

AGENCY, PARTNERSHIP, AND THE LLC:

THE LAW OF UNINCORPORATED BUSINESS ENTERPRISES

CASES, MATERIALS, PROBLEMS

**2009 Supplement to the Seventh Edition
Teacher's Manual**

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Chapter 2

RIGHTS AND DUTIES BETWEEN PRINCIPAL AND AGENT

DUTIES OF PRINCIPAL TO AGENT

DUTY TO INFORM AGENT OF RISKS

Page 101. *Deonier & Associates v. Paul Revere Life Insur. Co.*

This case involves an important duty that principals owe to their agents – the duty to inform an agent of risks that an agent faces in discharging duties to the principal. Here the principal (Paul Revere) failed to inform its agent (Doenier & Associates) that if a policyholder failed to properly disclose a pre-existing condition *and* that policyholder filed a claim based on that condition more than two years after the policy issued (thus possibly triggering the policy’s incontestability clause), Paul Revere intended to deny coverage and argue that the nondisclosure voided coverage notwithstanding the incontestability clause. (This is the so-called *Forman* defense, endorsed by the 5th Circuit Court of Appeals in a 1975 decision.) Doenier claimed that Paul Revere’s failure to inform her that it would invoke the *Forman* defense under such circumstances breached a fiduciary duty that Paul Revere owed to her. The District Court disagreed and ordered summary judgment in favor Paul Revere. The Montana Supreme Court reversed.

It is noteworthy that Paul Revere does not appear to have acted in bad faith, or even negligently. Although there were no Montana state court decisions supporting its view of the law, there was a federal district court opinion in Montana holding that the incontestability clause does not apply when there has been a misrepresentation by a policyholder regarding a pre-existing condition. In light of this and other court decisions, Paul Revere arguably had no reason to believe that its plan to rely on the *Forman* defense exposed its agents to litigation by disappointed policyholders. The Court reasoned, however, that Paul Revere should have known that the legality of the *Forman* defense was an open question in Montana and that the Montana courts might not adopt it. With that knowledge, Paul Revere should have realized that its agents were at “risk” – a key concept for the Court – if they failed to disclose Paul Revere’s interpretation of the incontestability clause. (In fact, the Court went on to hold that the defense was not valid in Montana.)

This reading of the duty to inform agents creates real problems for principals. It probably did not appear very likely to Paul Revere that a policyholder would make a misrepresentation regarding a pre-existing condition, a claim based on that condition would be made more than two years after the policy issued, Paul Revere would deny coverage, the policyholder would file suit against Paul Revere *and* its agent, and a Montana court would fail to adopt the *Forman* defense. Nevertheless, the Court’s opinion suggests that this is just the sort of risk of which an insurance company should advise its agents. The upshot of this decision, at least in Montana and possibly

nationwide, is that insurers may feel compelled to produce “disclosure documents,” disclosing any risk that anyone in the insurer’s legal department can dream up. Such a document will be of little use to an agent and may even adversely affect the agent if real risks are included among numerous remote ones.

Chapter 3 VICARIOUS TORT LIABILITY

THE MASTER-SERVANT RELATIONSHIP

THE SCOPE OF EMPLOYMENT LIMITATION

Negligent Acts

Page 219. *Spencer v. V.I.P., Inc.*

One of the most litigated issues in the area of “scope of employment” is the “going and coming” question: if an employee acts negligent while driving to work or returning home, is the employer liable? The general answer is “no,” but there are exceptions, as the note on p. 218 indicates. The *Spencer* case provides a fuller fact situation to apply to the doctrine. Here, an employee (Laliberte), on his day off, helped set up a promotional event for his employer (V.I.P.). On his way home, he drove negligently, killing one person and injuring two. The estate of the deceased and the two injured parties sued V.I.P., claiming it was vicariously liable for Laliberte’s negligence. The lower court granted summary judgment for the defendant V.I.P. The issue in the case is whether an exception to the “going and coming” rule applied, and the Supreme Judicial Court of Maine concluded that there were facts that supported a finding that vicarious liability might be appropriate. The Court reached this conclusion through a rather mechanical application of Restatement (Second) § 228.

We have included the dissenting opinion, both because it is well reasoned and demonstrates how a formalistic application of § 228 can lead to a questionable result. Pedagogically, the two opinions give the student important perspectives on the question and they might be asked which opinion is more persuasive.

Chapter 11
THE CREATION OF A PARTNERSHIP

THE PARTNER RELATIONSHIP DEFINED

THE UNIFORM PARTNERSHIP ACT (1914) AND THE REVISED UNIFORM PARTNERSHIP ACT (1997)

Page 540. *Byker v. Mannes*

The issue of whether parties have formed a partnership by default is frequently litigated. The RUPA definition of a partnership (§ 202(a)) is largely unchanged from the UPA definition (§ 6(1)), but the drafters of RUPA added a clause to make it clear that a partnership could be formed “whether or not the persons intend to form a partnership.” The *Byker* court determined that it has always been the law of Michigan that the existence of a partnership depends on the “parties’ actual conduct in their business arrangements, as opposed to whether the parties subjectively intend that such arrangements give rise to a partnership.” To the extent the lower court thought otherwise, it was mistaken and should reconsider the question. Thus, this case, though decided under UPA, provides a basis for discussing the RUPA change and its practical effect.

Chapter 12

THE OPERATION OF A PARTNERSHIP

SUITS BY THE PARTNERSHIP

Page 634. *Adams v. Land Services, Inc.*

This case considers the important question of whether minority partners in a general partnership can maintain an action on behalf of the partnership. The Colorado appellate court concludes that “a partner cannot maintain a suit to enforce a partnership claim if a majority of the partners do not agree to do so.” Thus, the remedy of a derivative action, so important to minority shareholders in a corporation, is unavailable to minority partners in a partnership. On the other hand, as the court points out, minority partners are not without a remedy to address alleged breaches of fiduciary duty by their co-partners. The minority partners may obtain an accounting or, in proper circumstances, a dissolution. Of course, dissolution is not a substitute for a financial recovery and, indeed, this partnership had been dissolved. An accounting, however, may provide the basis for a recovery.

Although dictum, the court seems to leave open that possibility that, under the right circumstances, it might permit a minority partner to maintain an action on behalf of the partnership (the *Cates* exception). Students might be asked to speculate on what those “exceptional circumstances” might be. We doubt that it would be sufficient to allege that the majority partners had a conflict of interest in deciding whether a claim should be brought. Interestingly, at the end of the opinion the court comes back to the *Cates* exception, but seems to be saying that it permits an action if the complaining partner suffered an injury distinct from the partnership. But if that is true, the partner does not need any special exception. For instance, if the partnership breached an agreement with a minority partner, the aggrieved partner could maintain an action on that breach. The court seems to be confusing a direct action, always permissible, with an exception to the rule that a derivative action may not be maintained by a partner.

RIGHTS AND DUTIES AMONG PARTNERS

THE DUTY OF LOYALTY

Dealing with Conflicts of Interest

Page 664. *J & J Celcom v. AT&T Wireless Services, Inc.*

In this case, the Washington Supreme Court considers a question certified to it by the Ninth Circuit Court of Appeals. The case arose from a squeeze-out transaction: the defendant, AT&T Wireless, wanted to rid itself of its minority partners, so it caused the partnerships to dissolve and then bought the assets on the liquidation of the partnership. The minority partners, understandably upset by this self-dealing, sued, and the question for the Washington court was whether RUPA permits a majority partner to engage in

such a transaction. The Court had little trouble concluding that the defendant's conduct was lawful.

This case provides an opportunity to explore, in depth, RUPA § 404, which sets forth a partner's fiduciary duties. The concurring opinion by Justice Madsen, included here, takes the time to consider each of the subsections of § 404 in reaching the same conclusion as the majority. In short, Judge Madsen's opinion concludes that there is nothing in the section that precludes this sort of conduct.

We find this decision at least a bit troubling. We would have liked the court or Justice Madsen to consider more carefully RUPA § 404(b)(2), which, *inter alia*, prohibits a partner from dealing with the partnership as an adverse party during the winding up of the partnership. That's exactly what the defendant did. Justice Madsen's opinion disposes of this problem by citing a law review article which, in turn, says that a partner does not violate this prohibition if the partner makes full disclosure, the partnership consents and the deal is fair. The defendant controlled the partnership, so its own consent was meaningless and, without the right to vote on the transaction, disclosure to the minority partners was equally meaningless. So what is left is that self-dealing, otherwise prohibited by § 404(b)(2), is permissible if the transaction is fair to the partnership. If the drafters of the section anticipated such an exception, would they not have said it?

Justice Madsen is correct to draw the distinction between the fiduciary approach of UPA and the contractual approach of RUPA. In that context, we think that if the partnership agreement had expressly permitted this sort of transaction (that is, on fair terms), a court would, and should, enforce the agreement. As Justice Madsen acknowledges, however, this agreement did not authorize this sort of self-dealing. He finesses this problem by noting that the agreement did authorize the partnership to sell assets and/or dissolve by majority vote. But this just begs the question. Of course the partnership can dissolve and sell assets, but can it sell to the majority partner on the basis of that partner's "consent?"

Corporate law has handled this problem by giving the minority shareholders a right to dissent from the transaction and receive the fair value of their shares in an appraisal action. Appraisal, however, is a statutory remedy and, thus, not an option here. One way to think about the transaction in this case is that the drafters of RUPA did not include an appraisal provision but did include a blanket prohibition on self-dealing in § 404(b)(2). If the parties did not contract around § 404(b)(2), which they had a perfect right to do, the transaction is simply illegal. That's a rough result, but one that AT&T should have considered when drafting the agreement. Finally, consider how the minority partners would have reacted had the agreement included a provision expressly permitting self-dealing. Perhaps they would have declined to make the investment.

Question following *J & J Celcom*:

The concurring opinion is rather curious in this regard. The opinion suggests that the adoption of RUPA affected the outcome in the case, but after setting out the UPA approach and then the relevant RUPA provisions, it never comes back to indicate why RUPA yields a different result. An argument can be made that the silence of the partnership agreement on the question of self-dealing means that the transaction could not occur (see discussion above). On the other hand, Justice Madsen seems satisfied that the transaction was fair and should be allowed to go forward. Under UPA, a court would not be constrained by the necessity of finding an exception in the partnership agreement, but may feel constrained by general agency principles that prohibit an agent from profiting at the expense of the principal, which may have occurred here.

SUITS AMONG PARTNERS

Page 710. *Berry v. Ostrom*

This case somewhat duplicates *Schuler v. Birnbaum* on p. 710, which the instructor may wish to omit. But the Court's discussion in *Berry* adds clarity to the issue of when a partner may maintain an action against a co-partner or when an accounting is the sole remedy. In this case, the partners sold property to a third party, who in connection with the transaction assumed an obligation to a bank under a partnership note. When that third party defaulted, the bank came back to the partners. At this point, the facts get a bit fuzzy on exactly how the bank's claim was resolved, but it is clear that the defendant agreed to pay a portion of that debt and subsequently defaulted. The plaintiff, who apparently paid defendant's obligation (again, the facts are a bit fuzzy), now seeks to hold defendant to his commitment. The defendant replies that the proper cause of action is an accounting. The Idaho Court of Appeals disagrees, holding that the nature of this claim is sufficiently separate from the partnership business that the claim may be maintained without an accounting.

THE LLP SHIELD

Page 723. *Ederer v. Gursky*

In a limited liability partnership, the partners are not vicariously liable for the debts and obligations of the partnership. Section 26(b) of the New York partnership statute, at issue in this case, provides, in relevant part, that "no partner...of a registered limited liability partnership is liable..., directly or indirectly,... for any debts, obligations or liabilities of...the limited liability partnership or each other, whether arising in tort, contract or otherwise, which are incurred, created or assumed by such partnership while [it] is a...limited liability partnership..." This broad protection from liability was challenged in this case by a lawyer who left the partnership pursuant to an agreement under which

the partnership agreed, among other things, to pay him certain amounts of money. This was clearly a partnership obligation, yet the majority of the New York Court of Appeals held the partners individually liable on the agreement. The Court reasoned that the phrase “any debts” is “part of a provision (section 26) that has always governed only a partner’s liability to third parties...not article 4,” which deals with relations among partners. “The logical inference, therefore, is that ‘any debts’ refers to any debts owed a third party, absent very clear legislative direction to the contrary.”

Is this a logical (or the only logical) inference? Judge Smith, writing in dissent, thought not and argues, persuasively in our view, for a contrary result.

There are few cases dealing the LLP shield and given New York’s importance as a commercial state, this decision may prove important. It is the first case we have found narrowing the LLP shield.

Question following *Ederer v. Gursky*:

The question raises the issue as to whether the liability shield was intended to go so far as to treat partners in an LLP like shareholders in a corporation in terms of liability for firm obligations. *Ederer* suggests that the answer is no, partly because the shield provision was grafted on to a statute in which partners were personally liable for all firm obligations. The graft was a limited one – intended to protect partners from vicarious liability to third-party creditors (as evidenced by its placement in the statute). All other partner liability (in this case, liability to account to a withdrawing partner) remains undisturbed. As a result of this case, lawyers drafting LLP agreements would be well advised to make clear whether personal liability attaches to such obligations. Interestingly, the partners in this case – lawyers all – did not have a written partnership agreement, so the default provisions of the statute applied.

Chapter 13

DISSOCIATION OF A PARTNER AND DISSOLUTION OF A PARTNERSHIP

CONTINUING THE BUSINESS

Rights of a Retired or Dissociated Partner or the Estate of a Deceased Partner When the Business is Continued

Page 778. *Estate of Matteson v. Matteson*

This case allows a careful look at how UPA § 42 operates when a withdrawn partner allows the partnership to continue. Here, after considerable angst, the court concluded that the plaintiff had, in fact, permitted the partnership to continue. That portion of the opinion, which was highly factual, has been omitted. The remaining portion of the opinion deals with two legal questions: how are the profits to which the plaintiff is entitled under § 42 calculated, and who bears the burden of proving that amount? As to the second question, the Court concludes that the plaintiff bears the burden, even though the defendant, as the person continuing the partnership business, had greater access to the partnership's records. The Court reasoned that since the plaintiff invoked the judicial process, it should bear the burden of proof. The Court also seems reluctant to part company with other states that resolved the issue in that way.

As to the former question – how are profits calculated – the issue is complicated. The Court jettisons the parties' pre-dissolution profit sharing agreement (which would have given the plaintiff 55% of the post-dissolution profits). This is unfair, the Court reasoned, because the exiting partner is not at risk for post-dissolution losses and does not provide services to the partnership. More importantly, the exiting partner is only entitled to "profits attributable to the use of his right in the property of the dissolved partnership...." (UPA § 42) Thus, the statute seems to require a deviation from any profit sharing agreement that the partners might have had. The Court gives some guidance as to how "profits attributable" might be calculated. The bottom line, so to speak, is that in service-oriented partnerships, the "profits attributable" may be relatively small, and that seems fair.

Chapter 15

THE LIMITED LIABILITY COMPANY

THE OPERATION OF THE LLC

The Management of an LLC

Page 931. *Weber v. U.S. Sterling Securities, Inc.*

This case considers what seems to be a fairly simple proposition: a member of an LLC (or a limited partner of a limited partnership or corporate shareholder) is always liable for his or her own misconduct. *Weber* forces one to distinguish between one's conduct as an agent and one's "own conduct." Here, the defendants, acting on behalf of a limited liability company, sent unsolicited faxes to the plaintiffs, allegedly in violation of a federal statute that prohibits such conduct. The defendants were sued as individuals and argued that because they were acting for a limited liability company, they could not be liable individually. While this argument convinced the trial court and resulted in a dismissal of the complaint, it was unpersuasive to the Connecticut Supreme Court. The Court noted that the applicable limited liability company statute (Delaware's, although it does not differ from most statutes) provides that a member of a limited liability company is not liable for the LLC's obligations "solely by reason of being a member or acting as a manager of the limited liability company." The court focused on the word "solely," and reasoned that if one does more than merely hold a membership interest, the liability exclusion does not apply. In this case, defendants' alleged conduct – causing unsolicited faxes to be sent – was "tortious in nature" according to the Court. Therefore, they could be individually liable.

Claims Among Members

Page 963. *Wood v. Baum*

Whether to include this case or not was a difficult decision. The case considers when members of a limited liability company must make a demand on the managers of the LLC before instituting a derivative action. The Delaware court applies the same doctrines to limited liability company members that it applies to corporate shareholders and, in fact, cites the leading Delaware decisions on the question. This is old hat to teachers of corporate law and typically thoroughly covered in courses on corporations. The case is included here because not all students take a course in corporate law and, more importantly, derivative actions filed by members of limited liability companies are becoming increasingly common. As noted elsewhere in the book, the number of new limited liability companies far outstrips the number of new incorporations, so we can expect the number of derivative actions involving limited liability companies to grow.

That all said, the Court restates the demand test succinctly in its opinion. In brief, the plaintiff bears the burden of pleading in this case that the board of the LLC could not fairly consider a demand to bring an action because they bore a substantial risk of

personal liability in such an action. Because the operating agreement exculpated the board from all misconduct, except “in the case of fraudulent or illegal conduct,” plaintiff must allege that a majority of the defendants engaged in such non-exculpated conduct. This the plaintiff failed to do. Thus, the complaint is dismissed.

What is of particular interest here is the interplay between the operating agreement and the demand requirement. Because the members of an LLC have considerable freedom in drafting an operating agreement, conduct otherwise actionable may not be and a derivative action would be precluded.

Dissolution

Page 982. *R & R Capital v. Buck & Doe Run Valley Farms, LLC*

This case considers whether the members of a limited liability company may prospectively waive their right to seek judicial dissolution in the operating agreement. Reminding the reader of Delaware’s commitment to freedom of contract, the court holds that the members may waive their right to seek judicial dissolution.

One abstract question one might ask is whether the section of the act that identifies nonwaivable provisions is exclusive. Put differently, are there provisions that cannot be waived in an operating agreement even though not identified as such in the statute? One might argue that this case resolves that question in the negative; unless identified as mandatory in the statute, a statutory provision may be waived. But note how Chancellor Chandler does not base his decision solely on the basis that the statute does not identify the dissolution provisions as nonwaivable. Instead, he deals with public policy and equity arguments, thereby implying that public policy considerations, or equitable considerations, are worthy of consideration.

Note, too, how the implied covenant of good faith and fair dealing, which cannot be waived, makes an appearance near the end of the opinion. As contractual freedom has grown, this nonwaivable covenant has gained greater importance in Delaware law.

Question following *R & R Capital*:

The Chancellor actually dealt with this issue in an omitted part of the case. The court had this to say:

If these provisions actually conflicted, the Waiver Entities' argument would be rendered unpersuasive by virtue of ambiguity in the Agreement. This Court is constrained, however, by rules of interpretation that require it to attempt to “harmoniz[e] seemingly conflicting contract provisions,” and these provisions can in fact be harmonized. A “decree of judicial dissolution” may be entered by the Court under section 18-802 upon an “application by *or for* a member or manager.” Although the members and managers of the Waiver Entities have apparently waived *their* rights to make an application under section 18-802, the

members and managers cannot waive the rights of others to make such applications *for* them. Consequently, under the interpretive principle requiring harmonization, sections 10.1 and 13 .1 do not conflict because it is possible both that a court could enter a “decree of judicial dissolution under Section 18-802 of the Act” and that the members could nonetheless have waived *their* right to seek such a decree. (citations omitted)

Holdeman v. Epperson

Chancellor Chandler’s opinion in *R & R Capital* stands in stark contrast to the Ohio Supreme Court’s opinion in the *Holdeman* case. The *Holdeman* Court frames the issue as whether “an executor of a deceased member may exercise ‘member’ rights in a limited liability company.” That does not strike us as a fair framing of the issue. The real issue in the case is whether the parties to an operating agreement may waive a statutory provision that allows an executor of a deceased member to exercise the member’s rights. The operating agreement clearly provided that a person ceases to be a member upon death and that person’s successor (including the executor of his estate) “shall not become a member” unless admitted in accordance with the operating agreement. The plaintiff here – the executor of a deceased member’s estate – sought, but was denied, membership. Nevertheless, the Court holds that the executor may exercise the deceased member’s rights; the statute takes precedence over the parties’ operating agreement. Note how the dissent takes a more contractual approach and, in our view, has the better argument.