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Partnerships

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PARTNERSHIPS

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I. INTRODUCTION

AS has been the case in recent years, we ventured outside of Texas for cases, especially looking for the usually scarce LLC cases, for this year's Survey. There are some notable cases, including a couple that impose partner fiduciary liability on non-owners, and we've covered a few cases for their nuggets of usefulness. Overall, it was an interesting period.

II. FIDUCIARY DUTY

It has become common for limited partnerships to be organized with an entity—currently, limited liability companies are popular—as the general partner, to provide the general partner's owners with a shield from liability for the general partner's obligations. There has always been the possibility, albeit not likely in most situations, that the veil of the entity could be pierced, resulting in liability for those owners who sought to be shielded.[1] The next two cases are frightening reminders that determined courts can find other ways to impose fiduciary duty liability.

FNFS Ltd. v. Harwood (In re Harwood),[2] a bankruptcy case from the Eastern District of Texas, concerned whether fiduciary duties were owed to a limited partnership by an officer of the corporate general partner for debts owed by the officer to the limited partnership. David Harwood

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1. *See* Faulkner v. Kornman (*In re* The Heritage Org., L.L.C.), 413 B.R. 438 (Bankr. N.D. Tex. 2009) (discussed *infra* Section III).

2. 404 B.R. 366 (Bankr. E.D. Tex. 2009).

owned fifty percent of the stock of B&W Finance Co., Inc. (the Corporation), which owned a fifty-one percent interest in FNFS, Ltd. (the Partnership) as the Partnership's general partner.[3] As the president and chief operating officer of the Corporation, Harwood controlled the day-to-day operations of the Corporation, which consisted exclusively of providing executive and managerial services to the Partnership.[4] Harwood, however, used that control to take Partnership funds for his personal use. Although Harwood accounted for the withdrawals by executing promissory notes to the Partnership, and securing them by giving deed of trust liens on real property owned by him, Harwood never recorded the deeds of trust in the real property records.[5] The Partnership sued Harwood to collect Harwood's debt, prompting him to file for Chapter 7 bankruptcy protection.[6] The Partnership sought a determination that the debts owed to it by Harwood were not dischargeable in bankruptcy because they were debts resulting from a "defalcation while acting in a fiduciary capacity."[7]

In evaluating the plaintiffs' claims, the bankruptcy court first had to decide whether, under Texas law, Harwood individually owed a "fiduciary" duty to the Partnership within the meaning of the discharge exception for fiduciary fraud or defalcation.[8] Citing Fifth Circuit analysis of Texas law, the court held that a fiduciary duty exists if "the degree of control actually exercised by a corporate officer over the actions of a corporate general partner warrants a corresponding recognition of the fiduciary responsibilities realistically assumed by that individual as to an affected limited partnership entity."[9] Applying that standard to the facts, the court found that Harwood owed a fiduciary duty to the Partnership because he directed the day-to-day activities of the Partnership in a nearly autocratic manner.[10]

After deciding that Harwood owed a fiduciary duty to the Partnership, the bankruptcy court held that Harwood's failure to ensure that the deeds of trust securing his debts to the Partnership were properly recorded went beyond a mere negligent breach of his fiduciary duty and constituted willful neglect, thus amounting to a "defalcation while acting in a fiduciary

3. *Id.* at 377. It appears that the court assumed that B&W Finance Co, Inc., was a Texas corporation and that FNFS, Ltd., was a Texas limited partnership, but the opinion is silent on those things.

4. *Id.* at 378.

5. *Id.* at 378-79.

6. *Id.* at 382.

7. *Id.* at 382, 386, 392 (citing 11 U.S.C. § 523(a)(4) (2004)).

8. *See id.* at 394-97.

9. *Id.* at 395-97 ("not only does Texas law impose a fiduciary duty upon a managing partner of a limited partnership, but that it also imposes a fiduciary responsibility on the managing partner *of that managing partner* in a two-tiered limited partnership arrangement") (citing LSP Inv. P'ship v. Bennett (*In re* Bennett), 989 F.2d 779 (5th Cir. 1993)) .

10. *Id.* at 397 ("No one with daily involvement in either [the Corporation's or the Partnership's] affairs could realistically challenge Harwood's authority or decision-making with regard to either entity.").

capacity."[11] Consequently, those debts were not dischargeable in the bankruptcy proceeding, and the Partnership was entitled to recover the outstanding amounts of the Harwood loans from the bankruptcy estate.[12]

It is concerning that courts feel so free to impose liability on persons who are not owners, and who have acted in a representative capacity. It is not so much that someone involved in self-dealing did not get what he or she deserved (if that is what happened here); it is the precedent for future matters that don't involve defalcation, and where, as here, a corporate officer can be found to have fiduciary duties to other parties (much less to partners who are two-tiers-down remote).[13]

McBeth v. Carpenter[14] involved claims of fraud, breach of fiduciary duty, and breach of contract, arising out of a failed land sale transaction.[15] As with Mr. Harwood in *In re Harwood*, discussed above, this case had a bad outcome for Mr. Carpenter, who was tagged with liability *individually*, even though he acted in a representative capacity (as the manager of a limited liability company that was a general partner, and as the president of other limited liability companies that were general partners of limited partnerships who were limited partners).[16] If, taken with *Harwood*, this decision suggests a trend, it is a disconcerting one.[17]

The procedural posture of the case—whether to overturn a jury verdict on a motion for judgment as a matter of law[18]—may limit its future effect, which would be a good thing.[19] The Fifth Circuit found sufficient evidence in the record to support the jury's findings that the defendants

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11. *Id.* at 399.

12. *Id.* at 399, 406-07.

13. On the surface, this feels like a "he can't do that and get away with it" result. Fine, here, but lawyers and then courts will rely on this as precedent where the facts do not support such a result.

14. 565 F.3d 171 (5th Cir. 2009).

15. *Id.* at 174-75. The case was in federal court because of diversity jurisdiction. The breach of fiduciary duty claim is the only one of interest to us here.

16. *Id.* at 176, 178-79. The Fifth Circuit's inconsistent descriptions of Carpenter's status and role was revealing. The first allusion in the opinion: "Carpenter signed the partnership agreement *as President of the general partner* . . . ." *Id.* at 175 (emphasis added). Later in the opinion: "Carpenter seeks to set aside the district court's judgment by arguing that he owed Plaintiffs no fiduciary duty pursuant to the . . . partnership agreement *in which he acted as general partner*." *Id.* at 177 (emphasis added). Also, "[t]he [limited partnership] agreement also contained Carpenter's signature as general partner on behalf of two other entities serving as limited partners . . . ." *Id.* at 175. See below for more on this issue.

17. Again, the troublesome thing here is precedent. Determining that an individual should be "punished" for putative misconduct, and in the process ignoring (especially without in-depth analysis) legal structures and rules, is a very dangerous thing. Even if the result in *Bennett* (see *supra* note 9) is conceded to be correct, it could and should be limited to its facts—it is not nearly the stretch to say that one who, individually, is a general partner and who has liability for the obligations of that limited partnership is liable as a fiduciary to lower-tier limited partners, that it is to impose that liability on one not an owner who is acting as the representative of an entity. And even *Harwood* had an element of "self-dealing" that could be pointed to.

18. The Fifth Circuit said that reversing the jury's verdict was proper "only if no reasonable jury could have arrived at the verdict." *McBeth*, 565 F.3d at 179 (quoting Stevenson v. E.I. DuPont De Nemours & Co., 327 F.3d 400, 405 (5th Cir. 2003)).

19. One example of the Fifth Circuit's perspective: "[W]e decline to disturb the jury's verdict and affirm the district court's judgment." *Id.* at 177.

breached their fiduciary duties.[20]

Carpenter was sued by limited partners for breach of fiduciary duty but not as a partner in any partnership. He was sued as the representative of the general partner of a limited partnership, and as the representative of a limited partner, for breaching duties owed to other limited partners. Because it is unusual these days for an individual to take on the liability of a general partner, without the interposed protection of a liability-shielding entity, and because of the opinion's limited and inconsistent treatment of the underlying facts, the authors contacted Carpenter's counsel. We confirmed that Carpenter was *not*, individually, a general partner or limited partner.[21] It is surprising that a court would invoke partner status under partnership law to impose partner fiduciary breach liability on an individual who was not a partner, without invoking a theory such as "piercing the veil."

It was clear from the opinion that Carpenter was "the guy," in charge of everything. In his testimony, he admitted that he made little or no effort to identify which hat he was wearing at a given time.[22] Of course, it is not unusual for a single individual to be the driving force in a limited partnership, whether acting as a representative of another entity or individually. And it is not unusual for an individual acting in a representative capacity to personalize the role by saying that "I am the general partner" instead of the awkward "I am an officer or other representative of the entity that is the general partner." The Fifth Circuit pointedly emphasized, and repeated, Carpenter's "control" over the activities of the business, for the general partner and for the general partner of two limited partners.[23] Notwithstanding the procedural posture of the case, the Fifth Circuit could have determined that the district court misapplied the law in imposing liability on Carpenter, individually; instead, it determined that the cases cited by the plaintiff were sufficient.

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20. *Id.* at 179.

21. Carpenter's counsel forcefully argued in briefing to the Fifth Circuit, including in a request for an *en banc* review, that unlike the facts in cases cited by the plaintiff, Carpenter was not a partner. *See infra* note 23.

22. *See McBeth*, 565 F.3d at 178-79. The Fifth Circuit said that "Carpenter was often quoted as making a point of telling all other partners that he was the general partner." *Id.* at 178. Undoubtedly, Carpenter could have helped himself (on the issue of having liability individually) by being more careful in his conduct.

23. *Id.* at 178. "Control" was the proffered underpinning for the Fifth Circuit's upholding the imposition of liability on Carpenter directly. *See id.* Carpenter's counsel made the better (though unsuccessful) case, in drawing the distinction between the facts here and those in *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.), and in LSP Inv. P'ship v. Bennett (*In re* Bennett), 989 F.2d 779 (5th Cir. 1993) (where the defendants individually were general partners of the controlling entity), both relied on by the plaintiffs and the court: "In contrast, Carpenter's actions which the Reynolds vie to attempt to establish 'control' were merely the required action of the manager of an LLC. [USCA 5 1017-1027]. Reynolds 'control' argument would effectively set forth a new expansion of Texas law and impose a *personal* fiduciary duty upon the manager of every LLC." Brief for Appellant James R. Carpenter at 28, *McBeth*, 565 F.3d 171 (No. 07-51305).

The Fifth Circuit quickly disposed of two other issues—whether fiduciary duties extend down the ownership chain to another tier and whether limited partners owe fiduciary duties to other limited partners.[24] Again, Carpenter came out on the short end, with the court finding Texas law support for an affirmative finding on each issue.[25]

The case relied on by the Fifth Circuit for the proposition that "the managing partner of a managing partner" owes fiduciary duties to lower-tier limited partners was factually distinguishable, as was *Crenshaw*, which the *Bennett* court discussed in great detail.[26] The Fifth Circuit relied on both here.[27] Among other things, *Crenshaw* involved an individual who was the general partner of a general partner, and who otherwise had complete control over all partnership activities (and who would have had general partner liability for the fiduciary breach committed by the lower-tier general partner anyway).[28] In *Bennett*, the issue was whether a second-tier-up individual general partner (again, not one acting in a representative capacity, but an actual natural-person partner) could obtain a discharge in bankruptcy. It was argued that he could not because he breached fiduciary duties owed to lower-tier partners, which was equated to "defalcation while acting in a fiduciary capacity" which must be shown to deny a discharge.[29] Originally, the Fifth Circuit upheld the bankruptcy court's grant of the discharge, on the grounds that whatever the duty, it was not the express trust relationship required (vs. constructive trust) to support defalcation while acting in a fiduciary capacity.[30] In that original opinion, the *Bennett* court declined to extend *Crenshaw* to find that there was an express trust relationship between the managing partner of the managing partner of a limited partner, and the limited partners.[31]

That opinion was withdrawn on rehearing, and a new one substituted, blazing new law in Texas. Relying on *Crenshaw*, the Fifth Circuit found that the managing partner of a managing partner did owe fiduciary duties to the limited partners of a limited partnership.[32] As previously noted, and regardless of one's feelings about the correctness of that result, the facts are distinguishable from those here—in both *Crenshaw* and *Bennett*, the defendant found to have fiduciary duties to lower-tier partners was, individually, a partner of the managing partner, which is not the case here.

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24. *See McBeth*, 565 F.3d at 177-79.

25. *See id.* at 177-78.

26. *See Bennett*, 989 F.2d at 787-90.

27. *See McBeth*, 565 F.3d at 177-79.

28. *See* Crenshaw v. Swenson, 611 S.W.2d 886, 888-92 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

29. *Bennett*, 989 F.3d at 783 (quoting 11 U.S.C. § 523(a)(4) (2010)).

30. *See In re* Bennett, 970 F.2d 138, 141, 149 (5th Cir. 1992) (opinion withdrawn on rehearing).

31. *Id.* at 149.

32. *Bennett*, 989 F.2d at 790.

The authority cited by the court for the proposition that limited partners owed one another fiduciary duties was recent, but flimsy. In the 2007 Survey we wrote about *Zinda v. McCann*:

> The partners might have pursued the argument that limited partners do not, as such, owe fiduciary duties; apparently, there was no need to do that in view of the overwhelming evidence otherwise in their favor. In fact, it is not obvious that limited partners owe fiduciary duties, as such, at least if they do not participate in control of the partnership's business.[33]

The other case cited to support finding limited partners liable to one another as fiduciaries was *Dunnagan v. Watson*, another appellate case in which, as here, the court was seeking support in the record for the lower court's jury finding on the issue.[34] In the same 2007 Survey, we wrote, after noting in the text that the Fort Worth Court of Appeals had found fiduciary liability among limited partners:

> Again, the number of hats worn by Watson make it difficult to say with conviction which hat sunk the boat. The headnotes of the reporter suggest that it was a limited partner who owed duties to the partnership in that capacity, but the opinion itself is much less clear on that. Yes, that person was a limited partner, but it is not clear that he was acting as such when his conduct resulted in breach of a duty.[35]

We are hopeful that the precedential value of this case will be limited by its procedural posture. Issues as important as those addressed in this case call for the utmost rigor by the courts that dispose of them. A valuable practice tip may develop from this—having limited partners acknowledge going in that Party X is acting in a representative capacity.

III. PIERCING THE VEIL

Faulkner v. Kornman (In re The Heritage Organization, L.L.C.),[36] an adversary proceeding brought in connection with the Chapter 11 bankruptcy of a Delaware LLC, addresses, among other things, a party's ability to pierce the veil of a limited partnership.[37] The bankrupt LLC that is the subject of this case, The Heritage Organization, L.L.C. (Heritage), was owned by various member entities, including Delaware limited partnerships. In addition, several entities related to Heritage, also including Delaware limited partnerships, supplied goods and services to Heritage.[38] The bankruptcy trustee brought this proceeding against the CEO of Heritage (who directly or indirectly controlled essentially all of the member and supplier entities, in addition to Heritage itself) and the member and

33. Steven A. Waters & Joel Iglesias, *Partnerships*, 60 SMU L. REV. 1217, 1220 n.26 (2007) [hereinafter Waters & Iglesias].

34. 204 S.W.3d 30 (Tex. App.—Fort Worth 2006, pet. denied).

35. Waters & Iglesias, *supra* note 33, at 1222 n.46.

36. 413 B.R. 438 (Bankr. N.D. Tex. 2009).

37. The goal of a veil-piercing effort is to make an owner, who is not otherwise responsible for the obligations of a limited liability entity, liable for the obligations of that entity.

38. *In re The Heritage*, 413 B.R. at 456-57.

supplier entities to (i) set aside distributions made to them, on fraudulent transfer and preference theories, and (ii) to hold the CEO and the member and supplier entities liable for Heritage's debts, on a veil-piercing theory.[39]

The bankruptcy court opened by noting that the trustee's veil-piercing claims were based on two theories: "alter ego and sham to perpetrate injustice."[40] After it reviewed relevant Delaware law,[41] the court found that Delaware law does not recognize a distinct "sham to perpetrate injustice" veil-piercing theory; instead, the "sham" analysis is merely one component of the alter ego theory.[42] Consequently, for the member and supplier entities that were Delaware limited partnerships, the court concluded that the bankruptcy trustee's claims must be evaluated solely under an alter ego analysis.[43] However, after noting that current Delaware law was unclear on the issue, the court held that the alter ego theory cannot pierce the veil of a Delaware limited partnership to hold its limited partners liable for the partnership's debts, citing Texas appellate case law[44] and the similarities between the limited partnership statutes of Delaware and Texas to support its reasoning.[45] The court agreed with the reasoning of Texas courts that a limited partner should be liable for the partnership's debts only where the limited partner participates in the control of the partnership's business, as specifically provided by applicable statutes.[46]

Schwab v. McDonald (In re LMcD, LLC),[47] an adversary proceeding that arose from the Chapter 7 bankruptcy of a Pennsylvania LLC, concerned a bankruptcy trustee's efforts to pierce the veil of an LLC under Pennsylvania law. LMcD, LLC, was formed by Kevin and Helen McDonald to showcase ice-carving artwork. The business was unsuccessful, and the LLC sought Chapter 7 bankruptcy protection. The Chapter 7

39. *Id.* at 459, 498, 509-10. Most of the decision analyzed whether distributions to insiders of Heritage constituted "fraudulent transfers" that should be avoided under the Bankruptcy Code and the Texas Uniform Fraudulent Transfer Act. *See id.* at 459-98. The court found the distributions to be avoidable as fraudulent transfers or preferences. *See id.* at 490, 501.

40. *Id.* at 510.

41. The court applied Delaware law, because Texas choice-of-law rules mandated following the law of the jurisdiction where the entity was formed, and the bankruptcy court applied Texas choice-of-law provisions, as bankruptcy courts must apply the law of the jurisdiction in which they sit. *See id.*

42. *Id.* Because the supplier entities included a Tennessee corporation and a Texas corporation, the court performed a similar review of the laws in each of those states. *Id.* at 511. The court found that Tennessee law mirrors Delaware law (in that Tennessee courts examine whether an entity was operated as a "sham" only as a component of the alter ego theory), except that Texas law does recognize the "sham to perpetrate injustice" (or "sham to perpetrate fraud") as a separate means of piercing the corporate veil. *Id.*

43. *Id.*

44. *Id.* at 514 n.64 (citing Pinebrook Props. Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487 (Tex. App.—Texarkana 2002, pet. denied); Asshauer v. Wells Fargo Foothill, 263 S.W.3d 468 (Tex. App.—Dallas 2008, pet. denied).

45. *Id.*

46. *Id.* (citing DEL. CODE. ANN. tit. 6, §§ 17-303(a), 17-303(b) (2008)).

47. 405 B.R. 555 (Bankr. M.D. Pa. 2009).

trustee sued the McDonalds on a veil-piercing theory, seeking to hold them, the members, liable for the debts of the LLC.[48]

In denying the trustee's veil-piercing claim, the bankruptcy court held that the veil of a Pennsylvania LLC could not be pierced solely because the LLC was undercapitalized.[49] The court was persuaded that the LLC sufficiently adhered to company formalities by filing a certificate of organization, entering into a limited liability operating agreement, registering a fictitious name for the LLC, applying for an employer identification number, establishing a bank account, entering into a commercial lease, obtaining a certificate of occupancy and a license to operate a public eating and drinking establishment, and filing tax returns.[50] In addition, although "there may have been an intermingling of identities" (that is, many vendors and creditors doing business with the LLC could not differentiate between the LLC and its members), there was no "commingling of assets, financial records, or employees."[51] The members' direct payments at the LLC's liabilities did not constitute commingling of assets, and there was no evidence that the LLC's funds were ever deposited into a member's personal bank account.[52]

This case was not a complete victory for the defendants, however. Because Kevin McDonald signed some of the LLC's contracts in his own name, without identifying himself as a representative of the LLC, the bankruptcy court found that was personally liable on those contracts.[53]

JNS Aviation, Inc. v. Nick Corp.[54] is the successor to a bankruptcy case covered in the 2008 Survey, in which a creditor was permitted, under Texas law, to pierce the veil of a bankrupt LLC to hold its owners personally liable for the LLC's debts.[55] Despite the exceptionally unfavorable facts set forth by the bankruptcy court in the prior case, the LLC owners decided to appeal the decision. To no avail—the Northern District of Texas affirmed the bankruptcy court's ruling.[56] The district court held that the bankruptcy court properly applied the "sham to perpetrate fraud" doctrine, correctly characterizing the Texas Business Corporation Act as having added an "actual fraud" requirement to Texas veil-piercing

48. *Id.* at 559. This case also addressed the trustee's attempts to reverse-pierce the corporate veil of a Pennsylvania corporation (also solely owned by the McDonalds), to hold the corporation liable for the debts of the LLC through the McDonalds, as the corporation's shareholders (assuming that the McDonalds were liable for the LLC's debts on the veil-piercing theory). *Id.* The trustee's reverse-piercing claims did not succeed. *Id.* at 564.

49. *Id.* at 560-61.

50. *Id.* at 561. These details are good reminders that there is an operational cost to enjoying limited liability.

51. *Id.* at 562. It is awkward to constantly inform customers and vendors that, even though they deal only with a natural person, they are doing business with an entity with which that person is involved (as owner, representative, etc.).

52. *Id.*

53. *Id.* at 568. That is an appropriate outcome; indicating representative capacity on contracts is Entity/Liability Protection 101 stuff.

54. 418 B.R. 898 (N.D. Tex. 2009).

55. *See* Steven A. Waters & Peter Christofferson, *Partnerships*, 61 SMU L. REV. 995, 1004-07 (2008) (discussing *In re* JNS Aviation, 376 B.R. 500 (Bankr. N.D. Tex. 2007)).

56. *JNS Aviation*, 418 B.R. at 901.

law in breach-of-contract suits, rather than having completely overturned the line of Texas cases that developed Texas veil-piercing law.[57] The district court also held that the bankruptcy court did not err in finding actual fraud by the owners of the LLC.[58]

IV. STATUTE OF FRAUDS

Last year's Survey discussed the forerunner of the *Olson v. Halvorsen* [59] case, which for the first time addressed whether the statute of frauds applies to the Delaware LLC Act.[60] In *Olson*, the Supreme Court of Delaware affirmed the Court of Chancery's decision that the statute of frauds applies to LLC agreements, reasoning that the statute of frauds and the Delaware LLC Act can be construed together, and that the Delaware legislature did not clearly intend for the LLC Act to preclude the application of the statute of frauds.[61]

V. ENTITY LIABILITY FOR OWNER'S DEBTS

Wilburgene, LLC v. Kwon (In re Wilburgene, LLC),[62] a bankruptcy case from Utah, reminds us of the minimal qualifications required to be a member of an LLC and takes quite an expansive view of a member's ability to bind an LLC for his or her personal debts. While it does not apply to Texas law, Texas has similar statutory provisions and this case can be used as a guide when faced with entity liability for owner's debts. Wilbur Sandbulte and Eugene Kwon formed Wilburgene, LLC, a Utah limited liability company, to purchase a commercial building and lot in Park City, Utah. Under its formation documents, the LLC was a member-managed entity whose only members were Sandbulte and Kwon. Sandbulte contributed $330,000 toward the purchase of real property; Kwon made no monetary contribution. The LLC also borrowed money from Zions First National Bank (Zions Bank) to pay the balance of the purchase price for the real property, securing the loan with a first deed of trust lien in favor of Zions Bank against the purchased property.[63]

Sometime after the real property purchase, a group of individuals, the Blosch Group, made a personal loan to Kwon, evidenced by a promissory

57. *Id.* at 908 (citing TEX. BUS. ORGS. CODE ANN. § 21.223(b) (Vernon 2009)). The result is that Texas law now recognizes three veil-piercing theories: "alter ego," "use[ ] for illegal purposes," and "sham to perpetrate a fraud." *Id.* at 907 (quoting Rimade Ltd. v. Hubbard Enters., Inc., 388 F.3d 138, 143 (5th Cir. 2004)). The Texas Business Corporation Act did remove "failure to observe corporate formalities" and "constructive fraud" as available veil-piercing theories for a contract claim. *Id.* at 906-07 (quoting W. Horizontal Drilling v. Jonnet Energy Corp., 11 F.3d 65, 68 (5th Cir. 1994)).

58. *Id.* at 908.

59. 986 A.2d 1150 (Del. 2009).

60. *See* Steven A. Waters & Bradley S. Carson, *Partnerships*, 62 SMU L. REV. 1345, 1349-50 (2009) (discussing Olson v. Halvorsen, No. 1884-VCL, 2008 WL 4661831 (Del. Ch. Oct. 22, 2008)).

61. *Olson*, 986 A.2d at 1162.

62. 406 B.R. 558 (Bankr. D. Utah 2009).

63. *Id.* at 560-62.

note signed by Kwon individually and on behalf of two other Kwon-controlled entities unrelated to the LLC. The note was secured by a deed of trust lien in favor of the Blosch Group, executed by Kwon as "manager" of the LLC, pledging the LLC's real property as collateral for the Blosch Group loan. The LLC was not a party to the promissory note, there was no evidence that it benefited in any way from the loan to Kwon, and no LLC member vote was taken to authorize the pledge of LLC real property to the Blosch Group.[64] Kwon later defaulted on the note, and the Blosch Group moved to foreclose its lien against the LLC's real property. The LLC and Sandbulte filed a state court action to prevent the foreclosure. Kwon was then removed as a member of the LLC, as evidenced by a member's resolution signed by Kwon,[65] followed by the LLC's filing for Chapter 11 bankruptcy. The state court action was removed to the bankruptcy court.[66]

The plaintiff's first argument against the Blosch Group's enforcement of its deed of trust was that Kwon had no authority to bind the LLC, because, with no economic interest, he was not truly a member.[67] The bankruptcy court disagreed and held that, under Utah law, because Kwon signed the LLC's operating agreement and articles of organization as a member (and various other documents on behalf of the LLC as a member or manager[68]), he had to be regarded as a member, even though "only Sandbulte [(i)] receive[d] income from the [LLC], [(ii)] ha[d] sole control over the [LLC's] bank account, and [(iii)] would receive any and all distributions upon dissolution" of the LLC, and Kwon never made any capital contribution or other monetary investments in the LLC.[69] The court noted that Kwon could have contributed his services to the LLC, and even if he provided no services, Kwon represented himself to the public as a member of the LLC by "signing . . . the Articles of Organization, the plat map, the tax letter, the loan documents with Zions Bank, and the shareholders' resolution [that removed him] as a member."[70] In sum, it was not necessary that a person have an economic interest in the LLC to be considered a member of the LLC.[71]

The same is true under Texas law, which provides: "A person is not required, as a condition to becoming a member of or acquiring a membership interest in a limited liability company, to: (1) make a contribution to the company; (2) otherwise pay cash or transfer property to the company; or (3) assume an obligation to make a contribution or otherwise

64. *Id.* at 560-61.

65. *Id.* at 562.

66. *Id.* at 559.

67. *Id.* at 562.

68. *Id.* at 563. Despite the LLC's being member-managed, Kwon still signed some documents, including the Blosch Group deed of trust, as "manager." *Id.* at 560-61.

69. *Id.* at 563-64.

70. *Id.* at 564. These things were delegated to Kwon and done without much oversight by Sandbulte. *Id.* at 560.

71. *See id.* at 562.

pay cash or transfer property to the company."[72] In addition, "[i]f one or more persons own a membership interest in a limited liability company, the company agreement may provide for a person to be admitted to the company as a member without acquiring a membership interest in the company."[73]

Arguing alternatively, the plaintiff contended that, even if Kwon was a member of the LLC, his granting of the deed of trust to the Blosch Group did not bind the LLC because he was not acting in the ordinary course of the LLC's business.[74] In evaluating that claim, the bankruptcy court first observed that, similar to Utah's partnership law, Utah's LLC law did include a general rule that a member's acts do not bind the LLC if not apparently undertaken for carrying on, in the ordinary course, the company's business, unless authorized by the other members.[75] However, Utah's LLC law has an exception for a member's acts in transferring the LLC's interest in real or personal property if the transferee "gives *value* without knowledge of the lack of authority of the person who signs and delivers the [conveyance] document," unless the articles of organization expressly limit the member's authority.[76] There was no such limitation (express or otherwise) in the LLC's articles of organization.[77]

The LLC law of Texas includes a similar general rule, but does not have an exception to the general rule for the giving of value in connection with transfers of real or personal property. Under Texas law,

> [a]n act committed by an agent of a limited liability company . . . for the purpose of apparently carrying out the ordinary course of business of the company, including the execution of an instrument, document, mortgage, or conveyance in the name of the company, binds the company unless: (1) the agent does not have actual authority to act for the company; and (2) the person with whom the agent is dealing has knowledge of the agent's lack of actual authority.[78]

"An act committed by an agent of a limited liability company . . . that is not apparently for carrying out the ordinary course of business of the company binds the company only if the act is authorized in accordance with this title."[79] On the other hand, the partnership law of Texas includes an exception somewhat similar to that of Utah's LLC law, but only for subsequent transferees: "A conveyance of real property by a partner on behalf of the partnership not otherwise binding on the partnership binds the partnership if the property has been conveyed by the grantee or a person claiming through the grantee to a holder for value without

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72. TEX. BUS. ORGS. CODE ANN. § 101.102(b) (Vernon 2009).
73. *Id.* § 101.102(c).
74. *Wilburgene, LLC*, 406 B.R. at 562 (citing UTAH CODE ANN. § 48-2c-802(1) (2008)).
75. *Id.* at 565.
76. *Id.* at 563, 565 (quoting UTAH CODE ANN. § 48-2c-802(3)) (emphasis added).
77. *Wilburgene, LLC*, 406 B.R. at 566.
78. TEX. BUS. ORGS. ANN. CODE § 101.254(b) (Vernon 2009).
79. *Id.* § 101.254(c).

knowledge that the partner exceeded that partner's authority in making the conveyance."[80]

After distinguishing between Utah's partnership and LLC laws, the bankruptcy court answered whether the Blosch Group gave "value," for purposes of applying the exception. Surprisingly, the court found that by lending money to Kwon and refraining from taking any action against him after his default, the Blosch Group gave "value" sufficient to permit it to enforce the deed of trust against the LLC, so long as the Blosch Group gave that value without knowledge of any limitation on Kwon's authority to encumber the LLC's assets.[81] The value need not be given to the LLC itself.[82] The court acknowledged that this was "an odd and harsh ruling" but felt that it, nevertheless, was in harmony with Utah law.[83] Because the Texas provisions are similar to Utah's provisions, practitioners in Texas should look to this outcome as a possible way Texas courts would handle this situation.

VI. TAX

Garnett v. Commissioner of Internal Revenue,[84] a case from the United States Tax Court, highlights some potentially important differences between limited partnerships, on the one hand, and LLCs and limited liability partnerships, on the other hand, for federal income tax law purposes. A married couple, Paul and Alicia Garnett, were found by the I.R.S. to have underpaid their federal income taxes for three years. The deficiency resulted from the I.R.S.'s disallowance of losses claimed in connection with the couple's ownership of interests in various Iowa LLPs and LLCs. The I.R.S. disallowed the losses as "passive activity losses" based on § 469(h)(2) of the Internal Revenue Code, which treats losses from an "interest in a limited partnership as a limited partner" as presumptively passive.[85]

The issue in this case was whether the Garnetts held their LLP and LLC "interests in limited partnerships 'as a limited partner,'" for purposes of § 469(h)(2).[86] The tax court held that because owners of interests in LLPs and LLCs "are not barred by state law from materially participating in the entities' business" (unlike limited partners in state law

80. *Id.* § 152.302(c).

81. *Wilburgene, LLC*, 406 B.R. at 566-67. The court did not say whether the Blosch Group had knowledge of Kwon's lack of authority, or whether the required "knowledge" includes constructive or inquiry knowledge or is limited to actual knowledge. *Id.* at 567.

82. *Id.*

83. *Id.* The court also justified its holding by reasoning that the LLC could have better protected itself at formation by ensuring that Kwon was not a member, or by expressly limiting Kwon's authority to sign documents. *Id.*

84. 132 T.C. No. 19, 2009 WL 1883965 (June 30, 2009).

85. *Id.* at *1-3 (citing 26 U.S.C. § 469(h)(2) (2005)). The Internal Revenue Code limits an individual taxpayer's ability to deduct losses from certain passive activities—typically a trade or business in which the taxpayer does not materially participate. *Id.* at *3 (citing § 469(a)(1), (c)(1)). "Material participation is defined generally as regular, continuous, and substantial involvement in the business operations." *Id.* (citing § 469(h)(1)).

86. *Id.* at *4.

limited partnerships),[87] they did not hold their interests as limited partners.[88] Therefore, their interests were not subject to § 469(h)(2), and consequently, their losses in connection with these ownership interests were not presumptively passive.

VII. PROCEDURE

In *Urquhart v. Wertheimer*,[89] the United States District Court in Massachusetts faced the question of who the necessary and indispensable parties are in a federal diversity suit among partners of a limited partnership. Robert Urquhart, a limited partner of Chelmsford Holding Limited Partnership, sued another limited partner and the general partner for breaching the partnership agreement and common-law fiduciary duties. Specifically, Urquhart alleged that the defendants "paid themselves excessive management fees, borrowed money in the name of the Partnership for personal use, caused the partnership to lend money at below-market interest rates, and commingled partnership funds with their own."[90] The court granted the defendants' motion to dismiss for failure to join the partnership as a necessary and indispensable party under the Federal Rules of Civil Procedure, because the claims were based on alleged harms to the partnership itself, which only indirectly resulted in harm to the plaintiff.[91] The effect of the court's ruling (that the partnership was an indispensable party) is that a suit like the one here cannot be brought in federal court. There is no federal issue to sustain jurisdiction, and because the citizenship of a partnership for diversity purposes is determined by the citizenship of each of its partners, the required diversity is missing—the partnership automatically shares the citizenship of the partner on the other side of the lawsuit (whether joined as a plaintiff or defendant), defeating complete diversity.[92]

VIII. CONCLUSION

Time will tell, but some potentially important fiduciary duty cases were decided during this year's Survey period. They did not advance the state's jurisprudence, but if they are cited as precedent by future courts, then they will become important. One can hope that they were isolated aberrations and can be limited in their future application.

87. *Id.* at *7. Limited partners who so participate put their limited liability at risk. *Id.* at *5.
88. *Id.* at *7-8.
89. 646 F. Supp. 2d 210 (D. Mass. 2009).
90. *Id.* at 212.
91. *Id.* at 212-13.
92. *See id.* at 212.