To create an LLC requires the filing of articles.[33] ◂◂◂

Case in Point—Reid v. Town of Hebron (Significance of Separate Person)

“On May 19, 1993, the plaintiff [Reid] applied to the Commission for a [building] permit to build a single-family seasonal dwelling on the plaintiff’s property. . . . On October 19, 1993 [after a public hearing], the Commission denied the plaintiff’s application for a permit . . . [and the plaintiff timely appealed to the court]. A party appealing a decision of a municipal land use agency must be ‘aggrieved’ by the agency’s decision. . . . The question of aggrievement is essentially one of standing. ... At the hearing on September 3, 1996, evidence was proffered to show that the plaintiff transferred his interest in [the] lot ... to M & A Investments, LLC, ... a limited liability company, of which, [plaintiff] is a 50 percent owner. . . . The plaintiff [thereby] . . . transferred his interest in the property to another party who was not a party before the Commission and not a party to this action. Therefore, the plaintiff is not aggrieved.” (Plaintiff was not the owner of the land. The LLC was.)[34] ◂◂◂

Case in Point—All Comp Constr. Co., LLC v. Ford (Significance f Separate Person)

> A contractor sued a subcontractor for damages, including emotional distress. The court rejected the emotional distress claim outright, stating: "[The contractor] is a limited liability company. As such, its owners are entitled to certain legal rights and protections. It is a fictional 'person' for legal purposes. [The contractor] has cited no authority which would allow it to be treated as a natural person that would be capable of experiencing emotions such as mental stress and anguish. The damages, if any, due to [the contractor] from [the subcontractor], are due to it as a fictional person, and may not be recovered by its owners. . . ."[35] ◄◄◄

Uniform Act on Point—Role of the Operating Agreement:

> ULLCA (2013) §102(10) defines "operating agreement" as: "the agreement, whether or not referred to as an operating agreement and whether oral, implied, in a record, or in any combination thereof, of all the members of a limited liability company, including a sole member, concerning the matters described in Section 105(a) [describing the permissible scope of an operating agreement]."

An official comment further explains:

> The definition in Paragraph 13 is very broad and recognizes a wide scope of authority for the operating agreement: "the matters described in Section 105(a)." Those matters include not only all relations inter se the members and the limited liability company but also all "activities and affairs of the company and the conduct of those activities and affairs." Section 105(a)(3). Moreover, the definition puts no limits on the form of the operating agreement. To the contrary, the definition contains the phrase "whether oral, implied, in a record, or in any combination thereof."

b.Range of Variations

Under all LLC statutes, rules pertaining to an LLC's internal structure (e.g., management rights, financial rights) are "default rules"—that is, applicable only to the extent the operating agreement does provide otherwise. The

resulting flexibility is one of the great attractions of the LLC form. LLC governance structure runs the gamut from a New England townmeeting style (with decisions made through discussion and consensus among all members) to an enterprise dominated autocratically by a single managing member. Some LLCs use corporate-style governance,[36] and two state LLC statutes formerly provided that arrangement as the default structure. Most LLC statutes dichotomize governance between "member- managed" LLCs and "manager-managed" LLCs, with:

- governance in a member-managed LLC resembling governance in a general partnership; and
- governance in a manager-managed LLC resembling governance in a limited partnership.[37]

Great flexibility exists as to the rights and roles of LLC members in the LLC. To comply with IRS tax accounting requirements for partnerships, members' interests must continue to reflect a capital account and profit and loss-sharing percentages. In other respects, however, there is no paradigmatic construct. In some LLCs, members are unremittingly passive—their governance rights scant and their financial rights preferred.[38] Other members have a "hands-on" role in their LLC. Depending on the operating agreement, that role ranges from intermittent to constant; responsibilities range from the most senior, supervisory of management duties to the most prosaic of day-to-day work.

Example

> Hobbes, LLC is a manager-managed LLC with five members and a single manager. According to the LLC's operating agreement, the manager, who is also a member, has "full and complete authority to make all decisions concerning the operations and business of the LLC, except: (i) requiring members to make additional contributions; (ii) selling all or substantially all of the company's assets or taking or failing to take any other action that makes it impossible to carry on the company's business; and (iii) dissolving the Company." ◂◂◂

Example

> Jefferson, LLC is a member-managed LLC with five members.

> According to the LLC's operating agreement, "the Company will be managed exactly as if the Company was a general partnership organized under the Revised Uniform Partnership Act, and each member will have the same rights to manage and participate in the business as if she, he, or it were a partner in a general partnership organized under the Revised Uniform Partnership Act." ◂◂◂

---

§13.2 VARIATION AMONG LLC STATUTES; CONSEQUENCES §

§13.2.1 Variations Among State LLC Statutes

The 50 states and the District of Columbia each have their own limited liability company statutes. In some ways, all LLC statutes resemble each other, for example, in the formalities involved in forming a limited liability company, the importance of the operating agreement to structuring the "deal" among the members, the partnership-like concept of dissolution and winding up, etc. Moreover, most provisions of an LLC statute pertain to internal affairs and, with some limitation, are merely default rules, i.e., applicable only if the company's operating agreement does not provide otherwise. In addition, all LLC statutes tend to address the same topics, even though one statute might take one approach to a particular topic while another statute might take a significantly different approach.

Still, "once you've read one LLC statute," you have certainly not read them all. However, a book of this size and nature cannot "cover the waterfront" and discuss 51 different statutes.[39]

The most efficient vehicle for exemplifying LLC issues is necessarily a uniform act. For several reasons, this book focuses principally on the most recent uniform act: ULLCA (2013):[40]

- Versions of ULLCA (2006) or (2013) have been adopted in 17 states and the District of Columbia. Many of the adopting states or of substantial commercial consequence, e.g., California, Florida, Illinois, New Jersey, and Pennsylvania.
- ULLCA (2013) reflects the most up-to-date, coherent, and comprehensive thinking on issues related to LLC law.

—The ULC promulgated its original Uniform Limited Liability Company Act in 1996.

—By 2004, when the ULC began drafting what became ULLCA (2006) (then known colloquially as the Re-ULLCA or RULLCA), an opportunity existed for significant improvements in the law. Many tax classification complexities had disappeared, many important non-tax issues had crystalized, and "[it was] an opportune moment to identify the best elements of the myriad 'first generation' LLC statutes and to infuse those elements into a new, 'second generation' uniform act."[41] The Re-ULLCA drafting committee benefitted from excellent advice from a group of experienced advisors from the American Bar Association and observers from various backgrounds.

—The Harmonization Project, which began in 2009 and produced ULLCA (2013),[42] used ULLCA (2006) as its lodestone, made few policy changes, but did find opportunities to improve statutory language as to both clarity and coherence. In addition to benefitting from input from ABA advisers and various observers, ULLCA (2013) also reflects detailed review by state bar committees in Florida and Pennsylvania.

—ULLCA (2006) contained detailed official comments useful for bringing neophytes quickly up to speed on the numerous issues addressed by the act. ULLCA (2013) has improved and extended those comments, which comprise a very useful source of information and understanding.

—ULLCA (2013) is the most current uniform limited liability company act.

One non-uniform LLC statute requires special note, and Section 13.2.2 addresses specifically the attractions, influence, and dangers of the Delaware LLC Act.

§13.2.2 Delaware Law

a.The Preeminence of Delaware Law

Although Wyoming, not Delaware, pioneered the modern limited liability company, many practitioners consider the Delaware LLC Act the statute of choice for sophisticated ventures organized as LLCs. Moreover, in many deals involving entrepreneurs or investors from more than one state, the lawyers routinely "default" to using the Delaware LLC statute rather than the LLC statute of any of the states actually involved in the deal.[43]

b.Reasons for the Preeminence[44]

1.Not the Inherent Quality of the Delaware Statute

The Delaware Limited Liability Company Act is a complex, sophisticated,

and eminently flexible statute that exalts freedom of contract even to the point of permitting an operating agreement to eliminate some or all fiduciary duties. However, the act's attractiveness has little to do with its inherent qualities.

To the contrary, the act's drafting style is arcane: substantive requirements embedded in definitions, sentences in which length seems a virtue, and provisions that overlap and intertwine so as to require substantial efforts of deconstruction. As Delaware's own Supreme Court has stated, "To understand the overall structure and thrust of the Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly."[45]

As for substance, many other states have statutes offering comparable flexibility and an essentially equal commitment to enforcing agreements made by LLC members. The Delaware act does stand out by authorizing an operating agreement to eliminate all fiduciary duties, but (i) two of Delaware's leading jurists have criticized that approach as resting on false premises and being otherwise misguided;[46] and (ii) the implied contractual covenant of good faith and fair dealing remains in place to constrain unduly opportunistic behavior.[47]

2.The Inherent Quality of the Delaware Judiciary

Why, then, do many non-Delaware practitioners choose Delaware when forming LLCs? The answer lies in the reputation of the Delaware judiciary. The Delaware Court of Chancery has jurisdiction over claims relating to the internal affairs of a Delaware LLC, and that court is the preeminent business court in the United States. It is comfortable with business disputes and is capable of handling esoteric and even arcane issues of law. The Delaware Supreme Court is likewise; many of its judges previously served in the Court of Chancery.

Both the Chancery Court and the Delaware Supreme Court accept and adhere to the policy of the Delaware Act "to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." Indeed, Delaware courts are conservative about contracts in general. They lean away from modernist notions that all agreements are necessarily indeterminate and toward the old-fashioned approach that a contract is a contract and that a court is not a proper forum for

salving the pain from a “buyer’s remorse.”

c.But Don’t Dabble in Delaware

Despite its ubiquitous influence,[48] the Delaware LLC Act is not safe for use by attorneys who merely “dabble in Delaware.” The Act excels in flexibility rather than guidance, and, as noted above, the drafting is byzantine, yielding meaning only after reiterative study (which must take into account statutory changes made annually).

Keeping pace with relevant Delaware LLC case law is almost a full-time job. Being a court of equity, the Court of Chancery often ladens its decision with voluminous statements of facts. Fifty page decisions are not unusual. For some years the most important decision dealing with good faith took up 200-plus pages.

Moreover, a “Delaware LLC lawyer” must stay up to date on more than just LLC law; Delaware LLC and limited partnership law are reciprocally precedential. Knowledge of Delaware contract law is also essential. For example, when an attorney is asked for a formal legal opinion pertaining to a Delaware limited liability company, “[i]t is . . . the responsibility of the opinion-giver to navigate Delaware common law [especially contract law] prior to rendering a Delaware LLC opinion, and to keep abreast of its shifting landscape.”[49]

And sometimes—somewhat unpredictably—a “Delaware LLC lawyer” must take into account current developments in Delaware corporate law. On more than one occasion, the Court of Chancery has applied that law to resolve a dispute among members of a Delaware LLC.

In short, Delaware LLC law is important and influential, but, for the *noncognoscenti* quite dangerous.

problem 113

Under local law “a person may represent him or herself in court, but no person who is not an attorney licensed to practice in this state may represent another person.” Todd Morgan has formed Todd, LLC, of which he is the sole member. Todd, LLC is the lessee on a lease with SamMik, Inc., and SamMik has sued Todd, LLC in state court for nonpayment of rent. May Todd Morgan, who is not an attorney, represent Todd, LLC in state court?

◄◄◄

Explanation

> No. An LLC and its members are separate persons. If Todd Morgan were to represent Todd, LLC, the representation would involve a "person who is not an attorney licensed to practice in this state . . . representing another person."[50] ◄◄◄

problem 114

If Todd, LLC defaults on its lease payments, may SamMik sue Todd Morgan for the amount due? ◄◄◄

Explanation

> Not unless Todd Morgan has guaranteed the LLC's payment or SamMik can establish grounds to "pierce the veil." An LLC member is not liable for the LLC's debts merely on account of being a member.◄◄◄

---

1. Some of this chapter is based on materials in Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (Warren, Gorham & Lamont/RIA 1994, Supp. 2008-1) ("Bishop & Kleinberger"), Chapter 1, which in turn evolved from an earlier edition of this book.
2. For the significance of the year 1988, see section 13.1.4(b).
3. See section 7.3.
4. See section 12.2.3.
5. The board of directors is the top decision-making component of a corporation.
6. See section 12.2.5 (agent acting for disclosed principal).
7. See section 12.2.3 (explaining how, under RULPA, a limited partner risks personal liability from being overly involved in the business and describing a list of safe harbors).
8. See section 3.2 (discussing *respondeat superior*). The conduct of a person *qua* shareholder is not attributable to the corporation, but the conduct of a servant/employee (who happens to be a shareholder) may be.
9. See section 4.4.1.
10. See section 16.1 for further discussion of piercing.
11. Business organizations are also subject to state tax codes, and in most matters discussed in this chapter most state income tax regimes follow the federal approach.
12. So-called because it is taxed under Subchapter C of the internal Revenue Code.
13. For present purposes, it does not matter whether the partnership is a general partnership or a limited partnership.
14. Rounded, for simplicity's sake. Consistent with the pass-through nature of partnerships, it is the allocation of profits that creates tax liability for partners. So, a partner might have to pay taxes on

profits not yet received.
15. Rounded.
16. One dollar is unaccounted for, due to rounding.
17. The advent of LLCs led to the invention of LLPs and LLLPs, discussed in Chapter 17.
18. I.e., a corporation as the general partner.
19. So-called because its owners have elected to have the corporation taxed under Subchapter S of the Internal Revenue Code.
20. For a discussion of the control rule, see sections 12.2.3 and 12.3.4.
21. In some circumstances, an S corporation provides advantages over partnerships (and limited liability companies) with regard to employment taxes.
22. The "one class of stock" restriction pertains to economic rights but not to governance rights.
23. Appreciated property is property whose fair market value (FMV) exceeds the corporation's tax "basis" in the property. This situation can occur because the value of the property has increased since the time the corporation acquired it, or because the value of the property has decreased by an amount less than the amount of tax deductions taken by the corporation on account of the property. Suppose, for example, that Fencing, Inc., owns three antique epees, each purchased by the corporation several years ago for $1,000 (giving the corporation a tax basis of $1,000 in each epee), and each epee is now worth $2,000. If the corporation decides to distribute one epee to each of its shareholders as a dividend "in kind," and assuming (for the sake of simplicity) that the corporation has taken no deductions on account of the epees, each of the shareholders will incur $1,000 of taxable gain ($2,000 FMV minus $1,000 basis). Other "traps" include: (i) the basis of a shareholder's stock is not increased to take into account any corporate debt, thereby limiting the shareholders' ability to take advantage of passed-through losses; (ii) when a shareholder dies, the basis of the assets of the corporation is not adjusted to reflect the estate's stepped-up basis, thereby putting the estate at risk of realizing unexpected and (in an economic sense) phantom gains.
24. Unless the shareholder employees are all doing work whose fair market value just happens to be in proportion to the shareholders' stock holdings, this situation suggests that the payments are "in respect of' the ownership interests (i.e., dividends, and taxable as such) rather than in compensation for services.
25. Unless the shareholder employees are each doing work whose fair market value just happens to be in proportion to the shareholders' respective stock holdings, this situation suggests that the payments are "in respect of' the ownership interests (i.e., dividends, and taxable as such) rather than in compensation for services.
26. If assets owned by the corporation (i.e., capital) play an important role in producing revenue, the owners of the corporation would normally expect a return on (i.e., remuner-ation for) the investment reflected in those assets. If the corporation is not providing that return formally through appropriate dividends, it may be doing so unlawfully by disguising dividends as salary payments.
27. Although state LLC statutes permitted manager-managed LLCs to have nonmember managers, the IRS pronouncements concerned manager-managed LLCs whose manager or managers were also members.
28. This description applies only to organizations formed under the law of one of the 50 states, the District of Columbia, or a U.S. territory. The regulations are more complicated for organizations formed under the laws of other nations and also for various special U.S. entities. The "check-the-box" regulations have no effect on the tax classification of publicly traded partnerships, which with very few exceptions are taxed as corporations.
29. Although the "check-the-box" regulations were undoubtedly a response to LLCs, they apply equally to other unincorporated business organizations. As a result, "check the box" prompted changes in the law of limited partnerships, see section 12.3, and led to the increased use of limited liability partnerships and limited liability limited partnerships. See Chapter 17.
30. As explained in section 14.5.1, an LLC operating agreement functions like the partnership

agreement in a general or limited partnership.
31. An official comment to ULLCA (2013) suggests a possible difference in connotation: “The original ULLCA and most other LLC statutes use ‘articles of organization’ rather than ‘certificate of organization.’ This act purposely uses the latter term to signal that the certificate: (i) merely reflects the existence of an LLC (rather than being the locus for important governance rules); and (ii) is significantly different from articles of incorporation, which have a substantially greater power to affect inter se rules for the corporate entity and its owners.” ULLCA (2013) §102(1), cmt.
32. Some LLC statutes label this agreement the “limited liability company agreement.” Two former statutes, since replaced by ULLCA (2006) used the term “member control agreement.”
33. The name for this document varies across states: article—certificate; organization—formation.
34. Reid v. Town of Hebron, No. CV 9354384S, 1996 WL 634254, at *1-3 (Conn. Super. Ct. Oct. 22, 1996) (citations and internal quotations omitted).
35. All Comp Constr. Co., LLC v. Ford, 999 P.2d 1122, 1123 (Okla. Ct. App. 2000).
36. For a succinct description of “corporate-style governance,” see Daniel S. Kleinberger, “Why Not Good Faith? - The Foibles of Fairness in Closely Held Corporations,” 16 WILLIAM MITCHELL L. REV. 1143, 1144 (1990) (“Traditional legal theory recognizes three sharply distinct roles in corporate governance. The owners of the business, the shareholders, elect a board of directors, who function collectively to set policy for and superintend the operations of the business. The board, in turn, selects the top officers, who function as the chief administrators of the business and who manage day-to-day operations. The structure is tripartite and hierarchical.”). In closely held corporations, the distinctions often blur. See *Id*., *passim*.
37. The resemblance is not complete. For example, managers in a manager-managed LLC are not required by statute to be members, although they usually are. In contrast, the managers of a limited partnership—i.e., the general partners—are necessarily partners.
38. Such members have rights that, in substance, resemble those of preferred shareholders. Preferred stock typically has some sort of preference or priority with regard to distribution rights but often lacks any voting power.
39. This count includes the District of Columbia.
40. The ULC’s formal name for this act is ULLCA (2006) (last amended 2013).
41. ULLCA (2006), Prefatory Note (Background to this Act: Developments since the Conference Considered and Approved the Original Uniform Limited Liability Company Act (ULLCA)).
42. For an explanation of the Harmonization Project, see introductory Note on the ULC Harmonization Project.
43. See Bishop & Kleinberger, supra n. 1, *fl14.01[2] (stating that“for ventures with members or substantial business relationships in more than one state, the Delaware law seems to exert an almost gravitational pull on attorneys”) (footnote omitted).
44. This section is derived from Bishop & Kleinberger, supra n. 1, ^14.01 and is printed here with permission of Professor S. Kleinberger.
45. Atochem N. Am., Inc. v. Jaffari, 727 A2d 286, 291 (Del. 1999).
46. Leo E. Strine Jr. and J. Travis Laster, “The Siren Song of Unlimited Contractual Freedom,” Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations (Robert W. Hillman and Mark J. Loewenstein, eds.) (Edward Elgar Publishing, 2015).
47. For a discussion of the implied covenant, see section 15.4.8.
48. Consider, as an example of this influence, the LLC Institute presented annually by the Limited Liability Companies, Partnerships, and Unincorporated Entities Committee of the ABA’s Business Law Section. The Institute always includes a discussion of recent case developments, and that discussion allocates approximately equal time to Delaware case law and to case law from the other 49 states, the District of Columbia, and U.S. territories.
49. B.M. Gottesman & S.E. Swenson, “More Than Bargained For? Topics for Consideration in the Issuance and Acceptance of Delaware LLC Opinions,” 81-FEB NY St. B.J. 20, 22 (2009) (commenting

on the TriBar Opinion Committee, “Third-Party Closing Opinions: Limited Liability Companies,” 61 Bus. Law. 679 (2006)).

50. In some states, either by statute or court rule, the answer would be different so long as the matter remained in “small claims” court.

CHAPTER 14 Creating the LLC

§14.1 MECHANICS OF FORMATION

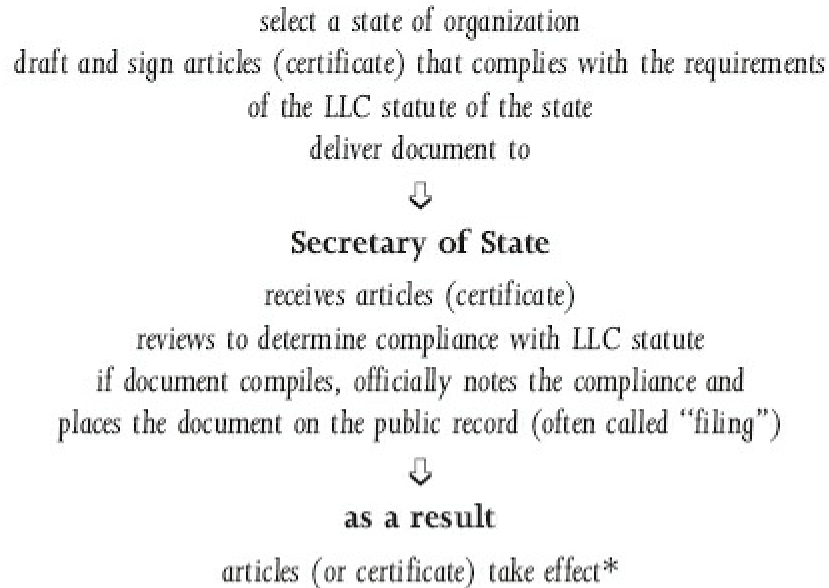
§14.1.1 Overview

As a matter of mechanics, the formation of a limited liability company (LLC) involves multiple components:

- one or more persons (often referred to as “organizers”):
  - select the state LLC statute under which the limited liability company will be formed (“state of organization” or “state of formation”);
  - draft the document (“articles of organization,” “certificate of organization,” or “certificate of formation”), the public filing ofwhich will create the limited liability company as a legal person;
- that document is:
  - properly drafted and signed;
  - delivered to the public office (in most states, the state Secretary of State) specified in the LLC statute to receive the articles or certificate of organization (sometimes referred to as “delivery for filing” and sometimes as “filing”);
- that office decides that the document meets the requirements of the LLC statute (almost always a merely ministerial act) and accepts the document into the public record; and
- under most LLC statutes, one or more persons —not necessarily the organizers — become the LLC’s initial member or members when the LLC comes into existence.[1]

Figure 14.1 shows the sequence graphically.

Figure 14.1. Mechanics of LLC Formation — Timeline Organizers



limited liability company	**one or more persons**
comes into existence	become initial member(s)

* It is possible for the articles or certificate to have a delayed effective date.

§14.1.2 State of Formation; Choice of Law

a.Where LLCs Are Typically Formed

Most limited liability companies are formed under the law of the state in which the company does all or most of its business, but it is not legally necessary to do so. To the contrary, LLC law requires virtually no nexus between the situs of an LLC's activities and the state under whose LLC law the LLC is formed. In particular, the state of Delaware has made a business of attracting LLC formation from companies whose business has little or nothing to do with Delaware.

LLC statutes typically require only that an LLC maintain an office and an agent for service of process in the state of formation,[2] and some statutes require only a resident agent. A limited liability company that does business in more than one state inevitably does business outside its state of

organization. A limited liability company that transacts business in a state other than its state of formation is required to register in that other state as a "foreign" limited liability company.[3]

b.Regardless of Where a Limited Liability Company Does Business, the Law of the Company's State of Formation Governs the Limited Liability Company's Internal Affairs

Under the "internal affairs" doctrine, the law of an LLC's state of formation governs the LLC's internal affairs, including the relationships of the members *inter se*. The doctrine is a "choice of law" rule and originated in early cases dealing with the then new phenomenon of the private corporation.[4]

Most LLC statutes codify the doctrine. For example, the South Dakota LLC statute states: "The law of this state governs [t]he internal affairs of a limited liability company."[5] Even under LLC statutes that do not codify the rule, case law produces the same result.[6]

Determining whether a matter is an "internal affair" is for the most part a straightforward task. As explained in a comment to ULLCA (2013):

> Like any other legal concept, "internal affairs" may be indeterminate at its edges. However, the concept certainly includes interpretation and enforcement of the operating agreement, relations among the members as members, relations between the limited liability company and a member as a member, relations between a manager-managed limited liability company and a manager, and relations between a manager of a manager-managed limited liability company and the members as members.[7]

c."Internal Affairs" and the Member's Liability Shield

It is debatable whether "internal affairs" include the liability of a member as member for obligations of an LLC, because the issue certainly implicates rights of persons outside the LLC (i.e., the LLC's creditors).[8] Some LLC statutes address this issue directly, excluding the liability shield from the rubric of internal affairs but nonetheless applying the law of an LLC's statement of formation when considering the liability shield.[9] For example, ULLCA (2013) §104 states: "The law of this state governs: (1) the internal affairs of a limited liability company; and (2) the liability of a member as member and a manager as manager for a debt, obligation, or other liability of a limited liability company."

Georgia's statute makes an even broader (and lengthier) statement:

> The personal liability of a member of a limited liability company to any person or in any action or proceeding for the debts, obligations, or liabilities of the limited liability company, or for the acts or omissions of other members, managers, employees, or agents of the limited liability company, shall be governed solely and exclusively by this chapter and the laws of this state. Whenever a conflict arises between the laws of this state and the laws of any other state with regard to the liability of members of a limited liability company for the debts, obligations, and liabilities of the limited liability company or for the acts or omissions ofother members, managers, employees, or agents of the limited liability company, this state's laws shall be deemed to govern in determining such liability.[10]

As a matter of legal analysis, this particular choice of law issue is important principally when a creditor of an LLC seeks to disregard the liability shield (i.e., "pierce the veil" of an LLC) and hold one or more members personally liable for the entity's debts.[11] For the most part, the legal question has no practical consequence: "The general rule is that a plaintiff's alter ego theory is governed by the law of the state in which the business at issue is organized."[12]

d. The "Internal Affairs Rule" and Legal Analysis of LLC Issues

Due to the internal affairs doctrine, the analysis of any question of LLC law must begin with specific reference to the LLC statute under which the LLC was formed. Thus, when an attorney is asked a question about an LLC matter, her or his first question should be, "What's the state of organization?"[13]

§14.1.3 Organizers

a.Nomenclature

LLC statutes differ as to how they refer to the persons who "do the paperwork" to create an LLC. Some statutes refer particularly to "organizers." For example, the Georgia LLC Act states in pertinent part: "One or more persons may act as the organizer or organizers of a limited liability company.[14]

other statutes eschew that label and simply refer to persons acting to "form" a limited liability company. The Arizona LLC statute is an example: "One or more persons may form a limited liability company by signing and filing with the [corporation] commission an original copy of the articles of organization for the limited liability company."[15] Regardless of the statutory language, however, the term "organizer" is colloquially accepted usage.

b.Organizer(s)

1. Role

The role of the organizer is mechanically simple: cause to be drafted, signed, and submitted to the appropriate official the document whose public filing is a precondition to creating the limited liability company as a legal entity.[16] Under most LLC statutes, another requirement exists: at least one person must become a member.[17]

2. Must the Organizer Be a Natural Person?

In the early days of LLCs, some statutes required that an organizer be an individual. That requirement gradually gave way, however.[18] Today, "[a]ll LLC statutes contemplate an entity acting as an organizer. Some expressly require that an individual acting as an organizer be at least eighteen years old. Others do not."[19]

3. Are Organizers Ipso Facto Members?

No. AN LLC member is a member *of* an LLC,[20] and the organizer's role is preformation. At the moment a person becomes an organizer, it is impossible for the person to be a member, because an LLC that does not yet exist cannot have members. Put another way, member status for anyone presupposes that the organizer's task is finished.

4. Must the Organizer Become a Member Upon Formation of the LLC?

No LLC statute requires that an organizer become a member when the LLC comes into existence, and many make this point expressly. For example, the Virginia statute states: "One or more persons may act as organizers of a limited liability company by signing and delivering articles of organization to the [State Corporation] Commission for filing. An organizer need not be a member of the limited liability company after formation has occurred."[21] Likewise, the Arizona statute provides: "The person or persons [who act to form the LLC] need not be members of the limited liability company at the time of formation or after formation has occurred."[22] An organizer of an LLC thus differs from the person or persons who sign and deliver the documents to form a limited partnership; the latter are necessarily general partners in the limited partnership they form.[23]

5. May an Organizer Become a Member Upon Formation of the LLC?

It is certainly permissible for an organizer to become a member once the LLC exists. No LLC statute prohibits that situation, and many expressly contemplate it. The original California statute, for example, provided: "The person or persons who execute and file the articles of organization may, but need not, be members of the limited liability company."[24]

6. What Is the Legal Relationship Between an Organizer and the LLC the Organizer Acts to Form?

In an agency law sense, there can be no legal relationship. A person cannot be an agent for a nonexistent principal.[25] In this respect, the organizer of an LLC is comparable to a person who acts to incorporate a corporation.

7. What Is the Legal Relationship Between an Organizer and the Person or Persons Who Have Agreed or Are Otherwise Destined to Become the Initial Members of the LLC?

Most LLC statutes are silent on this point. The Delaware statute is an exception, referring to "1 or more authorized persons . . . execut[ing] a certificate of formation."[26] However, the Delaware statute raises (but does not

answer) the question, “authorized by whom?”

The logical answer is “authorized by the person or persons who will become the initial member or members of the limited liability company.” The same characterization is appropriate under all other LLC statutes, except the few that permit an LLC to be formed without having any initial mem- bers.[27] Where the statute presupposes an initial member upon formation, the organizer must be acting to serve that person’s interests.

ULLCA (2013) contains an explicit and detailed explanation of the relationship between those who form an LLC and those who become its initial members:

> (a) If a limited liability company is to have only one member upon formation, the person becomes a member as agreed by that person and the organizer of the company. That person and the organizer may be, but need not be, different persons. If different, the organizer acts on behalf of the initial member.
> (b) If a limited liability company is to have more than one member upon formation, those persons become members as agreed by the persons before the formation of the company. The organizer acts on behalf of the persons in forming the company and may be, but need not be, one of the persons.[28]

The word “authorized” and the phrase “acts on behalf” both signify an agency relationship, which means the organizer owes fiduciary duties to the person or persons who will become the initial member or members.[29] If the person serving as an LLC’s organizer also functions as the promoter for the enterprise,[30] the person also owes duties in that capacity.

Case in Point — Roni LLC v. Arfa

Investors who acquired membership interest in LLCs sued the organizers/ promoters of those LLCs for breach of fiduciary duties. The organizers not only promoted membership in the LLCs, they sold properties to the LLCs and allegedly failed to disclose commissions received from the sale ofproperties. Affirming a decision of the motion court, the appellate court likened the organizer or promoter of an LLC to a promoter of a corporation and held that (i) “the organizer of a limited liability company is a fiduciary of the investors it solicits to become members”; and (ii) “[t]he fiduciary duty includes the obligation to disclose fully any interests of the promoter that might affect the company and its members, including profits that the promoter makes from organizing the company.”[31] ◂◂◂

8. One or More Organizers?

LLC statutes contemplate "one or more" organizers, but most limited liability companies are formed by a single organizer. Certainly, when the organizer is merely "doing the paperwork" on behalf of others who will become the LLC's initial members, it would be superfluous to have more than one organizer. Multiple organizers are more likely when the LLC is to have more than one initial member and those persons feel more comfortable "being on" the LLC's initial public paperwork.

Example

> Larry and Moe wish to form an LLC to house their new business, Whoopee- Cushions-R-Us. They consult Curley, an attorney knowledgeable about limited liability companies. Upon his advice, Larry and Moe decide *inter alia* to form their LLC under the law of their state of residence ("Home State"), where their company will do all its business. Acting on behalf of Larry and Moe, Curley drafts a certificate of organization for Whoopee-Cushions-R- Us, LLC. He signs the document as "organizer," delivers the document to the office of the Home State Secretary of State, together with the filing fee specified by law.[32] An official in that office:

- ascertains that:
  - — the certificate complies with the Home State LLC Act (including that the proposed name of the LLC is available);[33] and
  - — the fee is correct; and
- files the certificate, bringing the LLC into existence.

> Larry and Moe become the initial members of the LLC; Curley's role as organizer is over. ◂◂◂

Example

> Same facts as the previous Example, except that Larry and Moe (acting with or without legal advice) sign the certificate as organizers and use a courier service to deliver the document and filing fee to the office of the Home State Secretary of State. Larry and Moe are the organizers of Whoopee-Cushions- R-Us, LLC. They signed the

certificate in that capacity and — through an intermediary —caused the certificate to be delivered to the filing office. ◂◂◂

Example

Three large corporations agree to use an LLC to form and operate a joint venture. As the deal comes closer to closing, two of the three participants are still deciding what legal form they will use to own their respective part of the joint venture (e.g., directly as a member, through a wholly owned subsidiary that is a member). For various reasons, the parties want to have the LLC “in place” as soon as possible. They therefore form an LLC that initially has no members. Because under the relevant LLC statute admis-sion of new members is the province of the organizers, each participant may well want to serve as an organizer. ◂◂◂

§14.1.4 Articles of Organization (Certificate of Organization; Certification of Formation)

a.Nomenclature

Most LLC statutes refer to “articles of organization.” A few refer instead to a “certificate” either “of formation” or “of organization.” The predominant nomenclature traces back to the original Wyoming LLC Act and resonates with the nomenclature ofcorporate law, which predominately uses the term “articles of incorporation.”[34]

The word “certificate” resonates with the law of limited partnerships,[35] is the term of art under the influential Delaware statute,[36] and was selected in the drafting process that produced ULLCA (2006) “purposely ... to signal that: (i) the certificate merely reflects the existence of an LLC (rather than being the locus for important governance rules); and (ii) this document is significantly different from articles of *incorporation*, which have a substantially greater power to affect *inter se* rules for the corporate entity and its owners.” [37]

For simplicity’s sake, this book will refer generally either to “articles (or certificate) of organization” or simply “articles of organization.”

b.Required Contents

LLC statutes vary as to how much information they require in the articles (or certificate) of organization, ranging from "bare bones" to fulsome.
Delaware's statute exemplifies the "bare bones" approach, requiring only "[t]he name of the limited liability company" and "[t]he address of the registered office and the name and address of the registered agent for service of process."[38] The Arizona statute, section 29-632(A), illustrates the other end of the continuum:

> The articles of organization shall state:
>
> 1. The name of the limited liability company.
>
> 2. The name, street address in this state and signature of the agent for service of process required to be maintained by section 29-604.
>
> 3. The address of the company's known place of business in this state, if different from the street address of the company's statutory agent.
>
> 4. The latest date, if any, on which the limited liability company must dissolve.
>
> 5. Either of the following statements:
>
> (a) Management of the limited liability company is vested in a manager or managers.
>
> (b) Management of the limited liability company is reserved to the members.
>
> 6. The name and address of either of the following:
>
> (a) If management of the limited liability company is vested in a manager or managers, each person who is a manager of the limited liability company and each member who owns a twenty per cent or greater interest in the capital or profits of the limited liability company.
>
> (b) If management of the limited liability company is reserved to the members, each person who is a member of the limited liability company.

Most LLC statutes require the articles to state whether the LLC is member-managed or manager-managed, a characterization that has important power-to-bind implications.[39] Most statutes do not require disclosure of the identity of members or managers. Recent controversy regarding "shelf LLCs" has caused some statutes to require the articles to assert "[t]hat there is at least one member of the limited liability company."[40]

c. Name Requirement

LLC statutes require that the name of a limited liability company contain language signifying the entity's status as an LLC. Statutes typically require the name to contain either the phrase "limited liability company" or some abbreviation — for example, LLC or L.L.C.

In addition, like other business organization statutes, LLC statutes require

that an LLC's name be somewhat different from other names already "on the record" in the filing office. At one time, the predominant standard (regardless of the type of entity involved) was the term "confusingly similar"[41] but the trend is toward "distinguishable in the records."[42] The change reflects a shift away from a consumer protection perspective — on the theory that other law adequately addresses that concern — and toward a recordkeeping perspective — that is, names must be sufficiently dissimilar to facilitate effective indexing, storage, and retrieval.

d. Optional Contents

All LLC statutes permit the articles or certificate to include additional information. Most LLC statutes leave unclear the effect of this additional information. The situation is especially complicated if the articles differ with the operating agreement.[43]

e.Notice Function

Following limited partnership law,[44] a few LLC statutes provide that an LLC's articles or certificate of organization are "constructive notice" that the organization is a limited liability company. The effect of such provisions is unclear. In a seminal case, Colorado's provision was held "ineffective to change common law agency principles, including the rules relating to the liability of an agent that transacts business for an undisclosed principal."[45]

---

§14.2 LIMITED LIABILITY COMPANY AS A JURIDIC PERSON

Once the articles or certificate takes effect and, if necessary, at least one person has become a member,[46] the limited liability company comes into existence as a legal person, separate from its members, with its own purpose, powers, rights, and liabilities.[47]

§14.2.1 Permissible Purposes for an LLC

a.In General

At one time, most if not all LLC statutes required an LLC have a business purpose, but the modern trend is to permit an LLC to have any lawful purpose. For example, ULLCA (2013) §108(b) provides that: "A limited liability company may have any lawful purpose, regardless of whether for profit." The official comment explains: "Although some LLC statutes continue to require a business purpose, this act follows the current trend and takes a more expansive approach. The phrase 'any lawful purpose, regardless of whether for profit' encompasses even charitable activities."[48]

The business purpose requirement reflects the LLC's partnership law antecedents,[49] but can raise questions when individuals seek to use the LLC to protect some of their assets from liability claims arising from non-commercial use of other assets.

Example

> Several branches of the Jones family own a lake cottage and its surrounding land as tenants in common. For years the family has used the cabin for social occasions — sometimes for reunions, other times one family unit at time, sometimes simply for individual family members. For several reasons, the Jones all agree to form Jones Cabin, LLC, and contribute to that LLC their respective ownership interests in the cabin and land in return for membership in the LLC. The reasons include: (i) preventing the transfer of ownership in the cottage and land outside the family; (ii) controlling the fragmentation of ownership that will occur as the family grows; (iii) precluding an action of partition of the realty; and (iv) protecting family members from liability as owners of the land, in case someone is injured on the land. Under a "business purpose" statute, it will be plausible to attack the LLC as improperly formed. Not so under an "any lawful purpose" statute. ◂◂◂

b. Tax-Exempt SMLLCs

To be "nonprofit" is not the same as being "tax exempt." To be tax exempt under federal income tax law, an organization must: (i) be organized for one or more nonprofit purposes; (ii) be classified as a corporation, comply with stringent limitations on governance, operations, and use of assets; and (iii) apply for and obtain a tax-exempt determination letter from the IRS. An LLC could obtain tax-exempt status by "checking the box" to be classified as a corporation, but, in light of the stringent restrictions, it will rarely make sense to do.

It can, however, make sense for a tax-exempt corporation to form a nonprofit, single member LLC ("SMLLC") to carry on one or more nonprofit projects. Using a subsidiary helps shield the organization's general assets from liability arising from special projects. A corporate subsidiary would provide the same protection, but that approach would require a separate "tax-exempt" determination letter for the subsidiary. In contrast, a single-member LLC that has not "checked the box" needs no separate determination letter. The relevant tax is the income tax, and an SMLLC is disregarded for federal income tax purposes.

Example

> Low Income Housing, Inc. (LIHI), is a nonprofit corporation, tax exempt, and eligible to receive tax-deductible contributions under Internal Rev. Code §501(c). LIHI plans to build a complex of garden apartments to provide affordable housing for senior citizens on fixed incomes, and plans to finance the construction with tax-advantaged bonds. The sole recourse of the bondholders is to be the assets comprising the apartments. To insulate LIHI's assets from claims of the bondholders and any other creditors of the project, LIHI forms and becomes the sole member of Senior Housing, LLC. The limited liability company undertakes the garden apartment project, and LIHI saves the time, effort, and expense of obtaining a separate tax- exempt determination for its wholly owned subsidiary. ◂◂◂

c. Professional Firms as LLCs

States typically impose special requirements on professionals (e.g., doctors, lawyers) who wish to practice as a limited liability company. In some states,

these requirements appear in a separate part of the LLC statute. Other states have a professional-firms statute applicable to LLCs, LLPs, and corporations alike.

Case in Point — Allstate Ins. Co. v. A&A Medical Transp. Servs., Inc.

> An insurance company asserted that it was not obligated to pay "no-fault" insurance benefits for medical services provided by clinics organized as Michigan LLCs, because:
>
> - "a limited liability company (LLC) that provides medical, physical therapy, or occupational therapy services to the public must be organized under article 9 of the Michigan Limited Liability Company Act (MLLCA) instead of under the general provisions of the MLLCA"; and
> - the clinics "were improperly organized because (1) article 9 of the MLLCA requires, among other things, that all members and managers of a company providing certain health care services 'shall be licensed or legally authorized in this state to render the same professional service'; and (2) the LLC clinic defendants could not satisfy the licensure requirements of article 9 because certain of their members lacked a professional license." ◂◂◂

In an unreported, *per curium* opinion, based on a prior unreported decision, the court of appeals rejected the insurance company's assertion. But for the precedent established in the prior case, a concurring judge would have held in favor of the insurance company, reasoning that (i) Michigan law only permitted no-fault insurance payments to entities that lawfully rendered treatment, and (ii) by not complying with article 9 of the MLLCA, the clinics were not legally authorized to render professional services in Michigan.[50]

§14.2.2 Powers of an LLC

Agency law deals comprehensively with the power of one person to bind another, but "entity law" must address the question of what powers are possessed by an entity itself. For example, may an entity buy insurance; transfer title to land; sue and be sued in its own name; make contracts? Understanding this question for LLCs requires knowing some background about the issue in the context of corporations and partnerships.

"The law of corporations has always proceeded on the fundamental assumption that corporations are creations with limited power."[51] As the

U.S. Supreme Court explained more than 200 years ago, a corporation "is

the mere creature of the [legislative] act to which it owes its existence [and] ... it may correctly be said to be precisely what the incorporating act has made it, to derive all its powers from that act, and to be capable of exerting its faculties only in the manner which that act authorizes."[52]

Until the mid 1800s, state legislatures chartered corporations one by one, each time for a specific, narrow purpose.[53] Eventually, legislatures adopted general statutes, which permitted private individuals to organize corporations by complying with the statutory requirements. In general, the history of corporate law "in this area is largely one ensuring that corporate powers are broad enough to cover all reasonable business transactions,"[54] and today corporate statutes typically contain a lengthy and comprehensive list of particular powers.[55]

The history of partnership law is different. Neither UPA (1914) nor UPA (1997) consider the "powers" issue as a general matter.

Under the aggregate construct,[56] the notion of a partnership's power is almost an oxymoron. Indeed, when UPA (1914) was promulgated, some states did not permit a general partnership to own real property in its own name. UPA (1914) addressed that problem, but its response was specific to the questions of acquiring, owning, and transferring property.[57] Likewise, the aggregate concept raised issues about a partnership's power (or capacity) to sue and be sued in its own name, but here too partnership law (and "common name" statutes) provided a specific response.[58]

Although UPA (1997) proclaims that "[a] partnership is an entity distinct from its partners,"[59] the Act contains no general statement of the entity's powers. As for limited partnerships, before 2001 no uniform act had considered the powers issue. The 1916, 1976, and 1985 acts each contain the same language on "nature of business," but the language pertains to permitted purposes rather than powers: "A limited partnership may carry on any business that a partnership without limited partners may carry on except [here designate prohibited activities]."[60]

In contrast, section 105 of ULPA (2001) directly addresses the powers question, stating, in pertinent part, that "[a] limited partnership has the powers to do all things necessary or convenient to carry on its activities."[61] This change in approach was occasioned by "de-linking" the limited partnership act from the general partnership act[62] but also reflects the drafters' recognition that "[a] limited partnership is a creature of statute" which "comes into existence" under the authority and requirement of the

limited partnership act.[63]

Like limited partnerships, limited liability companies come into existence “under” an enabling statute, and almost all LLC statutes expressly address the powers question. Some LLC statutes eschew a corporate-like list and substitute a succinct and general statement of powers. For example, ULLCA (2013) provides: “A limited liability company has . . . the power to do all things necessary or convenient to carry on its activities and affairs.”[64] The Delaware statute is in accord, although not as succinct:

> A limited liability company shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by its limited liability company agreement, together with any powers incidental thereto, including such powers and privileges as are necessary or convenient to the conduct, promotion or attainment of the business, purposes or activities of the limited liability company.[65]

Other LLC statutes ape corporate law and contain a detailed list of the powers of an LLC. For example, the original California LLC act provided the following list:

> Subject to any limitations contained in the articles of organization and to compliance with this title and any other applicable laws, a limited liability company organized under this title shall have all of the powers of a natural person in carrying out its business activities, including, without limitation, the power to:
>
> (a) Transact its business, carry on its operations, qualify to do business, and have and exercise the powers granted by this title in any state, territory, district, possession, or dependency of the United States, and in any foreign country.
>
> (b) Sue, be sued, complain and defend any action, arbitration, or proceeding, whether judicial, administrative, or otherwise, in its own name.
>
> (c) Adopt, use, and at will alter a company seal; but failure to affix a seal does not affect the validity of any instrument.
>
> (d) Make contracts and guarantees, incur liabilities, act as surety, and borrow money.
>
> (e) Sell, lease, exchange, transfer, convey, mortgage, pledge, and otherwise dispose of all or any part of its property and assets.
>
> (f) Purchase, take, receive, lease, or otherwise acquire, own, hold, improve, use, or otherwise deal in and with any interest in real or personal property, wherever located.
>
> (g) Lend money to and otherwise assist its members and employees.
>
> (h) Issue notes, bonds, and other obligations and secure any of them by mortgage or deed of trust or security interest of any or all of its assets.
>
> (i) Purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, use, employ, sell, mortgage, loan, pledge, or otherwise dispose of and otherwise use and deal in and with stock or other interests in and obligations of any person, or direct or indirect obligations of the United States or of any government, state, territory, governmental district, or municipality, or of any instrumentality of any of them.
>
> (j) Invest its surplus funds, lend money from time to time in any manner which may be appropriate to enable it to carry on the operations or fulfill the purposes set forth in its articles of organization, and take and hold real property and personal property as security for the payment

of funds so loaned or invested.

(k) Be a promoter, stockholder, partner, member, manager, associate, or agent of any person.

(l) Indemnify or hold harmless any person.

(m) Purchase and maintain insurance.

(n) Issue, purchase, redeem, receive, take, or otherwise acquire, own, hold, sell, lend, exchange, transfer, or otherwise dispose of, pledge, use, and otherwise deal in and with its own bonds, debentures, and other securities.

(o) Pay pensions and establish and carry out pension, profit-sharing, bonus, share purchase, option, savings, thrift, and other retirement, incentive, and benefit plans, trusts, and provisions for all or any of the current or former members, managers, officers, or employees of the limited liability company or any of its subsidiary or affiliated entities, and to indemnify and purchase and maintain insurance on behalf of any fiduciary of such plans, trusts, or provisions.

(p) Make donations, regardless of specific benefit to the limited liability company, to the public welfare or for community, civic, religious, charitable, scientific, literary, educational, or similar purposes.

(q) Make payments or donations or do any other act, not inconsistent with this title or any other applicable law, that furthers the business and affairs of the limited liability company.

(r) Pay compensation, and pay additional compensation, to any or all managers, officers, members, and employees on account of services previously rendered to the limited liability company, whether or not an agreement to pay such compensation was made before such services were rendered.

(s) Insure for its benefit the life of any of its members, managers, officers, or employees, insure the life of any member for the purpose of acquiring at his or her death the interest owned by such member, and continue such insurance after the relationship terminates.

(t) Do every other act not inconsistent with law that is appropriate to promote and attain the purposes set forth in its articles of organization.[66]

This list was preserved when California replaced its original act with the state's version of ULLCA (2006).[67]

However stated, the result is the same. In the eyes of the law, an LLC is a person with the attendant powers necessary to pursue its lawful objectives.

§14.3 SHELF LLCs — THE NECESSITY *VEL NON* OF HAVING AT LEAST ONE MEMBER UPON FORMATION

"Shelf LLC" is a colloquial term of art for "an LLC formed without having at least one member upon formation."[68] Although the concept has substantial practical advantages, it has been quite controversial. For example, the official comment to ULLCA (2006), §201 recounts that: "No topic received more

attention or generated more debate in the drafting process for [the Revised Uniform Limited Liability Company Act] than the question of the 'shelf LLC."'

Understanding the concept and the controversy involves understanding: (i) the practical advantages; (ii) the various approaches taken to the issue by LLC statutes; and (iii) the almost theological nature of the issue for some of the country's leading practitioners of LLC and partnership law.

§14.3.1 The Practical Advantages

In various situations, it can be helpful to have the LLC in existence before the precise identity of the members is determined.

Example

> On Monday, an attorney receives a phone call from a long-time client, with whom the attorney has been discussing an LLC arrangement for several months. The client now says, "I've decided to go ahead with putting some of my assets into an LLC with some of my kids. Get the LLC organized, and I'll be in on Friday to discuss the details and tell you which kids are going to be involved." Creating the entity in anticipation of the client's detailed decisions may: (i) help the client along the decision path (by symbolizing that something concrete has been done); and (ii) avoid delay later, if the filing office has any backlog. Acceding to the client's wishes does no harm, if the attorney has properly explained to the client that merely creating the entity does not resolve many key issues that pertain to formation (e.g., the contents of the operating agreement).[69] ◂◂◂

Example

> Three large corporations have been negotiating for months to shape a joint venture that will handle oil exploration on the north shore in Alaska. The key executives for each corporation have agreed on the basic structure of the LLC that will house the joint venture and on most of the "deal points" with regard to scope of the venture, investment amounts, operational control of the LLC, etc. The

negotiations "have momentum" — both the lawyers and business people involved are convinced that final agreement is just a matter of time. However, two of the corporations have not yet decided how they will own their respective membership interests (e.g., directly, through a wholly owned subsidiary that is a corporation, through an SMLLC). The "closing" of the deal will involve hundreds of documents, and for various regulatory and financial reasons, timing has become quite important. Forming the LLC in advance greatly facilitates the rest of the paperwork. ◂◂◂

§14.3.2 The Approach of LLC Statutes

LLC statutes differ in how they approach the question of shelf LLCs. Many define a limited liability company as necessarily having one or more members,[70] which might seem to prohibit a shelf LLC. But that interpretation proves too much; a single-member LLC that loses its sole member does not cease to be an LLC.[71] Also, most of these same statutes provide that an LLC is formed when the specified public official files the articles (or certificate) of organization — without reference to whether the LLC has any members at that moment. In short, on this question many LLC statutes are equivocal.[72]

A few statutes do provide a clear answer. The Virginia LLC Act, for example, expressly contemplates the shelf LLC (although not by that colloquial label). Section 13.1-1003(F)(2) provides that the articles of organization may be executed by an organizer "[i]f the limited liability company . . . has been formed without any managers or members."[73] Section 13.1-1038.1(A)(3) addresses the admission of members into "a limited liability company that has no members as of the commencement of its existence.[74]

The Colorado Act, in sharp contrast, expressly prohibits the shelf LLC. Section 7-80-204(1)(g) provides that "[t]he articles of organization shall state . . . [t]hat there is at least one member of the limited liability company."[75]

ULLCA (2006) attempted to steer a middle course:

> A product of intense discussion and compromise with several ABA Advisors, ULLCA (2006) used a double filing and "embryonic certificate" approach. An organizer may deliver for filing a certificate of organization without the company having any members and the filing officer will file the certificate, but:

- the certificate as delivered to the filing officer must acknowledge that situation;
- the limited liability company is not formed until and unless the organizer timely delivers to the filing officer a notice that the company has at least one member; and
- when the filing officer files that notice, the company is deemed formed as of the date stated in the notice.
- if the organizer does not timely deliver the required notice, the certificate lapses and is void.[76]

An organizer who files a certificate of formation without a "no members" statement has effectively affirmed the contrary — that is, that the limited liability company will have at least one member upon formation.[77]

As part of its project on the Harmonization of Business Entity Act, the ULC abandoned this approach. ULLCA (2013) provides that: (i) a certificate of formation is effective when filed by the filing officer; but (ii) the LLC comes into existence only when the certificate is in effect and at least one person has become a member.[78]

§14.3.3 Theology, Shelf LLCs, and *Quo Vadis*?

Opposition to the idea of a shelf LLCs rests on two interrelated premises: that an LLC is essentially a form of partnership and that an LLC is essentially a creature of contract. From these premises, it is simple to see that the organization should not pre-exist its members. How can a contract exist without parties? How can a partnership exist without partners?[79]

This perspective hung together under the old "Kintner" tax classification regulations, which influenced LLC statutes to impose a two-member requirement.[80] Even then, however, the perspective ignored several fundamental ways in which an LLC is a "creature of statute."

1. A mere agreement among prospective members cannot bring an LLC into existence. Invocation of a statute is necessary.
2. Invoking the statute and complying with its requirements brings into existence a separate legal person—"an entity distinct from its members."[81]
3. "The 'separate entity' characteristic is fundamental to a limited liability company and is inextricably connected to . . . the liability shield."[82]
4. The liability shield is half the *raison d'etre* for the LLC[83] and results from the formal invocation of the statute, not from the members' agreement.

Once the "check-the-box" regulations opened the gate (or tore down the wall) to single-member LLCs, the partnership/contract paradigm lost all claim to coherence. A contract requires at least two parties,[84] and a

partnership must have at least two partners. But SMLLCs have become major players in the law and practice ofbusiness organizations, and their existence and importance irrefutably call for a paradigm shift.[85]

The SMLLC does not by itself demonstrate that shelf LLCs ought to be permitted. The SMLLC does, however, reveal that the partnership/contract paradigm is no longer a plausible reason to oppose the shelf LLC.

§14.4 CONSEQUENCES OF ENTITY STATUS

§14.4.1 The Liability Shield

Because a limited liability company is "an entity distinct from its member or members,"[86] its assets and obligations pertain to it and not to its members. As a result, absent extraordinary circumstances,[87] an LLC's members are not answerable *qua* members for the debts and other obligations of the LLC.[88]

LLC statutes each contain "shield language," and many statutes extend the shield to include managers. For example, ULLCA (2013) provides:

> A debt, obligation, or other liability of a limited liability company is solely the debt, obligation, or other liability of the company. A member or manager is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the company solely by reason of being or acting as a member or manager.[89]

The phrase "*solely* by reason of' is crucial. The liability shield merely severs the automatic vicarious liability that would attend the status of general partner. The LLC shield provides no protection against liability that comes from some other source.

Example

> A manager personally guarantees a debt of a limited liability company formed under ULLCA (2013). ULLCA (2013) §304(a) is irrelevant to the manager's liability as guarantor. (As a practical matter, the person's role as manager may cause the obligee to seek, and the manager to provide the guarantee. As a legal matter, however, the person's status as manager does not pertain to the guarantee.) ◂◂◂

Example

> A member purports to bind a ULLCA (2013) limited liability company while lacking any agency law power to do so. The limited liability company is not bound, but the member is liable for having breached the "warranty of authority."[90] ULLCA (2013) §304(a) does not apply. The liability is not *for* a "debt, obligation, or other liability of the limited liability company," but rather is the member's direct liability resulting because the limited liability company is *not* indebted, obligated or liable.[91] ◂◂◂

Case in Point — People v. Pacific Landmark

> "The City of Los Angeles and the People of the State of California (collectively, the City) brought a red-light abatement action against the operators of a business and the owners of the strip mall where the business was located. The action alleged that the business was a front for prostitution and an illegal massage parlor. The trial court issued a preliminary injunction prohibiting the operation of a massage parlor or a house of prostitution. Pacific Landmark, LLC (Pacific), a limited liability company and owner of the property, and Ron Mavaddat, Pacific's manager . . . [appealed. On appeal] Mavaddat . . . contends, as manager of Pacific, that he is exempt from personal liability for any order or judgment against Pacific. . . . [W]e hold that managers of limited liability companies are not immune from personal liability if they have participated in tortious or criminal conduct while performing duties as managers."[92] ◂◂◂

The liability shield pertains only to claims by third parties and is irrelevant to claims by a limited liability company against a member or manager and *vice versa*.

Example

> Narnia LLC is a member-managed LLC. Edmund, one of the members, breaches his duty of loyalty, causing damage to the LLC. For two reasons, the liability shield is irrelevant. First and foremost,

Edmund's liability is not that "*of* a limited liability company"[93] but rather *to* the limited liability company. Second, Edmund's liability is not "solely by reason of acting as a member" but rather by reason of Edmund's breach of the duty of loyalty. ◀◀◀

§14.4.2 Other Consequences of Entity Status

There are numerous other consequences to an LLC's entity status.[94] Many can be grouped as follows.

a. Capacity to Sue and Other Matters Related to the Mechanics of Litigation

As a separate legal entity, an LLC is:

- authorized and required to sue and be sued in its own name;
- not able to be represented in court by a non-attorney member;
- subject to particular requirements relating to service of process; and
- not an agent for service of process on any of its members (including a sole member).

b.Matters Related to Property

Most courts agree that a member's contribution of property to an LLC constitutes "more than a change in the form of ownership; it is a transfer from one entity to another,"[95] which means that a contribution of property to an LLC:

- can trigger a deed tax, even if the contributor is the LLC's sole member, unless the tax statute provides otherwise;
- can entitle a real estate broker to commission for the "sale" from the member to the LLC;
- means that the former owner of property contributed to an LLC lacks standing to contest zoning activities pertaining to the property and that LLC members cannot sue to partition land contributed to (and therefore owned by) the LLC;
- puts the contributed property out of the reach of the contributor's creditors, unless a creditor can make a case of fraudulent transfer or persuade the court to do a reverse pierce, treating the LLC as if it were the member;[96]
- renders improper a *lis pendens* filed by a creditor of an LLC member against real property owned by the LLC; and
- renders inapplicable the statute of frauds to an agreement to sell an LLC membership interest, even when the LLC's only asset is land.

Case in Point — Gebhardt Family Inv., L.L.C. v. Nations Title Ins. of NY, Inc.

For estate planning purposes, a husband and wife formed a limited liability company, became the company's only members, and conveyed to the company real estate that they had previously owned as joint tenants. As joint tenants, they had title insurance on the property and had previously reported to the insurer a cloud on the title. After the conveyance, the insurer successfully asserted that the title insurance no longer applied. The policy excluded coverage for subsequent purchasers and the LLC had succeeded to the title by "purchase."[97] ◂◂◂

---

§14.5 THE OPERATING AGREEMENT

§14.5.1 Definition, Function, Power, and Scope

All LLC statutes contemplate an agreement among the members of an LLC and provide a pivotal role for that agreement; the label "operating agreement" is used by almost all LLC statutes.[98] "Like the partnership agreement in a general or limited partnership, an LLC's operating agreement serves as the foundational contract among the entity's owners."[99]

Many LLC statutes contain definitions such as the following: "'Operating agreement' means the agreement and any amendments thereto, of the members as to the affairs *of* a limited liability company and the conduct of its business."[100] A few statutes reserve specified matters to the articles of organization, but under all LLC acts the operating agreement has broad power and scope.

Flexibility of structure is one the hallmarks of the LLC, and the operating agreement is the mechanism through which members can revise or displace the statutory default rules to create "a specially tailored relationship."[101] The Delaware Supreme Court has characterized the operating agreement as the "cornerstone" of a Delaware limited liability company,[102] and, assuming the members (or their lawyers) have given thought to the operating agreement, the same is true under any LLC act.

In a highly lawyered deal, the operating agreement might entirely displace the statutory default rules. The Delaware Chancery Court must have had such situations in mind when it noted that, under Delaware law, "LLC members' rights begin with and typically end with the Operating Agreement."[103]

The following is a nonexhaustive list of topics that an operating agreement might address:

- *membership* — requirements and rights for admitting members, both as to memberships obtained directly from the limited liability company and as to memberships obtained as a transferee from a current member; transferability of membership interests; conditions and consequences of member dissociation;
- *governance* — management structure; classes of membership interests; voting rights ofmembers; number ofmanagers; qualifications, selection procedures, and duties for managers; matters reserved for member decision;
- *finance* — amount and status of member contributions; consequences for nonperformance of a contribution promise, including the power of the limited liability company to compromise its claims; amount and timing of interim distributions; priorities in liquidating distributions; distributions in kind; and
- *dissolution* — events that trigger dissolution; ability of the limited liability company to avoid dissolution following member dissociation; authority to manage winding up; preferences in liquidating distributions.[104]

The extent to which an operating agreement can reshape or even negate fiduciary duties among members and to the limited liability company is a complicated and controversial question. Section 15.4.7 addresses that question.

§14.5.2 Required upon Formation?

Few LLC statutes expressly require an LLC to have an operating agreement, but most LLC statutes define "operating agreement" so broadly that, "as soon as a limited liability company has any members, the limited liability company [necessarily] has an operating agreement."[105]

A comment to ULLCA (2006)'s definition of "operating agreement" provides a useful example:

> For example, suppose: (i) two persons orally and informally agree to join their activities in some way through the mechanism of an LLC, (ii) they form the LLC or cause it to be formed, and (iii) without further ado or agreement, they become the LLC's initial members. The LLC has an operating agreement. "[A]ll the members" have agreed on who the members are, and that agreement — no matter how informal or rudimentary — is an agreement "concerning the matters described in Section 110(a) [which delineates the broad scope of the operating agreement]."[106]

Requiring an LLC to have an operating agreement can cause mischief if the statute requires the operating agreement to be in writing.

Case in Point—Horning v. Horning Const., LLC

The founder of a business transformed it into a limited liability company and, as a long-term exit strategy, agreed to have two employees become members of the LLC. When they subsequently took control of the company over the founder's objection, he sought judicial intervention. The relevant LLC statute required a written operating agreement, and no such agreement had been executed. The LLC statute allowed for court-ordered dissolution when it was not "reasonably practicable" to carry on the business of the LLC in conformity with the operating agreement, and there were ample facts to establish an oral agreement protecting the founder. However, in light of the statute's requirement for a *written* operating agreement, the court declined to apply that dissolution provision.[107] ◄◄◄

In any event, it is unwise to form a limited liability company without simultaneously arranging for an operating agreement. The simple mechanics for creating the LLC as a legal entity can be a trap for the unwary;[108] those who organize an LLC without considering an operating agreement saddle the members with the default provisions of the statute. Those provisions might comprise rules unexpected by the members and inappropriate for the enterprise.

§14.5.3 Operating Agreement in a Single-Member LLC?

An operating agreement is a contract, and at common law a contract necessarily has at least two parties. "It may therefore seem oxymoronic to refer to" an operating agreement in a single-member LLC.[109] However, many (perhaps most) LLC statutes do just that.

For example, under the Arizona LLC statute, operating agreement means, "[i]n the case of a limited liability company that has a single member, any written or oral statement of the member made in good faith."[110] The Oregon statute vests the "power to adopt, alter, amend or repeal an operating

agreement of . . . a single member limited liability company, in the sole member of the limited liability company,"[111] and Washington law defines "limited liability company agreement" to include "any written statement of the sole member."[112]

A comment to ULLCA (2013) explains the history beyond this seemingly strange approach:

> This re-definition of "agreement" is a function of "path dependence." LLC statutes initially required an LLC to have at least two members, and almost all LLC statutes contemplated an agreement among members as an LLC's key organic document. Because LLC statutes make the operating agreement the principal way to override statutory default rules, the advent of single member LLCs made it necessary to provide that a sole member could make an operating agreement.[113]

§14.5.4 Mechanics of Adoption and Amendment

a. Adoption

An operating agreement must initially be agreed to by all persons who are members of the limited liability company at the moment at which the agreement is adopted. Some LLC statutes make this point directly. For example, the Virginia LLC act provides: "An operating agreement must initially be agreed to by all of the members."[114] Under other statutes, the rule is implied by the definition of the term "operating agreement" as an agreement of the members and from the common law concept of "agreement."

b. Writing Requirement?

A few LLC statutes require the operating agreement to be in writing or require a writing to revise or displace specified statutory default rules.[115] However, most LLC statutes define the operating agreement as "written or oral"[116] or even as including terms implied in fact.[117]

c. Articles of Organization as Part of the Operating Agreement?

If the members of an LLC control the contents of the articles of organization and each member must consent to any change, it is possible to consider those contents to be part of the operating agreement. The broad definition of "operating agreement" invites this analysis, at least where the articles and the contents of the operating agreement do not conflict.[118]

Often, however, an LLC's articles can be amended with less than unanimous consent of the members. ULLCA (2013), for example, provides that an amendment to an LLC certificate of organization may be signed by any "person authorized by the company"[119] and does not necessarily require unanimous member consent to authorize amending the certificate.[120]

Where possible, it would be wise to have the LLC's operating agreement expressly determine whether the articles of organization comprise part of the operating agreement.

d.Amending the Operating Agreement — Quantum of Consent

As a default matter, amending the operating agreement requires the consent of all persons then members. This rule follows from basic contract law principles and is also stated expressly in some acts. The rule applies regardless ofwhether an LLC is managed directly by its members or through managers.[121]

Example

> Faculty Support Services, LLC ("FSS"), is a limited liability company organized under the law of a state that requires each limited liability company's articles of organization to specify either a member-managed or manager-managed structure. FSS is manager-managed, and its operating agreement provides that "all management questions will be decided exclusively by the managers, Lynette and Melissa." Amendment of the operating agreement will nonetheless require the consent of all the members. ◄◄◄

Non-unanimous amendment is permissible, if the operating agreement itself so provides. Some statutes make this point expressly. For example, ULLCA (2013) states that the operating agreement governs "the means and

conditions for amending the operating agreement."[122] It is common for operating agreements to specify a quantum of consent in terms of profits interest held by members, rather than providing that members vote *per capita*.

Example

> Framers, LLC, has five members, with profits interests allocated as follows, per the operating agreement:

Ben	10%
James	30%
John	10%
Sam	20%
Thomas	30%

> The operating agreement also provides that "this agreement may be amended by a writing signed by members who at proposed effective date of the amendment own 70 percent of the profits interests then owned by members." A writing signed by Ben, James, and Thomas will suffice to amend the operating agreement. Likewise will a writing signed by all the members other than James, or all the members other than Thomas. ◂◂◂

Requiring unanimity can be problematic, but relaxing the unanimity requirement has risks as well. If unanimous consent is required, in effect each member can veto any fundamental changes in an LLC's governance and operations — no matter how advisable or even necessary the proposed changes might be. Moreover, this veto power extends to efforts to adjust even minor rules that happen to be delineated in the operating agreement.

On the other hand, requiring less than unanimity carries the risk of majoritarian oppression. Requiring a supermajority reduces but does not eliminate the problem.

Example

> Litigation Support Services, LLC ("LTS") is a member-managed

limited liability company, whose operating agreement provides that the agreement can be amended by the consent of members owning 80 percent of interests in current profits owned by members. Members owning 85 percent of the interests in current profits consent to amend the operating agreement to reduce the profit percentage of the other members from an aggregate of 15 percent to an aggregate of 10 percent, with the other 5 percent being allocated among the members comprising the 85 percent majority. There is no plausible business justification for the amendment, but the amendment complies with the quantum requirement stated in the operating agreement and, at least formally speaking, is valid. ◂◂◂

Careful drafting can limit the risks of nonunanimous amendments, and sophisticated operating agreements sometimes specify several categories of amendment, each requiring a different quantum of consent (e.g., members holding a majority of profit interests owned by members; members owning a specified supermajority of profits interests; unanimous consent).

In extreme situations — such as described in the Example just above — the contractual obligation of good faith and fair dealing will apply and the perpetrators will be in breach.[123] Also, if the relevant jurisdiction recognizes member-to-member fiduciary duties, majoritarian oppression will breach those duties as well.[124]

e.Amending the Operating Agreement — Writing Requirement

To the extent that an LLC statute requires the operating agreement to be in writing, perforce any amendment must also be in writing. Under statutes permitting oral or implied-in-fact operating agreements, it is an open question whether a written operating agreement can itself preclude oral or implied-in-fact amendments. An operating agreement is a contract, and at common law, courts have often overridden or disregarded contractual terms aimed at precluding nonwritten amendments. It is for that reason that Article 2 of the Uniform Commercial Code expressly and specifically authorizes such provisions in contracts for the sale of goods.[125]

Few, if any, LLC statutes contain language as specific as the UCC provision. However, many LLC statutes authorize an operating agreement to control the means of its amendment. For example, the Virginia LLC statute

states: “If the articles of organization or the operating agreement provide for the manner by which an operating agreement may be amended, including by . . . requiring the satisfaction of conditions, an operating agreement may be amended only in that manner or as otherwise permitted by law.”[126] The final phrase (“or as otherwise permitted by law”) is perhaps an invitation to courts to indulge their common law antipathy. In contrast, ULLCA (2013) provides simply that “the operating agreement governs . . . the means and conditions for amending the operating agree- ment,”[127] and an official comment states that “Under this provision, the operating agreement can control . . . the means by which the consent [to an amendment] is manifested [including] prohibiting modifications except when consented to in writing.”[128] Another section buttresses this view, stating that: “An operating agreement may specify that its amendment requires . . . the satisfaction of a condition. An amendment is ineffective if its adoption does not . . . satisfy the specified condition.”[129] The comment states directly that, under the quoted language, “an operating agreement can require that any amendment be made through a writing or a record signed by each member.”[130]

§14.5.5 Lacunae in the Operating Agreement

If an operating agreement does not address a particular issue, those with management authority in the LLC will likely deem the issue within their authority. In some circumstances, the results can be quite unexpected for other members.

Case in Point — KBL Properties LLC v. Bellin

Two members of an LLC (constituting a majority) voted for a capital call of $225,000. Those members contributed $157,500 in the aggregate, and Bellin (the third member) contributed nothing. “Under the terms of the operating agreement, Bellin’s financial interest declined to 0.00063 percent as a result of the new contributions of equity capital.” Pursuant to the operating agreement, the majority members served Bellin with a notice of purchase of his interest calculated at $6.30. When Bellin would not sell, the LLC brought an action for declaratory judgment that “additional equity capital was lawfully raised, minority member’s [Bellin’s] financial interest was lawfully

reduced, plaintiff member had lawfully exercised his buy-sell option, and that he was entitled to lawfully purchase minority member's entire membership interest in accordance with buy-sell offer." The court of chancery found that the operating agreement required unanimous consent before any mandatory capital contributions could be required and ruled the buy-sell offer to be void. The LLC appealed. The Supreme Court reversed, holding that "[the] resolution makes no change or modification to the operating agreement and, therefore, cannot be called an amendment. Thus, the operating agreement's default provision on voting applies, and this resolution could properly be approved by a vote of members holding an aggregate governance interest of at least 51 percent."[131] ◂◂◂

§14.5.6 Relationship of Operating Agreement to New Members

It would be conceptually and practically chaotic to allow persons to become members of an LLC without being bound to the operating agreement, and many LLC statutes address this issue. Delaware's approach is perhaps the most complex. ULLCA (2013)'s approach is comparatively straightforward.

Under Delaware law:

> A member or manager of a limited liability company or an assignee of a limited liability company interest is bound by the limited liability company agreement whether or not the member or manager or assignee executes the limited liability company agreement. . . . A written limited liability company agreement or another written agreement or writing:
>
> a. May provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned:
>
> 1. If such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) executes the limited liability company agreement or any other writing evidencing the intent of such person to become a member or assignee; or
> 2. Without such execution, if such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) complies with the conditions for becoming a member or assignee as set forth in the limited liability company agreement or any other writing; and
>
> b. Shall not be unenforceable by reason of its not having been signed by a person being admitted as a member or becoming an assignee as provided in paragraph (7)a. of this section, or by reason of its having been signed by a representative as provided in this chapter.[132]

Under ULLCA (2013), “A person that becomes a member [of a limited liability company] is deemed to assent to the operating agreement.”[133]

If the relevant LLC statute is silent on this important issue, it is possible to argue that a person’s assent to becoming a member amounts to assent to the operating agreement. The argument intertwines aspects of LLC law and contract law: Given the fundamental nature of an operating agreement and the chaos that would result if the operating agreement did *not* apply to all members, a reasonable person would interpret a person’s manifestation of assent to becoming a member as implicit assent to the operating agreement.

There are counterarguments, however, especially if the operating agreement is not in writing and a new member claims to have assented to becoming a member while ignorant of some subsequently problematic term. In any event, careful drafting can eliminate the problem, for example, by having the operating agreement specify that no person can become a member without first agreeing to be a party to and bound by the operating agreement. Or, put another way, the operating agreement could provide that one of the conditions to becoming a member is to agree to (and, if the operating agreement is in writing, sign) the operating agreement.

§14.5.7 Resolving Conflicts Between Articles and Operating Agreement

Suppose that an LLC’s articles of organization and operating agreement conflict. Which governs? Most LLC statutes are silent on this issue.

ULLCA (1996) was the first LLC Act to address the problem,[134] giving priority to the operating agreement in *inter se* matters and priority to the articles of organization when third-party interests are involved. However, as noted in section 14.1.3, ULLCA (1996) has not been widely adopted.

ULLCA (2006) and (2013) both carried forward and expanded the approach of ULLCA (1996); each contemplates conflicts between the operating agreement and any “record” that has been filed by the filing officer. In the words of ULLCA (2103):

> [I]f a record that has been delivered by a limited liability company to the [Secretary of State] for filing becomes effective and conflicts with a provision of the operating agreement:
>
> (1) the agreement prevails as to members, persons dissociated as members, transferees,

and managers; and

(2) the record prevails as to other persons to the extent they reasonably rely on the record.[135]

This approach makes the operating agreement paramount among the members, but protects third parties that have reasonably relied on the public record.[136]

In the absence of a statutory mechanism for resolving conflicts, courts might well adopt the quoted approach as a matter of common law.[137]

Problem 115

> Standup, LLC, ("Standup"), a limited liability company organized under the law of the state of Delaware, is for all practical purposes "located" in Des Moines, Iowa. All three of its members are individual residents in Iowa, and Standup does all its business within Iowa. After fruitless attempts to collect on an invoice, Standup sues one of its customers. Which state's law applies to the dispute? ◂◂◂

Explanation

> Unless the contract between Standup and its customer provides otherwise, ordinary choice of law principles make Iowa law the applicable law. Although Standup is a "Delaware" LLC, the "internal affairs" doctrine does not apply here. A dispute between a limited liability company and one of its customers is not an *internal* affair. ◂◂◂

Problem 116

> Carolyn acts as the organizer of a limited liability company, formed under the law of a state whose statute has typical provisions so far as may be relevant to this question. Which of the following statements is (are) true?

1. Carolyn may be, but need not be, an initial member of the limited liability company.
2. In acting as an organizer, Carolyn does not act as an agent of the limited liability company.
3. For some purposes, the law requires at least one additional organizer.
4. Carolyn is acting on behalf of the person or persons who will become the limited liability company's initial member or members.

5. Carolyn is acting as a gratuitous agent. ◂◂◂

Explanation

1. True.
2. True — until Carolyn has completed the tasks necessary to form the limited liability company, the limited liability company does not exist. A person cannot act as agent for a nonexistent principal.[138]
3. False.
4. Close call — this proposition is arguably true under most LLC statutes but problematic for those statutes that permit "shelf' LLCs.
5. Ambiguous — LLC law does not address this point. In practice, the answer varies. For example, it is quite possible for one of the initial members of an LLC to "handle the paperwork" without compensation for that task. But it is also quite common for an attorney (or an attorney's paralegal) to serve as an organizer as part of compensated legal work — typically in connection with other related tasks, such as drafting the operating agreement. ◂◂◂

Problem 117

> Propane, LLC ("Propane") is a manager-managed limited liability company in the business of supplying propane to commercial and residential users. InCharge, Inc. ("InCharge"), is a member of Propane and also its sole manager. HandsOff, Inc. ("HandsOff') is the other member of Propane. Beth is the Executive Vice President of InCharge, and in that capacity directs both InCharge's efforts as manager of Propane and InCharge's other day-to-day activities.

After a propane accident at the home of one of Propane's customers, the customer sues both Propane and InCharge. Assuming that: (i) the accident was proximately and foreseeably caused by Beth's negligence; and (ii) Beth's negligence was within the scope of her employment as the Executive Vice President of InCharge, does InCharge benefit from the LLC liability shield? Does HandsOff?[139] ◂◂◂

Explanation

> InCharge does not benefit. Under the doctrine of *respondeat superior*, Beth's liability is imputed to InCharge.[140] This liability is as a tortfeasor (albeit vicariously, through principles of agency law) — not by reason of InCharge's status as a manager or member of Propane.
>
> In contrast, HandsOff does benefit from the LLC liability shield.

The facts provide no nexus whatsoever between the customer's claim and HandsOff except HandsOff s status as a member of Propane. ◂◂◂

Problem 118

Todd, a physician, forms a member-managed limited liability company, Bear, LLC ("Bear") to take title to a plot of land that Todd has owned individually for 15 years. Todd contributes the land to the limited liability company in return for becoming the LLC's sole member.

Subsequently, Todd learns of a proposed zoning ordinance that would limit the permissible uses of the land. He seeks judicial intervention to fight the zoning change. May he appear *pro se*? ◂◂◂

Explanation

For several interrelated reasons, the answer is no. A non-lawyer may only represent him or herself in court, and Todd, as an individual, has no standing to object to the zoning change. That is, the land belongs to Bear, not to Todd, and, therefore, cognizable injury (if any) directly affects Bear, not Todd. A limited liability company is a legal person distinct from its members, even when the LLC has only one member. In this context, it is irrelevant that Todd's position as sole member gives him total control over Bear's activities. ◂◂◂

Problem 119

Wainright, LLC ("Wainright") has existed for five years, and since its formation has had an oral operating agreement. Gideon is admitted as a new member of Wainright without expressly agreeing to the operating agreement, and later asserts that a particular provision of the operating agreement is not binding on him. The operating agreement is silent on the issue. From the perspective of the limited liability company, would the Delaware LLC Act or ULLCA (2013) be the more favorable statute? ◂◂◂

Explanation

ULLCA (2013) — it provides that "[a] person that becomes a member [of a limited liability company][141] is deemed to assent to the operating agreement and does not limit its scope to written operating agreements."[142] In contrast, the Delaware provision appears to refer to a written operating agreement: "A member or manager of a limited liability company or an assignee of a limited liability company interest is bound by the limited liability company agreement whether or not the member or manager or assignee *executes* the limited liability company agreement."[143] ◂◂◂

---

1. Because an LLC is a legal person separate from its members and because an LLC is created by the public filing of a document (rather than an agreement among its members), it is conceptually possible for an LLC to be formed without having any initial members. The label "shelf LLC" suggests that the memberless entity "sits on the shelf' awaiting the arrival of one or more initial members. Whether LLC statutes should allow such "shelf' LLCs has been controversial. See section 14.3.

2. Service companies exist to provide either or both for a fee.

3. In this context, the term "foreign" does not mean "non-United States" but rather "not domestic," and a limited liability company is considered "domestic" vis-a-vis its state of organization. See ULLCA (2013), §§102(5) (defining "foreign limited liability company"); 902(a) (stating that "[a] foreign limited liability company may not do business in this state until it registers with the [Secretary of State] under this [article]"); 905(a) (enumerating those activities that do not constitute "transacting business" by a foreign LLC). In this regard, LLC law follows the law of other business entities. See, e.g., Rev. Model Bus. Corp. Act, §§15.01, 15.02; ULPA (2001), §§902, 903, 907.

4. For a relatively current formulation, see RESTATEMENT (SECOND) OF CONFLICT OF LAWS §302, cmt. a (1971) (defining "internal affairs" with reference to a corporation as "the relations *inter se* of the corporation, its shareholders, directors, officers or agents").

5. SD Stat. §47-34A-113(1). "Limited liability company" is defined to mean a domestic limited liability company, i.e., a limited liability company organized under "the law of this state." *Id*., §47-34A-101(8). See also ULLCA (2013) §102(8) defining the term to mean "an entity formed under this [act]."

6. Ironically, even those LLC statutes that do not codify the internal affairs doctrine as to domestic LLCs do so with regard to foreign LLCs. That is, every LLC statute expressly provides that the law of the state of formation of a foreign limited liability company governs that company's internal affairs.

7. ULLCA (2013), §104(1), cmt.

8. ULLCA (2013), §104(2), cmt.

9. Such claims are typically labeled "piercing" claims. See section 13.1.2(a).

10. Ga. Code Ann., §14-11-1107(h).

11. See section 14.1.2(b).

12. Rual Trade Ltd. v. Viva Trade L.L.C., 549 F. Supp. 2d 1067, 1077 (E.D. Wis. 2008) (quoted in ULLCA (2013) §104(2), cmt).

13. For a discussion of the variation among LLC statutes and this book's approach to the variation, see section 13.2.1. The second question should be, "Is there a written operating agreement?" See Section 14.5.

14. Ga. Code Ann., §14-11-203(a). See also, e.g., Va. Code §13.1-1010 and ULLCA (2006), §102(14) (defining "organizer" as a person that acts under section 201 to form a limited liability company).

15. Ariz. Stat. §29-631(A).

16. Although the organizer must sign the document, drafting and delivery can be delegated. If the

person or persons seeking to form the LLC have consulted an attorney, typically the attorney drafts the document, the organizer signs, and a paralegal or legal assistant arranges to submit the document. As noted in Section 14.1.3(b)(1), an organizer need not be a natural person. When an organization is an organizer, the organizer signs through an authorized, disclosed agent.
17. See section 14.3.
18. E.g., Ariz. Laws 1997, Ch. 282, §18 (amending Ariz. Rev. Stat. §29-631); Colo. Laws 2003, Ch. 352, §178 (amending Colo. Rev. Stat. §7-80-203).
19. Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax and Business Law (Warren, Gorham & Lamont/RIA 1994, Supp. 2017-1) ("Bishop & Kleinberger"), *fl5.05[1][a]. "Practice-pointer: Even under statute that states no age requirement for organizers that are individuals, prudence requires use of only individuals who have the capacity to make a non-voidable contract." *Id*.
20. See, e.g., Del. Code Ann., tit. 6, §18-101(6) (defining "limited liability company" as "a limited liability company formed under the laws of the State of Delaware") and (11) (defining "member" as "a person who has been admitted to a limited liability company"); ULLCA (2006)§102(8) (defining "limited liability company" as "an entity formed under this [act]") and (11) (defining member as "a person that has become a member of a limited liability company"). A few statutes are careless on this conceptual point.
21. Va. Code Ann., §13.1-1010.
22. Ariz. Stat. §29-631.
23. See section 12.2.2.
24. Cal. Corp. Code, §17050(a). Effective 2014, California repealed this act and substituted its version of ULLCA (2006).
25. See section 2.7.2(a).
26. Del. Code Ann., tit. 6, §18-201(a).
27. The so-called "shelf LLC" is discussed in section 14.3.
28. ULLCA (2013) §401. ULLCA (2006), §4011is verbatim the same.
29. See section 4.1.1.
30. "Promoter" is a term of art referring to a person who: (i) identifies a business oppor-tunity; (ii) solicits investors who will become owners of a legal entity to be formed to house the proposed business; and (iii) sometimes makes initial arrangements for the business in anticipation of the formation of business entity.
31. Roni LLC v. Arfa, 74 A.D.3d442, 444-45, 903 N.Y.S.2d 352, 355 (A.D. 1 Dept. 2010).
32. In some states, the applicable LLC statute specifies LLC-related filing fees. In other states, a statute pertaining to the filing office contains all fees for filings in that office.
33. See section 14.1.4(c).
34. See, e.g., Rev. Model Bus. Corp. Act, §1.40(1); Cal. Corp. Code, §154. Va. Code Ann., §13.1-603.
35. A limited partnership is formed through the signing and filing of a certificate of limited partnership. See section 12.2.2.
36. Del. Code Ann., tit. 6, §§18-101(2) and 18-201 (using the term "certificate of formation").
37. ULLCA (2006), §102(1), cmt. (referring to "certificate of organization") (emphasis in original). ULLCA (2013) made no change. See *Id*., §102(1) and cmt.
38. Del. Code Ann., tit. 6, §18-201(a)(1) and (2).
39. See section 15.3.
40. Colo. Rev. Stat. §7-80-204(1)(g). For a discussion of shelf LLCs, see section 14.3.
41. See, e.g., Limerick Auto Body, Inc. v. Limerick Collision Center, Inc., 769 A.2d 1175, 1179 (Pa. Super. Ct. 2001).
42. ULLCA (2013), §112, cmt.
43. See the discussion at section 14.5.7.
44. ULPA (2013), §103(c); ULPA (2001), §103(c).
45. ULPA (2013), §103(c), cmt, discussing Water, Waste & Land, Inc. v. Lanham, 955 P.2d 997, 1001,

1003 (Colo. 1998). The ULPA (2001) §103(c), cmt. is the same.
46. For a discussion ofwhy an entity entirely separate from its owners might need to have at least one owner to come into existence, see section 14.3.
47. For the circumstances under which members of an LLC might become liable for the LLC's liabilities, see section 14.4.1.
48. ULLCA (2013) §108(b), cmt. The comment warns, however, that "this act does not include any comprehensive protections pertaining to charitable assets and purposes."
49. Recall that a general partnership is "an association of two or more persons to carry on as co-owners a business for profit." UPA (1914), §6(1); UPA (1997), §202(a). The ULPA (1976/1985), §106 stated that a limited partnership may carry on "any business that a partnership without limited partners might carry on" and thereby limited a limited partnership to a business purpose. The ULPA (2013) §110(b) harmonized the uniform limited partnership act with the uniform limited liability company act and thus removed the business purpose requirement: "A limited partnership may have any lawful purpose, regardless of whether for profit."
50. Allstate Ins. Co. v. A&A Medical Transp. Servs., Inc., Docket Nos. 260766, 261504, 2007 WL 162477 at *1, 3-6 (Mich. App. Jan. 23, 2007) (citations omitted). The insurance company made parallel assertions with regard to clinics organized as ordinary corporations.
51. Model Business Corporation Act, §3.02, cmt.
52. Head & Armory v. Providence Ins. Co., 6 U.S. (2 Cranch) 127, 160 (1804).
53. See Alan R. Palmiter, Corporations: Examples and Explanations 8 (Aspen 5th ed.) (2006).
54. Model Business Corporation Act, §3.02, cmt.
55. The drafters of the Model Business Corporation Act gave "serious consideration . . . to whether there was a continued need for a long list of corporate powers of whether a general provision granting every corporation power to act to the same extent as an individual might be substituted." MBCA §3.02, cmt. The decision to the contrary was "[b]ecause of the long history of these [enumerated] powers." *Id*.
56. For an explanation of the aggregate and entity construct, see section 7.2.7.
57. UPA (1914) §§8(1), 10, and 25.
58. UPA (1914) §15 (providing for joint and several liability of partners for partnership obligations resulting from the wrongful conduct of a partner and joint liability of partners for other partnership obligations); UPA (1997), §307(a) (providing that a partnership may sue and be sued in the name of the partnership); Del. Code Ann., tit. 10, §3904 (stating that "[a]n unincorporated association of persons, including a partnership, using a common name may sue and be sued in such common name").
59. UPA (1997), §201(a).
60. This provision originated as §3 of the 1916 uniform act, appears unchanged in the RULPA (1976), §106, and was unaffected by the 1985 amendments.
61. ULPA (2001), §105. For reasons not relevant here, the section also states a few specific powers. See *Id*., cmt.
62. See section 12.3.3.
63. ULPA (2001), §201, cmt.
64. ULLCA (2013) §109.
65. Del. Code Ann., tit. 6, §18-106(b).
66. Cal. Corp. Code §17003 (1994).
67. In the new California statute, which took effect January 1,2013, the list appears in section 17701.05.
68. ULLCA (2006), §201, cmt.
69. This Example is based on a comment by a Uniform Law Commissioner Bruce A. Cogge- shall, during the floor debate on ULLCA (2006) at the 2005 Annual Meeting of the Uniform Law Commissioners: What often happens is, a client will call you up and say, I need to get a limited liability company formed. You have to form it right away. I am not sure who the members are going to be. It might be me. It might be my wife. It might be my kids. But I want to get the thing formed. You as the lawyer, as the organizer, sign the articles, send them to secretary of state, and then you are legally

formed. But there isn't anybody who feels at that point that they're a member or that they have the obligations of a member or the obligations to a member that a member has.
70. Cal. Corp. Code, §17001(t); Del. Code Ann., tit. 6, §18-101(6).
71. Under most LLC statutes, the LLC will dissolve and be required to wind up its business unless at least one new member is admitted within a specified time limit. But, as with a partnership, dissolution does not terminate the existence of the LLC. See section 11.2.1(g) (partnership dissolution).
72. See, e.g., ConnectU LLC v. Zuckerberg, 482 F. Supp.2d 3 (D. Mass. 2007), reversed on other grounds, 522 F.3d 82, (1st Cir. 2008). Although learned practitioners have debated whether the Delaware LLC statute permits a shelf LLC, the ConnectU district court held that there "simply is no requirement under Delaware law that there be members of an LLC at formation." This holding was integral to the court's decision that diversity jurisdiction did not exist. *Id*. at 27.
73. Va. Code Ann., §13.1-1003(F)(2). See also, N.C. Gen. Stat. §57C-1-20 (providing that articles of organization may be executed by an organizer or fiduciary "if no initial members of the limited liability company have been identified").
74. Va. Cod Ann., §13.1-1038.1(A)(3).
75. Colo. Rev. Stat. §7-80-204(1)(g).
76. ULLCA (2006), §201, cmt. (citations omitted). The suggested deadline for filing the second notice is 90 days.
77. ULLCA (2006), §201, cmt., explaining the interaction between §§201(b)(3) and 207(c). This double-filing approach reflects a last-minute compromise. The official comment to §201 contains the text of the Drafting Committee's previous approach, which "provided for a 'limited shelf —a shelf that lacked capacity to conduct any substantive activities." *Id*.
78. ULLCA (2013)§201(d) ("A limited liability company is formed when the company's certificate of organization becomes effective and at least one person has become a member.").
79. In contrast, a corporation can be formed without any initial shareholders. See Rev. Model Bus. Corp. Act, §§2.01 (stating that one or more persons may act as the incorporator or incorporators by delivering articles of incorporation to the secretary of state for filing), 2.03(a) (providing that the corporate existence begins when the articles of incorporation are filed, unless a delayed effective date is specified), 2.05(a)(2) (providing that the incorporator or incorporators shall elect directors if none are named in the articles of incorporation).
80. For a discussion of the Kintner Regulations, see section 13.1.4(a) and (b).
81. ULLCA (2013), §104(a). See also Del. Code Ann., tit. 6, §18-201(b).
82. ULLCA (2013), §104(a), cmt.
83. The other half is tax classification — either partnership or disregarded entity status.
84. See Restatement (Second) of Contracts, §1, cmt. c (1981) (stating that "[o]ne person may make several promises to one person or to several persons, or several persons may join in making promises to one or more persons").
85. SMLLCs are important in both (relatively) simple situations (e.g., to provide a liability shield for a business owned by an individual entrepreneur) and complex ones (e.g., to serve as a liability-deflecting wholly owned subsidiary for a nonprofit corporation, or as a "special- purpose, bankruptcy-remote entity" used to facilitate sophisticated "securitization" arrangements).
86. ULLCA (2013) §108(a). See also, e.g., Del. Code Ann., tit. 6, §18-201(b).
87. See section 16.1.
88. The obverse is true, as well. The assets and obligations of a member pertain to the member and not to the LLC. As a result, absent extraordinary circumstances, the assets of the LLC are not chargeable with the debts and other obligations of its members. See section 14.4.2(b) (discussing the "reverse pierce" and fraudulent transfers). The term "asset parti-tioning" is sometimes applied to describe the separation of an entity's assets and liabilities from those of its owners.
89. ULLCA (2013), §304(a).
90. See section 4.2.2 for a discussion of this agency law doctrine.

91. These two Examples are taken essentially verbatim from the official comment to ULLCA (2006), §304(a).
92. People v. Pacific Landmark, 129 Cal.App.4th 1203, 1206-07 (Cal.App. 2 Dist. 2005) (citations omitted).
93. ULLCA (2013), §304(a).
94. This section is based on Bishop & Kleinberger, *fl5.05[1][e] (Consequences of Entity Status).
95. Hagan v. Adams Property Assocs., Inc., 482 S.E.2d 805, 806-07 (Va. 1997).
96. Each of these claims requires a showing of fraud or substantial injustice.
97. Gebhardt Family Inv., L.L.C. v. Nations Title Ins. of NY, Inc., 752 A.2d 1222, 1226 (Md. Ct. Spec. App. 2000).
98. The Delaware Act initially used the label "limited liability company agreement." However, in June 2002, the Delaware Legislature bowed to common usage, amending the Delaware Act to refer to "operating agreements" as well. 73 Del. Laws, Ch. 295, §1 (2002), amending Del. Code Ann., tit.6, §18-101(7).
99. ULLCA (2006), Prefatory Note, Noteworthy Provisions, The Operating Agreement. See also ULLCA (2013) §105, cmt. (Principal Provisions of the Act Concerning the Operating Agreement) (stating that "the operating agreement is pivotal to a limited liability company").
100. MD Code, Corps. & Assns., §4A-101(o).
101. Bishop & Kleinberger, fl5.02[3][b][v].
102. Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999).
103. Walker v. Resource Dev. Co. Ltd., L.L.C. (DE), No. CIV. A. 1843-S, 2000 WL 1336720, at *12 (Del. Ch., Aug. 29, 2000). Another Chancery Court opinion refers to the operating agreement as the LLC's "chartering agreement." Haley v. Talcott, 864 A.2d 86, 94 (Del. Ch. 2004).
104. This list is from Bishop & Kleinberger, *fl5.06[2][a][ii].
105. ULLCA (2006), §102(13), cmt.
106. *Id*.
107. Horning v. Horning Const., LLC, 12 Misc.3d 402, 816 N.Y.S.2d 877 (N.Y.Sup. 2006).
108. See section 14.1.
109. ULLCA (2013), §102(13), cmt.
110. Ariz. Rev. Stat. Ann. §29-601 (14)(b).
111. Or. Rev. Stat. Ann. §63.431(2).
112. Wash. Rev. Code Ann. §25.15.006(7).
113. ULLCA (2013) §102(13), cmt.
114. Va. Code Ann. §13.1-1023(B)(1).
115. E.g., Ga. Code Ann., §14-11-305(1) (providing that a member of a manager-managed LLC owes no duties to the LLC or to the other members solely by reason of acting in his or her capacity as a member "[e]xcept as otherwise provided in the articles of organization or a *written* operating agreement").
116. E.g., Ariz. Rev. Stat. §29-601(14).
117. E.g., ULLCA (2013) §102(13). In 2007, the Delaware statute was amended to include the concept of implied in fact agreements. 76 Del. Laws, Ch. 105, §1 (2007), amending Del. Code Ann., tit.6, §18-101(7).
118. For a discussion of how to resolve such conflicts, see section 14.5.7. Under the Michigan statute, the articles are automatically part of the operating agreement. Michigan's definition of "operating agreement" states: "The term includes any provision in the articles of organization pertaining to the affairs of the limited liability company and the conduct of its business." Mich. Comp. Laws Ann. §450.4102(r).
119. ULLCA (2013) §203(a)(1).
120. See ULLCA (2013) §407. Amending the certificate requires unanimous member consent only if the amendment is an "act outside the ordinary course" of the company's activities. *Id*. §§407(b)(4) and

(c)(3)(a). In contrast, §407 specifically provides that amending the operating agreement requires unanimous consent. *Id*., §§407(b)(4)(A) and (c)(3)(B).

121. ULLCA (2006), §§407(b)(4)(A) and (c)(3)(B).

122. ULLCA (2013) §105(a)(4).

123. The amendment seems designed to deprive a member of the "fruits of the bargain." For a discussion of the obligation of good faith and fair dealing, see section 15.4.8.

124. For a discussion of member-to-member fiduciary duties, see sections 15.4.3 and 16.4.

125. The UCC §2-209(2) states: "A signed agreement which excludes modification or rescission except by a signed record may not be otherwise modified or rescinded."

126. Va. Code Ann. §13.1-1023(B)(3).

127. ULLCA, §110(a)(4).

128. *Id*., cmt.

129. ULLCA (2013) §107(a).

130. *Id*., cmt.

131. KBL Properties LLC v. Bellin, 900 So.2d 1160, 1161, 1166 (Miss. 2005). The result might be different under ULLCA (2013). Under Section 407(b)(4)(A), Bellin could have argued that a capital call with such draconian effect on his ownership was "outside the ordinary course of the activities and affairs of the company."

132. Del. Code Ann., tit. 6, §18-101(7) (defining "limited liability company agreement").

133. ULLCA (2013) §106(b).

134. ULLCA, §203(c).

135. ULLCA (2013), 107(d). ULLCA (2006) §112(d) is substantively identical. Differences are only stylistic.

136. ULLCA, §107(d), cmt.

137. See Bishop & Kleinberger, *fl5.06[2][c] (Limitation on Power: Relationship of Operating Agreement to Articles of Organization) (suggesting a mode of analysis). See also McDonough v. McDonough, 2015 WL 11182526, at *4 (N.H.Super. 2015) (adopting the suggested mode of analysis).

138. See section 1.4.

139. This Example is based on Estate of Countryman v. Farmers Coop. Ass'n, 679 N.W.2d 598 (Iowa 2004).

140. See section 3.2.

141. ULLCA (2013) §106(b).

142. ULLCA (2013) §102(13).

143. Del. Code Ann., tit. 6, §18-101(7). Section 14.5.4 quotes the relevant language at length.

CHAPTER 15 LLC Governance and Finance; Member Exit Rights

§15.1 FLEXIBILITY, THE MEANING OF "OWNERSHIP," AND THE RELATIONSHIP BETWEEN GOVERNANCE RIGHTS AND ECONOMIC RIGHTS

§15.1.1 Flexibility of Structure; Resulting Limits on Generalization

With regard to internal structure, the LLC is "almost ineffably flexible."[1] As a result, generalizations about LLC governance and finance are—generally speaking—less predictive than generalizations about partnerships or corporations. Although LLC statutes provide "default rules" on governance and finance,[2] these rules channel arrangements less powerfully than do default rules applicable in other mainstream business entities.

This situation stems in part from history. LLCs are only about 30 years old, and for more than half that time flexibility of structure has been a key attraction of the LLC form.[3] In addition: (i) most LLC statutes have chosen to

provide two alternate sets of default rules for structuring LLC governance;[4] and (ii) the rules of partnership tax accounting undercut whatever apparent commonality an LLC statute might imply about capital structure.[5] As a result, making an LLC the "entity of choice" for a business deal implies only weakly, if at all, a basic "menu" of arrangements from which participants will likely begin their negotiations.

§15.1.2 The Meaning of Member, Membership, and Membership Interest

This "default mode" vagueness extends to what it means to own a membership in an LLC. As a matter of nomenclature, LLC statutes differ as to whether they even use the term "membership interest" and, if so, how they define the term. For example, the original California LLC Act defined "membership interest" as "a member's rights in the limited liability company, collectively, including the member's economic interest, any right to vote or participate in management, and any right to information concerning the business and affairs of the limited liability company."[6] In contrast, the Arizona statute provides: "'Member's interest,' 'interest in a limited liability company,' or 'interest in the limited liability company' means a member's share of the profits and losses of a limited liability company and the right to receive distributions of limited liability company assets."[7]

Neither ULLCA (2013) nor the Delaware LLC Act use "membership interest" as a defined term. And, while Delaware does define "[l]imited liability company interest," the term means only (and somewhat counterintuitively) "a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets."[8] More fundamentally, LLC statutes also differ as to what rights are necessarily involved in being a member—that is, in being one of the entity's owners.

Extrapolating from the law of general partnerships and corporations, one might expect a straightforward answer—namely, that being an owner means having some right to share in prof it distributions and some right to be involved in the organization's governance.[9] However, in this respect LLC law is far from straightforward. Probably one can state with accuracy that, under all LLC statutes, a member is a person who has been (somehow) admitted as

a member of an LLC.[10] However, it is not accurate to state that a member necessarily has both economic and governance rights. Indeed, at least a few LLC statutes expressly provide to the contrary.

Example

> ULLCA (2013) §401(d) states: "A person may become a member without: (1) acquiring a transferable interest [i.e., any economic rights]; or (2) making or being obligated to make a contribution to the limited liability company." The Comment explains the reasoning of this subsection: "To accommodate business practices and also because a limited liability company need not have a business purpose, this provision permits so-called "non-economic members."[11] ◂◂◂

Example

> Del. Code Ann., tit. 6, §18-301(d) provides: "Unless otherwise provided in a limited liability company agreement, a person may be admitted to a limited liability company as a member of the limited liability company without acquiring a limited liability company interest in the limited liability company." ◂◂◂

§15.1.3 Limited Generalizations About Ownership Interests in a Limited Liability Company

"Notwithstanding the foregoing" and so long as one remembers the ineffable flexibility of the LLC form, it is still possible to generalize about the typical LLC membership and the typical relationship between a member's governance rights and economic rights—keeping in mind that these generalizations are subject to variation by the operating agreement:

- When a person becomes a member through an interaction with the limited liability company (rather than as a transferee of an existing member), the person typically obtains "membership" in return for something of value the person has "brought to the party," e.g., "property transferred to, services performed for, or another benefit provided to the limited liability company or an agreement to transfer property to, perform services for, or provide another benefit to the company."[12]
- An LLC member typically has some governance rights—at minimum, rights to information about the company's activities and the right to vote on or consent to major issues; depending

on the LLC's management structure, membership may include the right to participate directly in managing the company.[13] Under typical statutory default rules (i.e., subject to change by the operating agreement):

—Some matters typically require unanimous member consent (e.g., amending the operating agreement; according membership to a non-member transferee of a member's economic rights).

—Where non-unanimous consent suffices, voting/consent power is allocated, depending on the statute:

~ per capita;
~ in proportion to capital contributions; or
~ in proportion to profit share or distribution rights.

- An LLC member typically has the right to share in profit distributions. in the default mode:

—Depending on the statute, interim or "operating" distributions (i.e., distributions not connected with the dissolution and winding up of the LLC) are allocated:

~ per capita; or
~ in proportion to capital contributions.

—When a limited liability company has dissolved and is winding up, liquidating distributions are made, to the extent the dissolved LLC's assets exceed its obligations to creditors:

~ first among members who have contributed capital whose value has not already been fully returned, in proportion to the unreturned value; and
~ if any "surplus" remains, then among all members, in proportion to their respective right to share in profit distributions.

—To the extent the obligations of a dissolved LLC exceed the value of the LLC's assets, the losses lie where they fall. No member is required to contribute anything further to the LLC, whether to permit additional payment to LLC creditors or to equalize losses among members.[14]

§15.2 GOVERNANCE OVERVIEW

§15.2.1 Issues Inter Se and Issues vis-à-vis Third Parties

Broadly understood, LLC "governance" includes three separate but related topics:

- the internal management structure of the limited liability company;
- the duties owed by those who manage the company to the company and to the company's members; and
- the right and power of members and managers (if any) to bind a limited liability company to others.

This framework should be familiar; it has parallels in both the law of agency and the law of partnerships. However, because an LLC is

fundamentally a creature of statute,[15] understanding the governance framework must begin with understanding how LLC statutes delineate governance rights, responsibilities, and powers.

All LLC statutes provide some approach to the management questions, and many apply some variant of UPA (1914) §9 to deal with the power of members or managers to bind the LLC.[16]

Example

> Like many LLC statutes, the Arizona LLC Act contains two distinct sections dealing respectively with “Management of limited liability company” and “Member or manager as agent.” The provisions are related conceptually and practically. However, they can produce different consequences, depending on whether an issue exists inter se the members or between the LLC and a third party. ◂◂◂

Example

> Part of the Arizona provision on “member ... as agent” states: “Each member is an agent of the limited liability company for the purpose of carrying on its business in the usual way.”[17] Under this language, a member has the power to bind a member-managed LLC to a vendor through a transaction in what has been “the usual way”—even though, unbeknownst to the vendor, the members of the LLC have scheduled a vote to discontinue that line of business. In contrast, vis-a-vis the other members, the acting member would have acted improperly—contrary to the statute and thus without actual authority. Part of the provision on “Management of limited liability company” states that “the affirmative vote, approval or consent of a majority of the members . . . is required to . . . [r]esolve any difference concerning matters connected with the business of the limited liability company.”[18] ◂◂◂

§15.2.2 The “Two Template” Paradigm

The overwhelming majority of LLC statutes:

- establish two alternative, semi-default templates: member-managed and manager-managed;

- model member management on the governance of a general partnership and manager management on the governance of a limited partnership; and
- provide for each template:
  - —*inter se* rules—mostly or entirely subject to the operating agreement[19]—which structure management rights and responsibilities *inter se* the members and managers (if any); and
  - —"third party" rules—not subject to change by the operating agreement—which govern the power of members and managers (if any) to bind the LLC to third parties.

"Two-template" statutes vary as to whether they: (i) require an LLC's formation document to choose one of the two templates; or (ii) permit the choice to be made either by the formation document or the operating agreement. Almost all "two-template" statutes establish one or the other template as the "default setting," and for most of those statutes the default setting is member management.

Thus, under "two-template" statutes, determining the applicable governance rules for a limited liability company involves considering two layers of "default" analysis—determining:

- which default template applies; and
- to what extent the operating agreement has varied the default governance rules associated with that template.

Example

> Grind the Coffee Ido, LLC ("Grind") is organized under a "two-template" statute. Grind's articles of organization state that Grind is "member managed," but its operating agreement provides that all "day-to-day" decisions are to be made by a "president" selected by the members. *Inter se* the members, no member has the right to make day-to-day decisions. ◂◂◂

Example

> Espresso Omer, LLC ("Espresso") is organized under a "two-template" statute. Espresso's certificate of organization states that Espresso is "manager managed," and the statute provides that "except as otherwise stated in the operating ement, in a manager-managed limited liability company, the managers l be elected by the members annually." Espresso's operating agreement identifies a sole manager, Yael, "who shall serve as manager until she resigns, dies, or is removed as provided in this operating agreement." The statutory

provision on annual election does not apply to Espresso and Yael. ◂◂◂

Some "two-template" statutes provide separate templates for each of the two management forms.

Example

In ULLCA (2013), the section captioned "MANAGEMENT OF LIMITED LIABILITY COMPANY" provides alternately:

> (b) In a member-managed limited liability company, the following rules apply: . . .
>
> (c) In a manager-managed limited liability company, the following rules apply: . . .

The section also identifies management rules applicable under both templates—specifically, matters requiring unanimous member consent. ◂◂◂

Other LLC statutes use cross-reference rather than duplication. These statutes provide a basic template applicable to one of the two structures and incorporate that template's rules into the other structure by reference.

Example

The original California LLC Act provided:

> [T]he business and affairs of a limited liability company shall be managed by the members subject to any provisions of the articles of organization or operating agreement restricting or enlarging the management rights and duties of any member or class of members. If management is vested in the members, each of the members shall have the same rights and be subject to all duties and obligations of managers as set forth in this title.[20] ◂◂◂

Within this latter category, the Michigan and New York statutes each provide an interesting example of a subcategory. Each of these statutes sets member-management as the default structure but provides the member-management rules with reference to manager-management (deeming the members to be acting as managers).

Example

M.C.L.A. 450.4401 first establishes member management as the

default rule:

> Unless the articles of organization state that the business of the limited liability company is to be managed by 1 or more managers, the business of the limited liability company shall be managed by the members, subject to any provision in an operating agreement restricting or enlarging the management rights and duties of any member or group of members. ◂◂◂

The section then defines member management by incorporating by reference the rules of manager-management:

> If management is vested in the members, both of the following apply:
>
> (a) The members are considered managers for purposes of applying this act, including [the section delineating] the agency authority of managers, unless the context clearly requires otherwise.
>
> (b) The members have, and are subject to, all duties and liabilities of managers and to all limitations on liability and indemnification rights of managers.

Example

After establishing member management as the default rule for New York LLCs, McKinney's Limited Liability Company Law, §401(b) states:

> "If management of a limited liability company is vested in its members, then (i) any such member exercising such management powers or responsibilities shall be deemed to be a manager for purposes of applying the provisions of this chapter, unless the context otherwise requires, and (ii) any such member shall have and be subject to all of the duties and liabilities of a manager provided in this chapter." ◂◂◂

§15.2.3 The Corporate Governance Paradigm

The original Minnesota and North Dakota statutes provided a default template based on a corporate governance model,[21] using a "board of governors" (like a corporate board of directors). Both statutes have since been repealed, replaced with ULLCA (2006), but each statute has retained a "board of governors" template. Under this template, the governors collectively have overall supervisory authority within the LLC while individually lacking both the right and power to act for the LLC. A governor may, however, also serve in some other capacity (e.g., Chief Executive Officer) and in that capacity have actual and perhaps apparent authority to

bind the LLC.

This corporate approach is worthy of general note because:

1. corporate members of LLC joint ventures often prefer (or think they prefer) a corporate-like board structure to govern the LLC;
2. under most LLC statutes, lawyers must create a board structure through detailed provisions in the operating agreement; and
3. such provisions can leave several important issues "up in the air," including:
   —whether each person on the board owes fiduciary duty to the limited liability company or to the member that appointed the person to the board; and
   —whether any member of the board has actual authority to bind the limited liability company to third parties.

If each person on the board owes fiduciary duties only to the member that appointed the person and no person on the board has authority to bind the limited liability company to third parties, then:

- the "board" is not itself the governing body for the company; but is instead
- merely a way for the company's members to carry on *member* management through appointed representatives.

If an operating agreement refers to management by a board but leaves unclear any of the issues just discussed, serious problems can arise.

§15.3 MANAGEMENT STRUCTURES (*INTER SE* RULES)

§15.3.1 Member Management

Regardless of which LLC statute applies, member management is inherently decentralized. The members as a group hold the right to manage the business; the statute prescribes that, when management decisions are to be made, the members act collectively. As always with *inter se* matters, the statutory rules are default rules, subject to change in the operating agreement.

In this conceptual realm, variations among LLC statutes are myriad. However, in the mechanically simplest statutes the management rules closely mirror the rules for general partnerships and eschew formalities such as member meetings and proxies. Statutory complexity increases as statutes add mechanisms drawn from corporate law or practice—such as meetings (which

require notice and imply that participation must be in person or through a proxy who is present).

Example

> Through 12 subsections and more than 2,400 words, the original California LLC Act provided rules for: "Meetings; time and place; presence of members; call of meetings; notice; adjournment; validity of actions; participation; quorum; validity of actions taken without meeting; proxies; record date for determining members; conduct of meetings by electronic transmissions or by electronic video screen communications."[22] ◂◂◂

Statutes differ as to the allocation of voting power among members. Contrast in the following examples the simple, per capita approach of the Georgia act with the far more elaborate approach of the original Florida statute, which: allocated votes according to profits interests; expressly contemplated the possibility of elected managing members within a *member*-managed LLC; and defined profits interests in terms of capital contributions.

Example

> According to the Georgia LLC Act, subject to the articles of organization, the operating agreement, and a statutory provision listing matters requiring unanimous member consent:
>
> > If management of the limited liability company is vested in the members, each member shall have one vote with respect to, and the affirmative vote, approval, or consent of a majority of the members shall be required to decide, any matter arising in connection with the business and affairs of the limited liability company.[23] ◂◂◂

Example

> Fl. Stat. Ann. §608.422(2) provided:
>
> > In a member-managed company, unless otherwise provided in its articles of organization or operating agreement:
> >
> > (a) Management shall be vested in its members or elected managing members in proportion to the then-current percentage or other interest of members in the profits of the limited liability company owned by all of the members or elected managing members.

(b) Except as otherwise provided . . . , the decision of a majority-in- interest of the members or elected managing members shall be controlling.

Section 608.4261 further provided that:

> If the articles of organization do not or the operating agreement does not provide for the allocation of profits and losses among members, profits and losses shall be allocated on the basis of the agreed value, as stated in the records of the limited liability company, of the contributions made by each member to the extent such contributions have been received by the limited liability company and have not been returned.[24] ◂◂◂

All LLC statutes specify some matters requiring unanimous consent. Some statutes contain a list that includes most such requirements. In other statutes, the requirements are scattered throughout the act.

Example

The Georgia statute provides a lengthy list:

> (b) Unless otherwise provided in the articles of organization or a written operating agreement, the unanimous vote or consent of the members shall be required to approve the following matters:
>
> (1) The dissolution of the limited liability company . . . ;
>
> (2) The merger of the limited liability company . . . ;
>
> (3) The sale, exchange, lease, or other transfer of all or substantially all of the assets of the limited liability company . . . ;
>
> (4) The admission of any new member of the limited liability company . . . ;
>
> (5) An amendment to the articles of organization ... or an amendment to a written operating agreement;
>
> (6) Action . . . to reduce or eliminate an obligation to make a contribution to the capital of a limited liability company;
>
> (7) Action to approve a distribution under . . . ; or
>
> (8) Action to continue a limited liability company. . . .[25] ◂◂◂

Example

ULLCA (2013) uses both a centralized list and separate provisions to identify matters requiring unanimous member consent. Section 407 contains a list requiring unanimous member consent to undertake “[a]n act outside the ordinary course of the activities of the company” [26] or amend the operating agreement.[27] Individual sections require unanimity to: (i) admit a person as a member after the formation of the limited liability company;[28] (ii) approve the limited liability

company's participation in a merger,[29] interest exchange,[30] conversion,[31] or domestication;[32] or (iii) cause the dissolution of the company via member consent.[33] ◄◄◄

Example

As originally enacted, the Washington LLC Act required unanimous consent to *inter alia*:

- permit a person acquiring a "limited liability company interest" to become a member;[34]
- amend the operating agreement;[35]
- "[a]uthorize a . . . member, or other person to do any act on behalf of the limited liability company that contravenes the limited liability company agreement;"[36]
- compromise a member's obligation to make a contribution to the limited liability company;[37] and
- dissolve the limited liability company via member consent.[38] ◄◄◄

Obviously, where a statute requires unanimous member consent, no individual member has the right to act unilaterally. Beyond such requirements, however, LLC statutes typically do not specify when a member in a member-managed limited liability company is entitled to act unilaterally and when a member is obliged to consult with other members before making a decision.[39] The operating agreement should address this matter.

If not, a comment to ULLCA (2013) provides a mode of analysis likely applicable to any LLC statute whose member-management template is based the management structure of a general partnership:

> In the unlikely event that two or more people form a member-managed LLC without any understanding of how to allocate management responsibility, agency law, operating in the context of the act's "gap fillers" on management responsibility, will produce the following result:
>
> A single member of a multi-member, member-managed LLC:

- has no actual authority to bind the LLC to any matter "outside the ordinary course of the activities of the company," section 407(b)(3); and
- has the actual authority to bind the LLC to any matter "in the management and conduct of the company's [ordinary course of] activities and affairs," section 407(b)(2), unless the member has reason to know that other members might disagree or the member has some other reason to know that consultation with fellow members is appropriate.[40]

§15.3.2 Manager Management

a.The Typical Template

Under most LLC statutes, the manager-management template resembles a limited partnership, causing one federal judge to remark: "This animal is like a limited partnership; the principal difference is that it need have no equivalent to a general partner, that is, an owner who has unlimited personal liability for the debts of the firm."[41]

The resemblance is fundamental; in both an LLC and a limited partnership, subject to the operating agreement or partnership agreement:

- most management authority is allocated to one or more persons (manager/general partner); and
- the entity has a class of more or less passive owners (nonmanager members/limited partners).

There are also fundamental differences. In an LLC:

- managers are not automatically liable for the entity's obligations;
- managers may be members and typically are, but there is no statutory requirement to that effect; and
- members do not risk their liability shield by being involved in management.[42]

b. Statutory Descriptions of Manager Authority

In most LLC statutes, the manager-managed template parallels many of the rules for member-management; the roles and duties of managers are described by: (i) cross-referencing the sections describing member roles and duties in a member-managed entity or *vice versa*; (ii) replicating the member-managed provisions in a manager-managed section; or (iii) stating the two sets of duties in tandem.

In addition, the typical manager-managed template: (i) provides for the selection, removal, and replacement of managers; and (ii) delineates important decisions over which members retain direct control. ULLCA (2013)'s provisions provide a useful illustration:

Example

Under ULLCA (2013) §407(c):

In a manager-managed limited liability company, the following rules apply:

(1) Except as expressly provided in this [act], any matter relating to the activities and affairs of the company is decided exclusively by the manager, or, if there is more than one manager, by a majority of the managers.

(2) Each manager has equal rights in the management and conduct of the company's activities and affairs.

(3) The affirmative vote or consent of all members is required to:

(A) undertake an act outside the ordinary course of the company's activities and affairs; or

(B) amend the operating agreement.

(4) A manager may be chosen at any time by the affirmative vote or consent of a majority of the members and remains a manager until a successor has been chosen, unless the manager at an earlier time resigns, is removed, or dies, or, in the case of a manager that is not an individual, terminates. A manager may be removed at any time by the affirmative vote or consent of a majority of the members without notice or cause.

(5) A person need not be a member to be a manager, but the dissociation of a member that is also a manager removes the person as a manager. If a person that is both a manager and a member ceases to be a manager, that cessation does not by itself dissociate the person as a member.

(6) A person's ceasing to be a manager does not discharge any debt, obligation, or other liability to the limited liability company or members which the person incurred while a manager.

Although ULLCA (2013) §407(c) lists major provisions allocating governance rights to members, the list is not exhaustive. As is the situation with all LLC statutes, one must search the Act generally for other provisions relating to member governance rights in a manager-managed LLC.

Example

Under the default template for a ULLCA (2013) manager-managed LLC, the decision to allow a person to become a member is made "with the consent of all the members" and "the consent of all the members" causes dissolution. The relevant language does not appear in the act's centralized list, but rather respectively in §§401(c)(3) and 701(a)(2). ◂◂◂

N.B. Under all LLC statutes, the rules comprising the manager-managed template are default rules subject to change by the operating agreement. The actual authority of a manager is ultimately a question of agency law, with the manager as agent and the LLC as principal. The operating agreement and the statute (to the extent not displaced by the operating agreement) comprise the manifestations of the principal. "Other information may be relevant as well, such as the course of dealing within the LLC, unless the operating agreement effectively precludes consideration of that information."[43]

c.Authority for One of Several Managers to Act Unilaterally

Obviously, when a manager-managed LLC has only one manager, that manager may act unilaterally on any matter that the statute or operating agreement commits to the manager's discretion.[44] However, when an LLC has more than one manager, the question of authority for unilateral action is complex, and no LLC statute contains any direct answer.[45]

If an LLC has been well advised by counsel, the operating agreement will address this matter definitively. If not, the answer must be inferred—as a matter of agency law and actual authority—from any relevant language in the LLC statute and the operating agreement, as well as other circumstances that manifest the principal's (LLC's) intent. The following analysis appears in a comment in ULLCA (2013) and makes specific reference to provisions of the Act's template for manager-management. However, the analysis can likely be extrapolated to the manager-managed templates of many other LLC statutes:

> If the operating agreement states only that the LLC is manager-managed and the LLC has more than one manager, ... [i]t is necessary to determine what actual authority any one manager has to act alone. . . .
>
> A single manager of a multi-manager LLC:
>
> - has no actual authority to commit the LLC to any matter . . . for which this act elsewhere requires unanimity;
> - has the actual authority to commit the LLC to usual and customary matters, unless the manager has reason to know that: (i) other managers might disagree; or (ii) for some other reason consultation with fellow managers is appropriate; and
> - has no actual authority to take unusual or non-customary actions that will have a substantial effect on the LLC.
>
> The first point follows self-evidently from the language of . . . provisions requiring the affirmative vote or consent of the members, which reserves specified matters to the members. Given that language, no manager could reasonably believe to the contrary (unless the operating agreement provided otherwise).
>
> The second point follows because:
>
> Subsection (c) [providing equal rights in management to all managers] serves as the gap-filler manifestation from the LLC to its managers and does *not* require managers of a multi-manager LLC to act *only* in concert or after consultation. . . .
>
> - It would be impractical to require collective action on even the smallest of decisions.
> - However, to the extent a manager has reason to know of a possible difference of opinion among the managers, Paragraph (c)(1) requires decision by "a majority of the managers."

The third point is a matter of common sense. The more serious the matter, the less likely it is that a manager has actual authority to act unilaterally. *Cf.* RESTATEMENT (THIRD) OF AGENCY §3.03, cmt. *c* (2006) (noting the unreasonable-ness of believing, without more facts, that an individual has "an

unusual degree of unilateral authority over a matter fraught with enduring consequences for the institution" and stating that "[t]he gravity of the matter from the standpoint of the organization is relevant to whether a third party could reasonably believe that the manager has authority to proceed unilaterally").[46]

d.The Problem of Nomenclature: What Does "Manager" Mean?

Almost all LLC statutes use "the term 'manager' to refer to those with top governance authority in a centralized management structure."[47] For example, the Delaware statute defines "manager" as "a person who is named as a manager of a limited liability company in, or designated as a manager of a limited liability company pursuant to, a limited liability company agreement or similar instrument under which the limited liability company is formed."[48] Under most two-template statutes, the terms "member-managed" and "manager-managed" are key statutory phrases; they are terms of art under almost all LLC statutes.

"This nomenclature is unfortunate, because the word 'manager' has different meanings in other contexts."[49] Sometimes the overlap is harmless.

Example

> Squid, LLC is organized under a "two-template" statute. Squid's certificate of organization states that Squid is "manager-managed," and the company's operating agreement provides for a single manager elected annually by the members. Squid's business involves owning and operating a network of "Calamari to Go" shops throughout the United States. In its employee manual, Squid refers to the employee in charge of each shop as "the shop manager." That label matches colloquial usage well. (People are gen-erally used to asking "to speak with the manager" when a problem arises.) The label is not likely to confuse anyone into thinking that one of the shop managers is the "manager" to whom Squid's certificate of organization and operating agreement refer.[50] ◄◄◄

Other times, confusion and then litigation result.

Case in Point—Brown v. MR Group, LLC

> A liability insurance policy covered actions by "managers" of an LLC, and the LLC sought coverage for actions allegedly taken by a person it called (and who had functioned as) a "real estate manager." The LLC was organized under a two-template statute, and its certificate of organization declared the LLC to be "manager-managed." The real estate manager was not one of the statutory managers. The court denied coverage in part on the theory that the statutory definitions were more probative than any dictionary definition of a reasonable insured's understanding of the policy term.[51] ◂◂◂

§15.3.3 Guidelines in the Midst of Ineffable Flexibility: A Checklist for Discerning an LLC's Management Structure

In a book of this nature, it is impossible to list all the ways in which LLC statutes differ (or, at the whim of a legislature, might differ) in their delineation of LLC governance structure. Likewise, space does not allow even a shorthand description of the multitudinous ways in which operating agreements have shaped the management structure of particular LLCs.

However, it is possible to provide a coherent way to approach discerning the management structure of any LLC.

- Begin by identifying the relevant statute; i.e., the statute under whose authority the LLC has been created.[52]
- Read the relevant statutory language carefully, keeping in mind that statutes often address the same issue in several different places. In addition to scrutinizing any definition section and sections with captions such as "Management" or "Members," use electronic means to search the entire statute for references to "member" and "manager."
- Consider the following list of issues:[53]

  I. What is the statutory default setting; i.e., in the absence of other arrangements made by the members, is the LLC manager- managed or member-managed?
  II. Which document(s) can change that setting—only the articles of organization or also the operating agreement?
  III. What does the relevant document provide; i.e., is the basic structure manager-managed or member-managed?

IV. Keep in mind that the statutory structures are mostly default rules, mostly subject to revision or even elimination by the operating agreement.

A. According to the statute, what means may be used to alter the management rules of the relevant template?

1. Are some rules mandatory; i.e., not subject to change by either the operating agreement or articles of organization?
2. Are some rules subject to change only in the articles?
3. Are some rules subject to change only by a written operating agreement?

B. What do the operating agreement and the articles provide as to management rules and roles?

1. Does the statute have a rule for determining the results, if these two sources of authority conflict?[54]

V. As to an LLC that operates under the member-managed template, under the statutory template *as modified by the operating agreement*:

A. Is each member expressly authorized to participate in the activities of the LLC?

B. Does a rule exist for determining when a member may make a decision unilaterally?

C. Is member decision-making contemplated to be by member "consent" or "voting" or either?

D. For what issues is member consent required by:

1. some form of majority consent/vote?
2. unanimous consent/vote?

E. For matters requiring majority consent/vote:

1. Is each member's voting or consent "power" measured:

a. per capita (by member)?

b. per some form of economic rights?

c. profit interest (and if so, how defined)?

d. per amount of capital contributed (and if so, how defined)?

2. Are formal meetings of the members contemplated or required to make member decisions effective?
3. Is acting by proxy expressly:

a. authorized?

b. prohibited?[55]

4. Where consent/voting power is allocated according to some form of economic rights and a member has transferred some or all of the economic rights, what is the consequence to the member's consent/voting rights:

a. none, so long as the member remains a member?

b. diminished, to the extent the economic rights are transferred?

VI. As to an LLC that operates under the manager-managed template, under the statutory template *as modified by the operating agreement*:

A. How many managers are provided for?

B. How is/are the manager(s):

1. selected?
2. removed?

a. without cause?

b. with cause (how defined)?

3. replaced (e.g., upon death, disability [how defined] or resignation)?

C. Does the LLC have a separate management agreement with the manager(s)?

1. If so, how are conflicts between that agreement and the operating agreement resolved?
2. Few LLC statutes contemplate this problem directly. An official comment to ULLCA (2006) analyzes the problem as follows:

a. If the operating agreement and a management contract conflict, the reasonable manager will know that the operating agreement controls the extent of the manager's rightful authority to act for the LLC—despite any contract claims the manager might have. See the comment section 105(a)(2) (stating that the operating agreement governs "the rights and duties under this [act] of a person in the capacity of manager").[56]

3. How is the scope of the manager(s)' authority generally delineated?

a. obversely, how is the scope of matters reserved to the members generally delineated?

4. which, if any, matters/decisions are specifically stated as:

a. within the manager(s)' authority?

b. reserved to the members?

D. If the LLC has more than one manager:

1. how is authority divided among the managers?
2. does a rule exist for determining when a manager may make a decision unilaterally?
3. is manager decision-making contemplated to be by "consent" or "voting" or both?
4. are formal meetings of the managers contemplated or required to make manager decisions effective?
5. Is acting by proxy expressly:

a. authorized?

b. prohibited?

6. With regard to matters reserved for decision by the members, is decision-making to be by member “consent” or “voting”?
7. For what issues is member consent required by:

a. some form of majority consent/vote?

b. unanimous consent/vote?

8. For matters requiring majority consent/vote:

a. Is each member’s voting or consent “power” measured:

• per capita (by member)?

• per some form of economic rights?

— profit interest (and if so, how defined)?

— per amount of capital contributed (and if so, how defined)?

b. Are formal meetings of the members contemplated or required to make member decisions effective?

c. Is acting by proxy expressly:

• authorized?

• prohibited?

d. Where consent/voting power is allocated according to some form of economic rights and a member has transferred some or all of the economic rights, what is the consequence to the member’s consent/voting rights:

• none, so long as the member remains a member?

• diminished, to the extent the economic rights are transferred?

---

§15.4 FIDUCIARY DUTIES OF THOSE WHO MANAGE

§15.4.1 Overview

As in agency relationships and partnerships, management authority in LLCs comes with fiduciary duties—primarily the duties of care and loyalty. Questions as to fiduciary duties are “internal affairs” and therefore analyzed under the law of an LLC’s state of organization;[57] however, regardless of the jurisdiction involved the same general issues exist:

- Who owes the duties?
  - —This question is primarily a question of whether the LLC is member-managed or manager-managed. However, in a manager-managed LLC a member with enough consent/voting power to control the managers might also owe fiduciary duties.
- To whom is the duty owed?
  - —This question is more complicated here than in the agency or general partnership context. The LLC is an entity separate from its owners, and in most instances those who manage the LLC owe duties directly to the entity, not to the members.
- How are the duties of care and loyalty defined?
  - —Most LLC statutes contain some formulation, although the influential Delaware statute does not. Delaware courts have applied standard Delaware concepts of fiduciary duty to Delaware LLCs.
  - —Two major statutory paradigms exist: one borrowing from corporate formulations, the other from the law of general partnerships.
- To what extent may an LLC’s operating agreement carve back or even eliminate fiduciary duties?

§15.4.2 Who Owes the Duties?

It might seem obvious to state that “the fiduciary duties of management are owed by those with management authority,” and certainly that statement is the starting point for understanding the question of “who owes the duties.” Under two-template statutes, any stated fiduciary duties “switch” according to whether an LLC is member-managed or manager-managed.

Example

> Under the Michigan LLC Act: “If management [of a limited liability company] is vested in the members, . . . [t]he members have, and are subject to, all duties and liabilities of managers. . . .”[58] ◂◂◂

The paradigm seems simple: in a member-managed LLC the members owe fiduciary duties; in a manager-managed LLC the managers do. There are, however, a few consequences, including a few “wrinkles.”

One straightforward consequence is that, in a manager-managed LLC:

- members who are managers owe fiduciary duty *qua* managers; and
- non-managing members are therefore not fiduciaries.

Example

> JeTodd, LLC is a manager-managed LLC with two members (Jeff and Todd) and a nonmember manager, Selma. Selma owes fiduciary duties to the LLC, but Jeff and Todd do not. Therefore, absent a contrary agreement, Selma may not compete with JeTodd, but Jeff and Todd each may. The managerial duty of loyalty includes the duty not to compete, but Jeff and Todd are not managers.[59] ◄◄◄

Case in Point—In re South Canaan Cellular Investments, LLC

> Bankrupt LLC sued a minority member for breach of fiduciary duties. The defendant moved to dismiss for failure to state a claim because he was not a manager of the LLC and, thus, did not owe the fiduciary duties which he allegedly breached. The bankruptcy court sought to look to the operating agreement for guidance, but no operating agreement was provided. In the absence of an operating agreement, the court stated that "Delaware common law does not impose fiduciary and other related duties to members of LLCs who are neither managers nor controlling members."[60] ◄◄◄

Many LLC statutes expressly negate any fiduciary duties for nonmanaging members in a manager-managed LLC.

Example

> The Arkansas LLC statute states: "One who is a member of a limited liability company in which management is vested in managers . . . and who is not a manager shall have no duties to the limited liability company or to the other members solely by reason of acting in the capacity of a member."[61] ◄◄◄

This statutory exculpation has at least four "wrinkles" (complexities).

1. The exculpation applies by its terms to a member's exercise of consent or voting rights within a manager-managed LLC. That is, even though a non-managing member has *power* over a governance matter, the statutory

exculpation prevents the application of fiduciary duties.

Example

> TMS, LLC is a manager-managed LLC with three members: Teri, Mikki, and Samantha. Teri is the sole manager. The LLC owns and operates several shopping centers, and the operating agreement requires the consent of “members holding 60 percent of the interests in profits” before the LLC may acquire or build any new shopping centers. Teri proposes that the LLC build a shopping center in an area near a shopping center separately owned by Mikki. Mikki votes against the LLC building a new shopping center, because she does not want competition with her separately owned shopping center. Mikki’s self-interested vote is not a breach of fiduciary duty. ◂◂◂

Example

> Same facts, except that the LLC is member-managed. Mikki’s vote is burdened by fiduciary duty. ◂◂◂

2. *The statutory exculpation does not apply to liability for conduct that is wrongful regardless of a person’s status as a member*.

Example

> Bud, a nonmanaging member of a manager-managed LLC, learns of a potential business opportunity from confidential information provided by the LLC to its members. Knowing that the information is confidential, Bud nonetheless acts on it and takes the opportunity for himself. He is liable to the LLC for damages resulting from the breach of confidentiality. The statutory exculpation does not protect him. “A member who gains access to confidential information may be acting ‘in the capacity as a member,’ but a member who exploits that information for covetous purposes is not. Liability results not ‘solely by reason’ of the access, but rather from the act of exploitation.”[62] ◂◂◂

3. If a non-managing member effectively controls the manager(s), the exculpation probably will not immunize the non-managing member’s exercise

of that control.

Case in Point—Carson v. Lynch Multimedia Corp.

> A manager-managed LLC was governed, according to its operating agreement, by a five-person Board of Managers. The LLC's majority member was not on the Board but did appoint three of the five managers. Another member believed that the Board had badly mismanaged the company and sued both the persons on the Board and the majority member. The majority member sought dismissal on the grounds that she was a non-managing member and under the applicable statute owed no fiduciary duties. The court rejected that argument, holding that, if the majority of the Board were merely the "alter ego" of the non-managing member, the Board's fiduciary duties could be imputed to the nonmanaging member.[63] ◂◂◂

4. The exculpation generally does not apply to the implied contractual covenant of good faith and fair dealing. Section 15.4.8 discusses this topic.

Wrinkles also exist with regard to member-managed LLCs, because it is possible for the operating agreement of a member-managed LLC to reserve particular management functions to only some of the members.

Example

> Party LLC ("Party") is a limited liability company that organizes parties. Party was formed under a two-template LLC statute that requires the articles of organization to choose a managerial template. Party's articles state that the LLC is member-managed. Party has 15 members, who make all major decisions collectively, but Party's operating agreement provides for a three- person "management committee" to superintend Party's day-to-day activities. ◂◂◂

Given the way two-template statutes delineate fiduciary duties, it does not automatically follow that a member's fiduciary duties shrink as the member's authority shrinks. The duty of care probably does, but not necessarily the duty of loyalty. ULLCA (2013) addresses this issue by expressly empowering the operating agreement to address the issue:

> To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member otherwise would have under this [act] and imposes the responsibility on one or more other members, the agreement also may eliminate or limit any fiduciary duty of the member relived of the responsibility which would have pertained to the responsibility.[64]

The same approach should be possible under LLC statutes without this specific language, given the broad powers accorded to operating agreements by all LLC statutes.[65]

§15.4.3 To Whom Are the Duties Owed?

In an agency relationship, the agent's fiduciary duties are owed to the principal, and obviously the principal has the right to sue the agent for breach of those duties. In a general partnership, each partner has the right to seek a remedy for harm done by another partner to the partnership—even under the "entity" approach first announced in UPA (1997).[66]

The situation with an LLC is far more complicated, as is discussed in some detail in section 16.4. The overview is that, under the law of most states, even if the LLC statute states generally that governance duties are owed to individual members as well as to the LLC, a member may not sue directly to enforce a governance duty unless the breach of duty has *directly* harmed the member.

Example

> TMS, LLC is a manager-managed LLC with three members: Teri, Mikki, and Samantha. Teri is the sole manager. Mikki and Samantha believe that Teri has mismanaged the company and thereby damaged the company's business. Although the relevant LLC statute describes the duty of care as being owed "to the company and its members," neither Mikki nor Samantha has the right to seek a remedy in their own names. They have been damaged only indirectly.[67] In such circumstances, it is meaningless (and misleading) to refer to Teri as owing a duty of care to Mikki and Samantha. For all practical purposes, Teri owes a duty of care only to TMS and not its members. ◄◄◄

The major exception to this general proposition is that, under the law of most states, members obliged not to use managerial power to “oppress” or “unfairly prejudice” a fellow member. The concepts of “oppression” and “unfair prejudice” were developed in the law of close corporations, but courts are increasingly making use of them in analogous LLC situations. The concepts are somewhat vague, and definitions differ. At the core is a concept of unfair, almost expropriating behavior.

However defined, when oppression or unfair prejudice occurs, the damage is to a member, not the LLC, and the duty runs directly from member to member as well.

Example

> PotGold, LLC is a five-member LLC that is member-managed. Under Pot- Gold’s operating agreement: (i) any member may be expelled without cause by the consent of the other four members; and (ii) the expelled member is “bought out” under a formula based on the financial results of the preceding 24 months. PotGold is about to sell an asset for a very large profit, far out of proportion to any profits realized over the past 24 months. To grab that profit for themselves, four of the members expel the fifth. The four members have breached a duty owed directly to the fifth member. ◂◂◂

§15.4.4 The Duty of Care

Some LLC statutes set a low bar for the duty of care, requiring only that those with management authority—whether as members or managers—avoid gross negligence and intentional wrongdoing.

Example

> The Arkansas LLC Act states:
>
> > A member or manager shall not be liable, responsible, or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes gross negligence or willful misconduct. . . .[68] ◂◂◂

Other statutes borrow from a prominent corporate law formulation, requiring the exercise of ordinary care.

Example

The Georgia statute provides:

> In managing the business or affairs of a limited liability company, ... [a] member or manager shall act in a manner he or she believes in good faith to be in the best interests of the limited liability company and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.[69] ◂◂◂

This statutory "split of authority" is understandable in light of the hybrid nature of LLCs. UPA (1997), whose drafting and promulgation overlapped the early days of LLCs, codifies the general partner's duty of care as avoiding gross negligence. That point of view doubtlessly influenced some LLC statute drafters.[70] Other drafters doubtlessly were influenced by the corporate analogy.[71]

The drafters of ULLCA (2006) recognized an additional issue, namely that one standard might be appropriate in some circumstances and the other in other circumstances. The drafters' solution was to codify a hybrid standard —ordinary care "[s]ubject to the business judgment rule."[72] ULLCA (2006) chose not to define the business judgment rule,[73] and books could be (and have been) written solely exploring the meaning of that concept.

In the most general terms, the rule:

- applies when an entity (or those seeking to enforce an entity's rights)[74] challenges a decision made by those persons having top governance authority within the entity;
- presumes that those persons made the challenged decision in good faith, without any breach of the duty of loyalty, and using the requisite degree of care; and
- requires the court not to second guess the decision—no matter how damaging it may have turned out to be—unless the complainant can rebut some aspect of the presumption of proper conduct.

The business judgment rule originated in corporate law, pertaining to directors, but recently has been used by courts considering claims against persons with top governance authority within an LLC.[75]

During the Harmonization Project, that drafting committee chose to harmonize the uniform limited liability company act with the general and limited partnership acts. Each of the latter has a "gross negligence" standard. Accordingly, ULLCA (2013) §409(c) provides: "The duty of care of a

member of a member-managed limited liability company in the conduct or winding up of the company's activities and affairs is to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or knowing violation of law."[76]

§15.4.5 The Duty of Loyalty

Not all LLC statutes codify a duty of loyalty. Some states whose statutes use a corporate-like formulation of the duty of care leave the question of loyalty to case law, again paralleling their state corporate law approach. LLC statutes that address loyalty explicitly have some form of loyalty language derived either from UPA (1914) §21 or from UPA (1997) §404. ULLCA (2013) contains the most current example of the latter approach:

> The duty of loyalty . . . includes the duties:
>
> (1) to account to the company and hold as trustee for it any property, profit, or benefit derived by the member:
>
> (A) in the conduct or winding up of the company's activities;
> (B) from a use by the member of the company's property; or
> (C) from the appropriation of a company opportunity;
>
> (2) to refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company; and
>
> (3) to refrain from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.[77]

Whatever the formulation, and regardless whether statute or case law provides the rules, the core elements of the duty of loyalty are the same across jurisdictions: no usurping of a company opportunity; no self-dealing; no competition. The analysis is parallel to the analysis for agents and general partners.[78]

§15.4.6 The Duty to Provide Information

The notion that those with managerial authority have an obligation to provide information to those on whose behalf they manage:

- traces back to agency law;[79]

- is part of partnership law;[80] and
- is part of LLC law, although under some LLC statutes the duty is partially codified.

For example, ULLCA (2013) §410 includes a detailed provision on the informational rights of members, persons dissociated as members (e.g., former members), and transferees.[81] Likewise, the Delaware LLC Act has a detailed provision that closely resembles a provision in the Delaware limited partnership act:

> (a) Each member of a limited liability company has the right, subject to such reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense) as may be set forth in a limited liability company agreement or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the limited liability company from time to time upon reasonable demand for any purpose reasonably related to the member's interest as a member of the limited liability company:
>
> (1) True and full information regarding the status of the business and financial condition of the limited liability company;
> (2) Promptly after becoming available, a copy of the limited liability company's federal, state and local income tax returns for each year;
> (3) A current list of the name and last known business, residence or mailing address of each member and manager;
> (4) A copy of any written limited liability company agreement and certificate of formation and all amendments thereto, together with executed copies of any written powers of attorney pursuant to which the limited liability company agreement and any certificate and all amendments thereto have been executed;
> (5) True and full information regarding the amount of cash and a description and statement of the agreed value of any other property or services contributed by each member and which each member has agreed to contribute in the future, and the date on which each became a member; and
> (6) Other information regarding the affairs of the limited liability company as is just and reasonable.
>
> (b) Each manager shall have the right to examine all of the information described in subsection (a) of this section for a purpose reasonably related to the position of manager.
> (c) The manager of a limited liability company shall have the right to keep confidential from the members, for such period of time as the manager deems reasonable, any information which the manager reasonably believes to be in the nature of trade secrets or other information the disclosure of which the manager in good faith believes is not in the best interest of the limited liability company or could damage the limited liability company or its business or which the limited liability company is required by law or by agreement with a third party to keep confidential. . . .[82]

Even when a statute includes a detailed information rights provision, the courts will fill in any gaps as a matter of fiduciary duty. In particular, "many cases characterize a manager's duty to disclose as a fiduciary duty"[83] and, more generally, "some cases characterize owners' information rights as reflecting a fiduciary duty of those with management power."[84]

Example

> JeTodd, LLC is a member-managed LLC with two members, Jeff and Todd. Jeff is seeking to buy Todd's interest, and the relevant LLC statute does not impose any relevant disclosure obligations on Jeff or provide any relevant information rights to Todd. Nonetheless, Jeff has a fiduciary duty to disclose material information to Todd. ◂◂◂

§15.4.7 Altering Fiduciary Duty by Agreement

As is the case with agency and partnership law, LLC law permits fiduciary duties to be delineated or modified by agreement. Delaware law is the most extreme on this point, permitting even wholesale elimination of fiduciary duties:

> To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement. . . .[85]

ULLCA (2013) takes a less radical, more complicated approach. Subject to a "manifestly unreasonable standard," the operating agreement may:

- "alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law";[86]
- "alter or eliminate the [core] aspects of the duty of loyalty";[87] and
- "alter or eliminate any other fiduciary duty."[88]

ULLCA (2013) derives it approach to restricting fiduciary from ULLCA (2006), and an official comment to the latter sums up the ULC's approach to an operating agreement's power over the duty of loyalty.[89] The following table is derived from that summary, revised to reflect the provisions of ULLCA (2013).

ULLCA (2013) provides various separate methods through which those with management power in a limited liability company can proceed with conduct that would otherwise violate the duty of loyalty.

15.1 ULLCA (2013) Methods for Restricting the Duty of Loyalty

Method	Statutory Authority
If not manifestly unreasonable, the operating agreement might eliminate the duty or otherwise permit the conduct, without need for further authorization or ratification.	Section 105(d)(2), (3)(A); (3)(B)
If not manifestly unreasonable, the operating agreement might establish a mechanism for authorizing or ratifying the conduct by one or more "disinterested and independent persons after full disclosure of all materials facts."	Section 105(d)(1)(A)
The conduct might be authorized or ratified by all the members after full disclosure.	Section 409(f)
In the case of self-dealing the conduct might be successfully defended as being or having been fair to the limited liability company.	Section 409(g)

In all but the most extreme circumstances, the Delaware approach and the ULLCA (2013) approach should produce the same outcome. The "manifestly unreasonable" standard does not apply under Delaware law, but in egregious situations a disputant under Delaware law can push litigation under the contractual obligation of good faith and fair dealing.

§15.4.8 The Implied Covenant of Good Faith and Fair Dealing

a. The Obligation Described[90]

1. Importance and Ubiquity of the Phrase

Over the past several decades, "good faith" has become increasingly important in the law of business organizations. The phrase appears five times in ULLCA (2013), more than 40 times in the official comments, and has similar importance in ULPA (2013) and UPA (2013). The phrase also has fundamental importance in the Delaware law of limited liability companies and limited partnerships and has been central in one of the most important recent developments in Delaware corporate law.[91]

2. *Meaning Differs with Context*

One might think, therefore, that "good faith" can be defined easily or, at least, definitively. But the term is polysemous, a chameleon whose meaning changes dramatically depending on the context. Depending on context and on jurisdiction, the term indicates a test that is either entirely subjective or has both subjective and objective aspects. In one context, the objective standard is a very lax duty of care reclassified as part of the duly of loyalty. In another context, the word "objective" has a meaning radically different from the "reasonableness" concept typically associated with an "objective" test.

3. *The Salient Context for LLCs—the Implied Contractual Obligation*

In the context of limited liability companies, the most important context for "good faith" is the implied contractual covenant (or obligation) of good faith and fair dealing.[92] The obligation, which is not a fiduciary duty, originated in the common law of contracts; has been codified in the Uniform Commercial Code (UCC); is variously labeled a duty, an obligation, and an implied covenant; and has in recent has years developed its own, special character as applied to operating and partnership agreements.

The variation of labels imports no difference in meaning. Under the common law of contracts, the obligation of "good faith and fair dealing" is an implied and inescapable term of every agreement. Per the Restatement (Second) of Contracts, §201, "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." The official comments suggest that a complete definition is impossible—the duty "excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness, or reasonableness," but "[a] complete catalogue of types of bad faith is impossible."

This type of impossibility is a boon to litigators and a bane for transactional lawyers. "Good faith," as codified by the UCC, is little better. Under UCC, §1-201(20), "'[g]ood faith' . . . means honesty in fact and the observance of reasonable commercial standards of fair dealing." Presumably, the UCC's concept of usage of trade imparts some content to "reasonable commercial standards of fair dealing." Nevertheless (and arguably as a

result), those standards assess a contract obligor's conduct from a perspective disconnected from the language of the contract. The results can be startling, as in *K.M.C. Co. v. Irving Trust Co.*, which used such standards to hold that: (i) a lender's exercise of its totally discretionary right to call a demand note was objectively unreasonable; and therefore (ii) the lender was liable for the collapse of the borrower's business.[93]

4.The Approach of the ULC and Delaware

ULLCA (2013) and Delaware law are more friendly to transactional lawyers (and their clients), although both the ULC and Delaware case law have flirted at least briefly with an objective standard divorced from the words of the parties' agreement. For example, in *Policemen's Annuity and Benefit Fund v. DV Realty Advisors LLC*, the Delaware Court of Chancery considered the implied covenant in the context of a limited partnership agreement which required the limited partners to act "in good faith" if they chose to remove the general partner but did not define good faith. The Court decided to "presume that the parties intended to adopt Delaware's common law definition of good faith as applied to contracts" and then resolved the matter in light of the UCC definition of the implied convent—including that definition's objective aspect.[94]

The Delaware Supreme Court affirmed the judgment but flatly ended the flirtation: "This Court has never held that the UCC definition of good faith applies to limited partnership agreements."[95]

Recent Delaware decisions have moved toward greater precision, mooring both "good faith" and "fair dealing" to the words of the parties' contract:

> "Fair dealing" is not akin to the fair process component of entire fairness, i.e., whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care. . . . It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise, "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.[96]

Because the actual words of the agreement control the application of the implied covenant:

> An implied covenant claim . . . looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but *rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting*.[97]

At one time, the ULC appeared to do more than merely flirt with the vagueness of the common law/UCC approach. UPA (1997) §404(d) codified the implied obligation of good faith and fair dealing for the first time, and comment 4 to that section noted and argued in favor of vagueness:

> The meaning of "good faith and fair dealing" is not firmly fixed under present law. "Good faith" clearly suggests a subjective element, while "fair dealing" implies an objective component. It was decided to leave the terms undefined in the Act and allow the courts to develop their meaning based on the experience of real cases.

Having courts "develop" meaning as they go hardly makes for the rule stability that transactional lawyers seek. In 2001, the ULC adopted a new uniform limited partnership act with the same codifying language, but the official comment took a decidedly different approach:

> The obligation of good faith and fair dealing is *not* a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner's own self-interest. Courts should not use the obligation to change *ex post facto* the parties' or this Act's allocation of risk and power. To the contrary, in light of the nature of a limited partnership, the obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made.[98]

On this point ULLCA (2006) followed ULPA (2001), and the Harmonization Project took both the statutory language and commentary further still from comment 4's embrace of indefiniteness. All three current uniform acts now expressly characterize the implied covenant as "contractual."[99] And, in their respective official comments, all three acts interweave the 2001 "non-abnegation" language with quotations from the Delaware cases quoted above.

Thus, under both Delaware law and the uniform acts, the implied covenant of good faith and fair dealing is a cautious enterprise, intended only to preserve the fruits of the bargain—as evidenced by the words of the contract—from one party's lack of prescience and the other party's desire to exploit that lack.

> No contract, regardless of how tightly or precisely drafted it may be, can wholly account for every

> possible contingency. Even the most skilled and sophisticated parties will necessarily fail to address a future state of the world . . . because contracting is costly and human knowledge imperfect. . . .[100]

Thus, properly understood and delimited, implied covenant analysis resembles the rule for determining whether a party's contractual duties are discharged by supervening impracticably. "In order for a supervening event to discharge a duty . . . , the non-occurrence of that event must have been a 'basic assumption' on which both parties made the contract."[101] As for the implied contractual covenant, "parties occasionally have understandings or expectations that were so fundamental that they did not need to negotiate about those expectations."[102]

Or put another way, both doctrines identify situations or claims that—if contemplated at the time of contracting—would have been deal breakers. Thus, "In sum, the purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the members have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it."[103]

Case in Point—PAMI-LEMB I Inc. v. EMB-NHC, LLC

The operating agreement of a manager-managed LLC contained a buy-sell procedure for resolving disputes between the manager-member and the non-manager member. When a serious dispute arose, the non-manager member invoked the buy-sell provision by offering to buy the other member's interest or sell its own interest to the other member. Without breaching any specific term of the buy-sell procedure, the manager-member frustrated the procedure's purpose by: making counter offers at egregiously low prices; threatening to litigate; and announcing that it would not permit any distributions while the dispute lasted. This conduct breached the managing member's obligation of good faith and fair dealing.[104] ◂◂◂

Example

> Pipeline, LLC ("Pipeline") is a manager-managed limited liability company, whose manager, Alexandria Honcho ("Honcho") owns 65 percent membership interests comprising 65 percent of member voting rights. Pipeline's operating agreement provides that: (i)

> Honcho can buy out the other members at any time; and (ii) the price is not subject to challenge is an independent investment bank provides an opinion that the price is "fair" to the other members (the "safe harbor").

In due course, Honcho proposes to buy out the other members at a specified price and an independent investment bank provides the necessary fairness opinion. However, in its analysis the bank does not take into account two of Pipeline's assets—namely, the value of claims the company may have against Honcho for gross mismanagement. A member challenges the buyout transaction, and Honcho asserts the safe harbor as a dispositive defense, noting that the operating agreement says nothing about how the investment bank should determine the fairness of the buyout price. Citing the implied contractual covenant of good faith and fair dealing, the court rejects the defense.[105]

b. May the Implied Covenant Be Delineated?[106]

May an operating agreement delineate the implied contractual obligation, perhaps identifying particular circumstances and specifying conduct as satisfying the implied obligation in those circumstances? On this question, it is worth considering both ULLCA (2013) and the Delaware law.

1. Under ULLCA (2013)

Under ULLCA (2013), the answer to the delineation question appears straightforward under the uniform act. Section 105(c)(6) states that, while an operating agreement may not "eliminate the contractual obligation of good faith and fair dealing under section 409(d)," the agreement "may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured."[107] The official comment provides several examples, including this one:

> The operating agreement of a manager-managed LLC gives the manager "sole discretion" to make various decisions. The agreement further provides: "Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, the manager complies with section 409(d) of [this act] if the manager makes the decision with:

a. the honest belief that the decision:
i. serves the best interests of the LLC; or
ii. at least does not injure or otherwise disserve those interests; and
b. the reasonable belief that the decision breaches no member's rights under this agreement."

This provision "prescribe[s] the standards by which the performance of the [section 409(d)] obligation is to be measured."[108]

2. Under Delaware Law

Under Delaware law, the delineation question requires a different and more complicated analysis. The conceptual answer is "not possible," but the practical answer is "can do." Under Delaware law, the implied covenant acts as a special type of "gap filler," a process of interpolation implied by law: "An implied covenant claim . . . [asks] what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting."[109]

The law supplies the gap-filling methodology, which no agreement has the power to change. By its nature, this approach is invariable. For instance, an operating agreement may not provide that "a manager's act in any manner pertaining to this agreement satisfies the implied covenant of good faith and fair dealing if the person asserting a breach of the implied covenant had at the time of contracting reason to know that the agreement could reasonably be interpreted to authorize the act."

However, a Delaware operating or partnership agreement can reign in the implied covenant by avoiding gaps. Consider the above example from ULLCA (2013) comments, revised as follows:

> Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, ~~the manager complies with Section 409(d) of [this act]~~the manager's decision is binding and breaches no duty to the company or its members, if the manager makes the decision with:
>
> a. the honest belief that the decision:
> i. serves the best interests of the LLC; or
> ii. at least does not injure or otherwise disserve those interests; and
> c. the reasonable belief that the decision breaches no member's rights under this agreement."

Although "[n]o contract, regardless of how tightly or precisely drafted it may be, can wholly account for every possible contingency,"[110] it is opportunistic conduct that brings Delaware's implied covenant into play.
ULLCA (2013) example as revised leaves scant, if any, room for such

conduct. Thus, while under Delaware law "safe harbor" provisions cannot be upheld as "prescribing] the standards ... by which the performance of the obligation [of good faith and fair dealing] is to be measured,"[111] safe harbor provisions can render the implied covenant inapposite if carefully drafted and sensibly invoked.[112]

c. The Effect of Expressly Requiring Conduct to Be in "Good Faith"[113]

Great care is required when an operating imposes an express requirement of "good faith." Left undefined, the phrase is a minefield for parties and a godsend for litigators—as exemplified in *Policemen's Annuity and Benefit Fund v. DV Realty Advisors LLC*. The case arose from a limited partnership agreement that permitted the limited partners to remove the general partner:

> "without cause by an affirmative vote or consent of the Limited Partners holding in excess of 75% of the [Limited] Partnership Interests then held by all Limited Partners; provided that consenting Limited Partners in good faith determine that such removal is necessary for the best interest of the [Limited] Partnership."[114]

The agreement did not, however, define the term.[115]

Both the Chancery Court and Delaware Supreme Court addressed the definitional omission, but each used a different approach and reached a different definitional conclusion. The Chancery Court used an a *fortiori* analysis to resolve the case without actually deciding on a definition:

> The conduct of the Limited Partners in this case does not approach the sort of unreasonable conduct that is necessarily undertaken in bad faith. A test is nevertheless required; the Limited Partners' conduct must be analyzed under some rubric. . . . The definition prescribed in [Delaware's Uniform
>
> Commercial Code] §1-201(20) ["honesty in fact and the observance of reasonable commercial standards of fair dealing"] is at least as broad of a defini-tion of good faith as that applied to contracts at common law, and . . . the Limited Partners can meet the [the broader] definition. . . . Thus, the Limited Partners necessarily satisfy Delaware's common law definition of good faith as applied to contracts, which is the definition of good faith that the Court presumes was adopted in [the limited partnership agreement].[116]

The Delaware Supreme Court flatly rejected the lower's court methodology, substituting a standard far more easily met. Relying on one of its own decisions, the Court held that the limited partners' "determination will be considered to be in good faith unless the Limited Partners went 'so far

beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.”’[117]

The moral of this story is clear—never use the phrase “good faith” in an operating agreement without carefully defining the term.

d. How Restrictions on Fiduciary Duty Affect the Implied Covenant of Good Faith and Fair Dealing

Restrictions on fiduciary duty affect implied covenant in two very different ways:

- Constraining fiduciary duty can put “inordinate pressure [to expand] the concept of ‘good faith and fair dealing.”’[118] As explained at the ULC’s 2006 Annual Meeting:

  > When you say there are no . . . fiduciary duties and courts for hundreds of years have looked to fiduciary duties as a policing mechanism that they can develop, if you say you can’t have fiduciary duties, they will go to good faith. And, in fact, I had a conversation with . . . [t]he judge of North Carolina’s business court [who] said, if you stop us on fiduciary duty, we will just go to good faith.”[119]

- Well written restrictions on fiduciary duty reduce the scope of the implied covenant, at least where the obligation is read narrowly (as in Delaware and under ULLCA (2013)). The implied covenant defers to express contractual provisions. Therefore, specific and clear limitations on fiduciary duty preclude application of the implied covenant within the scope of the limitations.[120]

§15.5 THE RIGHT AND POWER OF MEMBERS AND MANAGERS TO BIND A LIMITED LIABILITY COMPANY

§15.5.1 Actual Authority

As is the case with agent and principal and partner and partnership, the power of an LLC member or manager to bind an LLC encompasses both actual and apparent authority. “In general, a member’s [or manager’s] actual authority to act for an LLC will depend fundamentally on the operating agreement,”[121] as well as on the rules provided by whatever management template might be

applicable.[122]

§15.5.2 Statutory Apparent Authority

Almost all two-template statutes provide for statutory apparent authority for members in a member-managed LLC and managers in a manager-managed LLC.[123] As explained in a comment to ULLCA (2013):

> Most LLC statutes, including the original ULLCA (1996), provide for what might be termed "statutory apparent authority" for members in a member- managed limited liability company and managers in a manager-managed limited liability company. This approach codifies the common law notion of apparent authority by position and dates back at least to the original Uniform Partnership Act. UPA (1914), §9 provided that "the act of every partner . . . for apparently carrying on in the usual way the business of the partnership . . . binds the partnership," and that formulation has been essentially followed by UPA (1997), §301, ULLCA (1996), §301, ULPA (2001), §402, and myriad state LLC statutes.[124]

The statutory power to bind switches from member to manager according to which management template the LLC has in effect, and most LLC statutes also expressly negate any authority for a nonmanager member in a manager-managed LLC.

Example

For example, the Colorado LLC statute provides:

> (1) If the articles of organization provide that management of the limited liability company is vested in one or more managers:
>
> (a) A member is not an agent of the limited liability company and has no authority to bind the limited liability company solely by virtue of being a member; and
>
> (b) Each manager is an agent of the limited liability company for the purposes of its business and an act of a manager, including the execution of an instrument in the name of the limited liability company, for apparently carrying on in the ordinary course the business of the limited liability company or business of the kind carried on by the limited liability company binds the limited liability company, unless the manager had no authority to act for the limited liability company in the particular matter and the person with whom the manager was dealing had notice that the manager lacked authority.
>
> (2) If the articles of organization provide that management of the limited liability company is vested in the members, each member is an agent of the limited liability company for the purposes of its business and an act of a member, including the execution of an instrument in the name of the limited liability company, for apparently carrying on in the ordinary course the business of the limited liability company 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 had notice that the member lacked authority.[125] ◂◂◂

Under most two-template statutes, a publicly filed document (i.e., the articles of organization, certificate of formation, etc.) must state which template applies, so in theory third parties can determine whether members of an LLC have statutory apparent authority.

§15.5.3 The ULC's New Approach: Eliminating Statutory Apparent Authority

In ULLCA (2006), the ULC broke with more than 90 years of tradition and eliminated statutory authority. That decision has not been popular, and most states that have enacted ULLCA (2006) have preserved the concept. Nonetheless, ULLCA (2013) also omits statutory apparent authority.

Although ULLCA (2013), like ULLCA (2006), provides both a member-management and manager-management template, the templates serve to structure the relations *inter se* of members and managers (if any); the templates do not, however, result in automatic apparent authority by position.

ULLCA (2013) §301(a) states: "A member is not an agent of a limited liability company solely by reason of being a member," and the Act contains no automatic, statutory apparent authority for managers. The apparent authority of members and managers is left to "other law—most especially the law of agency."[126]

Although this approach is radical, it is consistent with the underlying rationale for statutory apparent authority. As explained in the lengthy official comment to section 301(a):

> The concept [of statutory apparent authority] still makes sense both for general and limited partnerships. A third party dealing with either type of partnership can know by the formal name of the entity and by a person's status as general or limited partner whether the person has the power to bind the entity.
>
> Most LLC statutes have attempted to use the same approach but with a fundamentally important (and problematic) distinction. An LLC's status as member-managed or manager-managed determines whether members or managers have the statutory power to bind. But an LLC's status as member- or manager-managed is not apparent from the LLC's name. A third party must check the public record, which may reveal that the LLC is manager-managed, which in turn means a member as member has no power to bind the LLC. As a result, a provision that originated in 1914 as a protection for third parties can, in the LLC context, easily function as a trap for the unwary. The problem is exacerbated by the almost infinite variety of management structures

permissible in and used by LLCs.

The new Act cuts through this problem by simply eliminating statutory apparent authority. Codifying power to bind according to position makes sense only for organizations that have well-defined, well-known, and almost paradigmatic management structures. Because:

- flexibility of management structure is a hallmark of the limited liability company; and
- an LLC's name gives no signal as to the organization's structure,

it makes no sense to:

- require each LLC to publicly select between two statutorily preordained structures (i.e., manager-managed/member-managed); and then
- link a "statutory power to bind" to each of those two structures.[127]

Under ULLCA (2013) §301(b): "A person's status as a member does not prevent or restrict law other than this [act] from imposing liability on a limited liability company because of the person's conduct." The same is true for a person's status as a manager. Indeed, either such status can be relevant to a common law authority analysis.

Example

> A vendor knows that an LLC is manager-managed, but chooses to accept the signature of a person whom the vendor knows is merely a member of the LLC. Assuring the vendor that the LLC will stand by the member's commitment, the member states, "It's such a simple matter; no one will mind." The member genuinely believes the statement, and the vendor accepts the assurance. The person's status as a mere member will undermine a claim of apparent authority. R.3d §2.03, cmt. *d* (2006) (explaining the "reasonable belief" element of a claim of apparent authority, and role played by context, custom, and the supposed agent's position in an organization). Likewise, the member will have no actual authority. Absent additional facts, section 407(c)(1) ([part of the manager-management template] vesting all management authority in the managers) renders the member's belief unreasonable.[128] ◂◂◂

§15.5.4 Statements of Authority under ULLCA (2006) AND ULLCA (2013)

In part due to its rejection of statutory apparent authority, ULLCA (2006) has:

> "souped up" RUPA's statement of authority to permit an LLC to publicly file a statement of authority for a position (not merely a particular person). Statements of authority will enable LLCs to provide reliable documentation of authority to enter into transactions without having to disclose to third parties the entirety of the operating agreement.[129]

With regard to statement of authority, ULLCA (2013) closely follows ULLCA (2006), making only stylistic changes.

§15.5.5 The Statutory Lacuna: Power to Bind for Acts of Negligence

Although statutory apparent authority reaches torts involving misrepresentation and defamation,[130] most LLC statutes have no language to impute to the LLC torts of negligence committed by members or managers. ULLCA (1996) is an exception; it contains a provision (derived from UPA (1997) §305) captioned "Limited liability company liable for member's or manager's actionable conduct." As for ULLCA (2006), a comment specifically contemplates that "the doctrine of respondeat superior might make an LLC liable for the tortious conduct of a member."[131] The same comment appears in ULLCA (2013).[132] Under non-uniform LLC statutes, there is no guidance. This area of LLC law continues to await judicial clarification.

---

§15.6 CAPITAL STRUCTURE: THE ECONOMIC RIGHTS AND ROLES OF MEMBERS

§15.6.1 Overview

The phrase "capital structure" is a fancy way to label the economic rights of an entity's owners vis-à-vis each other and the entity. In the hybrid that is a limited liability company, the basic rules for "capital structure" derive from

the law of partnerships. The situation has persisted even after "check the box," because partnership tax accounting rules still apply to any multimember LLC that is taxed as a partnership.

As a result, LLC statutes are remarkably similar in the substance of their capital structure (or "finance") provisions, although the statutory language can vary quite a bit and, of course, the operating agreement is controlling *inter se* the members. All LLC statutes:

- conceptualize a member's financial rights as separate from the member's governance rights, providing a label for the financial rights, such as:
  —"transferable interest;" or
  —confusingly— "membership interest;"
- provide default rules for allocating distributions among members and transferees of a member's financial rights, both for operating distributions and liquidating distributions; and
- contemplate a person acquiring economic rights either:
  —directly from the LLC by "buying into" the company and becoming a member; or
  —acquiring economic rights from a person already a member (and either becoming a member or remaining a "mere" transferee).

§15.6.2 A Member's Contribution ("Buying In")

A person can become a member of an LLC either:

- by acquiring another person's membership and being admitted to the LLC in connection with that acquisition; or
- through a transaction with the LLC.

In the former instance, the new member does not make any payment to the LLC; any consideration passes to the seller. In the latter instance, it is usual for the person becoming a member to make a "contribution" in return for membership.

LLC statutes put almost no limits on the possible forms of contribution.

Example

> The Colorado LLC Act provides that: "The contribution of a member may be in cash, property, or services rendered or a promissory note or other obligation to contribute cash or property or to perform services."[133] ◂◂◂

Example

Under ULLCA (2013):

> A contribution may consist of property transferred to, services performed for, or another benefit provided to the limited liability company or an agreement to transfer property to, perform services for, or provide another benefit to the company.[134] ◂◂◂

What (if anything) a person contributes to the LLC in return for membership is a matter for agreement. Formally the agreement is between the person and the LLC. In practice, especially in LLCs with few members, the agreement is reached between the new member and the existing members.

Some LLC statutes contain a statute of fraud provision applicable to promised contributions. Most LLC statutes expressly permit a person to become a member without making any contribution.

§15.6.3 A Member's "Payout" Rights (Distributions)

Most LLC statutes refer to a member's rights to share in profits, losses, and distributions. The reference to sharing profits and losses is primarily for tax purposes;[135] "distributions" refers to something of value actually transferred by an LLC to a member on account of the member's financial stake in the venture.

Example

> ABC, LLC has three members, each of whom has equal rights in the company's profits, losses, and distributions. ABC's operating agreement provides that the company's sole manager decides what, if any, distributions will be made to members before dissolution. The following table shows the financial results for ABC in the years 2004 through 2007 and the effect on ABC's members. ◂◂◂

15.2 Payout Rights Over Time—A Simple Example			
Year	Company's Profit/ Loss (loss shown in parentheses)	Allocation to Each Member (to be accounted for on the member's own tax returns)	Distribution to Each Member (as determined, per the operating agreement, by ABC's manager)
2004	$60,000	20,000	20,000
2005	60,000	20,000	0
2006	21,000	7,000	17,000
2007	(90,000)	(30,000)	2,000

Financial rights are among the most frequently negotiated parts of an LLC "deal," and therefore it is common for an LLC's operating agreement to displace the statutory default rules. The default paradigm is quite similar from statute to statute:

- The distinction between member-management and manager-management is immaterial, as is the distinction between manager members and non-manager members in a manager-managed LLC.
- Members have no right to any "interim" distributions (i.e., distributions before dissolution and winding up).
- Distributions are made in cash, not "in kind" (i.e., in property other than cash).
- Profits, losses, and distributions (when made) are allocated either:
  —per capita; or
  —in proportion, directly or indirectly, to the value of contributions made to the LLC.[136]
- A person who acquires a member's financial rights without becoming a member of the LLC is entitled "to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned"; i.e., a mem-ber's financial rights are transferable.[137]
- If the LLC dissolves, after all debts are paid, the surplus is distributed:
  —first "to each person owning a transferable interest that reflects contributions made by a member and not previously returned, an amount equal to the value of the unreturned contributions";[138]
  —then among the members and transferees according to the sharing ratios for distributions.

Example

XYZ, LLC is a manager-managed LLC with three members, one of whom is the company's sole manager. XYZ's operating agreement makes no changes in the financial structure provided by the relevant

> LLC statute but does provide that the LLC will dissolve and wind up its affairs once it has built and sold a major construction project. The relevant LLC statute allocates profits, losses, and distributions in proportion to "the value of contributions made and not returned."

The company was "capitalized" by a contribution of $1,000,000 from *X*, its managing member, and contributions of $500,000 each from *Y* and *Z*. The company did not make any distributions before dissolution. After the project was sold and creditors paid, the LLC had $10,000,000 remaining. That money is distributed as follows:

<u>$2,000,000 as return of capital</u>

$1,000,000 to *X*

$500,000 each to *Y* and *Z*

<u>$8,000,000 as distribution to profits, allocated in proportion to the value of capital previously contributed and not previously returned</u>

50% to *X*=$4,000,000

25% to *Y*=$2,000,000

25% to *Z*=$2,000,000

<u>Totals per member</u>

X: $5,000,000

Y: $2,500,000

Z: $2,500,000 ◂◂◂

---

§15.7 THE CONCEPT OF DISSOCIATION AND A MEMBER'S LIMITED "EXIT RIGHTS"

§15.7.1 Dissociation

In terms of susceptibility to dissolution, LLCs are at the far opposite end of the spectrum from a UPA (1914) general partnership.[139] Under all LLC

statutes, an LLC has perpetual duration, unless its articles of organization or operating agreement provide otherwise, and a person's ceasing to be a member has no effect on the continuity of the entity. Therefore, to understand a person's "exit" rights as a member of an LLC, it is necessary to understand the circumstances under which a person might cease to be a member and the consequences to the person's rights when such "dissociation" occurs.

As will be seen, a member always has the power to dissociate, but under most LLC statutes dissociation does not bring anything valuable in terms of "exit rights." Moreover, exit by sale—that is, selling one's interest to another member or a third party—has serious drawbacks.

LLC statutes vary with regard to how they label cessation of membership and in how they delineate the occasions for membership to end. UPA (1997) coined the term "dissociation," and many LLC statutes follow that usage. Causes of dissociation can be divided into voluntary and involuntary, with almost all statutes:

- recognizing, with regard to voluntary dissociation, that:
  - —a member always has the *power* to dissociate by expressing the intent to do so (variously called "express will," "resignation," or "withdrawal"); but
  - —the operating agreement can constrain or eliminate the *right* to dissociate (thereby making voluntary dissociation wrongful); and
- providing some grounds for involuntary dissociation, such as:
  - —death;
  - —bankruptcy;
  - —sale of all of the member's financial rights; and
  - —expulsion:
    - —by unanimous consent upon the occurrence of specified grounds; or
    - —as provided by the operating agreement.

§15.7.2 Consequences of Dissociation ("No Exit"—At Least Economically)

Dissociation ends a person's membership, which means that the person loses all governance rights in the LLC. As to the financial rights, in the early days of LLCs many statutes followed a then-prevalent tenet of limited partnership law and provided, as a default rule, that the LLC would pay the dissociating member the reasonable value of the membership's interest.

Today, the trend is to lock in the financial rights of a dissociation member (subject, of course, to a different "deal" being made in the operating

agreement).

Example

ULLCA (2013), §603(a) provides:

If a person is dissociated as a member:

(1) the person's right to participate as a member in the management and conduct of the limited liability company's activities and affairs terminates;
(2) the person's duties and obligations under section 409 as a member end with regard to matters arising and events occurring after the person's dissociation; and
(3) . . . any transferable interest owned by the person in the person's capacity as a member immediately before dissociation is owned by the person solely as a transferee. ◂◂◂

§15.7.3 Exit by Sale

Under all LLC statutes, in the default mode, a member's financial rights are freely transferable. It is therefore possible for a member to "exit" an LLC by selling its interest to another member or to a nonmember. The "hitch" is that transfer to a non-member does not entail the transfer of any governance rights, unless the other members decide to admit the transferee as a member. ULLCA (2103) states the situation quite starkly:

> [A] transfer, in whole or in part, of a transferable interest . . . does not entitle the transferee to: (A) participate in the management or conduct of the company's activities and affairs; or (B) . . . have access to records or other infor-mation concerning the company's activities [except for very limited information rights if the LLC dissolves and winds up its activities].[140]

As detailed in section 16.6.2, mere transferees are in a very risky position, which means that a member wishing to exit by sale must:

- accept whatever price another member might be willing to pay;
- find a person willing to invest in what is usually a closely held busi- ness[141] and persuade the other members to admit that person as a member; or
- sell at a distressed price to a non-member willing to risk the role of a mere transferee.

Problem 120

Jeff's Real Estate, LLC ("Jeff's") is a limited liability company organized under a statute that provides templates for manager-management and member-management and requires that an LLC's

certificate of formation specify one of the two templates. Jeff s certificate specifies manager-management. Is it lawful for Jeff s operating agreement to allocate certain day-to-day management responsibilities to a non-manager member? ◂◂◂

Explanation

Yes. Management templates are for the most part default rules governing the relations of the members and managers (if any) *inter se*. The operating agreement can revise or even negate these default rules.[142] ◂◂◂

Problem 121

Jacob and Youngs, LLC ("Jacob and Youngs") is a five-member, member- managed LLC. Its operating agreement states that "no member shall enter into a contract with a price of more than $25,000 without either the consent of all the members or the vote of a majority of the members at a regularly scheduled meeting of the members or at a special meeting properly held to consider the matter." The operating agreement also provides that "this agreement can be amended only with the consent of all the members."

Yesterday, Kent, one of the members of Jacob and Youngs, encountered "the opportunity of a lifetime" for the LLC and purported to commit the LLC to a contract with Allegheny College with a price of $45,000. Kent signed the contract "Jacob and Youngs, a member-managed limited liability company, by Kent, in his capacity as a member."

Today, at the members' regular weekly meeting, Kent explained the situation in detail, and all the other members voted to "authorize the contract." What is the effect of that vote on the issues of:

A. Jacob and Youngs' obligation to perform the contract?

B. Kent's liability to Allegheny College with regard to the contract?

C. Kent's liability to Jacob and Youngs with regard to the contract?

D. the $25,000 limit in the operating agreement? ◂◂◂

Explanation

A. The vote makes clear that Jacob and Youngs is obligated to perform the contract.

According to the operating agreement, Kent lacked the right to bind Jacob and Youngs in the matter. He might, however, have had the power to do so. The facts are insufficient to decide the power-to-bind question.

The vote clarifies matters. Under agency law principles, the vote constitutes a ratification of the contract.[143]

B. The vote protects Kent from possible liability to Allegheny College. If Kent lacked both the right and power to bind Jacob and Youngs, he would have been liable to Allegheny College for breach of an agent's warranty of authority.[144] This potential liability disappeared when the members voted to ratify the contract.[145]

C. The vote protects Kent from possible liability to Jacob and Youngs. An agent is liable to the principal for damages caused when the agent acts without authority and binds the principal. This liability disappears, however, if the principal subsequently ratifies the unauthorized act.[146]

D. The vote probably has no effect on the $25,000 limit. Although a course of conduct can amend an operating agreement unless the agreement effectively provides otherwise, a single event hardly constitutes a course of conduct. The result might be different if the vote of approval had been phrased generally—for example, referring to permitting exceptions in "exigent circumstances." ◂◂◂

Problem 122

> Executive Assistance, LLC is a five-member, manager-managed LLC with a single manager, Lynette, who is also a member. The LLC's business consists of providing temporary workers to perform high-level administrative functions for various clients. Melissa, a non-managing member, decides that she wants to open her own business, providing temporary workers to perform lower level clerical services. Under a typical LLC statute, must she first obtain the LLC's consent? ◂◂◂

Explanation

The answer is no, assuming that: (i) Melissa does not use any confidential information belonging to the LLC; and (ii) the LLC's operating agreement contains no relevant restrictions. Given those assumptions, the only relevant constraint is the fiduciary duty of loyalty, with the relevant doctrine being "usurpation of a company opportunity." However, the typical LLC statute negates any fiduciary duties for non-managing members of a manager- managed LLC. ◂◂◂

Problem 123

Shrek and Donkey form a member-managed limited liability company, which they name Onion-Parfait Company, LLC ("OPC"), to do land development within a large swamp. They plan to: buy individual parcels of land; build a house on each purchased parcel; and then sell each parcel-with-house to a customer. The relevant LLC statute does not require a written operating agreement, and Shrek and Donkey do not have any written agreement concerning OPC. However, they do orally agree to proceed conservatively and, in particular, never to buy a parcel of land without having first arranged to have a customer committed to buy the land upon completion of a house.

One day, while traveling around the swamp for pleasure (i.e., not on OPC business), Donkey comes upon a public auction of a parcel of land zoned solely for commercial development.[147] Donkey purchases the land for himself at an excellent price, and one month later sells the land for a substantial profit. Must Donkey account to OPC for the profit? ◂◂◂

Explanation

Probably not. The facts strongly suggest that Donkey and Shrek intended their business to be limited to residential development, which argues against characterizing a commercially zoned parcel as a company opportunity. The oral agreement between Donkey and Shrek likewise suggests that OPC's agreed business methodology excludes OPC from opportunities based on purchases made "on spec"—that is, without a confirmed re-purchaser.

On the other hand, OPC could argue that: (i) commercial land

development is connected closely enough with residential development as to constitute a diversification or expansion opportunity for OPC; and (ii) the oral agreement could be changed or waived by the members.[148]

Donkey might respond *inter alia* that, because the land was being auctioned when he first learned of it: (i) there was no time to obtain a change in the oral agreement; and, therefore, (ii) the land purchase could not become a company opportunity.

The ultimate resolution of this matter would depend on:

- how broadly the law of OPC's state of organization applies the "company opportunity" doctrine;[149] and
- on other facts not stated in the Problem, such as OPC's financial ability to undertake "on spec" investments and the extent to which the business expertise involved in residential development overlaps the business expertise necessary for investments in commercial land. ◂◂◂

Problem 124

Roundhead, LLC ("Roundhead"), is a manager-managed limited liability company organized under an LLC statute that negates any power-to-bind of a nonmanaging member of a manager-managed LLC. Cromwell is the LLC's sole manager. Cromwell wants the LLC to rent a luxury box at the arena that houses the local professional basketball team. Busy with other matters, Cromwell asks Charles, a non-managing member, to reserve the box. Charles does so in his own name, using his personal credit card and expecting to be reimbursed. Is Roundhead bound? ◂◂◂

Explanation

Yes, although Charles had no power to bind Roundhead in his capacity as a member, he was acting as the agent for an undisclosed principal.[150] (As sole manager of the LLC, Cromwell certainly had the authority to establish an agency relationship between Roundhead and Charles.) ◂◂◂

Problem 125

Same facts as in Problem 124, plus the LLC statute provides that "a person who is a member of a limited liability company in which management is vested in one or more managers, and who is not a

> manager, shall have no duties to the limited liability company or to the other members solely

by reason of acting in his or her capacity as a member." After reserving the luxury box, Charles declines to sign it over to Roundhead. Does the quoted statutory language protect Charles from a claim by Roundhead? ◂◂◂

Explanation

> No. Roundhead's claim is for Charles's breach of his duties as an agent[151] and not "solely by reason of acting in his or her capacity as a member." ◂◂◂

Problem 126

> SansCulottes LLC ("SansCulottes"), is a limited liability company organized under a "two-template" LLC statute with a typical "statutory apparent authority" provision. Five years ago, when SansCulottes was organized, its articles of organization described it as member-managed. Until last month: (i) SansCulottes remained member-managed; and (ii) Toscin, one of its members, routinely purchased supplies for SansCulottes from Vendor. Toscin signed each purchase agreement "SansCulottes, LLC, by Toscin, one of its members."

Last month, the members of SansCulottes decided to restructure SansCulottes into a manager-managed LLC. They amended SansCulottes' articles of organization to reflect the change and then appointed Robespierre, a nonmember, as sole manager. Robespierre immediately directed Toscin to make no further purchases from Vendor on behalf of SansCulottes.

Nonetheless, last week Toscin purported to commit SansCulottes to another purchase from Vendor. Assuming that the nature of the transaction and purchase price were in line with previous transactions entered into by Toscin with Vendor on behalf of SansCulottes, may Vendor hold SansCulottes to the commitment? ◂◂◂

Explanation

Yes. The restructuring and Robespierre's directive deprived Toscin of actual authority, and the LLC statute will negate Toscin's statutory apparent author-ity.[152] However, Toscin retains the power to bind SansCulottes under the agency law doctrine of "lingering apparent authority."[153] ◂◂◂

Problem 127

Which, if any, of the following statements is true *inter se* the members of a limited liability company, agreement?

A. A member's economic rights are freely transferable.
B. A member's governance rights are freely transferable.
C. Neither the governance nor economic rights of a member are freely transferable.
D. A membership's ownership rights are bifurcated into financial and governance rights.
E. In a manager-managed LLC, the power of a managing member to transfer governance rights to a nonmember is more restricted than the power of a non-managing member to transfer governance rights to a nonmember.

Explanation

All the listed matters are subject to change by the operating agreement, so without knowing the contents of the operating agreement, it is impossible to determine the truth or falsity of any of the statements.[154] ◂◂◂

Problem 128

One of the founding members of a three-person member-managed limited liability company dies, and, under the decedent's will, her interest in the limited liability company "passes in its entirety with all rights and privileges thereunto pertaining" to the widower. Assuming the operating agreement is silent both on the widower's rights in the limited liability company and on the requisites for amending the operating agreement:

A. Is the widower's consent required to amend the operating agreement?
B. How are the widower's rights to profits, losses, and distributions calculated? ◂◂◂

Explanation

A. The widower's consent is not necessary. Under all LLC statutes, absent a contrary agreement, amending the operating agreement requires the unanimous consent *of the members*. The widower is a mere transferee or assignee of a dissociated member; he cannot become a member without the consent of the remaining two members.

B. Under most LLC statutes, the widower is, in essence, a transferee of the decedent's economic rights. Therefore, his rights to profits, losses, and distributions are equal to whatever her rights were.[155] ◂◂◂

---

1. Daniel S. Kleinberger, "The LLC as Recombinant Entity—Revisiting Fundamental Questions through the LLC Lens," paper delivered at the 2lst Century Commercial Law Forum—Seventh International Symposium 2007 (Beijing, China), published in the United States, 14 Fordham J. of Corp. & Fin. L. 473 (2009).
2. See sections 15.2 (governance) and 15.6 (finance).
3. See section 13.1.4(d) (explaining how the IRS's "check-the-box" regulations removed constraints on LLC structure).
4. See section 15.3.
5. Tax accounting requires separate consideration of a member's "profit interest" and "capital account." The details are far beyond the scope of this book, but they mean that:
   - a person's economic stake in an LLC (or partnership) involves both concepts;
   - two persons, each with, e.g., a "10% profits" interest, may have different overall economic rights (due to different capital accounts); and
   - any use of LLC "units" or similar constructs is potentially confusing and often misleading (because such terms obscures the role of capital accounts and the fact that they can have a value that is not proportional to profit share).

For details, see Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (Warren, Gorham & Lamont/RIA 1994, Supp. 2017-1), *J2.06[5][b].
6. West's Ann. Cal. Corp. Code §17001(z).
7. A.R.S. §29-601(13).
8. Del. Code Ann. tit. 6, §18-101(8).
9. This extrapolation seems appropriate because the LLC is thought of as a hybrid between the partnership and corporate forms of organization.
10. E.g., Del. Code Ann. tit. 6 §18-101(11) (defining "member" as "a person who is admitted to a limited liability company as a member") and Ga. Code Ann. §14-11- 101(16) (defining "member" as "a person who has been admitted to a limited liability company as a member"). Some people have argued that being a member is more a matter vis- a-vis one's fellow members (or with oneself in the case of a single-member LLC) than vis-a- vis the entity. See section 16.2 ("corpufuscation"). In the context of a member's bankruptcy, this distinction is far more than theoretical. See section 16.7.2. ULLCA (2013) §102(11) dodges this issue, at least definitionally, by defining "member" as "a person that has become a member of a limited liability company under Section 401 ... and has not dissociated under section 601." See also ULLCA (2013) §401 (captioned "Becoming Member").
11. ULLCA (2013) §401(d)(1), cmt.
12. ULLCA (2013) §402 ("Form of Contribution"). "This section is intentionally quite broad, encompassing past, present, and promised benefits," id., cmt., and is easily broad enough to encompass a person's merely letting it be known that he or she is associated with the LLC.

13. See section 15.3.1 (member management).
14. Unequal loss sharing may produce tax consequences, but that issue lies far beyond the scope of this book.
15. The LLC is also fundamentally a creature of contract. See section 14.3.3.
16. When most LLC statute drafting was occurring, UPA (1997) had not yet been promulgated. UPA (1914) §9 is discussed in section 10.3.1.
17. Ariz. Rev. Stat. §29-654(A)(1).
18. Ariz. Rev. Stat. §29-681 (d)(1).
19. Most LLC statutes also authorize the formation document to change these rules, but it is very unusual for a well-advised LLC to use that method. Formation documents are public; why disclose internal relationships unless doing so is required?
20. Cal. Corp. Code §17150.
21. Minn. Stat. §322B.60; N.D. Cent. Code §10-32-67.
22. West's Ann. Cal. Corp. Code §17104. The quotation is from the section's caption. The original California statute has been repealed and replaced by California's version of ULLCA (2006). See Ca. Stats. 2012 c. 419 (SB 323).
23. Ga. Code Ann. §14-11-308(a)(1).
24. In 2013, Florida repealed its original LLC act and substituted ULLCA. 2013 Fl. Laws, Chapter 2013-180. (The Florida enactment reflects the ULC's then ongoing Harmonization Project.)
25. Ga. Code. Ann. §14-11-308(b).
26. ULLCA (2013), §407(b)(4)(A).
27. *Id*. §407(b)(4)(B).
28. *Id*. §401(C)(3).
29. *Id*. §10031023(a)(1).
30. *Id*. §1033(a)(1).
31. *Id*. §1043(a)(1), §1007(a)
32. *Id*., §1053(a)(1).
33. *Id*., §701(a)(2).
34. West's RCWA §25.15.115(2)(a) and (b). In 2015, Washington repealed this statute, substituting a version of ULLCA (2006). See Wash. Laws 2015, Chapter 188,
35. *Id*., §25.15.120(2)(a).
36. *Id*., §25.15.120(2)(b).
37. *Id*., §25.15.195(2).
38. *Id*., §25.15.270(3) (written consent required).
39. The same issue exists with regard to managers of a multi-manager LLC and is discussed in that context in section 15.3.2. The same issue also exists with general partners. See section 9.4. As with partnerships, whether an LLC member's or manager's unilateral action has the power to bind the LLC is a separate question from the *inter se* question of "right to act."
40. ULLCA (2013) §407(b), cmt.
41. Cosgrove v. Bartolotta, 150 F.3d 729, 731 (7th Cir. 1998).
42. This statement also applies to limited partners in limited partnerships organized under ULPA (2001) or ULPA (2013). Under predecessor limited partnership statutes, the "control rule" applies. See section 12.2.3.
43. ULLCA (2013), §407, cmt. *c*.
44. One might try to view this question from the opposite perspective; i.e., that a sole manager may act unilaterally on any matter unless either the statute or operating agreement clearly reserves the matter to the members. However, that perspective is contrary to agency law. A manager is an agent of the LLC, and the manager's actual authority extends only so far as the manager *reasonably* believes it to extend. Reasonableness includes resolving questions of authority by inquiring of the principal. See R.3d, §2.02, cmt. *f*.

45. The same issue exists for general partnerships (see section 10.2) and with any limited partnership that has more than one general partner.
46. ULLCA (2013) §407(c), cmt.
47. Bishop & Kleinberger, *fl7.02[1][b] (footnotes omitted). The two “corporate” model statues (both now repealed) used the term “governor” for board members, but even they used the term “chief manager.” E.g., Minn. Stat. §§322B.03, subd.24 (governors) and 322B.673, subd.2 (chief manager). See section 15.2.3.
48. Del. Code. Ann., tit.6, §18-101(10).
49. Bishop & Kleinberger, *fl7.02[1][b]. See also R.3d §3.03, cmt. *e*(3) (creation of apparent authority) (2006) (“In smaller firms, it is not unusual for the president to function as the ‘general manager,’ a term used in many cases involving smaller businesses and intended to describe a person with authority to bind an organization in all matters within the ordinary scope of its business.”).
50. For a real-life example, see American Anglian Envtl. Techs., LP v. Environmental Mgmt. Corp., 412 F3d 956, 959 (8th Cir. 2005) (deciding a dispute between a member and former member of an LLC; noting that “[b]y the Operating Agreement, day-to-day project management was the responsibility of a Project Manager appointed by EMC [one member], assisted by a deputy appointed by AAET [the other member],” but that “[w]hile EMC was the day-to-day manager of the company, the Operating Agreement establishes a Management Committee with four representatives, two each from AAET and EMC”).
51. Brown v. MR Group, LLC, 693 NW2d 138, 142-43 (Wis. Ct. App. 2005).
52. See section 14.1.2, explaining the “internal affairs” doctrine as a choice of law concept.
53. This list does not consider issues related to the governance duties of those who manage. For those issues, see section 15.4.
54. Most LLC statutes do not, but ULLCA (2006) and (2013) each do. See section 14.5.7.
55. In the absence of an express prohibition either in the statute or operating agreement, agency law would strongly support the use of proxies except in situations in which the circumstances manifest a requirement of personal involvement.
56. ULLCA (2013) §407(c), cmt. (citing RESTATE MENT (THIRD) OF AGENCY §8.13, cmt. *b* (2006) and RESTATEMENT (SECOND) OF AGENCY §432, cmt. *b* (1958) as stating that, when a principal’s instructions to an agent contravene a contract between the principal and agent, the agent may have a breach of contract claim but has no right to act contrary to the principal’s instructions). See also ULLCA (2013) §102(13), cmt.
57. See section 14.1.2.
58. M.C.L.A. 450.4401(b).
59. This very simple Example assumes *inter alia* no use of the LLC’s confidential information by a competing nonmanager member.
60. In re South Canaan Cellular Investments, LLC, 427 B.R. 85, 102-03 (Bkrptcy. E.D. Penn. 2010).
61. A.C.A. §4-32-402(3).
62. Bishop & Kleinberger, (|10.01[2][c][ii].
63. Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254 (D. Kan. 2000).
64. ULLCA (2013) §105(d)(2).
65. See section 14.5.1.
66. UPA (1997), §405, comment 2 (stating that “a partner may bring a direct suit against . . . another partner for almost any cause of action arising out of the conduct of the partnership business” and explaining that “[s]ince general partners are not passive investors like limited partners, RUPA does not authorize derivative actions”). The comment to ULLCA (2013) §410(b) paints a murkier picture, noting that “in general . . . the cases are conflicting and somewhat confused” as to whether a partner may sue a fellow partner directly for harm the fellow partner has done to the partnership or whether the suit must be brought as a derivative action. Derivative actions are discussed in section 16.4.
67. They therefore lack “standing” except to sue in the name and on behalf of the LLC. For a detailed

discussion of this point, see section 16.4.
68. A.C.A. §4-32-402(1).
69. Ga. Code Ann., §14-11-305(1).
70. The UPA (1997) standard was adopted essentially verbatim into the first uniform LLC act, for example. See ULLCA §409(c) (providing that the "duty of care ... is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law").
71. See In re Die Fliedermaus LLC, 323 B.R. 101, 110 (Bkrtcy. S.D.N.Y. 2005) (quoting the "ordinarily prudent person in a like position" language of the NY LLC statute, and noting: "This is the same fiduciary standard applied to corporate directors.") (quoting 16 N. Y. Jur. Business Relationships §2107; internal quotation marks omitted).
72. ULLCA (2006), §407(c).
73. A comment explains why the drafters chose to eschew a "uniform laws" definition: The content and force of the business judgment rule vary across jurisdictions, and therefore the meaning of this subsection may vary from jurisdiction to jurisdiction. That result is intended . . . [U]nder the law of many jurisdictions, the business judgment rule applies similarly across the range of business organizations. That is, the doctrine is sufficiently broad and conceptual so that the formality of organizational choice is less important in shaping the application of the rule than are the nature of the challenged conduct and the responsibilities and authority of the person whose conduct is being challenged. This Act seeks therefore to invoke rather than unsettle whatever may be each jurisdiction's approach to the business judgment rule. ULLCA (2006), §407(c).
74. The parenthetical phrase refers to derivative claims, which are discussed in section 16.4.
75. In 2011, as part of its project on the Harmonization of Business Entity Acts, NCCUSL eliminated the ordinary care/business judgment provision and substituted the "avoid gross negligence" standard. HULLCA, §409(c), available at http://www.uniformlaws.org/Shared/Docs/AM2011_Prestyle%20Finals/HUB0C_PreStyleFinal_Jul11.pdf.
76. The same standard applies to managers of a manager-managed limited liability company. See ULLCA (2013) §409(i)(1).
77. ULLCA (2013) §409(b) (emphasis added). ULLCA (2006) §409(b) was substantively identical. The 2006 and 2013 versions "un-cabin" fiduciary duty. That is, unlike UPA (1997), neither LLC act purports to exhaustively codify fiduciary duties. For a discussion of UPA (1997)'s decision to "cabin in" fiduciary duties and the Harmonization Project reversal of that decision, see section 9.7.2.
78. See sections 4.1.1 (agent's duty of loyalty) and 9.7 (partner's duty of loyalty). The nuances of analysis discussed in those sections apply to LLC law as well.
79. See section 4.1.5.
80. See section 9.2.
81. ULLCA (2013) §410.
82. Del. Code Ann., tit. 6, §18-305 (limited liability companies) and §17-305(limited partnership).
83. ULLCA (2013) §409(a), cmt.
84. *Id*., §410, cmt. See also Restatement (Second) of Contracts §161(d) (stating that "[a] person's non-disclosure of a fact is equivalent to an assertion that the fact does not exist . . . where the other person is entitled to know the fact because of a relation of trust and confidence between them").
85. Del. Code Ann., tit. 6, §18-1101(c) (emphasis added). The subsection contains a proviso: "that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." For a discussion of the implied covenant, see section 15.4.8.
86. ULLCA (2013) §105(d)(3)(C).
87. ULLCA (2013) §105(d)(3)(A).
88. ULLCA (2013) §105(d)(3)(D).
89. ULLCA (2006) §110(e), cmt.
90. This section is drawn mostly verbatim from Daniel S. Kleinberger, "In the World of Alternative

Entities—What Does 'Good Faith' Mean?" Business Law Today (March 2017). Used here with the author's permission.
91. See ULLCA (2013) §409(d), cmt (referring to "the corporate concept of good faith that for years bedeviled courts and attorneys trying to understand: (i) Delaware's famous corporate law exoneration provision; and (ii) that provision's exception "for acts or omissions not in good faith" and (explaining that"[i]n" that context, good faith is an aspect of the duty of loyalty") (citing Del. Code Ann. tit. 8, §102(b)(7) (2012); In Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006)). The phrase is also prominent in the law of close corporations. See, e.g., Donahue v. Rodd Electrotype Co. of New England, Inc., 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975) ("[Stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the utmost good faith and loyalty.") (footnotes, citations, internal quotations omitted).
92. The same is true in the context of partnerships, especially limited partnerships. Under Delaware law, on this point (and most others) LLC and limited partnership case law are reciprocally precedential. ULLCA (2013), ULPA (2013), and UPA (2013) each codify the implied obligation using identical language, accompanied by essentially identical comments. Therefore, the information provided in this section applies equally to the implied obligation in the context of partnerships.
93. K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).
94. Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC, No. CIV.A. 7204-VCN, 2012 WL 3548206, at *13 (Del. Ch. Aug. 16,2012) (brackets in original), affd sub nom. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101 (Del. 2013).
95. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 109 (Del. 2013).
96. Gerberv. Enter. Products Holdings, LLC, 67 A.3d400, 418-19 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440-42 (Del. Ch. 2012), aff d in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by *Gerber*).
97. Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440-42 (Del. Ch. 2012), aff d in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) (emphasis added) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by Gerber).
98. ULPA (2001), §305(b), cmt.
99. UPA (1997) (Last Amended 2013) §409(d); ULPA (2001) (Last Amended 2013) §§305(a), 409(d); ULLCA (2006) (Last Amended 2013) §409(d).
100. Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *11 (Del. Ch. June 20, 2014) (internal quotations and citations omitted).
101. Restatement (Second) of Contracts §261, cmt. *b* (1981).
102. Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *11 (Del. Ch. June 20, 2014) (internal quotations and citations omitted).
103. ULLCA (2013) §409(d), cmt.
104. PAMI-LEMB I Inc. v. EMB-NHC, L.L.C., 857 A.2d 998 (Del. Ch. 2004).
105. This Example is a simplified version of some of the issues and facts in Gerber v. Enter. Products Holdings, LLC, 67 A.3d400, 418-21 (Del. 2013), overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013).
106. This section is drawn mostly verbatim from Daniel S. Kleinberger, "Delineating the Implied Covenant and Providing for 'Good Faith"' Business Law Today (May 2017). Used here with the author's permission.
107. This column quotes from ULLCA (2013), text and comments, but the analysis applies equally to ULLCA (2006), sometimes informally referred to as the "RULLCA," and also to ULLCA (1996), the

first uniform LLC act.

108. ULLCA (2013), §105(c)(6), cmt. (noting thatNemecv. Shrader, 991 A.2d 1120 (Del. 2010) "consider[ed] such a situation in the context of the right to call preferred stock and decid[ed] by a 3-2 vote that exercising the call did not breach the implied covenant of good faith andfair dealing"). ULLCA (2013) §409(d) provides that"A member shall discharge the duties and obligations under this [act] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing. Section 409(i)(3) makes the provision applicable also to managers in a manager-managed limited liability company

109. Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440-42 (Del. Ch. 2012), aff din part, rev'd in part on other grounds, 68 A.3d665 (Del. 2013)) (emphasis added) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by *Gerber*). For further explanation of this concept, see the discussion in section 15.4.8(a).

110. Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *11 (Del. Ch. June 20, 2014) (internal quotations and citations omitted).

111. ULLCA (2013) §105(c)(6).

112. For example, in the author's opinion, it was not sensible to rely on a Special Approval valuation process that had ignored two assets of the company, which were arguably quite substantial. Gerber v. Enter. Prod. Holdings, LLC, 67 A.3d 400, 422-23 (Del. 2013) overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013).

113. This section is drawn mostly verbatim from Daniel S. Kleinberger, "Delineating the Implied Covenant and Providing for 'Good Faith"' Business Law Today (May 2017). Used here with the author's permission.

114. Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC, No. CIV.A. 7204-VCN, 2012 WL 3548206, at *11 (Del. Ch. Aug. 16, 2012) (quoting Section 3.10(a)(ii) of the limited partnership agreement) (brackets in the opinion), aff'd sub nom. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101 (Del. 2013).

115. Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC, No. CIV.A. 7204-VCN, 2012 WL 3548206, at *1213 (Del. Ch. Aug. 16, 2012), aff'd sub nom. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101 (Del. 2013).

116. Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC, No. CIV.A. 7204-VCN, 2012 WL 3548206, at *13 (Del. Ch. Aug. 16, 2012), aff'd sub nom. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101 (Del. 2013).

117. DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 110 (Del. 2013) (quoting Brinckerhoff v. Enbridge Energy Co., Inc., 67 A.3d 369, 373 (Del. 2013)).

118. ULLCA (2013), Prefatory Note to ULLCA (2006), Noteworthy Provisions of the 2006 Act.

119. Remarks of Co-Reporter Kleinberger at the 2006 Annual Meeting of the Uniform Law Conference, quoted in Daniel S. Kleinberger & Carter G. Bishop, "The Next Generation: The Revised Uniform Limited Liability Company Act, 62 BUS. LAW. 515, 551 n. 49 (2007).

120. See the discussion in section 15.4.8(b).

121. ULLCA (2013) §301(b), cmt.

122. See section 15.3.

123. See section 10.3 for an explanation of the term "statutory apparent authority" in the context of general partners.

124. ULLCA (2013) §301(a), cmt.

125. C.R.S. 7-80-405.

126. ULLCA (2013) §301(a), cmt.

127. ULLCA (2013) §301(a), cmt. (quoting PUBOGRAM, Vol. XXIII, no. 2 at 9-10) (internal quotation marks omitted; brackets in the original).

128. This Example is taken verbatim from ULLCA (2013), §301(a). On the unreasonableness of the

member’s belief, see R.3d §2.01, cmt. c (2006) (explaining the reasonable belief element of a claim of actual authority) and section 2.2.2(e).
129. ULLCA (2006), Prefatory Note, Noteworthy Provisions of the New Act, The Power of a Member or Manager to Bind the Limited Liability Company. In both ULLCA (2006) and (2013), Section 302 contains the statement of authority provisions.
130. See sections 3.3.3, 3.4.2, and 3.4.3 (discussing how apparent authority is relevant to these torts).
131. ULLCA (2006) §301(b), cmt.
132. ULLCA (2013) §301(b), cmt.
133. C.R.S.A. §7-80-501.
134. ULLCA (2013) §402.
135. See section 13.1.2(b) (explaining how an LLC’s tax classification as a partnership means that its profits and losses pass through directly to its members).
136. Many LLC statutes allocate distributions in proportion to the allocation of profits, which in turn are allocated per capita or in proportion to the value of contributions.
137. The quoted language is from Florida’s original LLC statute, West’s F.S.A. §608.432(2)(b) and is a bit more elaborate than the language found in most LLC statutes. However, the concept is universally present. (Florida has replaced its original act with ULLCA (2013). See 2013 Fl. Laws, Chapter 2013-180.
138. The quoted language is from ULLCA (2013) §707(b)(1).
139. Under UPA (1914), the dissociation of any partner inevitably caused the partnership to dissolve, even if the dissociation was wrongful. See section 11.2.1(a).
140. ULLCA (2013) §502(a)(3).
141. For several reasons, it is more difficult to find a purchaser for an ownership interest in a closely held company than in a company whose ownership interests are publicly traded.
142. The “power to bind” analysis would be more complicated, involving both statutory apparent authority of the managers and common law agency analysis for the member.
143. See section 2.7.
144. See section 4.2.2.
145. As a matter of agency law, he is not liable on a contract he signed on behalf of a disclosed principal. See section 4.2.1. As a matter of LLC law, his status as a member does not make him liable for the LLC’s contractual obligation. See section 14.4.1.
146. See sections 4.1.2 (discussing an agent’s liability for acting without authority) and2.7.1 (explaining the effect of ratification on that liability).
147. Readers who have trouble with the notion of zoning within a fairy-tale swamp should remember that “a willing suspension of disbelief’ is sometimes essential to handling law school hypotheticals.
148. As a practical matter, it would be Shrek who might want to assert this position. However, as a legal matter, the claim belongs to OPC. See section 16.4 (derivative claims).
149. The duty of loyalty is an “internal affair.” See section 15.4.1.
150. See section 2.2.3.
151. See sections 4.1.1 (duty of loyalty) and 4.1.3 (duty to obey instructions).
152. Per the typical statute of this type, the negation occurs even if Vendor is unaware of the amendment to SansCulottes’ articles of organization.
153. See section 2.3.7.
154. If this Problem were revised to assume that the operating agreement contains no relevant provisions, then statements A and D would be true. Statement E might be intuitively appealing, but it is nonetheless false; following the partnership model, in the default mode LLC statutes prohibit the transfer of any governance rights to a nonmember, no matter how comparatively minor those rights might be.
155. See section 16.6.2 for a discussion of the difficult issues that arise if the members subsequently attempt to amend the operating agreement to the widower’s prejudice or otherwise impair his economic

rights.

CHAPTER 16

Consequences of the Churkendoose: Unique Issues of LLC Law

§16.1 THE PROPER METAPHOR: HYBRID, CHURKENDOOSE, RECOMBINANT ENTITY

In 2007, Tsinghua University in Beijing, China, convened the 2lst Century Commercial Law Forum, Seventh International Symposium, around the topic of "Non-Incorporated Enterprises." The keynote address discussed "Two Decades of 'Alternative Entities"' and a later-delivered paper focused on "The LLC as Recombinant Entity":

> It is conventional wisdom that U.S. "limited liability companies are a conceptual hybrid, sharing some of the characteristics of partnerships and some of corporations." A more accurate description is that an LLC combines attributes of four different types of business organizations: general partnerships, limited partnerships, corporations, and closely held corporations.
>
> From partnership law comes the "pick your partner" principle and the bifurcation of ownership interests into financial and governance rights. From corporate law comes the "liability shield" — i.e., the conceptual "non-conductor" that protects owners from automatic liability for the debts of the enterprise. From the example of general partnerships comes the notion of management by owners as owners, which has been the blueprint for the "member-managed" LLC. From the example of limited partnerships comes the centralized management structure that has been the blueprint for "manager-managed" LLCs. From the concept of the "close corporation" comes the perspective for understanding the "lock in" problem that exists when the "pick your partner" principle overlaps with "perpetual duration." To this mixture, the "check the box" regulations have added permission for a flexibility and variability of structure

> unprecedented in the U.S. law of business entities.
>
> Thus, by connotation at least, the word "hybrid" understates the multifaceted and almost plastic nature of limited liability companies. Those who invented and developed LLC statutes have done more than graft the branch of one entity to the stalk of another. They have been gene splicing, and the adjective "recombinant" is more apt than "hybrid."[1]

A competing metaphor might be "churckendoose," which, according to a children's book published in 1946, is a multisourced hybrid, "part chicken, turkey, duck, and goose."[2] But whatever the imagery, the multilateral origins of the LLC raise a set of fundamental and closely related analytic questions:

- Is the LLC of interest in its own right? Do its multisourced characteristics constitute a whole that is somehow of interest as more than the aggregate of its parts?

  or

- Are all so-called "LLC issues" merely "borrowed issues," to be prosaically resolved by reference to some other jurisprudence?

One LLC treatise suggests that the answers to these questions are, respectively, no, no, yes:

> [LLC] . . . statutes . . . contain little that is truly new. Almost all their provisions are derived from either partnership law or corporate law, and in some instances, the copying has been virtually verbatim.
>
> These partnership and corporate law antecedents should inform the construction of [LLC] statutes, which in turn should be interpreted in light of their origins. Statutory interpretation is essentially a search for legislative purpose, and given the largely derivative nature of [LLC] statutes, the relevant purpose may well be the purpose underlying a particular provision of partnership or corporate law. Therefore, when a court seeks to interpret or fill a gap in a particular provision of an [LLC] statute, the court should make reference to the body of law that gave rise to that particular provision. Corporate law precedent should inform the interpretation of provisions drawn from corporate law, and partnership law precedent should inform the interpretations of provisions drawn from partnership law.[3]

It is undeniable that many LLC decisions rely heavily on analogy, especially with regard to claims of "piercing the veil"[4] and claims of oppression.[5] However, it is equally true that LLC law has some unique issues of its own, which require careful analysis and should comprise a separate jurisprudence.

In particular:

- As a legal construct, the limited liability company is a "shape shifter" — sometimes treated as a legal person separate from its owners and sometimes regarded as a contract among and encompassing its members. This "dual-status" situation is more than the old "entity-aggregate" debate from the 1914 Uniform Partnership Act,[6] because:
  - according to all LLC statutes, the LLC is emphatically an entity separate from its owners;

but

- under all LLC statutes, the LLC is an *incomplete* entity — as will be seen, the "pick your partner" principle is inconsistent with the separate entity concept.

This internal inconsistency:

- is fundamental to the limited liability company both theoretically and practically; and
- gives rise to numerous issues that are:
  - LLC-specific; or if not
  - are far more clearly revealed in the context ofLLCs than in regard to other business organizations.

These issues include the following, which will be discussed in this chapter:

- From the contract versus entity question:
  - the supposed heresy of corpufuscation;
  - the quandary of how the LLC relates to the operating agreement;
  - the relationship of the direct/derivative distinction to claimed breaches of the operating agreement; and
  - the radicalization of contract law
- From the incomplete entity question:
  - the plight of bare naked assignee;
  - the classification of LLCs for the purpose of federal diversity jurisdiction; and
  - the effect under bankruptcy law of the bankruptcy of an LLC member.[7]

---

§16.2 THE SUPPOSED HERESY OF CORPUFUSCATION

"Corpufuscation" is a neologism. The term reflects the disdain expressed by some leading partnership law practitioners for what they see as the creeping corporatization of the limited liability company.[8] Such practitioners "are steeped in the practice, philosophy and law of partnerships."[9] To them, the LLC is essentially and fundamentally an *unincorporated organization*, i.e., like a partnership and therefore *not* like a corporation. "They view the LLC entity mostly as a necessary evil for maintaining the liability shield," and perhaps also for obtaining perpetual duration.[10] Adding other "corporate-like" characteristics smacks of heresy, or at least of "conceptual miscegenation."[11]

The "corpufuscation" issue has influenced the question of "shelf LLCs"[12] and the question of whether an LLC should or can be a party to the operating agreement.[13] The viewpoint is losing strength, however, in the face of

practical realities, the tendencies of judges to analogize to corporate law, and cases such as ConnectU LLC v. Zuckerberg, which eschewed any philosophical inquiry into the “shelf’ question and held, almost cavalierly, that “[t]here is no need to engage in such circumlocution; there simply is no requirement under Delaware law that there be members of an LLC at formation.”[14]

§16.3 THE RELATIONSHIP OF THE LLC TO ITS OPERATING AGREEMENT

Although “the LLC comes into existence as an entity separate from its members and at least *ab initio* is a stranger to the operating agreement,” as a practical matter “the member’s operating agreement should govern and be enforceable by the LLC.”[15]

Because the LLC is a separate juridic person, LLC statutes could certainly make the LLC *ipso facto* party to the operating agreement or at least expressly empower the LLC to become party. However, to date no LLC statute has taken either approach.

For example, both ULLCA (2006 and 2013) each fudge the question; each states: “A limited liability company is bound by and may enforce the operating agreement, whether or not the company has itself manifested assent to the operating agreement.” [16]

The Delaware statute is even more complex. The statute’s definition of “limited liability company agreement” states the following rules: “A limited liability company is not required to execute its limited liability company agreement. A limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement.” [17]

The Delaware language omits a category of situations: those in which the LLC has not executed the operating agreement but seeks to enforce it.

Example

> Under the operating agreement of a Delaware LLC, a member is obligated to contribute $50,000 next Friday. When the deadline passes

and the member repudiates the obligation without justification, the logical plaintiff is the LLC. The contribution was promised to the LLC, and the benefit of the promise will inure directly to the LLC, not to any of the members. However, if the LLC itself has not executed the LLC agreement, the defaulting member might plausibly contend that the LLC, as a nonparty, lacks standing to bring the claim. (On the other hand, the LLC might well have to assert standing as an intended third-party beneficiary of the operating agreement.) ◂◂◂

Example

The above situation becomes even more problematic if, before the member fails to make the promised contribution, the LLC fails without justification to make a promised distribution to the member. Suppose the member subsequently declines to make the promised contribution when due and sues the LLC for nonperformance of the distribution obligation. Does the LLC have standing to assert the contribution obligation as a set-off, other than through a third-party beneficiary claim?[18] ◂◂◂

The statutory skittishness on this issue is difficult to explain without reference to the contract-entity question. Practically, "LLC as party" makes so much sense. Conceptually, the idea is discordant:

> Although as a matter of form, an LLC cannot exist *de jure* without having filed articles of organization, as a matter of both concept and practice, the operating agreement is the foundational document. Indeed, given the expansive language most LLC statutes use to describe the operating agreement, the formation of an LLC concomitantly and inevitably brings an operating agreement into existence.[19]

Given this view of LLC formation, it is difficult for statute drafters and practitioners to think of the LLC as being a party to the operating agreement. Thinking that way is like imagining "a snake swallowing its tail."[20]

If the LLC were seen as fundamentally an entity, the difficulty would disappear. For example, close corporations commonly have shareholder agreements, and it is a nonissue to make the corporation itself a party. However, "everyone knows" that a corporation exists as an entity before it has shareholders. Indeed, in a formal sense, each of the corporation's initial shareholders becomes a shareholder through a transaction with the

corporation. However important a shareholder agreement may be, it "is not foundational."[21]

§16.4 THE RELATIONSHIP OF THE DIRECT/DERIVATIVE DISTINCTION TO CLAIMED BREACHES OF THE OPERATING AGREEMENT

From the ordinary contract law perspective, it seems almost axiomatic — a "no-brainer" — that a party to a contract has standing to sue when the contract is breached. However, in the LLC context the entity nature of the LLC injects a major limitation to that axiom. The limitation involves the distinction between direct and derivative claims, which, although corporate in origin, is more generally "a separate entity characteristic."[22]

To understand the relationship between, on the one hand, a member's standing to enforce the operating agreement and, on the other hand, the direct/derivative distinction, it is necessary to first understand the distinction itself.

An LLC member sues directly to remedy a damage suffered directly by the member. In contrast:

> [An LLC member] asserts a derivative claim to vindicate the rights of the [LLC]. A wrongful act has depleted or devalued [company] assets or has undercut the [company] business. The [member] has suffered harm only indirectly, as a consequence of damage done to the [limited liability company]. The wrongful conduct relates to the [member] only through the medium of the [company], i.e., by reducing the value of the [owner's membership interest]. For example, when those in control of the [company] act negligently, or waste or misappropriate company assets, it is the [LLC], not the [member], that first suffers the loss. Likewise, if a [manager of an LLC] takes for him or herself a business opportunity that properly belongs to the [LLC], it is the [LLC], not the [member], that has lost the opportunity and any attendant profits.
>
>> In essence, a derivative plaintiff seeks to derive standing from the injury to the [entity] and to represent the [entity]'s interests in the derivative lawsuit. In ordinary circumstances, "[w]hether or not a [entity] shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of [those managing the entity]."
>>
>> A derivative lawsuit, therefore, necessarily impugns the management of the [entity] and inevitably involves two distinct fights. one fight concerns the underlying transaction or conduct, which is alleged to have caused some harm or breached some duty to the [entity]. The other

fight concerns who will control the [entity] for the limited purpose of seeking a remedy for the alleged misconduct.

The typical derivative suit alleges that, with regard to the underlying transaction, [those managing the entity] have acted improperly.[23]

With the above explanation in view, it is possible to understand how a member might lack standing to *directly* sue for breach of the operating agreement. To sue directly, a person must have suffered harm directly.[24] For example, if provisions of the operating agreement express management duties of managers or managing members, any breach of those provisions will first cause harm to the LLC.

Example

Raheli, LLC is a manager-managed LLC, whose operating agreement appoints Eli as sole manager and requires him to "exercise in all efforts on behalf of the company, and in all matters pertaining to his managerial responsibilities, the care that an ordinarily prudent person would exercise in like circumstances." If Eli were to carelessly forget to maintain fire insurance on the company warehouse and a fire were to destroy 90 percent of the company's inventory, the value of the members' investment would certainly be affected. However, the injury would be first to the assets of the company; the claim would therefore be derivative. ◂◂◂

Example

Gililan, LLC is a manager-managed LLC, whose operating agreement appoints Ilan, one of its members, as sole manager. The operating agreement also creates a class of memberships ("the preferred interests") whose owners have the right to a specified distribution whenever specified financial conditions are met. on two occasions, the specified conditions are met, but Ilan declines to make the distributions. A member holding a preferred interest brings suit against the LLC and Ilan (who, as a member, is a party to the operating agreement). The claim is direct; the failure to pay the promised distribution hurts the entitled members directly, not through the medium of the LLC. ◂◂◂

Following the example of ULPA (2001),[25] both ULLCA (2006 and 2013) codify the direct harm approach to the direct/derivative distinction. ULLCA (2013) §901(b) provides: "A member maintaining a direct action under this section must plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company." ULLCA (2006) §901 is identical. As to breaches of the operating agreement, a member's standing "to enforce the member's rights and otherwise protect the member's interests, including rights and interests under the operating agreement" is "[s]ubject to subsection (b)."[26]

Case in Point — El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff

As noted above, the ULC first used a limited partnership act (ULPA (2001)) to codify the direct/derivative distinction and to explain how the distinction limits a partner's standing to bring a claim for breach of a partnership agreement. Delaware Supreme Court has also used the limited partnership context to note the distinction and the distinction's effect on partner standing.

In *Brinckerhoff*, a limited partner alleged a breach of the limited partnership agreement ("LPA") and argued that as a party to agreement, it had standing to sue directly. The Court rejected the argument:

> [A person's] status as a limited partner and party to the LPA [does not] enable him to litigate directly every claim arising from the LPA. Such a rule would essentially abrogate *Tooley* [a Delaware case that recognized the direct harm test for distinguishing direct and derivative claims] with respect to alternative entities merely because they are creatures of contract. Limited partnerships are governed by their partnership agreements and by the Delaware Revised
>
> Uniform Limited Partnership Act (the "DRULPA"). The partnership agreement sets forth the rights and duties owed by the partners. . . . The reality that limited partnership agreements often govern the territory that in corporate law is covered by equitable principles of fiduciary duties does not make all provisions of a limited partnership agreement enforceable by a direct claim.[27]

§16.5 THE RADICALIZATION OF CONTRACT LAW

It is axiomatic in LLC jurisprudence that the limited liability company is "a creature *of* contract." As if to underline this notion, ULLCA (2006)'s official Comments state the point twice, first noting that "[a] limited liability company is as much a creature of contract as of statute,"[28] and then reiterating that "[a] limited liability company is a creature of contract as well as a creature of statute.[29]

The point is also a cornerstone ofDelaware law, as reflected forcefully in a 2008 letter decision from the Chancellor of the Delaware Chancery Court: "[L]imited liability companies are creatures of contract, designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved. *To the extent defendants intend to argue otherwise, plaintiff need not offer a rebuttal*."[30]

If the LLC is a creature of contract, it should follow that LLC law is at least consonant with contract law. But in several ways, LLC law has ignored or overturned fundamental precepts of contract law. For example, all LLC statutes now recognize the oxymoronic notion of an operating agreement "among" the sole member of a single member LLC. Although this approach is in part a result of "path dependence," [31]it also stems from trying to conceptualize a single member LLC as a contractual relationship.

The distortion of contract concepts is most advanced in Delaware law, where fundamental precepts of contract law are set aside under the banner of "freedom of contract." For example, since its inception the Delaware LLC Act has repudiated contract law's traditional antipathy toward penalties. For "[r]emedies for breach of limited liability company agreement by member," the Act proclaims:

> A limited liability company agreement may provide that:
>
> (1) A member who fails to perform in accordance with, or to comply with the terms and conditions of, the limited liability company agreement shall be subject to specified *penalties* or specified consequences; and
>
> (2) At the time or upon the happening of events specified in the limited liability company agreement, a member shall be subject to specified *penalties* or specified consequences.
>
> Such specified penalties or specified consequences may include and take the form of any penalty or consequence set forth in §18-502(c) of this title [which includes, in the event of a member breaching a promise to make a contribution, "*forfeiture* of the defaulting member's

> limited liability company interest"].[32]

Even more radically, Delaware law seeks to characterize fiduciary duty as foreign to the law of contract-based entities. The Delaware LLC Act empowers the operating agreement to "eliminate" fiduciary duties,[33] and the Chief Justice of the Delaware Supreme Court has written that: "Delaware courts need to be mindful of the distinction between status relationships and contractual relationships."[34] He has urged Delaware judges to:

> come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes — not the status relationship of the parties. When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law fiduciary duty principles. . . .[35]

Fiduciary duty serves to protect against both the limited prescience of contract drafters[36] and expropriating behavior by those with power. It is therefore an interesting question whether society ought to estrange fiduciary duty from contract law and thereby overturn centuries-old controls over extremes of self-interest.

Of at least equal interest is the ahistorical nature of the Delaware approach. In reality, there is no antipathy between contractual relationships and fiduciary duty. Obviously, not every contractual relation involves fiduciary duties, but the common law of contracts comfortably encompasses contracts that create (or reflect) a special relationship of trust and confidence.[37] Moreover, the law of partnerships — a principal progenitor of the limited liability company — has for hundreds of years balanced freedom of contract with fiduciary duty.

To many, the limited liability company seems the apotheosis of the unincorporated business organization; it will be ironic if the LLC construct of "entity as contract" serves to bury Cardozo's famous words on the duties of co-adventurers.[38]

---

§16.6 THE LLC AS AN INCOMPLETE ENTITY; THE PLIGHT OF THE BARE NAKED ASSIGNEE

§16.6.1 Complete Separation of Entity and Owners: Protection for Assignees of Financial Rights

In an entity that is completely separate from its owners, the entity has no stake in the identity of its owners. A change in ownership does not imperil the continuity of the entity, and the entity statute does not restrict transferability of ownership interests. If the owners wish to restrict transferability, they may do so by contract. However, their contract-based restrictions will have to be carefully drafted and will be narrowly interpreted by courts if challenged.[39]

The modern corporation is an entity completely separate from its owners. Moreover, because stock inextricably connects financial rights to at least some governance rights, either:

- the transferee of a shareholder's financial rights will directly have some governance rights (and therefore standing as a shareholder to bring suit if the financial rights are unjustly affected by those in control of the corporation); or
- the original transferor will still be a shareholder and available (and perhaps contractually obligated) to protect the transferee's rights.

Example

> The articles of incorporation of XYZ, Inc. provide for two classes of stock: ordinary, "common" stock, with distribution rights and the right to vote for directors and on major organic transactions (e.g., mergers);[40] and nonvot-ing preferred stock, whose owners receive a preferential return but have no voting rights. Peter, who owns 500 shares of each class of stock, sells 100 shares of nonvoting preferred to Caspian. The corporation subsequently proposes to enter into a merger that will unjustifiably expropriate most of the value of the preferred stock. As a shareholder, Caspian has standing to seek a judicial remedy. ◂◂◂

Example

> In a separate transaction, Peter borrows $50,000 from Lucy. In addition to promising to repay the amount with interest, he: (i) pledges 250 shares of his nonvoting, preferred stock to her as

collateral; and (ii) assigns to her all his distributions from those shares until the loan is repaid. The loan agreement between Peter and Lucy obligates Peter to use his status as a shareholder to "at all times protect Lucy's interests under this contract." In addition, as required by the loan agreement, Peter appoints Lucy as his irrevocable proxy and "attorney in fact" to exercise his rights as a shareholder until the loan is repaid.[41] When the above-described merger is announced, Lucy can use Peter's status as a shareholder to take action to protect her economic rights. ◂◂◂

§16.6.2 Incomplete Separateness and the Risk to the Bare Naked Assignee

With an LLC, the situation is fundamentally different; the limited liability company is an entity only *incompletely* separate from its owners. Built-in statutory transfer restrictions provide a default template under which economic rights are freely transferable, but transferees do not acquire even limited governance rights, let alone become owners.

To accommodate this codified "pick your partner" approach, LLC ownership is conceptually bifurcated; a person can own financial rights without owning any governance rights. Indeed, if the original owner of the financial rights dissociates, the financial rights are completely "naked."

Under LLC law, "bare naked assignees" face a substantial risk of abuse by LLC members. The term somewhat fancifully describes the situation in which:

- a person who is not a member owns financial rights as a transferee (a "naked transferee"); and
- the member to whom those rights originally pertained:
  - — has dissociated; and therefore
  - — is no longer a member; and therefore
  - — is incapable of protecting the transferee's financial rights even if the transfer contract so provided.[42]

owning economic rights without any corresponding governance rights means:

- having no right to any say in any company decision:
  - — no matter how significant the decision is; and
  - — no matter how directly (and even exclusively) the decision might affect the financial rights;
- having no rights to information about the company, except in the unusual event of the company dissolving, and even then information access is quite limited; and

- having no standing to seek judicial intervention, either directly or on behalf of the company, because:
  - under LLC law, “mere financial rights” do not constitute ownership; and
  - LLC statutes expressly limit standing for judicial intervention to

members.[43]

Uniform Act on Point — ULLCA (2013) §107(b)

> The obligations of a limited liability company and its members to a person in the person’s capacity as a transferee or a person dissociated as a member are governed by the operating agreement. . . . [A]n amendment to the operating agreement made after a person becomes a transferee or is dissociated as a member: (1) is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person’s capacity as a transferee or person dissociated as a member; and (2) is not effective to the extent the amendment imposes a new debt, obligation, or other liability on the transferee or person dissociated as a member.

§16.6.3 A Problem Both Old and New

a. The Problem Has Been Around for Quite a While

The “bare naked assignee” problem is not entirely new. A handful of partnership cases address the rights of assignees of partnership interests, and these decisions all hold against the assignee.

Bauer v. Blomfield Co./Holden Joint Venture is the classic example.[44] All partners approved a commission arrangement with a third party, and the arrangement dried up all the partnership profits. An assignee of a partnership interest objected and brought suit.

The case reached the Alaska Supreme Court, where the Court majority rejected the assignee’s very right to assert the claim. An assignee “was not entitled to complain about a decision made with the consent of all the partners.”[45] The notion that “partners owe a duty of good faith and fair dealing to assignees of a partner’s interest” was dismissed in a footnote.[46]

There was an angry dissent, which applied the law of contracts:

> It is a well-settled principle of contract law that an assignee steps into the shoes of an assignor as to the rights assigned. Today, the court summarily dismisses this principle in a footnote and leaves the assignee barefoot. . . .
>
> As interpreted by the court, the [partnership] statute now allows partners to deprive an assignee of profits to which he is entitled by law for whatever outrageous motive or reason. The court's opinion essentially leaves the assignee of a partnership interest without remedy to enforce his right.[47]

The conflict between the *Bauer* majority and dissent is in part a theoretical battle between, on the one hand, the general law of contracts and, on the other hand, statutory provisions designed to protect the "pick your partner" principle. However, the theoretical battle has very serious practical dimensions.

> If the law categorically favors the owners, there is a serious risk of expropriation and other abuse. on the other hand, if the law grants former owners and other transferees the right to seek judicial protection, that specter can "freeze the deal" as of the moment an owner leaves the enterprise or a third party obtains an economic interest.[48]

b.The Advent of LLCs Exacerbates the Problem

For two reasons, the advent of limited liability companies has greatly exacerbated this problem. First, LLCs are far more durable than previous forms of unincorporated businesses. An assignee may be "locked in" in perpetuity. The situation was different under UPA (1914) and UPA (1997) and was arguably different under RULPA (via linkage to UPA (1914)).[49]

- UPA (1914) §32(2) permits an assignee to seek judicial dissolution of an at-will general partnership at any time and of a partnership for a term or undertaking if partnership continues in existence after the completion of the term or undertaking.
- The RULPA §201(a)(1)(4) requires the certificate of limited partnership to state "the latest date upon which the limited partnership is to dissolve." Linkage arguably makes UPA (1914) §32 applicable and permits an assignee to bring suit if a limited partnership continues past the term stated in its certificate.[50]
- UPA (1997) §801(5) and UPA (1997) §801(6) are the same as UPA (1914) §32, except the two modern acts require the court to determine whether dissolution is equitable.[51]

The second reason is less conceptual but even more important. Before the advent of fully shielded unincorporated business organizations, partnership law was a legal backwater and the "bare naked assignee" problem was a small and rarely significant part of that backwater. With the advent of limited liability companies, the "bare naked" problem is going mainstream. "The

issue of whether, in extreme and sufficiently harsh circumstances, transferees might be able to claim some type of duty or obligation to protect against expropriation, is a question awaits development in the case law."[52]

Case in Point— Kohannim v. Katoli[53]

> In *Kohannim v. Katoli*, the court: (i) noted that the LLC's "Regulations provide[] for the distribution of 'available cash' to members quarterly provided that the available cash is not needed for a reasonable working capital reserve"; and (ii)noted that "Jacob [the defendant member] paid himself $100,000 for management services that were not performed and failed to make any profit distributions to Mike [former member and ex-spouse of the plaintiff Parvaneh] or Parvaneh [ex-spouse of Mike, who became Mike's transferee as part of their divorce proceeding] even though more than $250,000 in undistributed profit had accumulated in the company's accounts since the mortgage on the property had been paid off in February 2007"; and (iii) concluded that "more than a scintilla of evidence supports the trial court's finding that Jacob failed to make profit distributions to Parvaneh." In essence, the court upheld a finding that Jacob had breached (or caused the LLC to breach) a contractual obligation to make distributions. But the court went further: "We also agree with the trial court's conclusion that the established facts demonstrated Jacob engaged in wrongful conduct and exhibited a lack of fair dealing in the company's affairs to the prejudice of Parvaneh."[54] ◂◂◂

---

§16.7 INCOMPLETE ENTITY, SHAPE SHIFTING, AND THE OVERLAP WITH FEDERAL LAW

§16.7.1 LLCs and Federal Diversity Jurisdiction

For the federal courts to have jurisdiction over a case, the case must involve a "federal question" (i.e., a question arising from federal law) or the parties must be of diverse citizenship and the amount in controversy must meet or

exceed an amount specified by statute. For the purposes of "diversity jurisdiction," diversity must be complete; i.e., there must be no overlap in citizenship between parties on opposing sides of the litigation.

When an organization (such as an LLC) is a party, the federal courts must be able to assign citizenship to the organization. The citizenship of corporations is established by the federal statutes pertaining to diversity jurisdiction: "a corporation shall be deemed to be a citizen of any State by which it has been incorporated and of the State where it has its principal place of business." [55]

The diversity statutes are silent as to the citizenship of a limited liability company, and, in the early days of LLC, litigants sought to determine LLC citizenship by analogizing the LLC to a corporation. However, it soon became clear that the controlling precedent was a U.S. Supreme Court case dealing with limited partnerships.

That case, *Carden v. Arkoma Associates*, had rejected the analogical approach and looked through the limited partnership to the citizenship of its partners.[56] As a result, for diversity purposes, a limited partnership has the citizenship of each of its partners.

The same is true for an LLC and the citizenship of its members. In the words of the Eighth Circuit:

> We recognize numerous similarities exist between a corporation and an LLC, but Congress is the appropriate forum to consider and, if it desires, to apply the same "citizenship" rule for LLCs as corporations for diversity jurisdiction purposes. This issue appears resolved by Justice Antonin Scalia's analysis [for the majority] in *Carden*.[57]

Thus, for purposes of federal diversity jurisdiction, the LLC is hardly an entity at all. The practical consequences of this situation are substantial.

Example

> Manol, LLC is a manager-managed limited liability company organized under the law of the state of Missouri. One of its members seeks to bring a derivative claim in federal court against the manager-member of the LLC. There is no diversity jurisdiction. The LLC is an indispensable party to any derivative litigation. Regardless of whether the LLC is formally aligned as a plaintiff or defendant, it will have the same citizenship as an adverse party.◂◂◂

Case in Point — Dixon v. DB50 2007-1 Trust

> After Defendant brought an action to foreclose on plaintiff s home, Plaintiff sued Defendant in state court. Defendant removed the action to federal court based on diversity of citizenship, contending that it was wholly owned by an LLC whose state of formation was Delaware. The court held that an LLC's state of formation is irrelevant to its citizenship for the purposes of diversity jurisdiction. Defendant had provided no information regarding the citizenship of the members of its parent. The trial court was not amused: "Although this Court is tempted to remand this action at this time, it is mindful that the Eleventh Circuit Court of Appeals has counseled that the better course is to allow Defendant an opportunity to amend its notice of removal under these circumstances. . . . Accordingly, Defendant shall have one final opportunity to cure this defect in its notice of removal."[58] ◂◂◂

§16.7.2 Bankruptcy and the LLC Member

The bankruptcy of an LLC member illumines both the "entity as contract" and the "incomplete entity" aspects of LLC law. The relevant bankruptcy law is quite intricate, but the major outlines are clear:[59]

- Bankruptcy law seeks to maximize the value of assets within the "bankruptcy estate."
- Conceptually, all "property" of a bankrupt member becomes part of the estate at least initially — including the member's normally non- transferable governance rights.
  - — As explained above, "bare naked" financial rights are more vulnerable (and therefore less valuable) than financial rights associated with governance rights.
  - — As a result, the trustee will seek to maximize the bankruptcy estate by claiming governance as well as financial rights.
  - — Federal law trumps state law where a conflict exists; therefore, the bankruptcy code overrides state law restrictions on transfer.
- If an LLC were completely an entity, the rest of the analysis would be straightforward.
  - — There would be no statute-based transfer restrictions.
  - — As for any contract-based restrictions, even as a matter of state law they would be unenforceable unless they provided some reasonable opportunity for the member (or the trustee, standing in the member's shoes) to sell the rights.
  - — State law and bankruptcy would thus align on this issue.
- However, because the LLC is not completely an entity, the analysis is complicated, turning ultimately on whether bankruptcy law will respect the "entity as contract" construct.
  - — LLC law's transfer restriction will be respected by bankruptcy law only if the member's interest in the LLC is conceptualized:

  - ° as an "executory contract"; and, moreover,
  - ° as an executory contract involving what is colloquially called personal services.[60]
- The executory contract/personal services analysis focuses on the nature of duties the bankrupt member owes to the LLC and fellow members.
- If applicable nonbankruptcy law (in this context, essentially contract law) would consider the duties nondelegable,[61] then the trustee has no right to make use of the bankrupt member's governance rights.[62]

- In that circumstance:
  - — bankruptcy law will view the member's governance rights as contractual, rather than as part of a proprietary interest in an entity;
  - — the incomplete entity aspect of LLC law will prevail; and
  - — the statutory transfer restrictions will work.

Case in Point—In re Modanlo

Chapter 11 bankruptcy trustee moved for leave to: (i) resuscitate debtor's single-member Delaware LLC, which had dissolved upon filing bankruptcy; and (ii) cause the LLC to call a meeting of shareholders of a corporation in which the LLC was the controlling shareholder. The Delaware LLC Act, Delaware tit. 6, §18-806, permits "Revocation of dissolution," but the trustee could invoke that provision only if the trustee had succeeded to the debtor's governance rights in the LLC. In ruling for the trustee, the court distinguished a single member LLC from a multimember LLC, noting that the impetus for only allowing trustees to be assignees in the context of multimember LLCs did not and could not apply to a single-member LLC because there are no "relationships" at stake. Accordingly, the Trustee in this matter could have more than bare economic rights.[63] ◄◄◄

Problem 129

Alphabet, LLC ("Alphabet") was a two member, member-managed limited liability company, whose members were Alpha and Beta. The Alphabet operating agreement provided that: (i) Alpha would contribute $1,000,000 and Beta $350,000 to start up Alphabet; (ii) Alpha would contract with Alphabet to market a promising new product recently developed by Alpha, with payment and all other terms of that relationship specified in the operating agreement; and (iii) Alpha would run the day-to-day activities of Alphabet.

Alpha fulfilled its obligations under the operating agreement, but Beta never made its contribution. Over the course of several months, Alpha talked, cajoled, and remonstrated with Beta in an effort to cause Beta to comply with the operating agreement. Beta repeatedly made excuses but never made the promised contribution.

Eventually, the resulting capital shortage threatened to destroy Alphabet, taking Alpha's $1,000,000 investment "down the tubes" and also imperiling the introduction of Alpha's new product. To stave off this result, Alpha contributed another $350,000 to Alphabet.

Unfortunately, Alphabet failed despite Alpha's additional contribution; irrevocable financial damage had been done during the months of Beta's excuses. Alpha did manage to avoid harm to the marketing of its new product, but Alpha's investment loss totaled $1,350,000.

According to mainstream doctrine,[64] may Alpha sue Beta directly? If so, for what amount? ◂◂◂

Explanation

It is clear that Alphabet, the limited liability company, has a claim against Beta for at least $350,000 (direct damages for breach of the promise to contribute). In addition, Alphabet may have a claim for lost profits, if: (i) the jurisdiction allows a new business to claim lost profits; and (ii) Alphabet can prove the connection between Beta's breach and the company's failure and the amount of lost profits.

For Alpha to assert these claims, however, would require a derivative action. The breach first injures Alphabet — the LLC — not Alpha, the member. Beta breached an agreement to which Alpha was a party, but that does not change the fact that Alpha's injuries are indirect.

Alpha could make a "creative" claim of direct injury by asserting that Beta's breach caused Alpha to contribute (and then lose) additional capital. Under this theory, Alpha's claim would be limited to $350,000, the extra amount Alpha contributed in response to Beta's breach.[65] ◂◂◂

Problem 130

Same facts as Problem 129. Assume that the court permits Alpha to make a direct claim against Beta. May Beta effectively counterclaim that Alpha's marketing relationship with Alphabet constituted self-dealing and therefore a breach of Alpha's duty of loyalty? ◂◂◂

Explanation

For two reasons, the answer is no. First, any such claim would be a derivative claim; any harm would first affect the LLC. Second, although a member in a member-managed LLC does have a duty not to deal with the LLC, that duty can be modified or waived by agreement. The operating agreement expressly contemplated and therefore permitted Alpha to contract with Alphabet. Therefore, there was no breach of the duty of loyalty. ◂◂◂

Problem 131

After a member-managed limited liability company has been in existence for ten years, its members note that 35 percent of the interests in its profits are owned by mere transferees. The members arrange to merge the LLC into another, shell limited liability company, and the plan of merger converts the interests in profits held by transferees into highly subordinated and arguably worthless debt of the surviving LLC. The merger has no independent, legitimate business purpose. Its sole function is to "shuffle the equity" to the grave prejudice of the transferees. Are the transferees better off under ULLCA (2013) or the Delaware LLC Act?[66] ◂◂◂

Explanation

This question is "too close to call."

It might appear that Delaware law is better for the transferees, because:

(i) ULLCA (2013) §107(b) expressly subjects the transferees to any amendments to the operating agreement that might be made to facilitate the merger; while (ii) the Delaware LLC Act gives "assignees" standing to sue derivatively. [67]

However, the relevant claim is direct, not derivative. The merger

does no damage to the LLC; the harm is solely and directly to the transferees.

The question thus becomes whether the courts of the 20 ULLCA jurisdiction or the courts of Delaware are more likely to accord the transferees "member-like" standing to sue directly. Under ULLCA (2013), the transferees can at least cite an official comment: "The issue of whether, in extreme and sufficiently harsh circumstances, transferees might be able to claim some type of duty or obligation to protect against expropriation, awaits development in the case law."[68] On the other hand, if the limited liability company were a Delaware LLC, Delaware's Court of Chancery would have jurisdiction of the litigation, and that court is quite mindful of its role as a court of equity.[69] ◂◂◂

Problem 132

OutOfPocket, LLC ("OutOfPocket") is a manager-managed limited liability company organized under the law of the state of Illinois. OutOfPocket has five members, two of whom live in Illinois, one in Wisconsin, and two in New York City. Until last month, the sole manager of OutOfPocket was Faithless, Inc. ("Faithless"), a corporation organized under the laws of Delaware, with its principal place of business in Texas. Faithless was not and is not a member of OutOfPocket.

Last month, OutOfPocket terminated Faithless as manager, believing that Faithless had misappropriated more than $250,000 from OutOfPocket. OutOfPocket plans to sue Faithless in federal court, asserting diversity jurisdiction. The amount in controversy is more than sufficient. May OutOf- Pocket proceed in federal court? ◂◂◂

Explanation

Yes. Complete diversity exists. As an LLC, OutOfPocket has the citizenship of each of its members: Illinois, Wisconsin, and New York. As a corporation, Faithless has the citizenship of its state of incorporation and its principal place of business: Delaware and Texas. ◂◂◂

Problem 133

Same facts as Problem 132, but assume that OutOfPocket brings suit in federal court *before* terminating Faithless as manager. How, if at all, does the analysis change? ◂◂◂

Explanation

The analysis does not change.

For federal diversity purposes, the citizenship of each LLC *member is attributed to the LLC. The citizenship of a nonmember manager* is irrelevant. ◂◂◂

---

1. Daniel S. Kleinberger, "The LLC as Recombinant Entity — Revisiting Fundamental Questions through the LLC Lens," paper delivered at the 21st Century Commercial Law Forum — Seventh International Symposium 2007 (Beijing, China) published in the United States, 14 Fordham J. Corp. & Fin. L. 473 (2009).

2. Ben Ross Berenberg, The Churkendoose (Wonder Books, 1946).

3. Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax and Business Law (Warren, Gorham & Lamont/RIA; 1994, Supp. 2011-2) ("Bishop & Kleinberger"), *fl5.02[2][c] (footnotes omitted).

4. The typical piercing claim seeks to disregard the legal separateness of an entity from its owners in order to hold the owners liable for the entity's debts. The picturesque label refers to putting a huge hole in the owners' liability shield, i.e., piercing the "veil" of separation. As the U.S. Supreme Court explained 100 years ago, "[a] leading purpose of [the liability shield] is to interpose a nonconductor, through which ... it is impossible to see the men behind." Donnell v. Herring-Hall-Marvin Safe Co., 208 U.S. 267, 273 (1908). The piercing doctrine originated in the corporate context and sometimes goes under the name of the "alter ego" or "instrumentality" doctrine. Piercing analysis varies from state to state in its particulars, but has an essential structure regardless of jurisdiction: (1) Piercing becomes relevant when the entity cannot pay its debts. (2) The entity's insolvency is never by itself sufficient grounds to pierce, nor is the plight *simpliciter* of the entity's creditors. (3) Piercing is warranted when the circumstances involve an abuse of the entity form by a dominant owner, where the abuse: (i) constitutes or at least approaches fraud or injustice; and (ii) involves both formal and economic disregard of the supposed separateness of entity from owner. (4) A factor test is used to assess the issues of improper dominance and disregard of separateness. Although each state has its own list of factors, the key factors always include in some form or other: (i) disregard of corporate formalities (e.g., failing to keep proper corporate records, ignoring corporate governance structures, such as meetings of directors and of shareholders); (ii) disregard of the entity's economic separateness (e.g., using entity assets for personal purposes, commingling of entity and personal funds, failing to keep separate business records for the entity); (iii) undercapitalization; and (iv) siphoning of funds out of the entity (e.g., by paying owners excessive salaries or paying dividends that leave the entity underfunded or even insolvent).

5. See section 15.4.3.

6. See section 7.2.7.

7. As will be seen in section 16.7.2, this issue also pertains to the contract versus entity question.

8. Daniel S. Kleinberger, "The Closely Held Business Through the Entity-Aggregate Prism," 40 Wake

Forest L. Rev. 827, 872 (2005).
9.*Id.*
10.*Id.*
11.*Id.*
12. See section 14.3.
13. See section 16.3.
14. ConnectU LLC v. Zuckerberg, 482 F. Supp.2d 3, 21 (D. Mass. 2007) (holding that because the LLC at issue was, in fact, formed without having a member upon formation, the LLC was "stateless" at the relevant moment for determining diversity jurisdiction and therefore complete diversity did not exist), reversed on other grounds, 522 F.3d 82 (1st Cir. 2008). For an explanation of diversity jurisdiction, see section 16.7.1
15. Daniel S. Kleinberger, "The Closely Held Business Through the Entity-Aggregate Prism," 40 Wake Forest L. Rev. 827, 869 (2005).
16. ULLCA (2013) §106(a); ULLCA (2006) §111(a).
17. Del. Code Ann. tit. 6, §18-101(7).
18. As a matter of the merits, the member might contend that the contribution obligation, being subsequent, is a dependent promise; i.e., not due until the distribution promise is performed. The standing question is conceptually separate, however, and, moreover, prior as a matter of civil procedure. That is, if the LLC lacks standing to sue for the promised contribution, the member will have no need or occasion to raise the question of dependent promises.
19. Daniel S. Kleinberger, "The Closely Held Business Through the Entity-Aggregate Prism," 40 Wake Forest L. Rev. 827, 871 (2005) (footnotes omitted).
20. *Id*. at 872.
21. *Id*.
22. Daniel S. Kleinberger, "Direct Versus Derivative and the Law of Limited Liability Com-panies," 58 Baylor L. Rev. 63, 68 (2006).
23. Daniel S. Kleinberger & Imanta Bergmanis, "Direct vs. Derivative, or 'What's a Lawsuit Between Friends in an "Incorporated Partnership"?"' 22 Wm. Mitchell L. Rev. 1203, 1214-15 (1996) (footnotes omitted).
24. This "direct harm" approach is the predominant method for distinguishing between direct and derivative claims, but two others exist: the special injury approach and the duty owed approach. Also, some states have adopted an ALI approach that blurs the distinction as to closely held businesses. For a discussion and critique of the alternative approaches, see Daniel S. Kleinberger, "Direct versus Derivative and the Law of Limited Liability Companies," 58 Baylor L. Rev. 63, 93-114 (2006) (discussing the special injury approach, the duty owed approach, and the ALI approach).
25. ULPA (2001) §1001(b).
26. ULLCA (2013) §901(a). ULLCA (2006) §901(a) has "otherwise" immediately before "protect," but is otherwise identical.
27. El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff, No. 103, 2016, 2016 WL 7380418 *9 (Del. Dec. 20, 2016) had created two wholly owned subsidiaries as acquisition vehicles. Applying *Tooley*, the Chancery Court had characterized the parent's claims as derivative, since the collapse of the acquisition financing first harmed the subsidiaries. The Supreme Court reversed, stating: "*Tooley* and its progeny do not, and were never intended to, subject commercial contract actions to a derivative suit requirement." *Id*. 179. "[A] suit by a party to a commercial contract to enforce its own contractual rights is not a derivative action under Delaware law." *Id*. at 182.
28. ULLCA (2006) §110, cmt. The same language appears in the Prefatory Note to ULLCA (2013), in the part captioned "Role and Inevitability of Operating Agreement."
29. ULLCA 2006) §112(d), cmt.
30. TravelCenters of America, LLC v. Brog, No. 3516-CC, 2008 WL 1746987 (Del. Ch. Apr. 3, 2008) (footnote and internal quotations omitted; emphasis added).

31. See section 14.5.3.
32. Del. Code Ann., tit. 6, §18-306 (emphasis added). Section 18-405 has a comparable provision applicable to managers.
33. *Id*. at §18-1101(c).
34. Myron T. Steele, "Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies," 32 Del. J. Corp. L. 1, 9 (2007). In contrast, the current Delaware Chief Justice (Leo E. Strine, Jr.) and a Delaware Vice Chancellor (J. Travis Laster) have taken just the opposite approach in "The Siren Song of Unlimited Contractual Freedom," Research Handbook on Partnerships, LLCs and Alternative Forms of Business orga-nizations (Eds. Mark Lowenstein and Robert Hillman, Edward Elgar Publishing, 2015).
35. *Id*. at 25.
36. See Bishop & Kleinberger, 14.05[4][a][ii]: The open-ended nature of fiduciary duty reflects the law's long-standing recognition that devious people can smell a loophole a mile away. For centuries, the law has assumed that (1) power creates opportunities for abuse, and (2) the devious creativity of those in power may outstrip the prescience of those trying, through ex ante contract drafting, to constrain that combination ofpower and creativity. For an attorney to advise a client that the attorney's drafting skills are adequate to take the place of centuries of fiduciary doctrine may be an example of chutzpah or hubris (or both).
37. E.g., Restatement (Second) Contracts, §161(d) (A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist inter alia: . . . where the other person is entitled to know the fact because of a relation of trust and confidence between them.).
38. See section 9.7.1 (quoting "the punctilio of an honor most sensitive").
39. See Daniel S. Kleinberger, "The Closely Held Business Through the Entity-Aggregate Prism," 40 Wake Forest L. Rev. 827, 863 (2005) (discussing the view of courts that such restrictions constitute restraints on alienation); see also 12 Fletcher Cyc. Corp. §5455 (stating that "[c]ourts applying common law principles have held that transfer restrictions constitute restraints on alienation and should be strictly construed") and G. Van Ingen, "Construction and application ofprovisions ofarticles, bylaws, statutes, or agreements restricting alienation or transfer of corporate stock," 2 ALR2d 745 (stating that stock transfer restrictions "are regarded with disfavor and are strictly construed").
40. A merger is an "organic" change, authorized by statute, through which two or more organizations combine into a single organization, with all of the rights and obligations of the "constituent" organizations becoming "by operation of law" those of the "surviving" organization. The surviving organization might be one of the original, constituent organizations. or, the surviving organization might be created as part of the merger, with *all* the constituent organizations ceasing to exist when the merger takes effect. The "plan ofmerger" must *inter alia* provide for the compensation of owners of a nonsurviving entity, because their ownership interests disappear when the entity ceases to exist. The compensation can be: ownership interests in the surviving entity; cash; other consideration (e.g., bonds); or some combination.
41. For a discussion of this type of"ersatz" agency, see section 6.2.
42. The term "bare naked assignee" was first used, albeit colloquially, during the drafting process for the Uniform Limited Partnership Act (2001). The decision to provide for perpetual duration and to attenuate the nexus between general partner dissociation and entity dissolution raised the same issues described in the text. See ULPA (2001), July 1999 Draft, §101(1) (stating that "[b]are transferable interest" means a transferable interest whose original owner is no longer a partner) and Reporter's Notes (stating that "[t]his draft gives owners of bare transferable interests very limited rights to information about the limited partnership"). See also Daniel S. Kleinberger, "The Plight of the Bare Naked Assignee," xlii Suffolk l. Rev. 587 (2009).
43. Almost paradoxically, the Delaware LLC statute is an exception to this general statement. See Del. Code Ann., tit. 6, §18-1002 (permitting assignees to bring derivative claims).
44. 849 P2d 1365 (Alaska 1993).

45. *Id*. at 1367.
46. *Id*. at 1367 n.2
47. *Id*. at 1367-68 (Matthews, J., dissenting).
48. ULLCA (2013) §112(b), cmt.
49. For a discussion of"linkage," see section 12.2.1.
50. See RULPA §1105 (providing for linkage to the general partnership statute). Because the RULPA §802 addresses judicial dissolution, it is arguable that linkage does not apply. However, because the RULPA provision does not address the situation covered by UPA §32, it is also arguable that linkage does apply.
51. See also ULLCA (2006), §801(4) (permitting a dissociated member to seek dissolution on the grounds *inter alia* of oppressive conduct). The Harmonization Project deleted the provision as inconsistent with ULLCA (2013) §107(b).
52. ULLCA (2013) §107(b), cmt.
53. Kohannim v. Katoli, 08-11-00155-CV, 2013 WL 3943078, at *10-11 (Tex. App. July 24, 2013).
54. The Case on Point is taken verbatim from ULLCA (2013) §107(b), cmt. (citations omitted).
55. 28 U.S.C.A. §1332 (c)(1).
56. Carden v. Arkoma Assocs., 494 U.S. 185, 195 (1990).
57. GMAC Commercial Credit, LLC v. Dillard Dep't Stores, Inc., 357 F3d 827, 828 (8th Cir. 2004).
58. Dixon v. DB50 2007-1 Trust, No. 3:10-CV-35 (CDL), 2010 WL 5174758 at * 3 (M.D.Ga. Dec. 15, 2010) (citations omitted). Given the lack of information, it was unclear whether the defendant could cure the defect. *Id*. at *3, n.3
59. The sections of the Bankruptcy Code of principal importance to this discussion are §§541 (dealing with property of the bankruptcy estate), 363 (dealing with the trustee's power to assume and assign contracts of the debtor), and 365 (dealing with the personal services exception to the trustee's power to assume and assign).
60. The statutory language is more elaborate. See 11 U.S.C.A. §365(c)(1)(a) (referring to "applicable law excuses a party ... to such contract . . . [i.e., the other members of the LLC] from accepting performance from or rendering performance to an entity other than the debtor").
61. I.e., involving the exercise of substantial judgment or unusual expertise. See, e.g., Restatement (Second) of Contracts §318, cmt. *c* (entitled "*Non-delegable duties*" and stating that "[t]he principal exceptions [to delegable duties] relate to contracts . . . for the exercise of personal skill or discretion").
62. Depending on the contents of the operating agreement and the provision of the relevant LLC statute dealing with causes ofdissociation, an analogous analysis may operate to prevent the rights from ever entering the bankruptcy estate.
63. In re Modanlo, 412 B.R. 715 (Bankr. D. Md. 2006).
64. I.e., ignoring the "special injury" and "duties owed" approaches mentioned in section 16.4.
65. This Problem and the theory of a direct claim are based on Excimer Assocs., Inc. v. LCA Vision, Inc., 292 F3d 134, 139-140 (2d Cir. 2002) (reversing the trial court's determination that plaintiff member's claim was derivative; holding that the plaintiff stated a direct claim when it asserted that other member's failure to make a promised contribution caused plaintiff to make an additional contribution), decision after remand, LCA-Vision, Inc. v. New York Refractive Eye Assocs., PC, No. 98 Civ. 8387 DC, 2004 WL 213027, at *5 (SDNY Feb. 3, 2004) (concluding that no reasonable jury would sustain plaintiff's breach of contract claim, and, therefore, granting summary judgment to defendant).
66. This Problem is derived from an Example in Bishop & Kleinberger, 8.06[2][e].
67. Del. Code Ann., tit. 6, §18-703(a).
68. ULLCA (2013) §107(b), cmt.
69. Glanding v. Industrial Trust Co., 28 Del. Ch. 499, 511, 45 A.2d 553, 558-59 (Del. Ch. 1945) ("It cannot be said too forcefully that the general powers of the Court of Chancery refers to that complete system of equity as administered by the High Court of Chancery of Great Britain, and a proper

interpretation of the constitutions of this State lead to but one conclusion; that is, that the Court of Chancery shall continue to exercise that complete system of equity jurisdiction in all respects until the Legislature of this State shall provide otherwise, as by granting the exercise of a part of that jurisdiction exclusively to some other tribunal."); see also Nixon v. Blackwell, 626 A.2d 1366, 1378 n.17 (Del. 1993) ("We are mindful of the elasticity inherent in equity jurisprudence and the traditional desirability in certain equity cases of measuring conduct by the 'conscience of the court' and disapproving conduct which offends or shocks that conscience.").

CHAPTER 17

Limited Liability Partnerships and Limited Liability Limited Partnerships

§17.1 OVERVIEW: TERMINOLOGY AND ORIGINS

§17.1.1 Terminology

a. Limited Liability Partnership (LLP)

A *limited liability partnership:*

- is a *general* partnership that has invoked the limited liability partnership provisions of its governing general partnership statute
- by filing with a specific public official a specified document (typically called “a statement of qualification” or a “registration”)
- thereby becoming a limited liability [general] partnership and eliminating partially or completely the automatic personal liability of each partner for each partnership obligation.

Under some state statutes, a limited liability partnership is called a registered limited liability partnership. The term “limited liability partnership” is abbreviated *LLP* and, except in statutory provisions, the abbreviation is used far more often than the term itself.

The term “liability shield” is typically used to refer to the liability

protection provided the partners of an LLP. As discussed in more detail in Section 17.2.1 almost LLP statutes provide a "full shield" for the partners — completely eliminating a partner's liability *qua* partner for the partnership's obligations. A few LLP statutes may still provide only a "partial shield" — leaving in place some of a partner's automatic liability for partnership obligations.

b. Limited Liability Limited Partnership (LLLP)

A *limited liability limited partnership:*

- is a *limited* partnership[1] that has invoked the limited liability limited partnership provisions of its state of formation
- by identifying itself as a limited liability limited partnership either in its publicly filed certificate of limited partnership or in a separate document filed as specified by the applicable limited partnership act, which results in the limited partnership
- thereby becoming a limited liability limited partnership, a status that:
  — eliminates completely the automatic personal liability of each general partner for each partnership obligation; and
  — eliminates for limited partners the "control rule" liability risk that still exists under most limited partnership acts.[2]

The term "limited liability limited partnership" is abbreviated *LLLP* and, except in statutory provisions, the abbreviation is used for more often than the term itself. The abbreviation is usually pronounced "triple-L-P."

The term "liability shield" is used in this context too. With regard to *general* partner liability, all LLLP provisions are full shield provisions.

§17.1.2 Origins of LLPs and LLLPs

The advent of limited liability companies had a ripple effect on the law of general and limited partnerships. Put most simply: if a limited liability company could shield *its* owners from automatic, vicarious liability for the enterprise's debts and still be taxed as a partnership, why not provide a comparable liability shield for general partners? Once the IRS acknowledged that its Kintner Regulations means what they said, there was nothing in tax law deter state legislatures from providing for both limited liability [general] partnerships — LLPs — and limited liability limited partnership — LLLPs.[3]

There remained non-tax forces of inertia, however. Most importantly,

from a non-tax and historical perspective, a general partner's liability seemed inherently and inescapably the hallmark of partnership law. It took five years after the IRS's seminal ruling on LLCs for any state legislature to authorize limited liability partnerships. Moreover, the first LLP shield was decidedly inferior to an LLC or corporate shield.

Today, in contrast, the limited liability partnership is firmly established and widespread, and the limited liability limited partnership is only a few steps behind. All states authorize LLPs, and most LLP statutes now provide a shield that is essentially indistinguishable from an LLC or corporate shield. Almost 20 states have adopted either ULPA (2001) or ULPA (2103), and under either act a limited partnership can originate as or become an LLLP simply by including a one-line statement in the certificate of limited partnership.[4]

§17.2 LIMITED LIABILITY PARTNERSHIPS

§17.2.1 Origin and Development

In 1991, Texas enacted the first LLP legislation, which was targeted to help professional firms (especially firms of accountants and lawyers) and which provided a liability shield that made sense only in that context.[5] The shield was available only to general partnerships and protected only against a partner's vicarious liability[6] for:

> debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence, or malfeasance occurred.[7]

The shield thus gave partners no protection whatsoever against contract-based partnership obligations. Even as to tort-based partnership obligations, the shield was ineffective if the partner invoking the shield:

1. was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or
2. had notice or knowledge of the errors, omissions, negligence, in competence, or malfeasance by the other partner or representative at the time of occurrence.[8]

In addition, the efficacy of the shield was conditioned *inter alia* on the partnership carrying specified amounts of malpractice insurance.

In 1992 and 1993, a few states followed Texas's example, and in 1993 Texas clarified and refined its statute. The next major development occurred elsewhere, however.

In 1994, first Minnesota, then New York enacted "full shield" LLP provisions —enabling partners in a general partnership to have the same liability protection available to LLC members and corporate shareholders.[9]

Prior to 1996, LLP provisions were all based on UPA (1914). UPA (1997) was just beginning to gain acceptance, and, moreover, as originally promulgated in 1994, the revised act had no LLP provisions. In 1996, the ULC amended the 1994 version to provide for "full shield" LLPs,[10] and since that time most states have taken the "full shield" approach.

§17.2.2 Essential Characteristics

Most LLP provisions now appear in a state's enactment of UPA (1997), so most LLP statutes have nearly identical provisions.[11] Under UPA (1997):

1. An ordinary general partnership becomes an LLP by first obtaining the requisite quantum of consent from its partners and then filing a "statement of qualification" with a specified public official.[12]
2. Unless the partnership agreement provides otherwise, the quantum of partner consent necessary to approve becoming an LLP is the same quantum of consent as is necessary to approve an amendment to the partnership agreement "except, in the case of a partnership agree-ment that expressly considers obligations to contribute to the partnership, [the LLP approval quantum is] the vote necessary to amend those provisions."[13]
3. The statement of qualification "must be executed by at least two partners,"[14] must be accompanied by whatever filing fee is required bystatute,[15] and must contain: "(1) the name of the partnership; (2) the street address of the partnership's chief executive office and, if different, the street address of an office in this State [i.e., the State under whose law the general partnership is becoming an LLP], if any;(3) if the partnership does not have an office in this State, the name and street address of the partnership's agent for service of process; (4) a statement that the partnership elects to be a limited liability partnership; and (5) a deferred effective date, if any."[16]
4. An LLP's name must include specified designators — i.e., phrases or abbreviations that reflect the partnership's status as a limited liability partnership. "The name of a limited liability partnership must end with 'Registered Limited Liability Partnership,' 'Limited Liability Partnership,' 'R.L.L.P.,' 'L.L.P.,' 'RLLP,' or 'LLP.''"[17]
5. An LLP must file an annual report with the same public official that receives the statement of qualification. The annual report contains minimal information; its function is merely to keep

current the public record.[18]

6. When a statement of qualification takes effect, a full liability shield arises. “An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.”[19]

Example

> For several years, Locke, Hobbes, and Calvin have been operating a business as an ordinary general partnership governed by UPA (1997). They have no formal partnership agreement and have not previously agreed how to go about changing their inter se relationship. On March 1 of this year, Hobbes suggests that the partnership become an LLP. Calvin agrees, but Locke wants to “think it over for a few days.” At that point the partnership cannot become an LLP. Under UPA (1997) §1001(a), the decision to become an LLP requires the same consent as is required for amending the partnership agreement. This partnership has no agreement as to amending the partnership agreement, so UPA (1997) §401(j) applies and requires unanimous consent. ◂◂◂

§17.2.3 Important Non-Uniform Provisions

Some states that have adopted UPA (1997) have nonuniform provisions explicitly stating that the liability shield does not protect a partner from liability for the partner’s own misconduct or from liability for the misconduct of a person directly supervised by the partner. The former exception is unnecessary because an LLP shield by its terms addresses only a partner’s liability *qua* partner for obligations *of the partnership*.[20] The latter exception is significant, however, because it goes beyond holding a partner liable for the partner’s own misconduct. The “supervisee” exception appears not only to preserve a partner’s liability *qua* partner for a partnership obligation resulting from a supervisee’s misconduct but to do so without even requiring the claimant to prove that the partner’s supervision was negligent or otherwise deficient.

As to LLP provisions based not at all on UPA (1997), the principal variations are that:

- under a few statutes, the shield protects a partner only as to partnership obligations resulting from the malpractice or similar tort committed by a person other than the partner (leaving the partner liable *qua* partner for partnership obligations arising in any other way, including through contract);[21]
- many statutes expressly provide that the shield does not protect a partner from liability for the partner's own misconduct or from liability for the misconduct of a person directly supervised by the partner;[22]
- some statutes require each LLP to maintain specified levels of liability insurance;
- a few states require an LLP to renew its registration annually.

All these provisions are foot prints from the early days of LLPs.[23]

§17.2.4 No Protection for the Partnership and No Effect on Partner's Own Misconduct

What is true for the LLC and corporate shields is equally true for the LLP shield. The LLP shield protects the partners, not the partnership; indeed, the entire point of the shield is to prevent the partnership's obligations from being automatically imputed to the partners. Also, the LLP shield does not protect against liability resulting from a partner's own conduct.

Example

> Fencing, LLP is a UPA (1997) limited liability partnership, and Porthos is one of its partners. One day, while conducting the partnership's ordinary business and giving a fencing lesson to an individual student, Porthos becomes distracted by personal concerns. As a result, he negligently inflicts a leg wound on the student. The LLP shield is irrelevant to the student's tort claim against Porthos. The claim arises from Porthos's own misconduct and does not seek to impose on Porthos a partner's liability for an obligation of the partnership. Likewise, the shield is irrelevant to the student's UPA (1997) §305(a) claim against the partnership.[24] ◄◄◄

§17.2.5 Effects of LLP Status on the Partnership and of Dissolution on LLP Status

a. Becoming or Ceasing to Be an LLP

A limited liability partnership is a general partnership with an LLP shield. Donning or doffing the shield has considerable importance for the general partnership's partners but does not remake the underlying business organization. Whether that underlying organization is viewed as an aggregate or an entity:[25]

- the organization's becoming an LLP does not create a new partnership, and
- the organization's ceasing to be an LLP does not dissolve or terminate the existing partnership.[26]

b. Partnership Dissolution

Partnership dissolution has no effect on the partnership's LLP status. UPA (1997) makes this point explicitly,[27] but the same rule applies even under LLP provisions that lack comparable language. By definition, dissolution does not end a partnership,[28] so dissolution could affect the LLP only if statutory language were to so provide. No partnership statute contains any such language.

The situation is different, however, when a dissolved LLP winds up its business by transferring its assets, obligations, and operations to a successor general partnership. As explained in Chapter 11, for most purposes the transition can be and often is seamless.[29] However, the successor partnership is not the same organization as the dissolved partnership, which means that the successor partnership it *not* an LLP unless either: (i) the successor partnership itself files to become an LLP; or (ii) the LLP statute automatically transfers the dissolved partnership's LLP status to the successor partnership. Few, if any, LLP statutes provide for automatic transfer, and the transition to a successor partnership often occurs without the partners paying much attention or even recognizing that a transition is occurring. As a result, especially in UPA (1914), gaps in the shield seem likely.

Example

> Jay, Alfred, and Proofrock are partners in a general partnership governed by the law of a state that has grafted LLP provisions onto UPA (1914). The partnership has filed the necessary document to be

an LLP. On April 1, Jay decides to leave the partnership, and Alfred, Proofrock, and he informally agree that: (i) the business will continue without interruption; and (ii) Jay will be bought out at a specified price, payable in specified installments. No one thinks to do any paperwork other than a simple letter memorializing the buy-out arrangement. On May 5, a customer slips and falls while on the business's premises. On May 15, Alfred and Proofrock file the necessary document for their partnership to be an LLP. On May 20, a second customer slips and falls while on the business's premises. As to the tort claim ofthe first fallen customer, the partnership is not an LLP unless the LLP statute automatically transfers the LLP status of a dissolved partnership to a successor partnership. As to the second fallen customer, the partnership is an LLP regardless of whether the statute contains an automatic transfer provision.◂◂◂

§17.2.6 When Partnership Obligations Are Incurred

Under UPA (1997 and 2013) §306(c), both apply the LLP shield to protect partners from vicarious liability for partnership obligations "incurred while the partnership is a limited liability partnership." If a general partnership is an LLP throughout its existence, the question of when a partnership obligation is "incurred" never arises in this context.[30] If the question does arise, the answer can be quite complex.

The "when incurred" language originated in UPA (1914) §17, which states the liability of a "person admitted as a partner into an existing partnership" for partnership obligations "incurred" before the partner's admission. UPA (1997 and 2013) each replicate that approach in their respective sections 306(b).

None of the three acts provide statutory guidance, on how to approach the "when incurred" question in regard to the LLP shield, but the comments to UPA (2013) §306(b) and (c) provide a careful analysis of when an obligation is incurred. The analysis begins in the comment to section 306(b):

> With regard to when a partnership incurs a debt, obligation, or other liability, the case law is scant and concerns only contractual and similar obligations. The leading case . . . holds that: (i) obligations on a loan, whether for interest or principal, are incurred when the loan is made, not when each particular payment is due; and (ii) obligations for lease payments are incurred when each rental payment is due, not when the lease is made. . . . As to when a partnership incurs a tort

liability, the answer might be found by analogy to statute of limitation rules, another area of law concerned with when claims arise.

The analysis then shifts to the comment in section 306(c), in particular the part that addresses this question at length.[31] The subsection (c) analysis begins by differentiating the "when incurred" question under subsection (c) from the question under subsection (b):

> It could well be argued that "incurred" under subsection (c) has the same meaning as "incurred" under subsection (b). However, the argument should yield if the subsections' different contexts raise different issues of policy. . . .

The comment then asserts that one aspect of the analysis under subsection (b) is appropriate for the purposes of subsection (c):

> The case law [under subsection (b)] concerning contractual obligations (incurred when the contract is made) applies appropriately in the context of the LLP shield. However, the lease case law is problematic. If an obligation is incurred each time rent is due, subsection(c) is a trap for the unwary landlord.

Example

> Ordinary general partnership enters into a lease with a commercial landlord. Knowing that each partner is automatically liable for the partnership's debt, the landlord does not obtain personal guarantees. Subsequently, the partnership becomes an LLP. If future rent payments are incurred when due, and not as of when the lease was made, the landlord loses a very important part of the bargain. ◂◂◂

Thus, for the purposes of subsection (c), lease obligations should be treated as contractual obligations, incurred when the contract is made.

The comment then addresses the "when incurred" question as applied to a partnership's tort obligations:

> Courts must look to when the conduct causing the injury takes place and not to when actual injury occurs. Otherwise, a partnership could: (i) engage in wrongful conduct that does not cause immediate injury; (ii) come to realize that the conduct has occurred; (iii) subsequently file a statement of qualification; (iv) thereby become an LLP; and (v) thereby eliminate the vicarious liability of its partners for all harm subsequently arising from the misconduct. . . .
>
> In general, courts should determine the "incurred" question under subsection (c) so that the LLP shield protects the partners of an LLP to the same extent that the corporate and LLC shields protect corporate shareholders and LLC members. From that perspective, LLP status obtained after a partnership commits a wrongful act should provide no greater protection for the partners than a sole proprietor obtains by forming an LLC after committing a wrongful [act]i.e.,

none.

§17.2.7 The Contribution Conundrum

In an ordinary general partnership, partners share losses inter se, and both UPA (1914) and UPA (1997) require partners to contribute to the partnership so as to effectuate that loss sharing.[32] Many partnership agreements also establish contribution obligations among the partners, sometimes merely replicating and sometimes varying the statutory default rules.

In the context of an LLP, however, contribution is problematic. A partner's obligation to contribute to the benefit of a fellow partner translates, as a practical matter, into a liability to a creditor of the LLP.

Example

> Fencing, LLP is a limited liability partnership governed by UPA (1997), and Porthos is one of its partners. He and his co-partners, Aramis and Athos, share profits and losses equally. One day, while conducting the partnership's ordinary business and giving a fencing lesson to an individual student,
>
> Porthos becomes distracted by personal concerns. As a result, he negligently inflicts a serious leg wound on the student. The student successfully sues both Porthos and the partnership for $90,000. The partnership has no funds to pay the judgment, and — because the partnership is an LLP — the partners are not, merely on account of partner status, responsible for the partnership's obligation to the student.
>
> Porthos, however, is directly liable for his own negligence. Porthos also has a claim against the partnership for $90,000 in indemnification.[33] If the partnership cannot meet that indemnification obligation, Porthos has suffered a loss in the conduct of the partnership business. If Aramis and Athos are obliged to contribute to the partnership so as to equalize the loss among the three partners, that obligation effectively defeats the purpose of the LLP liability shield. Assuming for the sake of simplicity that there are no other losses to be shared among the partners, Aramis and Athos will each

have to contribute $30,000 to the partnership, the resulting $60,000 will be in theory available to Porthos but in practice will be garnered by the student as a judgment creditor of Porthos, the partnership, or both.[34] ◄◄◄

UPA (1997) pays considerable attention to this issue, and sections 306(c), 807(b), 807(c), and 1001(b) each specifically refer to a partner's contribution obligations. Section 1001(b) links the consent necessary to become an LLP to the consent necessary to amend any partnership agreement provisons pertaining to contribution.[35] Section 807(b) and (c) each make a partner's contribution obligations subject to Section 306(c), which shields an LLP's partner from liability *qua* partner for a partnership obligation, whether a claim is asserted "directly or indirectly, by way of contribution or otherwise." Section 306(c) even overrides contribution obligations that the partners may have chosen to state in their partnership agreement before the partnership became an LLP.

As a result of these provisions:

- The loss sharing provisions of UPA (1997) remain intact *as to capital losses suffered by the partners;*
- The contribution provisions of UPA (1997) will never create a hole in the LLP shield; and
- a partnership agreement's provisions on contribution will jeopardize the shield only if adopted or reaffirmed after the general partnership becomes an LLP.

§17.2.8 Piercing the Veil

Although only a few LLP statutes specifically contemplate the doctrine of "piercing the veil," piercing will nonetheless be part of the law applicable to LLPs. Piercing is, after all, an equitable doctrine which originated and exists in the corporate realm as "exclusively a case law phenomenon."[36] That case law has already helped establish the piercing doctrine as part of the law of limited liability companies,[37] and there is every reason to expect the same phenomenon with LLPs.[38]

§17.3 LIMITED LIABILITY LIMITED

PARTNERSHIPS

§17.3.1 Origins and Current Availability

Like LLPs, LLLPs, began in Texas. In 1993, Texas amended its general and limited partnership statutes to permit a limited partnership to invoke the LLP provisions of the general partnership statute and thereby become a registered limited liability limited partnership.[39] Several other states promptly followed Texas, and over the next decade the following pattern developed:

1. Several states expressly permitted a limited partnership to invoke the LLP provisions of the state's general partnership statue.[40]
2. A few states provided for LLLPs directly, solely through language in the limited partnership statute.
3. A few states expressly precluded a limited partnership from being an LLLP.
4. Most state partnership statutes did not expressly address the issue.

As to the first and second categories, by 2002 more than 15 states had authorized the existence of limited liability limited partnerships, although at least initially in a few ofthese states the LLP shield protected only general and not limited partners.[41]

As to the fourth category, despite the statutory silence, it is possible to argue "based on the language of the UPA, RUPA, and RULPA" that a limited part-nership may invoke the LLP provisions of its state's general partnership act, at least to provide a liability shield for the limited partnership's general partners.[42]

In 2001, the ULC promulgated its new Uniform Limited Partnership Act and sought to bring clarity, simplicity, and uniformity to this issue. ULPA (2001):

- defines a limited liability limited partnership simply as "a limited partnership whose certificate of limited partnership states that the limited partnership is a limited liability limited partnership";[43]
- requires the certificate of limited partnership of each limited partnership to state "whether the limited partnership is a limited liability limited partnership";[44]
- uses essentially verbatim the language of RUPA's *LLP* shiled to establish a full corporate and LLC-like *LLLP* shield;[45]
- eliminates the "control rule" and provides a full corporate and LLC-like liability shield for all

> limited partners regardless of whether the limited partnership is an LLLP.[46]

As of this writing, almost 20 states and the District of Columbia have adopted either ULPA (2001) or ULPA (2013).

§17.3.2 Name Requirements

Like the name of an LLP, the name of an LLLP must include specified phrases or abbreviation so as to designate the limited partnership's special status.
The designator requirements vary depending on whether the relevant statute refers to limited liability limited partnerships or, instead, treats an LLLP as merely a subset of LLPs. ULPA (2001) provides:

> The name of a limited partnership that is not a limited liability limited partnership must contain the phrase "limited partnership" or the abbreviation "L.P." or "LP" and may not contain the phrase "limited liability limited part-nership" or the abbreviation "LLLP" or "L.L.L.P." The name of a limited liability limited partnership must contain the phrase "limited liability limited partnership" or the abbreviation "LLLP" or "L.L.L.P." and must not contain the abbreviation "L.P." or "L.P."[47]

§17.3.3 Piercing and Dividend Recapture

An LLLP provides a full, corporate and LLC-like liability shield. There is no reason why this shield should be immune from the equitable doctrine of piercing the veil.[48]

As to distribution recapture, most current LLLP provisions rest either on ULPA (2001) or the RULPA, each of which provides for recapture of wrongfully made distributions.[49] The shield is inapposite to a partner's recapture liability, because the liability is not asserted "solely" on account of partner status. In this respect, LLLPs are less protective than LLPs, which typically do not provide for distribution recapture.[50]

Problem 124

> Fezzik, Vincini, and Buttercup are partners in an ordinary general partnership governed by UPA (1997). Fezzik is a very wealthy individual, while Buttercup has only modest means and Vincin is

nearly judgment proof. The partnership agreement: (i) names Fezzik as “managing partner”; (ii) authorizes him to make all decisions on behalfofthe partnership that pertain to “ordinary operations and activities”; (iii) allocates profits 65 percent to Fezzik, 20 percent to Buttercup, and 15 percent to Vincini; (iv) requires unanimous consent ofthe partners to amend the partnership agreement; and (v) does not mention the idea of a limited liability partnership. Does Fezzik have the authority, either as managing partner under the partnership agreement or as the owner of a majority of the profits interest, to cause the partnership to become an LLP? ◂◂◂

Explanation

No. Under UPA (1997) §1001(b), unless the partnership agreement provides otherwise, the decision to file a statement of qualification requires the same quantum of consent as an amendment to the partnership agreement. This partnership agreement does not address becoming an LLP but does require unanimous consent for an amendment. Fezzik’s role as managing partner and his ownership of 65 percent of the profits interests are both irrelevant. ◂◂◂

Problem 125

Same facts as Problem 124, plus the following: Fezzik suggests to Buttercup and Vincini that the partnership become an LLP. Buttercup readily agrees, but Vincini refuses. Vincini says to Fezzik, “You’re going to have to make it worth my while to get my agreement. The shield doesn’t much matter to me. They can’t get blood from a stone. But you, Mr. Moneybags, you’ve got a lot to lose. If you want my agreement, you’ll have to transfer me 5 percent of the profits.” Does Fezzik have any claim against Vincini? ◂◂◂

Explanation

Possibly. Fezzik might succeed with a claim that Vincini has breached the obligation of good faith and fair dealing stated in UPA (1997) §404(d). Fezzik would characterize Vincini as withholding consent solely for the purpose of extorting a transfer from Fezzik. Vincini

would invoke UPA (1997) §404(e) and argue that he is *entitled* to engage in "conduct [which] further [his] own interests." Fezzik would respond that:

1. UPA (1997) §404(e) in its entirety provides that "A partner does not violate a duty or obligation under this [Act] or the partnership agreement *merely* because the partner's conduct furthers the partner's own interest" (emphasis added);
2. more is involved here than mere self-interest;
3. LLP status could in no way prejudice Vincini, and Vincini was not protecting any legitimate self-interest by refusing his consent; and
4. Vincini was, in fact, using his veto power and Fezzik's concern about personal liability to coerce Fezzik. ◂◂◂

---

1. Recall that a limited partnership must have at least two partners, at least one person who is a general partner and, at least one other person that is a limited partner. See 12.1.1.
2. See section 12.2.3 and 12.3.4.
3. For a discussion of the Kintner tax classification regulations, see sections 13.1.4(a) and (b). The "check the box" regulations, discussed in section 13.1.4(d), removed any shadow of tax classification doubt, even for the most conservative of tax practitioners.
4. ULPA (2013) §201(5) (requiring the certificate of limited partnership state "(5) whether the limited partnership is a limited liability limited partnership); ULPA (2001), §201(a)(4) (same)." The provision requires those forming a limited partnership to at least consider forming a LLLP.
5. See Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax and Business Law (Warren, Gorham & Lamont/RIA 1994 Supp. 2011-2) ("Bishop & Kleinberger"), §15.01[3][a] at 15-6 to 15-9.
6. Like all shields, this LLP shield offered no protection against (and, indeed, was irrelevant to) claims arising from a partner's own conduct. See section 17.2.4.
7. 1991 Tex. Sess. Lav Serv. ch. 901 (H.B. 278), §§83-85.
8. 1991 Tex. Sess. Lav Serv. ch. 901 (H.B. 278), §§83-85. Note that these exceptions can but do not necessarily involve any directly culpable conduct by the partner. It is possible, for example, for an individual to be "directly involved in the specific activity in which . . . negligence" occurs without the individual being negligent. Likewise, an individual can have "knowledge or notice" of a co-worker's negligence without the individual being negligent.
9. 1994 Minn. Sess. Law Serv. ch. 539, §12, amending Minn. Stat. Ann. §323.14(2); 1994 NY Laws ch. 576, §8, amending N.Y. Partnership Law §26.
10. UPA (2013)—Quick Chronology.
11. The following analysis would also apply to a state that has enacted UPA (2013).
12. UPA (1997) §1001(b) and (c).
13. UPA (1997) §1001(b) (as to why this provision makes special reference to contribution obligations). See section 17.2.7.
14. UPA (1997) §105(c).
15. Most LLP statutes require a small filing fee — typically less than $200 —which must be paid when the general partnership first becomes an LLP and each time the LLP files an annual report or (under non-uniform statutes) renews its registration. A few states, however, impose significantly higher filing fees. Delaware, for example, imposes a fee of $200 per partner, subject to an annual limitof$120,000, forboth the initial statement of qualification and each subsequent annual report. Del. Code Ann. tit. 6, §15-1207(a)(3). This fee will be a substantial expense for any LLP with numerous partners, such as a large accounting firm.

16. UPA (1997) §1001(c)(1)-(5).

17. UPA (1997) §1002. This provision does not directly require that an LLP use its special designator when transacting business. Failure to do so, however, may result in personal liability for the person acting on behalf of the LLP on the agency law theory that the person is not acting for a fully (or correctly) disclosed principal. See Bishop & Kleinberger, §6.04[5] at S6-34 (discussing the issue in the context of limited liability companies).

18. UPA (1997) §1003(a) requires the annual report to state the LLP's name; the street address of the LLP's chief executive office and, if different, the street address of an instate office, if any; and, if the LLP does not have an in-state office, the name and street address of the LLP's agent for service of process. Failure to file the annual report can result in revocation

of an LLP's statement of qualification, which in turn ends the partnership's status as an LLP and removes the liability shield. UPA (1997) §1003(c) and (d). However, revocation does not occur automatically. A specified public official must take action — giving the LLP "at least 60 days' written notice of intent to revoke the statement [of qualification]." UPA (1997) §1003(c). Even after revocation, a general partnership can retroactively regain its LLP status (and retroactively reestablish the LLP shield) by properly applying for "reinstatement" ofthe revoked statement of qualification. UPA (1997) §1003(e) and (f). Reinstatement nullifies the effect of revocation *ab initio* ("as if the revocation had never occurred"). UPA (1997) §1003(f). Subsection (f) does not expressly preserve the rights of third parties who may have relied on the revocation, but principles of estoppel will likely provide that protection.

19. UPA (1997) §306(c). As to why this provision makes special reference to contribution obligations, see section 17.2.7.

20. See section 17.2.5.

21. Some of these statutes limit the shield protection to partnership obligations resulting from malpractice and other torts. Others provide protection against partnership obligations arising from all malpractice claims, regardless of whether the claim sounds in tort or contract.

22. These provisions have the same problems as noted for such provisions grafted onto uniform act LLP provisions.

23. See section 17.2.1.

24. See section 10.5.1.

25. On the entity/aggregate distinction, see section 7.2.7.

26. As to an LLP formed under UPA (1997), see UPA (1997) §§201(b) and 1003(d) and UPA (1997) to RUPA §201.

27. UPA (1997) §1001(e). The comment expands on the point: "[L]imited liability partnership status remains even though a partnership may be dissolved, wound up, and terminated. Even after the termination of the partnership, the former partners of a terminated partnership would not be personally liable for partnership obligations incurred while the partnership was a limited liability partnership."

28. See section 11.2.1(g).

29. See sections 11.4.3 and 11.4.4(b).

30. The question may be relevant to statute of limitation issues.

31. UPA (2013) §306(c), The Temporal Nexus — When Claim Incurred.

32. UPA (1914) §18 states: "Each partner . . . must contribute toward the losses . . . sustained by the partnership according to his state in the profits." See also UPA (1997) §40(a)(II) (a dissolved

partnership's assets include the partners' respective contribution obligations). UPA (1997) §807(b) provides that, following a partnership's dissolution: "A partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account. . . ." This aspect of UPA (2013) may require revision and is currently under study by the Joint Editorial Board on Uniform Unincorporated Organization Acts ("JEBUUOA"). (The author of this book serves as Research Director for the JEBUUOA.)

33. "In case of partner misconduct, section 401(c) sets forth a partnership's obligation to indemnify the culpable partner where the partner's liability was incurred in the ordinary course of the partnership's business." UPA (1997) §306, comment 3. See section 8.4.

34. UPA (1997) §807(f) provides: "An assignee for the benefit of creditors of a partnership or a partner, or a person appointed by a court to represent creditors of a partnership or a partner, may enforce a partner's obligation to contribute to the partnership."

35. The link is a default rule. If the partnership agreement contains no provision pertaining to contribution, or if the partnership agreement does not provide an amendment mechanism specific to the agreement's provisions on contribution, §1001(b) links to the consent mechanism generally applicable for amending the partnership agreement.

36. Bishop & Kleinberger, §6.03[3] at 6-29 (discussing piercing and LLCs).

37. See section 16.1.

38. Bishop & Kleinberger, §6.03[3] at 6-29. The case for piercing is, if anything, stronger for most LLPs than for corporations and limited liability companies, because, unlike corporate and LLC statutes, LLP statutes other than UPA (2013) lack any provisions imposing liability either on owners or managers for distributions which left the entity insolvent or which were otherwise improper.

39. Bishop & Kleinberger, §15.01[4] at 15-18.

40. Most such statues refer to "limited liability limited partnerships" but a few lump both general and limited partnership under the term "limited liability partnership." See, e.g., Ariz. Rev. Stat. §29-308(C), Ga. Code §14-8-2(6.1). For simplicity's sake, this book uses the term "limited liability limited partnership" and the abbreviation "LLLP."

41. See Bishop & Kleinberger, §15.03[3][b] at 15-73 to 15-74. As explained in section 12.2.3, in an ordinary limited partnership a limited partner's regular liability shield is subject to the "control rule," which in some circumstances exposes a limited partner to personal liability for a limited partnership obligation. If an LLLP shield applies to a limited partner, the shield overrides and renders moot the control rule.

42. See Bishop & Kleinberger, §15.03[2] at 15-70 for a detailed explanation.

43. ULPA (2001) §102(9).

44. ULPA (2001) §201(a)(4).

45. ULPA (2001) §404(c).

46. ULPA (2001) §303.

47. ULPA (2001) §108(b) and (c). ULPA (2013) §108 is identical.

48. For an explanation of this point in the context of LLPs, see section 17.2.8. For a discussion of the factors courts use in determining piercing claims, see section 13.5.7.

49. See section 12.2.3. ULPA (2001) §§508 and 509 take a more corporate-like approach but nonetheless retain some recapture exposure.

50. The Harmonization Project, seeing no rational basis for the distinction, has sought to end it. See UPA (1997) (Last Amended 2013) §407 ("Liability for Improper Distributions in a Limited Liability Partnership").