

# UNIFORM BUSINESS ORGANIZATIONS CODE

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NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

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AMERICAN BAR ASSOCIATION

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APPROVED AND RECOMMENDED FOR ENACTMENT  
IN ALL THE STATES  
BY THE NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

at its

ANNUAL CONFERENCE  
MEETING IN ITS ONE-HUNDRED-AND-TWENTY-SECOND YEAR  
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*WITH PREFATORY NOTE AND COMMENTS*

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## [ARTICLE] 9

### BUSINESS CORPORATIONS

## [RESERVED]



**[ARTICLE] 10**

**NONPROFIT CORPORATIONS**

**[RESERVED]**

## **PREFATORY NOTE**

Since the early 1990s, the Uniform Law Conference (ULC) has promulgated, or in several cases revised, eight unincorporated business entity acts:

Revised Uniform Partnership Act (1997)  
Revised Uniform Limited Partnership Act (2001)  
Revised Uniform Limited Liability Company Act (2006)  
Model Registered Agents Act (2006)  
Uniform Limited Cooperative Association Act (2007)  
Model Entity Transactions Act (2007)  
Revised Uniform Unincorporated Nonprofit Association Act (2008)  
Uniform Statutory Trust Entity Act (2009).

In 2006, the ULC authorized a project to integrate all these eight acts into the Uniform Business Organization Code, using the same type of hub-and-spoke structure used in the Uniform Commercial Code. The project, known as the Harmonization of Business Entity Acts Project (Harmonization Project), involved four steps: (1) the creation of the Hub, which contains provisions such as definitions, filing requirements, etc., which appear in almost all of the eight statutes; (2) harmonizing and updating the eight acts, which also continue to exist as stand-alone acts; (3) making the stand-alone acts “Code-ready” by removing from each act all provisions contained in the Hub and all provisions contained in the Model Entity Transactions Act; and (4) compiling the Code, by converting the Code-ready acts into separate articles of the Code.

The ULC originally approved the Hub, which is Article 1 of the Uniform Business Organizations Code (Code), in 2011. Article 1 contains basic definitions and provisions concerning filing requirements, entity names, registered agents (based on the Model Registered Agents Act), foreign entities, and administrative dissolution. The harmonization of the unincorporated entities acts phase of the Harmonization Project was completed and approved in 2013. The integration of the various Code-ready acts into the Code was completed in 2015.

It is contemplated that in the future the ULC and the American Bar Association Business Law Section will approve the inclusion of the Model Business Corporation Act and the Model Nonprofit Corporation Act into the Code. Articles 9 and 10 of the Code are listed as “Reserved” for this purpose.

The two corporate acts are promulgated by the American Bar Association Business Law Section. The Code has already benefitted by the ABA’s involvement with the drafting of the Hub, META, and MORAA. Because these acts cover corporate as well as unincorporated entities, their respective drafting projects were sponsored jointly by the ULC and the ABA.

States can choose to enact the entire Code, or substantial portions of it, for example Articles 1 through 5 (the Hub, META, UPA, ULPA, and ULLCA) in a single bill or enact the individual stand-alone harmonized entity acts. States may also choose to enact one or more of the stand-alone entity acts and then enact the Code.

Enacting the Code is not difficult, particularly by a state that already has one or more of the major stand-alone entity acts, such as the ULLCA. The issues warranting specific review are basically the same in all the articles of the Code. Thus one bar association or legislative study review committee can review all the articles of the Code that are included in the proposed act. This review process is much more efficient than having separate review committees for each act.

Moreover, because the language in parallel provisions is the same in all the articles of the Code dealing with specific entities, it is a simple process to make sure that amendments to one provision are made in all the articles with similar provisions. Similarly, if a state has enacted the Code an amendment can be made in the filing provisions or in the other provisions in Article 1 and it will no longer be necessary to make sure that the amendment is made in all the state's other entity acts – a process that often does not occur, leading to unintended inconsistent provisions in the state's entity acts.

The Drafting Committee on the Harmonization Project was greatly assisted in its work by the very substantial and knowledgeable contributions of the following Observers who diligently attended and actively participated in the Drafting Committee's meetings:

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## **GLOSSARY**

The comments to the Code use the following acronyms to distinguish among the current and prior versions of uniform business organization acts and to refer to commonly used concepts.

“Code” refers to the Uniform Business Organizations Code (2011) (Last Amended 2013).

“LLC” refers to a limited liability company.

“LLLP” refers to a limited liability limited partnership.

“LLP” refers to a limited liability partnership.

“MBCA” refers to the Model Business Corporation Act.

“UCC” refers to the Uniform Commercial Code.

“ULCAA (2007)” refers to the Uniform Limited Cooperative Association Act as promulgated in 2007.

“ULCAA (2007) (Last Amended 2013)” refers to the Uniform Limited Cooperative Association Act (2007) as harmonized.

“ULLCA (1996)” refers to the original Uniform Limited Liability Company Act as promulgated in 1996.

“ULLCA (2006)” refers to the Revised Uniform Limited Liability Company Act as promulgated in 2006.

“ULLCA (2006) (Last Amended 2013)” refers to the Revised Uniform Limited Liability Company Act as harmonized.

“ULPA (1916)” refers to the Uniform Limited Partnership Act as promulgated in 1916

“ULPA (1976)” refers to the Revised Uniform Limited Partnership Act as promulgated in 1976.

“ULPA (1976/1985)” refers to the Revised Uniform Limited Partnership Act as promulgated in 1976 and substantially revised in 1985.

“ULPA (2001)” refers to the Uniform Limited Partnership Act as promulgated in 2001.

“ULPA (2001) (Last Amended 2013)” refers to the Uniform Limited Partnership Act (2001) as harmonized.

“UPA (1914)” refers to the original Uniform Partnership Act as promulgated in 1914.

“UPA (1997)” refers to the version of the Uniform Partnership Act originally promulgated in 1994, with all amendments through 1997.

“UPA (1997) (Last Amended 2013)” refers to the Uniform Partnership Act (1997) as harmonized.

“USTEA (2009)” refers to the Uniform Statutory Trust Entity Act as promulgated in 2009.

“USTEA (2009) (Last Amended 2013)” refers to the Uniform Statutory Trust Entity Act as harmonized.

“UUNAA (2008)” refers to the Uniform Unincorporated Nonprofit Association Act as promulgated in 2008.

“UUNAA (2008) (Last Amended 2013)” refers to the Uniform Unincorporated Nonprofit Association Act as harmonized.

# **UNIFORM BUSINESS ORGANIZATIONS CODE**

## **ARTICLE 1**

### **GENERAL PROVISIONS**

#### **[PART] 1**

### **PRELIMINARY PROVISIONS**

#### **SECTION 1-101. SHORT TITLES.**

(a) This [Code] may be cited as the Uniform Business Organizations Code.

(b) This [article] may be cited as the Uniform Business Organizations Code - General Provisions.

#### **Comment**

This article contains definitions and other provisions that are generally applicable to all the articles in the Code.

**SECTION 1-102. DEFINITIONS.** In this [Code], except as otherwise provided in definitions of the same terms in other articles of this [Code]:

(1) “[Annual] [Biennial] report” means the report required by Section 1-213.

(2) “Business corporation” means a domestic business corporation incorporated under or subject to [Article] 9 or a foreign business corporation.

(3) “Business trust” means a trust formed under the statutory law of another state which is not a foreign statutory trust and does not have a predominately donative purpose.

(4) “Commercial registered agent” means a person listed under Section 1-405.

(5) “Common-law business trust” means a common-law trust that does not have a predominately donative purpose.

(6) “Debtor in bankruptcy” means a person that is the subject of:

(A) an order for relief under Title 11 of the United States Code or a comparable

order under a successor statute of general application; or

(B) a comparable order under federal, state, or foreign law governing insolvency.

(7) “Distributional interest” means the right under an unincorporated entity’s organic law and organic rules to receive distributions from the entity.

(8) “Domestic”, with respect to an entity, means governed as to its internal affairs by the law of this state.

(9) “Effective date”, when referring to a record filed by the [Secretary of State], means the time and date determined in accordance with Section 1-203.

(10) “Entity”:

(A) means:

(i) a business corporation;

(ii) a nonprofit corporation;

(iii) a general partnership, including a limited liability partnership;

(iv) a limited partnership, including a limited liability limited partnership;

(v) a limited liability company;

[(vi) a general cooperative association;]

(vii) a limited cooperative association;

(viii) an unincorporated nonprofit association;

(ix) a statutory trust, business trust, or common-law business trust; or

(x) any other person that has:

(I) a legal existence separate from any interest holder of that

person; or

(II) the power to acquire an interest in real property in its own

name; and

(B) does not include:

(i) an individual;

(ii) a trust with a predominately donative purpose or a charitable trust;

(iii) an association or relationship that is not listed in subparagraph (A)

and is not a partnership under the rules stated in Section 3-202(c) or a similar provision of the law of another jurisdiction;

(iv) a decedent's estate; or

(v) a government or a governmental subdivision, agency, or

instrumentality.

(11) "Entity filing" means a record delivered to the [Secretary of State] for filing pursuant to this [Code].

(12) "Filed record" means a record filed by the [Secretary of State] pursuant to this [Code].

(13) "Filing entity" means an entity whose formation requires the filing of a public organic record. The term does not include a limited liability partnership.

(14) "Foreign", with respect to an entity, means governed as to its internal affairs by the law of a jurisdiction other than this state.

[(15) "General cooperative association" means a domestic general cooperative association formed under or subject to [cite statute of this state under which an incorporated cooperative association is formed] or a foreign general cooperative association.]

(16) "General partnership" means a domestic general partnership formed under or subject to [Article] 3 or a foreign general partnership. The term includes a limited liability partnership.



(17) “Governance interest” means a right under the organic law or organic rules of an unincorporated entity, other than as a governor, agent, assignee, or proxy, to:

(A) receive or demand access to information concerning, or the books and records of, the entity;

(B) vote for or consent to the election of the governors of the entity; or

(C) receive notice of or vote on or consent to an issue involving the internal affairs of the entity.

(18) “Governor” means:

(A) a director of a business corporation;

(B) a director or trustee of a nonprofit corporation;

(C) a general partner of a general partnership;

(D) a general partner of a limited partnership;

(E) a manager of a manager-managed limited liability company;

(F) a member of a member-managed limited liability company;

[(G) a director of a general cooperative association;]

(H) a director of a limited cooperative association;

(I) a manager of an unincorporated nonprofit association;

(J) a trustee of a statutory trust, business trust, or common-law business trust; or

(K) any other person under whose authority the powers of an entity are exercised and under whose direction the activities and affairs of the entity are managed pursuant to the organic law and organic rules of the entity.

(19) “Interest” means:

(A) a share in a business corporation;

- (B) a membership in a nonprofit corporation;
- (C) a governance interest in a general partnership;
- (D) a governance interest in a limited partnership;
- (E) a governance interest in a limited liability company;
- [(F) a share in a general cooperative association;]
- (G) a member's interest in a limited cooperative association;
- (H) a membership in an unincorporated nonprofit association;
- (I) a beneficial interest in a statutory trust, business trust, or common-law business trust; or
- (J) a governance interest or distributional interest in any other type of unincorporated entity.

(20) "Interest holder" means:

- (A) a shareholder of a business corporation;
- (B) a member of a nonprofit corporation;
- (C) a general partner of a general partnership;
- (D) a general partner of a limited partnership;
- (E) a limited partner of a limited partnership;
- (F) a member of a limited liability company;
- [(G) a shareholder of a general cooperative association;]
- (H) a member of a limited cooperative association;
- (I) a member of an unincorporated nonprofit association;
- (J) a beneficiary or beneficial owner of a statutory trust, business trust, or common-law business trust; or

(K) any other direct holder of an interest.

(21) “Jurisdiction”, used to refer to a political entity, means the United States, a state, a foreign country, or a political subdivision of a foreign country.

(22) “Jurisdiction of formation” means the jurisdiction whose law includes the organic law of an entity.

(23) “Limited cooperative association” means a domestic limited cooperative association formed under or subject to [Article] 6 or a foreign limited cooperative association.

(24) “Limited liability company” means a domestic limited liability company formed under or subject to [Article] 5 or a foreign limited liability company.

(25) “Limited liability limited partnership” means a domestic limited liability limited partnership formed under or subject to [Article] 4 or a foreign limited liability limited partnership.

(26) “Limited liability partnership” means a domestic limited liability partnership registered under or subject to [Article] 3 or a foreign limited liability partnership.

(27) “Limited partnership” means a domestic limited partnership formed under or subject to [Article] 4 or a foreign limited partnership. The term includes a limited liability limited partnership.

(28) “Noncommercial registered agent” means a person that is not a commercial registered agent and is:

(A) an individual or domestic or foreign entity that serves in this state as the registered agent of an entity; or

(B) an individual who holds the office or other position in an entity which is designated as the registered agent pursuant to Section 1-404(a)(2)(B).

(29) “Nonfiling entity” means an entity whose formation does not require the filing of a public organic record.

(30) “Nonprofit corporation” means a domestic nonprofit corporation incorporated under or subject to [Article] 10 or a foreign nonprofit corporation.

(31) “Nonregistered foreign entity” means a foreign entity that is not registered to do business in this state pursuant to a statement of registration filed by the [Secretary of State].

(32) “Organic law” means the law of an entity’s jurisdiction of formation governing the internal affairs of the entity.

(33) “Organic rules” means the public organic record and private organic rules of an entity.

(34) “Person” means an individual, business corporation, nonprofit corporation, partnership, limited partnership, limited liability company, [general cooperative association,] limited cooperative association, unincorporated nonprofit association, statutory trust, business trust, common-law business trust, estate, trust, association, joint venture, public corporation, government or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.

(35) “Principal office” means the principal executive office of an entity, whether or not the office is located in this state.

(36) “Private organic rules” means the rules, whether or not in a record, that govern the internal affairs of an entity, are binding on all its interest holders, and are not part of its public organic record, if any. The term includes:

(A) the bylaws of a business corporation;

(B) the bylaws of a nonprofit corporation;

- (C) the partnership agreement of a general partnership;
- (D) the partnership agreement of a limited partnership;
- (E) the operating agreement of a limited liability company;
- [(F) the bylaws of a general cooperative association;]
- (G) the bylaws of a limited cooperative association;
- (H) the governing principles of an unincorporated nonprofit association; and
- (I) the trust instrument of a statutory trust or similar rules of a business trust or common-law business trust.

(37) “Proceeding” includes a civil action, arbitration, mediation, administrative proceeding, criminal prosecution, and investigatory action.

(38) “Property” means all property, whether real, personal, or mixed or tangible or intangible, or any right or interest therein.

(39) “Public organic record” means the record the filing of which by the [Secretary of State] is required to form an entity and any amendment to or restatement of that record. The term includes:

- (A) the articles of incorporation of a business corporation;
- (B) the articles of incorporation of a nonprofit corporation;
- (C) the certificate of limited partnership of a limited partnership;
- (D) the certificate of organization of a limited liability company;
- [(E) the articles of incorporation of a general cooperative association;]
- (F) the articles of organization of a limited cooperative association; and
- (G) the certificate of trust of a statutory trust or similar record of a business trust.

(40) “Receipt”, as used in this [Code], means actual receipt. “Receive” has a

corresponding meaning.

(41) “Record”, used as a noun, means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(42) “Registered agent” means an agent of an entity which is authorized to receive service of any process, notice, or demand required or permitted by law to be served on the entity. The term includes a commercial registered agent and a noncommercial registered agent.

(43) “Registered foreign entity” means a foreign entity that is registered to do business in this state pursuant to a statement of registration filed by the [Secretary of State].

(44) “Sign” means, with present intent to authenticate or adopt a record:

(A) to execute or adopt a tangible symbol; or

(B) to attach to or logically associate with the record an electronic symbol, sound, or process.

(45) “State” means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(46) “Statutory trust” means a domestic statutory trust formed under or subject to [Article] 8 or a trust formed under the statutory law of a jurisdiction other than this state which would be a statutory trust if formed under the law of this state.

(47) “Transfer” includes:

(A) an assignment;

(B) a conveyance;

(C) a sale;

(D) a lease;

(E) an encumbrance, including a mortgage or security interest;

(F) a gift; and

(G) a transfer by operation of law.

(48) “Type of entity” means a generic form of entity:

(A) recognized at common law; or

(B) formed under an organic law, whether or not some entities formed under that law are subject to provisions of that law that create different categories of the form of entity.

(49) “Unincorporated nonprofit association” means a domestic unincorporated nonprofit association formed under or subject to [Article] 7 or a nonprofit association formed under or subject to the law of a jurisdiction other than this state which would be an unincorporated nonprofit association if formed under or subject to the law of this state.

(50) “Written” means inscribed on a tangible medium. “Writing” has a corresponding meaning.

### **Comment**

The definitions in this section apply generally throughout the Code unless a particular term is defined differently in another article. Some of the definitions describe attributes that are significant in some forms of entity and not in others. For example, the concepts of separate “distributional” and “governance” interests are inherent in unincorporated entities but have no counterpart in corporations.

**“Commercial registered agent.” [(4)]** – A commercial registered agent is an individual or entity that is in the business of serving as a registered agent in the state and that files a listing statement under Section 1-405. Being listed as a commercial registered agent is voluntary and persons serving as registered agents are not required to be listed under Section 1-405. The benefits to the registered agent of being listed under Section 1-405, however, are substantial and most registered agents will elect to be so listed. Although this definition and Section 1-405 do not expressly require that a foreign entity that is listed as a commercial registered agent be qualified to do business in the state, the activity of serving as a registered agent is one that requires such registration.

**“Distributional interest” [(7)]** – This term is similar to the concept of a “transferable interest” found in the organic laws of several types of unincorporated entities, but has a broader

meaning because the scope of this Code includes entities in addition to those whose organic law uses the term “transferable interest.”

**“Domestic.” [(8)]** – The term “domestic”, when used in the Code with respect to an entity, means an entity whose internal affairs are governed by the organic laws of the adopting state. Except in the case of general partnerships and unincorporated nonprofit associations, this will mean an entity that is formed, organized, or incorporated under domestic law. In the case of a general partnership organized under Article 3, it will mean a general partnership whose governing law under Section 3-104 is the law of the adopting state. Under Section 3-104 the governing law is determined by the location of the partnership’s principal office, except for limited liability partnerships where the governing law is the state where the statement of qualification is filed. It is a factual question whether the activities and organization of an unincorporated nonprofit association make it a domestic or foreign entity.

**“Entity.” [(10)]** – This definition determines the overall scope of the Code.

This definition is intended to include all forms of private organizations, regardless of whether organized for profit, and artificial legal persons other than those excluded by paragraphs (B)(i)-(v).

This definition does not exclude regulated entities such as public utilities, banks and insurance companies. If any of those types of entities is organized under a separate statute, the state must decide whether that statute should be one of the spokes of the Code. If the statute is not included in the Code, entities formed under it will be automatically excluded from this article by Section 1-103. But in that case, a separate decision must be made as to whether to permit entities formed under it to participate in transactions under Article 2. Particular types of entities may also be excluded from the Code by listing them in optional Section 1-106.

Trusts with a predominantly donative purpose and charitable trusts are subject generally to the Uniform Trust Code (Last Amended 2010) and have been excluded from the definition of “entity,” thus excluding them from the Code. Trusts that carry on a business, however, such as a Massachusetts trust, real estate investment trust, Illinois land trust, or other common law or statutory business trusts are “entities.”

Section 7-106 gives an unincorporated nonprofit association the power to acquire an estate in real property and thus an unincorporated nonprofit association organized in a state that has adopted Article 7 will be an “entity.” At common law, an unincorporated nonprofit association was not a legal entity and did not have the power to acquire real property. Most states that have not adopted the UUNAA (2008) (Last Amended 2013) have nonetheless modified the common law rule, but states that have not adopted the UUNAA (2008) (Last Amended 2013) should analyze whether they should modify the definition of “entity” to add an express reference to unincorporated nonprofit associations.

There is some question as to whether a partnership subject to the UPA (1914) is an entity or merely an aggregation of its partners. That question has been resolved by Section 3-201, which makes clear that a general partnership is an entity with its own separate legal existence.



Section 8 of the UPA (1914) gives partnerships subject to it the power to acquire estates in real property and thus such a partnership will be an “entity.” As a result, all general partnerships will be “entities” regardless of whether the state in which they are organized has adopted the UPA (1997) (Last Amended 2013) or the UPA (1914).

Paragraph (B) (i) of this definition excludes a sole proprietorship from the concept of “entity.”

Paragraph (B)(iii) of this definition excludes from the concept of an “entity” any form of co-ownership of property or sharing of returns from property that is not a partnership under Section 3-202(c) or Section 7 of the UPA (1914). In that connection, 3-202(c) provides in part:

In determining whether a partnership is formed, the following rules apply:

(1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.

(2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

A virtually identical provision appears in Section 7(3)-(4) of the UPA (1914).

Paragraph (B)(iv) of this definition excludes decedent’s estates for the same policy reason as trusts with a predominantly donative purpose and charitable trusts.

Paragraph (B)(v) excludes governmental subdivisions, agencies, and instrumentalities because they are not properly within the scope of the Code.

Limited liability partnerships and limited liability limited partnerships are “entities” because they are general partnerships and limited partnerships, respectively, that have made the additional required election claiming LLP or LLLP status. A limited liability partnership is not, therefore, a separate type of entity from the underlying general partnership, nor is a limited liability limited partnership a separate type of entity from the underlying limited partnership that has elected limited liability partnership status.

**“Filing entity.” [(13)]** – Whether an entity is a filing entity is determined by reference to whether its legal existence requires the filing of a record with the state filing office. While the Code refers to the “formation” of an entity, it is intended to encompass corporations which are “incorporated” and limited liability companies which are “organized” as well as entities such as limited partnerships which are “formed” under their organic law. Business trusts (sometimes referred to as “statutory trusts”) present a special problem. In some states a business trust is a filing entity or common law relationship, while in other states business trusts are only recognized by common law. Under section 201(a) of the Uniform Statutory Trust Entity Act (2009) (Last Amended 2013) (§ 8-201(a) of the Code), a statutory trust entity formed under that act is formed by delivery of a certificate of trust to the appropriate filing office, and is a filing entity.

The term does not include a limited liability partnership because an election filed by a general partnership claiming that status (*e.g.*, a statement of qualification under Section 3-901) is not required to form the underlying partnership. A limited liability limited partnership, on the other hand, is a filing entity because formation of the underlying limited partnership requires the filing of a certificate of limited partnership.

**“Foreign.” [(14)]** – The term “foreign,” when used in the Code with respect to an entity, includes any non-domestic entity of any type. Where a foreign entity is a filing entity, the entity is governed by the laws of the state of filing. A nonfiling foreign entity is governed by the laws governing its internal affairs. It is a factual question whether a general partnership whose internal affairs are governed by the UPA (1914) is a domestic or foreign partnership. A UPA (1914) partnership will likely be deemed to be a domestic entity where the greatest nexus of contacts are found. The domestic or foreign characterization of partnerships under Article 3 that have not registered as limited liability partnerships will be governed by Section 3-104(2).

**“Governance interest.” [(17)]** – A governance interest is typically only part of the interest that a person will hold in an unincorporated entity and is usually coupled with a distributional interest (or economic rights). Memberships in some nonprofit corporations and unincorporated nonprofit associations consist solely of governance interests and memberships in other nonprofit entities may not include either governance interests or distributional interests. In some unincorporated business entities, there is a more limited right to transfer governance interests than there is to transfer distributional interests. An interest holder in such an unincorporated business entity who transfers only a distributional interest and retains the governance interest will also retain the status of an interest holder. Whether a transferee who acquires only a distributional interest will acquire the status of an interest holder is determined by the definition of “interest holder.”

Governors of an entity have the kinds of rights listed in the definition of “governance interest” by reason of their position with the entity. For a governor to have a “governance interest,” however, requires that the governor also have those rights for a reason other than the governor’s status as such. A manager who is not a member in a limited liability company, for example, will not have a governance interest, but a manager who is a member will have a governance interest arising from the ownership of a membership interest.

**“Governor.” [(18)]** – This term has been chosen to provide a way of referring to a person who has the authority under an entity’s organic law to make management decisions regarding the entity that is different from any of the existing terms used in connection with particular types of entities. Depending on the type of entity or its organic rules, the governors of an entity may have the power to act on their own authority, or they may be organized as a board or similar group and only have the power to act collectively, and then only through a designated agent. In other words, a person having only the power to bind the organization pursuant to the instruction of the governors is not a governor. Under the organic rules, particularly those of unincorporated entities, most or all of the management decisions may be reserved to the members or partners. Thus, if a manager of a limited liability company were limited to having authority to execute management decisions made by the members and did not have any authority to make independent management decisions, the manager would not be a governor under this

definition.

**“Interest.” [(19)]** – In the usual case, the interest held by an interest holder will include both a governance interest and a distributional interest (or economic rights). Members in nonprofit corporations or unincorporated nonprofit associations generally do not have any distributional interest because they do not receive distributions, but they nonetheless may hold a governance interest in which case they would have the status of interest holders for purposes of the Code.

**“Interest holder.” [(20)]** – The Code does not refer to “equity” interests or “equity” owners or holders because the term “equity” could be confusing in the case of a nonprofit entity whose members do not have an interest in the assets or results of operations of the entity but only have a right to vote on its internal affairs.

**“Noncommercial registered agent.” [(28)]** – A noncommercial registered agent is a person that serves as an agent for service of process but that is not listed under Section 1-405. All agents for service of process that are not commercial registered agents are noncommercial registered agents.

**“Organic law.” [(32)]** – Organic law means statutes other than the Code that govern the internal affairs of an entity, as well as the applicable provisions of the Code.

Entity laws in a few states purport to require that some of their internal governance rules applicable to a domestic entity also apply to a foreign entity with significant ties to the state. *See, e.g.*, CAL. CORP. CODE § 2115 (Foreign Corporations), N.Y. NOT-FOR-PROFIT-CORP. §§ 1318-1321 (Liabilities of Directors and Officers of Foreign Corporations), 15 PA.CONST. STAT. § 6145 (Applicability of Certain Safeguards to Foreign Corporations). Such a “sticky fingers” law is not included within the definition of “organic law” for purposes of the Code because those laws are not part of the law of the entity’s jurisdiction of formation.

**“Person.” [(34)]** – The term “person” has the standard meaning of that term in uniform acts at the time this Code was promulgated.

**“Private organic rules.” [(36)]** – The term private “organic rules” is intended to include all governing rules of an entity that are binding on all of its interest holders, whether or not in record form, except for the provisions of the entity’s public organic document, if any. The term is intended to include agreements in “record” form as well as oral partnership agreements and oral operating agreements among LLC members.

**“Public organic record.” [(39)]** – A “public organic record” is a record that is required to be filed publicly to form, organize, incorporate, or otherwise create an entity. The term does not include a statement of partnership authority filed under Section 3-303 or any of the other statements that may be filed under Article 3 since those statements do not create a new entity. Similarly, the term does not include a statement of authority filed under Section 5-302 relating to a limited liability company. A limited liability partnership is the same entity as the partnership that files a statement of qualification under Section 3-901 to become a limited liability

partnership and thus the statement is not a public organic record. A statement of authority filed under Section 7-107 relating to an unincorporated nonprofit association or a statement appointing an agent filed under Section 7-129 is also not a public organic record. Where a public organic record has been amended or restated, the term means the public organic record as last amended or restated.

In those states where a deed of trust or other instrument is publicly filed to create a business trust, that filing will constitute a public organic record. But in those states where a business trust is not created by a public filing, the deed of trust or similar record will be part of the private organic rules of the business trust.

**“Receipt.” [40]** – Section 15 of the Uniform Electronic Transactions Act, which provides rules as to when an electronic record is sent and received, applies to electronic records under this Code.

**“Record.” [(41)]** – The term “record” has the standard meaning of that term in uniform acts at the time this Code was promulgated.

**“Registered agent.” [(42)]** – This term is used in the Code to refer to agents for service of process in contexts where it is not necessary to differentiate between commercial registered agents and noncommercial registered agents.

**“Sign.” [(44)]** – The term “sign” has the standard meaning of that term in uniform acts at the time this Code was promulgated.

**“State.” [(45)]** – The term “state” has the standard meaning of that term in uniform acts at the time this Code was promulgated.

**“Transfer.” [(47)]** – The term “transfer” is broadly defined to include all types of conveyances of interests in property.

**“Type of entity.” [(48)]** – The term “type of entity” has been developed in an attempt to distinguish different legal forms of entities. It is sometimes difficult to decide whether one is dealing with a different form of entity or a variation of the same form. For example, a limited partnership, although it has been defined as a partnership, is a different type of entity from a general partnership, while a limited liability partnership is not a different type of entity from a general partnership. In some states cooperative corporations are categories of business corporations or nonprofit corporations, while in other states cooperatives are a separate type of entity.

**SECTION 1-103. APPLICABILITY OF [ARTICLE].** This [article] applies to an entity formed under or subject to this [Code].

### **Comment**

*See* the comment to Section 1-102(10) (“entity”).

### **SECTION 1-104. DELIVERY OF RECORD.**

(a) Except as otherwise provided in this [Code], permissible means of delivery of a record include delivery by hand, mail, conventional commercial practice, and electronic transmission.

(b) Delivery to the [Secretary of State] is effective only when a record is received by the [Secretary of State].

### **Comment**

Subsection (a) lists permissible means of delivery but, except for delivery to the filing office, does not determine when delivery occurs.

Permissible means of delivery are not limited to those listed in subsection (a) because subsection (a) by its terms is a nonexclusive list. Conventional commercial practice includes the use of private delivery or courier services. What constitutes conventional commercial practice may change over time.

Under subsection (b), delivery to the Secretary of State or other state filing office is effective only upon actual receipt. The effectiveness of records delivered other than to the filing office will be controlled by provisions in other articles of the Code and may vary depending on the type of entity to which the records relate and manner in which the records are delivered.

**SECTION 1-105. RULES AND PROCEDURES.** The [Secretary of State] may:

(1) adopt rules to administer this [Code] in accordance with [this state’s administrative procedure act]; and

(2) prescribe procedures that are reasonably necessary to perform the duties required of the [Secretary of State] under this [Code] and are not required by [this state’s administrative procedure act] to be adopted as rules.

### **Comment**

This section grants the filing office the authority necessary for the efficient performance

of the filing and other duties imposed on the filing office by the Code but is not intended as a grant of general authority to establish public policy. The most important aspects of a modern entity statute relate to the creation and maintenance of relationships among persons interested in or involved with an entity; these relationships should be a matter of concern to the parties involved and not subject to regulation or interpretation by the filing office. Further, even in situations where it is claimed that an entity has been formed or is being operated for purposes that may violate the public policies of the state, the filing office generally should not be the governmental official that determines the scope of public policy through administration of the filing responsibilities under the Code. Rather, the attorney general may seek to enjoin the illegal conduct or to dissolve involuntarily the offending entity. See Section 1-206(a) which makes clear that the duty of the filing office to file documents under the Code is “ministerial.”

**[SECTION 1-106. EXCLUSIONS.** This [Code] does not apply to:

- (1) \_\_\_\_\_;
- (2) \_\_\_\_\_;
- (3) \_\_\_\_\_.]

***Legislative Note:*** List any specific types of entities excluded from the Code.

## **[PART] 2**

### **FILING**

#### **SECTION 1-201. ENTITY FILING REQUIREMENTS.**

(a) To be filed by the [Secretary of State] pursuant to this [Code], an entity filing must be received by the [Secretary of State], comply with this [Code], and satisfy the following:

- (1) The entity filing must be required or permitted by this [Code].
- (2) The entity filing must be physically delivered in written form unless and to the extent the [Secretary of State] permits electronic delivery of entity filings.
- (3) The words in the entity filing must be in English, and numbers must be in Arabic or Roman numerals, but the name of the entity need not be in English if written in English letters or Arabic or Roman numerals.
- (4) The entity filing must be signed by or on behalf of a person authorized or

required under this [Code] to sign the filing.

(5) The entity filing must state the name and capacity, if any, of each individual who signed it, either on behalf of the individual or the person authorized or required to sign the filing, but need not contain a seal, attestation, acknowledgment, or verification.

(b) If law other than this [Code] prohibits the disclosure by the [Secretary of State] of information contained in an entity filing, the [Secretary of State] shall file the entity filing if the filing otherwise complies with this [Code] but may redact the information.

(c) When an entity filing is delivered to the [Secretary of State] for filing, any fee required under this [article] and any fee, tax, interest, or penalty required to be paid under this [article] or law other than this [Code] must be paid in a manner permitted by the [Secretary of State] or by that law.

(d) The [Secretary of State] may require that an entity filing delivered in written form be accompanied by an identical or conformed copy.

### **Comment**

The records filed under the Code are referred to as “entity filings” in order to encompass filings under corporation laws, which are typically referred to as “articles,” and filings under limited partnership and other unincorporated entity laws, which are typically referred to as “certificates.”

#### **1. Form of records.**

Section 1-104(b) provides that delivery of an entity filing to the Secretary of State or other state filing office is effective only upon actual receipt by the filing office.

An entity filing must be in typewritten or printed form unless the filing office permits delivery by electronic transmission. The types of electronic transmission that may be used will be determined by the filing office and are intended to include the evolving methods of electronic delivery, including facsimile transmissions, electronic transmissions between computers and filings through delivery of storage media. The text of an entity filing must be in the English language (except to the limited extent permitted by subsection (a)(3)).

The filing office is not authorized to prescribe forms (except to the extent permitted by

Section 1-202) and as a result may not reject entity filings on the basis of form if they contain the information called for by the specific statutory requirement and meet the minimal formal requirements of this section.

## **2. Signature.**

To be filed a record must be signed by the appropriate person. Who is an appropriate person will be determined by an entity's organic law. See the definition of "sign" in Section 1-102(44) for a description of the manner in which a record may be "signed."

The requirement in some state statutes that entity filings must be acknowledged or verified as a condition for filing has been eliminated. These requirements serve little purpose in connection with entity filings. On the other hand, many organizations, like lenders or title companies, may desire that specific records include acknowledgements, verifications, or seals; subsection (a)(4) does not prohibit the addition of these forms of execution and their use is not intended to affect the eligibility of the record for filing.

## **3. Contents.**

A record must be filed by the filing office if it contains the information required by the Code. In view of the very limited discretion granted to filing offices under this section and Section 1-206(a), which defines the role of the filing office as "ministerial," Section 1-206(e) provides that no presumption arises from the fact that the filing office accepted a document or filing. *See* the comment to Section 1-206.

### **SECTION 1-202. FORMS.**

(a) The [Secretary of State] may provide forms for entity filings required or permitted to be made by this [Code], but, except as otherwise provided in subsection (b), their use is not required.

(b) The [Secretary of State] may require that a cover sheet for an entity filing and [an annual] [a biennial] report be on forms prescribed by the [Secretary of State].

### **Comment**

As described in the comments to Section 1-201, records are entitled to filing if they meet the substantive and formal requirements of the Code. In these circumstances it is not appropriate to vest the filing office with general authority to establish mandatory forms for use under the Code. This section authorizes (but does not require) the filing office to prepare forms suitable for filing under the Code. However, the use of these forms is permissive and cannot be required by the filing office. The filing office is authorized to prescribe forms for annual / biennial reports, however, and for cover sheets for entity filings.



**SECTION 1-203. EFFECTIVE DATE AND TIME.** Except as otherwise provided in this [Code] and subject to Section 1-205(d), an entity filing is effective:

(1) on the date and at the time of its filing by the [Secretary of State] as provided in Section 1-206(b);

(2) on the date of filing and at the time specified in the entity filing as its effective time, if later than the time under paragraph (1);

(3) if permitted by this [Code], at a specified delayed effective date and time, which may not be more than 90 days after the date of filing; or

(4) if a delayed effective date as permitted by this [Code] is specified, but no time is specified, at 12:01 a.m. on the date specified, which may not be more than 90 days after the date of filing.

#### **Comment**

Records accepted for filing become effective at the date and time of filing, as recorded by the filing office, or at another specified time on that date, unless a permissible delayed effective date is stated in the record.

Section 1-206(b) requires the filing office to maintain some means of recording the date and time of delivery of an entity filing and to record that date and time as the date and time of filing. That provision gives express statutory authority to the common practice of most filing offices of ignoring processing time and treating a record as filed as of the date and time it is delivered for filing even though it may not be reviewed and accepted for filing until several days after delivery. That section contemplates that time of delivery, as well as the date, will be routinely recorded.

Under paragraph (1) of this section, in the absence of provision for a delayed effective date, an entity filing becomes effective on the date and time of filing by the filing office. Since under 1-206(b) the date and time of filing is the recorded date and time of delivery of the entity filing, together these provisions eliminate any doubt about situations involving same-day transactions in which a record, for example, a statement of merger, is delivered for filing on the morning of the day the merger is to become effective.

This section does not authorize or contemplate the establishment of a retroactive effective date before the date of filing.

A record that states an effective date beyond the 90-day limit provided in paragraph (3) or (4) is not a record that “satisfies this [Code]” under Section 1-206(a) and will properly be rejected for filing.

#### **SECTION 1-204. WITHDRAWAL OF FILED RECORD BEFORE EFFECTIVENESS.**

(a) Except as otherwise provided in this [Code], a record delivered to the [Secretary of State] for filing may be withdrawn before it takes effect by delivering to the [Secretary of State] for filing a statement of withdrawal.

(b) A statement of withdrawal must:

(1) be signed by each person that signed the record being withdrawn, except as otherwise agreed by those persons;

(2) identify the record to be withdrawn; and

(3) if signed by fewer than all the persons that signed the record being withdrawn, state that the record is withdrawn in accordance with the agreement of all the persons that signed the record.

(c) On filing by the [Secretary of State] of a statement of withdrawal, the action or transaction evidenced by the original filed record does not take effect.

#### **Comment**

Only records that have not yet taken effect may be withdrawn under this section. If a record has taken effect, it may be corrected under Section 1-205 if the requirements of that section are satisfied. Otherwise, the record must be amended in accordance with the applicable provisions of the Code or, if the record relates to the formation of an entity, the existence of the entity may be terminated in accordance with the applicable provisions of the Code.

If a signatory of a record being withdrawn has died or is incompetent, Section 1-209 provides for a substitute signatory.

#### **SECTION 1-205. CORRECTING FILED RECORD.**

(a) A person on whose behalf a filed record was delivered to the [Secretary of State] for

filing may correct the record if:

- (1) the record at the time of filing was inaccurate;
- (2) the record was defectively signed; or
- (3) the electronic transmission of the record to the [Secretary of State] was

defective.

(b) To correct a filed record, a person on whose behalf the record was delivered to the [Secretary of State] must deliver to the [Secretary of State] for filing a statement of correction.

(c) A statement of correction:

- (1) may not state a delayed effective date;
- (2) must be signed by the person correcting the filed record;
- (3) must identify the filed record to be corrected;
- (4) must specify the inaccuracy or defect to be corrected; and
- (5) must correct the inaccuracy or defect.

(d) A statement of correction is effective as of the effective date of the filed record that it corrects except as to persons relying on the uncorrected filed record and adversely affected by the correction. As to those persons, the statement of correction is effective when filed.

### **Comment**

This section permits making corrections in entity filings without re-filing the entire record. Under subsection (d), the correction relates back to the original effective date of the entity filing being corrected, except as to persons relying on the original entity filing and adversely affected by the correction. As to these persons, the effective date of the statement of correction is the date the statement is filed.

An entity filing may be corrected either because it contains an inaccuracy or because it was defectively executed (including defects in optional forms of execution that do not affect the eligibility of the original record for filing). In addition, an entity filing may be corrected if its electronic transmission was defective. This is intended to cover the situation where an electronic filing is made but, due to a defect in transmission, the filed record is later discovered to be inconsistent with the record intended to be filed. If no filing is made because of a defect in

transmission, a statement of correction may not be used to make a retroactive filing. Therefore, an entity making an electronic filing should take steps to confirm that the filing was received by the filing office.

A provision in an entity filing setting an effective date may be corrected under this section, but the corrected effective date must comply with the requirements of the Code limiting delayed effective dates to within 90 days after filing. A corrected effective date is thus measured from the date of the original filing of the record being corrected, i.e., it cannot be before the date of filing of the record or more than 90 day thereafter.

If a signatory of a record being withdrawn has died or is incompetent, Section 1-209 provides for a substitute signatory.

#### **SECTION 1-206. DUTY OF [SECRETARY OF STATE] TO FILE; REVIEW OF REFUSAL TO FILE.**

(a) The [Secretary of State] shall file an entity filing delivered to the [Secretary of State] for filing which satisfies this [Code]. The duty of the [Secretary of State] under this section is ministerial.

(b) When the [Secretary of State] files an entity filing, the [Secretary of State] shall record it as filed on the date and at the time of its delivery. After filing an entity filing, the [Secretary of State] shall deliver to the person that submitted the filing a copy of the filing with an acknowledgment of the date and time of filing.

(c) If the [Secretary of State] refuses to file an entity filing, the [Secretary of State], not later than [15] business days after the filing is delivered, shall:

(1) return the entity filing or notify the person that submitted the filing of the refusal; and

(2) provide a brief explanation in a record of the reason for the refusal.

(d) If the [Secretary of State] refuses to file an entity filing, the person that submitted the filing may petition [the appropriate court] to compel its filing. The filing and the explanation of the [Secretary of State] of the refusal to file must be attached to the petition. The court may

decide the matter in a summary proceeding.

(e) The filing of or refusal to file an entity filing does not:

(1) affect the validity or invalidity of the filing in whole or in part; or

(2) create a presumption that the information contained in the filing is correct or incorrect.

### **Comment**

#### **1. Filing duty in general.**

Under this section the filing office is required to file an entity filing if it “satisfies this [Code]” (*i.e.*, both this article and the article that constitutes the organic law of the entity, as well as Article 2 if the entity filing relates to a transaction under that article). The purpose of this language is to limit the discretion of the filing office to a ministerial role in reviewing the contents of entity filings. If the entity filing submitted is in the form prescribed and contains the information required by Section 1-201 and the other applicable provision of the Code, the filing office must file it. Consistently with this approach, subsection (a) states explicitly that the filing duty of the filing office is ministerial and subsection (e) provides that the filing of an entity filing by the filing office does not affect the validity or invalidity of any provision contained in the filing and does not create any presumption with respect to any provision. Persons adversely affected by provisions in an entity filing may test their validity in a proceeding appropriate for that purpose. A presumption should not be drawn about the validity of the provision from the fact that the filing office accepted the entity filing for filing.

#### **2. Mechanics of filing.**

Subsection (b) provides that when the filing office files an entity filing, the filing office records it as filed on the date and time of delivery to the filing office, retains the original record for the state’s records, and delivers a copy of the record to the entity or its representative with an acknowledgement of the date and time of filing. In the case of a record transmitted electronically, delivery may be made by electronic transmission. The copy returned will be the exact or conformed copy if one has been required by the filing office, or will be a copy made by the filing office if an exact or conformed copy was not required. Of course, a person desiring a certified copy of any filed record may obtain it from the office of the filing office by paying the fee prescribed in Section 1-214.

#### **3. Elimination of certificates and similar records.**

Subsection (b) provides that acceptance of a filing is evidenced merely by the delivery by the filing office of a copy of the entity filing with an acknowledgment of the date and time of filing. The Code does not provide for the filing office to issue a formal certificate of filing. A copy of the filed record together with an acknowledgment of the date and time of filing should

sufficiently indicate that the entity filing has been accepted for filing.

#### **4. Rejection of document by filing office.**

Because of the simplification of formal filing requirements and the limited discretion granted to the filing office by the Code, it is probable that rejection of entity filings will occur only rarely. Subsection (c) provides that if the filing office does reject an entity filing, the filing office must return it to the person that submitted the filing within 15 days together with a brief written explanation of the reason for rejection. In the case of an entity filing delivered by electronic transmission, rejection of the filing may be made electronically by the filing office or by a mailing to the entity.

#### **5. Effect of filing or rejection.**

Subsection (e) provides that the filing of a record by the filing office does not affect the validity or invalidity of any provision contained in the record and does not create a presumption with respect to any information in the record. Likewise, the refusal to file a record creates no presumption that any of the information in the record is incorrect. Persons adversely affected by a statement in a filed record may contest the statement in a proceeding appropriate for that purpose.

### **SECTION 1-207. EVIDENTIARY EFFECT OF COPY OF FILED RECORD. A**

certification from the [Secretary of State] accompanying a copy of a filed record is conclusive evidence that the copy is an accurate representation of the original record on file with the [Secretary of State].

#### **Comment**

The limited effect of a certificate issued by the filing office under this section is consistent with the ministerial filing obligation imposed on the filing office under the Code. See Section 1-206(a) which states the ministerial nature of the duties of the filing office under the Code, but contrast Section 1-208(c) which provide for a broader effect for a certificate of good standing or registration.

### **SECTION 1-208. CERTIFICATE OF GOOD STANDING OR REGISTRATION.**

(a) On request of any person, the [Secretary of State] shall issue a certificate of good standing for a domestic filing entity or a certificate of registration for a registered foreign entity.

(b) A certificate under subsection (a) must state:

(1) the domestic filing entity's name or the registered foreign entity's name used

in this state;

(2) in the case of a domestic filing entity:

(A) that its public organic record has been filed and has taken effect;

(B) the date the public organic record became effective;

(C) the period of the entity's duration if the records of the [Secretary of State] reflect that its period of duration is less than perpetual; and

(D) that the records of the [Secretary of State] do not reflect that the entity has been dissolved;

(3) in the case of a registered foreign entity, that it is registered to do business in this state;

(4) that all fees, taxes, interest, and penalties owed to this state by the domestic or foreign entity and collected through the [Secretary of State] have been paid, if:

(A) payment is reflected in the records of the [Secretary of State]; and

(B) nonpayment affects the good standing or registration of the domestic or foreign entity;

(5) that the most recent [annual] [biennial] report required by Section 1-213 has been delivered to the [Secretary of State] for filing;

(6) that a proceeding is not pending under Section 1-602; and

(7) other facts reflected in the records of the [Secretary of State] pertaining to the domestic or foreign entity which the person requesting the certificate reasonably requests.

(c) Subject to any qualification stated in the certificate, a certificate issued by the [Secretary of State] under subsection (a) may be relied on as conclusive evidence of the facts stated in the certificate.

### **Comment**

This section establishes a procedure by which anyone may obtain a conclusive certificate from the filing office that the records of the filing office either (i) do not indicate that a particular domestic entity has ceased to exist or (ii) indicate that a particular foreign entity is registered to do business in the state. The certificate will probably be a standardized form. The filing office is to make those determinations from public records only and is not expected to make a more extensive investigation.

This section refers only to fees, taxes, interest, and penalties collected by the filing office. In some states other agencies may report to the filing office that franchise or other taxes have been paid; in those state, this information may be included in the certificate. In states where this procedure does not unduly delay the issuance of certificates, this section may be revised appropriately. Subsection (b)(4)(B) limits the scope of the statement in the certificate that all fees, taxes, interest, and penalties have been paid to those where nonpayment affects the existence or registration to do business of the entity.

### **SECTION 1-209. SIGNING OF ENTITY FILING.**

(a) Signing an entity filing is an affirmation under the penalties of perjury that the facts stated in the filing are true in all material respects.

(b) A record filed under this [Code] may be signed by an agent. Whenever this [Code] requires a particular individual to sign an entity filing and the individual is deceased or incompetent, the filing may be signed by a legal representative of the individual.

(c) A person that signs a record as an agent or legal representative affirms as a fact that the person is authorized to sign the record.

### **Comment**

As provided in Section 1-102(44), “sign” includes any manual, facsimile, conformed, or electronic signature.

**Subsection (a)** – This subsection makes it a criminal offense for any person to sign an entity filing that the person knows is false in any material respect.

**Subsection (b)** – The filing office will not check the bona fides of a person purporting to have signed a record in a representative capacity. This subsection expressly authorizes taking action through an agent so as to provide context for Subsection (c) and for the avoidance of doubt. No negative inference should be drawn about using agents to take other action under this article.



**Subsection (c)** – As a matter of agency law, a person who signs in a representative capacity gives a “warranty of authority.” RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006) (Agent’s Implied Warranty of Authority).

**SECTION 1-210. SIGNING AND FILING PURSUANT TO JUDICIAL ORDER.**

(a) If a person required by this [Code] to sign or deliver a record to the [Secretary of State] for filing under this [Code] does not do so, any other person that is aggrieved may petition [the appropriate court] to order:

- (1) the person to sign the record;
- (2) the person to deliver the record to the [Secretary of State] for filing; or
- (3) the [Secretary of State] to file the record unsigned.

(b) If the petitioner under subsection (a) is not the entity to which the record pertains, the petitioner shall make the entity a party to the action.

(c) A record filed under subsection (a)(3) is effective without being signed.

**Comment**

This section gives the court the flexibility to order either that a record be signed or that the record be filed by the filing office unsigned. That later circumstance may arise, for example, in a situation where the person who should sign the record is not subject to the jurisdiction of the court. This section also makes clear that the court may order a person with control over a record that has been signed to deliver the record to the filing office for filing.

**SECTION 1-211. LIABILITY FOR INACCURATE INFORMATION IN FILED**

**RECORD.** If a record delivered to the [Secretary of State] for filing under this [Code] and filed by the [Secretary of State] contains inaccurate information, a person that suffers a loss by reliance on the information may recover damages for the loss from a person that signed the record or caused another to sign it on the person’s behalf and knew at the time the record was signed that the information was inaccurate.

### **Comment**

This section relates to liability to third parties for inaccurate information in a filed record. Section 1-209 provides for criminal liability where the facts in a filed record are not true in all material respects. In addition, an aggrieved person may seek a remedy under Section 1-210.

Specific rules on the responsibilities of certain persons for the accuracy of the information in the records of the filing office about an entity are found in some organic laws. *See, e.g.*, Sections 4-204 (limited partnerships), 5-205 (limited liability companies), and 8-205 (statutory trusts).

**SECTION 1-212. DELIVERY BY [SECRETARY OF STATE].** Except as otherwise provided by Section 1-412 or by law of this state other than this [Code], the [Secretary of State] may deliver a record to a person by delivering it:

- (1) in person to the person that submitted it for filing;
- (2) to the address of the person's registered agent;
- (3) to the principal office address of the person; or
- (4) to another address the person provides to the [Secretary of State] for delivery.

### **Comment**

This section provides several options for how the filing office may deliver a record in response to a request for the record or after the filing office has filed it.

**SECTION 1-213. [ANNUAL] [BIENNIAL] REPORT FOR [SECRETARY OF STATE].**

(a) A domestic filing entity, domestic limited liability partnership, or registered foreign entity shall deliver to the [Secretary of State] for filing [an annual] [a biennial] report that states:

- (1) the name of the entity and its jurisdiction of formation;
- (2) the name and street and mailing addresses of the entity's registered agent in this state;
- (3) the street and mailing addresses of the entity's principal office; and

(4) the name of at least one governor.

(b) Information in [an annual] [a biennial] report must be current as of the date the report is signed by the entity.

(c) The first [annual] [biennial] report must be delivered to the [Secretary of State] for filing after [January 1] and before [April 1] of the year following the calendar year in which the public organic record of the domestic filing entity became effective, the statement of qualification of a domestic limited liability partnership became effective, or the foreign filing entity registered to do business in this state. Subsequent [annual] [biennial] reports must be delivered to the [Secretary of State] for filing after [January 1] and before [April 1] of each [second] calendar year thereafter.

(d) If [an annual] [a biennial] report does not contain the information required by this section, the [Secretary of State] promptly shall notify the reporting entity in a record and return the report for correction.

(e) If [an annual] [a biennial] report contains the name or address of a registered agent which differs from the information shown in the records of the [Secretary of State] immediately before the report becomes effective, the differing information is considered a statement of change under Section 1-407.

### **Comment**

The requirement that the report include the name of at least one governor of the entity will be a new requirement for some entities in some states. There has been increasing pressure from law enforcement for access to more information about the ownership and control of legal entities. The identification of a governor for each entity will give law enforcement the ability to contact a person with some knowledge about the affairs of the entity.

**[SECTION 1-214. FEES.**

**Alternative A**

(a) The [Secretary of State] shall collect the following fees for copying and certifying the copy of any filed record:

- (1) \$ [ ] per page for copying; and
- (2) \$ [ ] for the certification.

(b) The [Secretary of State] shall collect the following fees when an entity filing is delivered for filing:

- (1) Statement of merger, \$ [ ].
- (2) Statement of withdrawal of merger, \$ [ ].
- (3) Statement of interest exchange, \$ [ ].
- (4) Statement of withdrawal of interest exchange, \$ [ ].
- (5) Statement of conversion, \$ [ ].
- (6) Statement of withdrawal of conversion, \$ [ ].
- (7) Statement of domestication, \$ [ ].
- (8) Statement of withdrawal of domestication, \$ [ ].
- (9) [Annual] [Biennial] report, \$ [ ].
- (10) Articles of incorporation of a business corporation, \$ [ ].
- (11) Articles of incorporation of a nonprofit corporation, \$ [ ].
- (12) Statement of qualification of a limited liability partnership, \$ [ ].
- (13) Certificate of limited partnership of a limited partnership, \$ [ ].
- (14) Certificate of organization of a limited liability company, \$ [ ].
- [(15) Articles of incorporation of a general cooperative association, \$ [ ].]

- (16) Articles of organization of a limited cooperative association, \$ [ ].
- (17) Certificate of trust of a statutory trust, \$ [ ].
- (18) Other public organic document, \$ [ ].
- (19) Commercial-registered-agent listing statement, \$ [ ].
- (20) Commercial-registered-agent termination statement, \$ [ ].
- (21) Registered agent statement of change, \$ [ ].
- (22) Registered agent statement of resignation, no fee.
- (23) Statement designating a registered agent, \$ [ ].
- (24) Foreign entity registration statement, \$ [ ].
- (25) Amendment of foreign entity registration statement, \$ [ ].
- (26) Notice of cancellation of foreign entity registration statement, \$ [ ].
- (27) Statement of withdrawal, \$ [ ].
- (28) Statement of correction, \$ [ ].
- [(29) Other entity filings, \$ [ ]. ]

(c) The withdrawal under Section 1-204 of a filed record before it is effective or the correction of a filed record under Section 1-205 does not entitle the person on whose behalf the record was filed to a refund of the filing fee.

### **Alternative B**

(a) The [Secretary of State] shall adopt rules in accordance with [this state's administrative procedure act] setting fees for entity filings authorized to be delivered to the [Secretary of State] for filing under this [Code] and for copying and certifying a copy of any entity filing under this [Code].

(b) There is no fee for filing a registered agent's statement of resignation.

(c) The withdrawal under Section 1-204 of a filed record before it is effective or the correction of a filed record under Section 1-205 does not entitle the person on whose behalf the record was filed to a refund of the filing fee.

### **End of Alternatives]**

***Legislative Note:*** *If the state includes fees of this kind in a general statute, add these fees to that statute and omit this section. If this state sets fees of this kind by administrative rule, select Alternative B.*

*Subsection (a) establishes standard fees for copying filed documents and certifying that the copies are true copies. The dollar amounts for these services should be conformed to the fees charged for similar services under other provisions of law.*

*Subsection (b)(29) of Alternative A will include all entity filings not specifically listed in subsection (b). As an alternative to relying on subsection (b)(29), the state may list in subsection (b) all of the specific entity filings required by the Code.*

### **Comment**

This section establishes the filing fees for all documents that may be delivered to the Secretary of State or other state filing office for filing under the Code.

## **[PART] 3**

### **NAME OF ENTITY**

#### **SECTION 1-301. PERMITTED NAMES.**

(a) Except as otherwise provided in subsection (d) or (f), the name of a domestic filing entity or domestic limited liability partnership, and the name under which a foreign entity may register to do business in this state, must be distinguishable on the records of the [Secretary of State] from any:

(1) name of an existing domestic filing entity which at the time is not administratively dissolved;

(2) name of a limited liability partnership whose statement of qualification is in effect;

(3) name under which a foreign entity is registered to do business in this state under [Part] 5;

(4) name reserved under Section 1-303;

(5) name registered under Section 1-304; or

(6) assumed name registered under [this state's assumed name statute].

(b) If an entity consents in a record to the use of its name and submits an undertaking in a form satisfactory to the [Secretary of State] to change its name to a name that is distinguishable on the records of the [Secretary of State] from any name in any category of names in subsection (a), the name of the consenting entity may be used by the person to which the consent was given.

(c) Except as otherwise provided in subsection (d), in determining whether a name is the same as or not distinguishable on the records of the [Secretary of State] from the name of another entity, words, phrases, or abbreviations indicating the type of entity, such as "corporation", "corp.", "incorporated", "Inc.", "professional corporation", "PC", "P.C.", "professional association", "PA", "P.A.", "Limited", "Ltd.", "limited partnership", "LP", "L.P.", "limited liability partnership", "LLP", "L.L.P.", "registered limited liability partnership", "RLLP", "R.L.L.P.", "limited liability limited partnership", "LLLLP", "R.L.L.L.P.", "limited liability company", "LLC", or "L.L.C." may not be taken into account.

(d) An entity may consent in a record to the use of a name that is not distinguishable on the records of the [Secretary of State] from its name except for the addition of a word, phrase, or abbreviation indicating the type of entity as provided in subsection (c). In such a case, the entity need not change its name pursuant to subsection (b).

(e) An entity name may not contain the words [insert prohibited words or words that may

be used only with approval by the appropriate state agency].

(f) An entity may use a name that is not distinguishable from a name described in subsection (a)(1) through (6) if the entity delivers to the [Secretary of State] a certified copy of a final judgment of a court of competent jurisdiction establishing the right of the entity to use the name in this state.

**Legislative Note:** *In subsection (e), add specific words that the state does not permit an entity to use as part of its name, such as “bank”, “banking”, “credit union”, “insurance”, or words of similar import, without approval by the appropriate state agency. If the state limits the use of certain words in the name of an entity unless the entity is of a certain type, those words should also be added in subsection (e). For example, some states prohibit the name of an entity from containing the word “cooperative” unless the entity is organized as a cooperative.*

*Subsection (f) only requires that the court order permitting use of a conflicting name be delivered to the Secretary of State or other state filing office, without going on to say that the purpose of delivering the order is for it to be filed. A state may also choose to add that the order is delivered “for filing” if it wishes the public record to include evidence of why the conflicting name has been accepted.*

### **Comment**

This section adopts the “distinguishable on the records” test for availability of an entity name and rejects the “deceptively similar” test widely used in the past.

## **SECTION 1-302. NAME REQUIREMENTS FOR CERTAIN TYPES OF ENTITIES.**

(a) The name of a business corporation must contain the word "corporation", "incorporated", "company", or "limited", or the abbreviation "Corp.", "Inc.", "Co.", or "Ltd.", or words or abbreviations of similar import in another language.

(b) The name of a limited partnership may contain the name of any partner. 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 partnership” or “registered limited liability limited partnership” or the



abbreviation “L.L.L.P.”, “LLL”, “R.L.L.L.P.”, or “RLLL”. If the limited partnership is a limited liability limited partnership, the name must contain the phrase “limited liability limited partnership” or the abbreviation “L.L.L.P.” or “LLL” “R.L.L.L.P.”, or “RLLL” and may not contain the abbreviation “L.P.” or “LP”.

(c) The name of a limited liability partnership must contain the phrase “limited liability partnership” or “registered limited liability partnership” or the abbreviation “L.L.P.”, “R.L.L.P.”, “LLP”, or “RLLP”.

(d) The name of a limited liability company must contain the phrase “limited liability company” or “limited company” or the abbreviation “L.L.C.”, “LLC”, “L.C.”, or “LC”. “Limited” may be abbreviated as “Ltd.”, and “company” may be abbreviated as “Co.”.

(e) The name of a limited cooperative association must contain the phrase “limited cooperative association” or “limited cooperative” or the abbreviation “L.C.A.” or “LCA”. “Limited” may be abbreviated as “Ltd.”. “Cooperative” may be abbreviated as “Co-op.”, “Coop.”, “Co-op”, or “Coop”. “Association” may be abbreviated as “Assoc.”, “Assoc”, “Assn.”, or “Assn”.

(f) The name of a statutory trust may contain the words “company”, “association”, “club”, “foundation”, “fund”, “institute”, “society”, “union”, “syndicate”, “limited”, or “trust”, or words or abbreviations of similar import, and may contain the name of a beneficial owner, a trustee, or any other person.

[(g) Insert requirements for names of other types of entities that may be included in this [Code], such as general cooperative associations or professional entities.]

**Legislative Note:** *If the state authorizes the organization of entities with protected series and requires that the name of each series indicate that it is a series, or if a separate document identifying each series with a distinct name must be delivered to the filing office for filing, those name requirements should be added to this section.*

## **Comment**

### **1. Corporations.**

Subsection (a) is derived from Model Business Corporation Act § 4.01(a). The Model Nonprofit Corporation Act does not require the name of a nonprofit corporation to include a corporate designator.

### **2. Limited Partnerships.**

Subsection (b)(1)) is derived from Uniform Limited Partnership Act (2001) (Last Amended 2013), § 114(a)-(c). The 1976/1985 version of the Uniform Limited Partnership Act prohibited the use of a limited partner's name in the name of a limited partnership except in unusual circumstances. That approach derived from the 1916 version of the Uniform Limited Partnership Act and has become antiquated. In 1916 most business organizations were either unshielded (*e.g.*, general partnerships) or partially shielded (*e.g.*, limited partnerships), and it was reasonable for third parties to believe that an individual whose own name appeared in the name of a business would “stand behind” the business. Today most businesses have a full shield (*e.g.*, corporations, limited liability companies, most limited liability partnerships), and corporate, LLC and LLP statutes generally pose no barrier to the use of an owner's name in the name of the entity. The Code eliminates the restriction on the use of a name of a limited partner and puts limited partnerships on equal footing with these other “shielded” entities.

### **3. Limited Liability Partnerships.**

Subsection (c) is derived from Uniform Partnership Act (1997) (Last Amended 2013) § 902(b).

### **4. Limited Liability Companies.**

Subsection (d) is derived from Uniform Limited Liability Company Act (2006) (Last Amended 2013) § 112(a).

### **5. Limited Cooperative Associations.**

Subsection (e) is derived from Uniform Limited Cooperative Association Act (2007) (Last Amended 2013) § 113(b).

### **6. Statutory Trusts.**

Subsection (f) is derived from Uniform Statutory Trust Entity Act (2009) (Last Amended 2013) § 213(a). That act does not require the name of a statutory trust to include a traditional limited liability designator. Such a requirement would be inconsistent with current practice under the Delaware Statutory Trust Act and other business trust entity statutes. For example, the names of mutual funds typically do not contain a limited liability appellation, though Section 35(d) of the Investment Company Act of 1940, which is applicable to a statutory trust that is a

registered investment company, prohibits “materially deceptive or misleading” names. 15 U.S.C. §80a-34(d). See also Rule 35d-1, 17 C.F.R. §270.35d-1 (listing types of names that have been deemed “materially deceptive or misleading”).

### **SECTION 1-303. RESERVATION OF NAME.**

(a) A person may reserve the exclusive use of an entity name by delivering an application to the [Secretary of State] for filing. The application must state the name and address of the applicant and the name to be reserved. If the [Secretary of State] finds that the entity name is available, the [Secretary of State] shall reserve the name for the applicant’s exclusive use for [120] days.

(b) The owner of a reserved entity name may transfer the reservation to another person by delivering to the [Secretary of State] a signed notice in a record of the transfer which states the name and address of the transferee.

#### **Comment**

This section does not provide for the renewal of a name reservation for successive 120 day periods. A new reservation may be filed upon the expiration of a reservation, but by requiring a new filing this section creates the possibility that another party may timely submit a reservation for the same name. It was considered appropriate to allow for that possibility so that the procedure in this section cannot be used to block a name indefinitely. Compare Section 1-304 which authorizes a renewable registration of certain names.

### **SECTION 1-304. REGISTRATION OF NAME.**

(a) A foreign filing entity or foreign limited liability partnership not registered to do business in this state under [Part] 5 may register its name, or an alternate name adopted pursuant to Section 1-506, if the name is distinguishable on the records of the [Secretary of State] from the names that are not available under Section 1-301.

(b) To register its name or an alternate name adopted pursuant to Section 1-506, a foreign filing entity or foreign limited liability partnership must deliver to the [Secretary of State] for filing an application stating the entity’s name, the jurisdiction and date of its formation, and any

alternate name adopted pursuant to Section 1-506. If the [Secretary of State] finds that the name applied for is available, the [Secretary of State] shall register the name for the applicant's exclusive use.

(c) The registration of a name under this section is effective for [one year] after the date of registration.

(d) A foreign filing entity or foreign limited liability partnership whose name registration is effective may renew the registration for successive [one-year] periods by delivering, not earlier than [three months] before the expiration of the registration, to the [Secretary of State] for filing a renewal application that complies with this section. When filed, the renewal application renews the registration for a succeeding [one-year] period.

(e) A foreign filing entity or foreign limited liability partnership whose name registration is effective may register as a foreign filing entity or foreign limited liability partnership under the registered name or consent in a signed record to the use of that name by another entity.

### **Comment**

Unlike the reservation of a name under Section 1-303, a registration of a name under this section may be renewed for successive periods thus permitting a name to be protected for a period longer than the initial registration period. Use of the procedure in this section is limited, however, to the names of foreign filing entities and foreign limited liability partnerships that are not registered to do business in the state. The purpose of this section is to permit a foreign entity to make sure its name will be available in the event it should choose to register in the state at some time in the future.

## **[PART] 4**

### **REGISTERED AGENT OF ENTITY**

#### **SECTION 1-401. DEFINITIONS.** In this [part]:

(1) "Designation of agent" means a statement designating a registered agent delivered to the [Secretary of State] for filing under:

(A) [Section 7-129]; or

(B) Section 1-411 by a nonregistered foreign entity or domestic nonfiling entity.

(2) “Registered agent filing” means:

(A) the public organic record of a domestic filing entity;

(B) a statement of qualification of a domestic limited liability partnership;

(C) a registration statement filed pursuant to Section 1-503; or

(D) a designation of agent.

(3) “Represented entity” means:

(A) a domestic filing entity;

(B) a domestic limited liability partnership;

(C) a registered foreign entity;

(D) a domestic or foreign unincorporated nonprofit association for which a designation of agent is in effect;

(E) a domestic nonfiling entity for which a designation of agent is in effect; or

(F) a nonregistered foreign entity for which a designation of agent is in effect.

### **Comment**

**“Designation of agent.” [(1)]** – A designation of agent is an optional filing that may be made by an entity that does not otherwise make a public filing in the state naming an agent for service of process. If a state has not enacted the Uniform Unincorporated Nonprofit Association Act (2008) (Last Amended 2013), paragraph (A) of this definition should be omitted.

**“Registered agent filing.” [(2)]** – Some states require that filings in addition to those listed in this definition, such as articles of amendment or articles of merger, state the registered agent information of the entity making the filing. In states where that is the case, this definition should be amended to add the following additional provision:

“(E) any other filing with the [Secretary of State] under an entity’s organic law that must include the information required by Section 1-404(a).”

**“Represented entity.” [(3)]** – This definition is used in this part as a way of referring to

all of the various types of entities that have registered agents.

**SECTION 1-402. ENTITIES REQUIRED TO DESIGNATE AND MAINTAIN REGISTERED AGENT.** The following shall designate and maintain a registered agent in this state:

- (1) a domestic filing entity;
- (2) a domestic limited liability partnership; and
- (3) a registered foreign entity.

**Comment**

The Model Registered Agents Act (2006) (Last Amended 2013), from which this part of Article 1 is derived, does not contain a provision mandating which entities must designate a registered agent, leaving that to the state's specific entity acts.

When an organic law for a filing entity is integrated into the Code, the provision specifying the contents of the public organic record for that type of filing entity will require a statement of the registered agent for that entity but the organic law will not include an express requirement to have a registered agent.

**SECTION 1-403. ADDRESSES IN FILING.** If a provision of this [part] other than Section 1-410(a)(4) requires that a record state an address, the record must state:

- (1) a street address in this state; and
- (2) a mailing address in this state, if different from the address described in paragraph (1).

**Comment**

When this part requires that a filing state an address, the address used must always be a geographic location. Where a person uses a post office box as its mailing address, paragraph (2) requires that the post office box address also be stated.

This section is derived from Model Registered Agent Act (2006) (Last Amended 2013) § 4.

**SECTION 1-404. DESIGNATION OF REGISTERED AGENT.**

- (a) A registered agent filing must be signed by the represented entity and state:

- (1) the name of the entity's commercial registered agent; or
- (2) if the entity does not have a commercial registered agent:

- (A) the name and address of the entity's noncommercial registered agent;

or

- (B) the title of an office or other position with the entity, if service of process, notices, and demands are to be sent to whichever individual is holding that office or position, and the address to which process, notices, or demands are to be sent.

(b) The designation of a registered agent pursuant to subsection (a)(1) or (2)(A) is an affirmation of fact by the represented entity that the agent has consented to serve.

(c) The [Secretary of State] shall make available in a record as soon as practicable a daily list of filings that contain the name of a registered agent. The list must:

- (1) be available for at least 14 calendar days;
- (2) list in alphabetical order the names of the registered agents; and
- (3) state the type of filing and name of the represented entity making the filing.

***Legislative Note:*** Subsection (c) may be omitted if (i) the records of the Secretary of State or other state filing office are searchable electronically in a manner that permits filings to be identified by the date of the filing and by the name of the registered agent named in the filing, and (ii) the searchable database is updated frequently. Subsection (c) will not be necessary under those circumstances because registered agents may consult the regular database maintained by the filing office to verify when they have been named as a registered agent.

### **Comment**

Subsection (a)(1) gives an entity the option of listing just the name of its commercial registered agent in a registered agent filing and omitting the address of the registered agent. If the commercial registered agent subsequently changes its address, that change will be reflected in the filing made by the agent under Section 1-405, as amended under Section 1-409, but no change will be necessary in the registered agent filing of any of the entities represented by the commercial registered agent. The address of an entity's commercial registered agent may be ascertained from the records of the filing office by consulting its listing under Section 1-405.

The address of an entity's noncommercial registered agent is usually not a business

address of the represented entity. On the other hand, subsection (a)(2)(B) permits an entity to designate a person within the organization, such as its general counsel, to serve as its registered agent; and in that circumstance the address of the registered agent may very well be a business address of the represented entity.

The addresses required by subsection (a) to be stated in a registered agent filing must satisfy the requirements in Section 1-403.

Subsection (b) avoids the need to include with a registered agent filing a consent of the registered agent to serve as such.

Subsection (c) creates a procedure that will permit registered agents to determine if they have been named in filings of which they were not aware by periodically consulting the list prepared by the filing office. Subsection (c) requires the registered agents to be listed in alphabetical order to facilitate the use of the list by registered agents and also to indicate the type of filing (*e.g.*, articles of incorporation, certificates of limited partnership, appointments of agents under Section 1-411, etc.) in which each registered agent is named.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 5.

#### **SECTION 1-405. LISTING OF COMMERCIAL REGISTERED AGENT.**

(a) A person may become listed as a commercial registered agent by delivering to the [Secretary of State] for filing a commercial-registered-agent listing statement signed by the person which states:

(1) the name of the individual or the name of the entity, type of entity, and jurisdiction of formation of the entity;

(2) that the person is in the business of serving as a commercial registered agent in this state; and

(3) the address of a place of business of the person in this state to which service of process, notices, and demands being served on or sent to entities represented by the person may be delivered.

(b) A commercial-registered-agent listing statement may include the information regarding acceptance by the agent of service of process, notices, and demands in a form other



than a written record as provided in Section 1-412(d).

(c) If the name of a person delivering to the [Secretary of State] for filing a commercial-registered-agent listing statement is not distinguishable on the records of the [Secretary of State] from the name of another commercial registered agent listed under this section, the person shall adopt a fictitious name that is distinguishable and use that name in its statement and when it does business in this state as a commercial registered agent.

(d) The [Secretary of State] shall note the filing of a commercial-registered-agent listing statement in the [index of filings] [records] maintained by the [Secretary of State] for each entity represented by the agent at the time of the filing. The statement has the effect of amending the registered agent filing for each of those entities to:

(1) designate the person becoming listed as a commercial registered agent as the commercial registered agent of each of those entities; and

(2) delete the name and address of the former agent from the registered agent filing of each of those entities.

***Legislative Note:*** *If the Secretary of State or other state filing office is not able to identify from the records maintained by the filing office all of the entities represented by a registered agent, subsection (d) should be amended to read:*

*“(d) The commercial registered agent listing statement must be accompanied by a list in alphabetical order of the entities represented by the person. The [Secretary of State] shall note the filing of the commercial-registered-agent listing statement in the index of filings maintained by the [Secretary of State] for each listed entity. The statement has the effect of deleting the address of the registered agent from the registered agent filing of each of those entities.”*

### **Comment**

This section is a substantial simplification of practice because it removes the need to amend the filed record of every entity represented by a commercial registered agent when the agent changes its address.

Subsection (a)(3) only permits a commercial registered agent to list one address where service of process and other notices may be sent to entities represented by the agent. This may

require a change in practice for registered agents who have previously maintained more than one address in a state and have permitted represented entities to choose which address they would use in their registered agent filings. A corporation, for example, located in one part of a state might include in its articles of incorporation an address for its registered agent which is the address of an office of the agent located close to the corporation and which is different than the address used by a corporation in another part of the state which has the same registered agent but uses a different office of the agent. In the example given, the registered agent will need to pick just one address in the state where all service of process will be sent to it. If a commercial registered agent wishes to maintain more than one office in a state where service of process will be received by it, it can accomplish that result by organizing separate entities to conduct its business in the state and filing separate statements for each entity under this section.

The address required by subsection (a)(3) to be stated in a commercial registered agent listing statement must satisfy the requirements of Section 1-403.

Subsection (d) is a transitional provision that deals with the effect on the entities represented by a registered agent at the time the agent is first listed under this section. The effect is to amend the registered agent filing of each such entity to delete the address of the registered agent consistent with Section 1-404(a)(1).

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013)  
§ 6.

#### **SECTION 1-406. TERMINATION OF LISTING OF COMMERCIAL REGISTERED AGENT.**

(a) A commercial registered agent may terminate its listing as a commercial registered agent by delivering to the [Secretary of State] for filing a commercial-registered-agent termination statement signed by the agent which states:

(1) the name of the agent as listed under Section 1-405; and

(2) that the agent is no longer in the business of serving as a commercial registered agent in this state.

(b) A commercial-registered-agent termination statement takes effect at 12:01 a.m. on the 31st day after the day on which it is filed by the [Secretary of State].

(c) The commercial registered agent promptly shall furnish each entity represented by the agent notice in a record of the filing of the commercial-registered-agent termination statement.

(d) When a commercial-registered-agent termination statement takes effect, the commercial registered agent ceases to be the registered agent for each entity formerly represented by it. Until an entity formerly represented by a terminated commercial registered agent designates a new registered agent, service of process may be made on the entity pursuant to Section 1-412. Termination of the listing of a commercial registered agent under this section does not affect any contractual rights a represented entity has against the agent or that the agent has against the entity.

### **Comment**

This section provides a procedure for a commercial registered agent to withdraw from the business of providing registered agent services. Use of the procedure in this section will terminate the status of the registered agent as the agent for service of process of all the entities represented by the agent. Thus, the procedure in this section differs from the procedure in Section 1-410, which permits a registered agent to resign with respect to just a single represented entity instead of resigning generally with respect to all of its represented entities.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 7.

### **SECTION 1-407. CHANGE OF REGISTERED AGENT BY REPRESENTED ENTITY.**

(a) A represented entity may change the information on file under Section 1-404(a) by delivering to the [Secretary of State] for filing a statement of change signed by the entity which states:

(1) the name of the entity; and

(2) the information that is to be in effect as a result of the filing of the statement of change.

(b) The interest holders or governors of a domestic entity need not approve the filing of:

(1) a statement of change under this section; or

(2) a similar filing changing the registered agent or registered office, if any, of the entity in any other jurisdiction.

(c) A statement of change under this section designating a new registered agent is an affirmation of fact by the represented entity that the agent has consented to serve.

(d) As an alternative to using the procedure in this section, a represented entity may change the information on file under Section 1-404(a) by amending its most recent registered agent filing in a manner provided by the law of this state other than this [Code] for amending the filing.

### **Comment**

A change in the identity of the registered agent of a represented entity or a change of the office address of a registered agent are usually routine matters that do not affect the rights of the interest holders of the represented entity. This section permits those changes to be made without a formal amendment of an entity's public organic document, without approval of its interest holders, and, indeed, even without formal approval by its governors (*i.e.*, the persons managing the entity's affairs, such as the board of directors of a corporation).

Subsection (c) avoids the need to file with a statement of change a consent of the new registered agent being designated.

Subsection (d) makes clear that the procedures in this section are not exclusive. A common way in which an entity changes its registered agent or registered office is to include the change in an amendment of its public organic document or in its annual/biennial report.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 8.

### **SECTION 1-408. CHANGE OF NAME OR ADDRESS BY NONCOMMERCIAL REGISTERED AGENT.**

(a) If a noncommercial registered agent changes its name or its address in effect with respect to a represented entity under Section 1-404(a), the agent shall deliver to the [Secretary of State] for filing, with respect to each entity represented by the agent, a statement of change signed by the agent which states:

- (1) the name of the entity;
- (2) the name and address of the agent in effect with respect to the entity;
- (3) if the name of the agent has changed, the new name; and
- (4) if the address of the agent has changed, the new address.

(b) A noncommercial registered agent promptly shall furnish the represented entity with notice in a record of the delivery to the [Secretary of State] for filing of a statement of change and the changes made in the statement.

### **Comment**

This section permits a noncommercial registered agent to change the name and address of the agent that appears in the registered agent filing of an entity represented by the agent. Because the noncommercial registered agent is not listed under Section 1-405, the agent will not be able to use the procedures in Section 1-409 which permit commercial registered agents to make only one filing to change their name and address for all entities represented by them. Thus the noncommercial registered agent will need to make a filing under this section for each entity represented by the agent.

An address included in a statement of change must satisfy the requirements in Section 1-403.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 9.

### **SECTION 1-409. CHANGE OF NAME, ADDRESS, TYPE OF ENTITY, OR JURISDICTION OF FORMATION BY COMMERCIAL REGISTERED AGENT.**

(a) If a commercial registered agent changes its name, its address as listed under Section 1-405(a), its type of entity, or its jurisdiction of formation, the agent shall deliver to the [Secretary of State] for filing a statement of change signed by the agent which states:

- (1) the name of the agent as listed under Section 1-405(a);
- (2) if the name of the agent has changed, the new name;
- (3) if the address of the agent has changed, the new address; and

(4) if the agent is an entity:

(A) if the type of entity of the agent has changed, the new type of entity;

and

(B) if the jurisdiction of formation of the agent has changed, the new jurisdiction of formation.

(b) The filing by the [Secretary of State] of a statement of change under subsection (a) is effective to change the information regarding the agent with respect to each entity represented by the agent.

(c) A commercial registered agent promptly shall furnish to each entity represented by it a notice in a record of the filing by the [Secretary of State] of a statement of change relating to the name or address of the agent and the changes made in the statement.

(d) If a commercial registered agent changes its address without delivering for filing a statement of change as required by this section, the [Secretary of State] may cancel the listing of the agent under Section 1-405. A cancellation under this subsection has the same effect as a termination under Section 1-406. Promptly after canceling the listing of an agent, the [Secretary of State] shall serve notice in a record in the manner provided in Section 1-412(b) or (c) on:

(1) each entity represented by the agent, stating that the agent has ceased to be the registered agent for the entity and that, until the entity designates a new registered agent, service of process may be made on the entity as provided in Section 1-412; and

(2) the agent, stating that the listing of the agent has been canceled under this section.

### **Comment**

This section permits a commercial registered agent to make a single filing that has the effect of changing the name or address of the agent for all of the entities represented by it.

An address included in a statement of change must satisfy the requirements in Section 1-403.

Subsection (d) provides a procedure by which the filing office may cancel the listing of a commercial registered agent when the filing office learns that the agent has changed its address without amending its listing as a commercial registered agent. When the filing office acts to cancel the listing of a commercial registered agent, the filing office is required to notify both (i) the entities represented by the agent that they no longer have a valid registered agent and (ii) the agent that it no longer is listed as a commercial registered agent. Unlike in the case of a resignation under Section 1-410, which is initiated by the registered agent and thus does not require a notice from the filing office to the agent, notice by the filing office to the agent is needed under this section so that the agent has notice that its representation of the entities it previously represented has been terminated.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 10.

#### **SECTION 1-410. RESIGNATION OF REGISTERED AGENT.**

(a) A registered agent may resign as agent for a represented entity by delivering to the [Secretary of State] for filing a statement of resignation signed by the agent which states:

- (1) the name of the entity;
- (2) the name of the agent;
- (3) that the agent resigns from serving as registered agent for the entity; and
- (4) the address of the entity to which the agent will send the notice required by

subsection (c).

(b) A statement of resignation takes effect on the earlier of:

(1) 12:01 a.m. on the 31st day after the day on which it is filed by the [Secretary of State]; or

(2) the designation of a new registered agent for the represented entity.

(c) A registered agent promptly shall furnish to the represented entity notice in a record of the date on which a statement of resignation was filed.

(d) When a statement of resignation takes effect, the person that resigned ceases to have

responsibility under this [part] for any matter thereafter tendered to it as agent for the represented entity. The resignation does not affect any contractual rights the entity has against the agent or that the agent has against the entity.

(e) A registered agent may resign with respect to a represented entity whether or not the entity is in good standing.

### **Comment**

Resignation under this section may be accomplished solely by action of the registered agent and does not require the cooperation or consent of the represented entity. Whether a resignation violates a contract between the registered agent and the represented entity is beyond the scope of this part and subsection (d) preserves whatever claims a represented entity may have against its registered agent for a wrongful termination. Even if a resignation were to violate such a contract, the resignation would still be effective if the provisions of this section are followed.

Resignation under this section relates only to the entity named in the statement of resignation. Thus, the procedure in this section differs from the procedure in Section 1-406 which terminates the status of the agent as agent for all of the entities represented by it.

The requirements of Section 1-403 with respect to addresses do not apply to subsection (a)(4) because the registered agent may not have all the required information available.

Subsection (b) delays the effectiveness of a statement of resignation for 31 days to allow the notice of the resignation that must be sent under subsection (c) to reach the represented entity and to allow the represented entity to arrange for a substitute registered agent.

Subsection (e) makes clear that a registered agent may resign with respect to an entity that is not in good standing and supersedes the contrary administrative practice in some states of refusing to accept any filings with respect to an entity that is not in good standing until the problem with the entity's standing is cured.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 11.

## **SECTION 1-411. DESIGNATION OF REGISTERED AGENT BY NONREGISTERED FOREIGN ENTITY OR NONFILING DOMESTIC ENTITY.**

(a) A nonregistered foreign entity or domestic nonfiling entity may deliver to the [Secretary of State] for filing a statement designating a registered agent signed by the entity



which states:

- (1) the name, type of entity, and jurisdiction of formation of the entity; and
- (2) the information required by Section 1-404(a).

(b) A statement under subsection (a) is effective for five years after the date of filing unless canceled or terminated earlier.

(c) A statement under subsection (a) must be signed by a person authorized to manage the affairs of the nonregistered foreign entity or domestic nonfiling entity. The signing of the statement is an affirmation of fact that the person is authorized to manage the affairs of the entity and that the agent has consented to serve.

(d) Designation of a registered agent under subsection (a) does not register a nonregistered foreign entity to do business in this state.

(e) A statement under subsection (a) may not be rejected for filing because the name of the entity signing the statement is not distinguishable on the records of the [Secretary of State] from the name of another entity appearing on those records. The filing of such a statement does not make the name of the entity signing the statement unavailable for use by another entity.

(f) An entity that delivers to the [Secretary of State] for filing a statement under subsection (a) designating a registered agent may cancel the statement by delivering to the [Secretary of State] for filing a statement of cancellation that states the name of the entity and that the entity is canceling its designation of a registered agent in this state.

(g) A statement under subsection (a) for a nonregistered foreign entity terminates on the date the entity becomes a registered foreign entity.

### **Comment**

Filing under this section is elective, and no inference should be drawn from the failure of an entity to make such a filing.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013)  
§ 12.

**SECTION 1-412. SERVICE OF PROCESS, NOTICE, OR DEMAND ON ENTITY.**

(a) A represented entity may be served with any process, notice, or demand required or permitted by law by serving its registered agent.

(b) If a represented entity ceases to have a registered agent, or if its registered agent cannot with reasonable diligence be served, the entity may be served by registered or certified mail, return receipt requested, or by similar commercial delivery service, addressed to the entity at the entity's principal office. The address of the principal office of a domestic filing entity, domestic limited liability partnership, or registered foreign entity must be as shown in the entity's most recent [annual] [biennial] report filed by the [Secretary of State]. Service is effected under this subsection on the earliest of:

(1) the date the entity receives the mail or delivery by the commercial delivery service;

(2) the date shown on the return receipt, if signed by the entity; or

(3) five days after its deposit with the United States Postal Service or commercial delivery service, if correctly addressed and with sufficient postage or payment.

(c) If process, notice, or demand cannot be served on an entity pursuant to subsection (a) or (b), service may be made by handing a copy to the individual in charge of any regular place of business or activity of the entity if the individual served is not a plaintiff in the action.

(d) Service of process, notice, or demand on a registered agent must be in a written record, but service may be made on a commercial registered agent in other forms, and subject to such requirements, as the agent has stated in its listing under Section 1-405 that it will accept.

(e) Service of process, notice, or demand may be made by other means under law other than this [Code].

### **Comment**

Subsection (b) offers three alternative methods for establishing the date service is effected, a date important for determining the time frame in which an entity must respond to the process, notice, or demand served. Under subsection (b)(1), service is effected on the date or receipt by the entity of the mail or commercial delivery. Under subsection (b)(2), service is effected on the date shown on the return receipt, if signed on behalf of the entity. Under subsection (b)(3), service is effected five days after it is deposited with the Postal Service or with a commercial delivery service, if correctly addressed and with correct postage or payment. Service is effective at the earliest of the three listed circumstances. But for the party effecting service there are difficulties of proof under the first two circumstances. Under subsection (b)(1) the exact date of the receipt by the entity of mail or commercial delivery is peculiarly within the knowledge of the entity. Under subsection (b)(2) the return receipt must be signed on behalf of the entity. That requirement is designed to assure that the service is actually received by the entity. The problem is that the signature on the return receipt may not always show unambiguously that the signer was acting for the entity and was authorized to do so. As a practical matter, therefore, parties effecting service under subsection (b) may find it most convenient to rely on subsection (3) and to maintain their own records so that the date of deposit in the mails or with a commercial delivery service can easily be established.

Subsection (c) provides a means for serving process on an entity that cannot be served under subsection (a) or (b). Some entity organic laws require that service of process in that circumstance be made on the filing office, but that leaves unanswered the question of what the filing office should do with the process. Compare Fed. R.Civ.Proc. 4(h)(1) which permits service to be made on an officer or managing or general agent of an entity.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 13.

**SECTION 1-413. DUTIES OF REGISTERED AGENT.** The only duties under this [part] of a registered agent that has complied with this [part] are:

(1) to forward to the represented entity at the address most recently supplied to the agent by the entity any process, notice, or demand pertaining to the entity which is served on or received by the agent;

(2) to provide the notices required by this [part] to the entity at the address most recently supplied to the agent by the entity;

(3) if the agent is a noncommercial registered agent, to keep current the information required by Section 1-404(a) in the most recent registered agent filing for the entity; and

(4) if the agent is a commercial registered agent, to keep current the information listed for it under Section 1-405(a).

### **Comment**

This section is limited to prescribing the duties of a registered agent under this part. An agent may undertake other responsibilities to a represented entity, such as by contract or course of dealing, but those duties will be determined under other law.

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 14.

**SECTION 1-414. JURISDICTION AND VENUE.** The designation or maintenance in this state of a registered agent does not by itself create the basis for personal jurisdiction over the represented entity in this state. The address of the agent does not determine venue in an action or a proceeding involving the entity.

### **Comment**

This section makes clear that the address of a registered agent does not determine venue. This section may be inconsistent with other law or procedural rules in a state, and thus existing law on venue should be reviewed when this article is considered for adoption in a state. *Compare Cooper v. Chevron U.S.A., Inc.*, 132 N.M. 382, 49 P.3d 61 (N.M. 2002) (applying New Mexico statute permitting venue “in the county where the statutory agent designated by the foreign corporation resides”).

This section is derived from Model Registered Agents Act (2006) (Last Amended 2013) § 15.

## **[PART] 5**

### **FOREIGN ENTITIES**

#### **SECTION 1-501. GOVERNING LAW.**

(a) The law of the jurisdiction of formation of an entity governs:

(1) the internal affairs of the entity;

(2) the liability that a person has as an interest holder or governor for a debt, obligation, or other liability of the entity; and

(3) the liability of a series of a limited liability company, statutory trust, or other unincorporated entity.

(b) A foreign entity is not precluded from registering to do business in this state because of any difference between the law of the entity's jurisdiction of formation and the law of this state.

(c) Registration of a foreign entity to do business in this state does not authorize the foreign entity to engage in any activities and affairs or exercise any power that a domestic entity of the same type may not engage in or exercise in this state.

### **Comment**

Subsection (a) provides that the laws of the jurisdiction of formation of a foreign entity, rather than the laws of this state, govern both the internal affairs of the entity and the liability of its interest holders and governors for the obligations of the entity.

The limited liability company and statutory trust entity statutes of several states authorized those entities to create series. According to those statutes, if series are properly created, a debt, obligation, or liability associated with the property of a particular series is enforceable only against property of that series, and not against the property of the limited liability company or statutory trust entity generally or any other series thereof. Subsection (a)(3) respects that type of internal shield, not just in limited liability companies and statutory trust entities but also in any other form of unincorporated entity that is authorized to create series. Subsection (a)(3) does not address, however, the myriad of other unsettled issues pertaining to series.

Subsections (b) and (c) together make clear that, although a foreign entity may not be denied registration simply because of a difference between the laws of its jurisdiction of formation and the laws of this state, the foreign entity may not engage in any activity or exercise any power in this state that a domestic entity of the same type may not engage in or exercise. Thus subsection (c) puts a registered foreign entity on the same, but no better, footing as a domestic entity.

### **SECTION 1-502. REGISTRATION TO DO BUSINESS IN THIS STATE.**

(a) A foreign filing entity or foreign limited liability partnership may not do business in

this state until it registers with the [Secretary of State] under this [article].

(b) A foreign filing entity or foreign limited liability partnership doing business in this state may not maintain an action or proceeding in this state unless it is registered to do business in this state.

(c) The failure of a foreign filing entity or foreign limited liability partnership to register to do business in this state does not impair the validity of a contract or act of the foreign filing entity or foreign limited liability partnership or preclude it from defending an action or proceeding in this state.

(d) A limitation on the liability of a series of a foreign unincorporated entity or an interest holder or governor of a foreign filing entity or of a partner of a foreign limited liability partnership is not waived solely because the foreign unincorporated entity or any series thereof, foreign filing entity or foreign limited liability partnership does business in this state without registering.

(e) Section 1-501(a) and (b) applies even if a foreign entity fails to register under this [article].

### **Comment**

The purpose of subsection (b) is to induce foreign entities to register without imposing harsh or erratic sanctions. Often the failure to register is a result of inadvertence or bona fide disagreement as to the scope of Section 1-505 which is necessarily imprecise; and the imposition of harsh sanctions in those situations is inappropriate.

The sanction in subsection (b) of closing the courts of the state to suits brought by foreign entities that should have registered is not a punitive one. Subsection (c) makes clear that the failure to register does not impair the validity of an entity's acts and subsection (d) preserves the effectiveness of any liability shields applicable under the entity's organic law. If an entity should have registered and failed to do so, it may still enforce its contracts simply by registering.

Subsection (b) does not prevent a foreign entity that has failed to register from "defending" an action or proceeding. The distinction between "maintaining" and "defending" an action or proceeding under subsection (b) is determined on the basis of whether affirmative relief

is sought. A nonregistered foreign entity may interpose any defense or permissive or mandatory counterclaim to defeat a claimed recovery, but may not obtain an affirmative judgment based on the counterclaim unless it has registered.

**SECTION 1-503. FOREIGN REGISTRATION STATEMENT.** To register to do business in this state, a foreign filing entity or foreign limited liability partnership must deliver a foreign registration statement to the [Secretary of State] for filing. The statement must be signed by the entity and state:

(1) the name of the foreign filing entity or foreign limited liability partnership and, if the name does not comply with Section 1-301, an alternate name adopted pursuant to Section 1-506(a);

(2) the type of entity and, if it is a foreign limited partnership, whether it is a foreign limited liability limited partnership;

(3) the entity's jurisdiction of formation;

(4) the street and mailing addresses of the entity's principal office and, if the law of the entity's jurisdiction of formation requires the entity to maintain an office in that jurisdiction, the street and mailing addresses of the office; and

(5) the information required by Section 1-404(a).

### **Comment**

The foreign registration statement provides certain basic information about the foreign entity to ensure that citizens of the state have access to that information in their dealings with the foreign entity. The statement also facilitates making the foreign entity subject to the jurisdiction of the courts of the state.

Once registered, a foreign entity must file an annual/biennial report under Section 1-213.

### **SECTION 1-504. AMENDMENT OF FOREIGN REGISTRATION STATEMENT.**

A registered foreign entity shall sign and deliver to the [Secretary of State] for filing an amendment to its foreign registration statement if there is a change in:

- (1) the name of the entity;
- (2) the type of entity, including, if it is a foreign limited partnership, whether the entity became or ceased to be a foreign limited liability limited partnership;
- (3) the entity's jurisdiction of formation;
- (4) an address required by Section 1-503(4); or
- (5) the information required by Section 1-404(a).

### **Comment**

This section works in tandem with the annual / biennial report required by Section 1-213 to keep the information of record in the office of the filing office about a registered foreign entity up to date.

### **SECTION 1-505. ACTIVITIES NOT CONSTITUTING DOING BUSINESS.**

(a) Activities of a foreign filing entity or foreign limited liability partnership which do not constitute doing business in this state under this [article] include:

- (1) maintaining, defending, mediating, arbitrating, or settling an action or proceeding;
- (2) carrying on any activity concerning its internal affairs, including holding meetings of its interest holders or governors;
- (3) maintaining accounts in financial institutions;
- (4) maintaining offices or agencies for the transfer, exchange, and registration of securities of the entity or maintaining trustees or depositories with respect to those securities;
- (5) selling through independent contractors;
- (6) soliciting or obtaining orders by any means if the orders require acceptance outside this state before they become contracts;
- (7) creating or acquiring indebtedness, mortgages, or security interests in



property;

(8) securing or collecting debts or enforcing mortgages or security interests in property securing the debts, and holding, protecting, or maintaining property so acquired;

(9) conducting an isolated transaction that is not in the course of similar transactions;

(10) owning, without more, property; and

(11) doing business in interstate commerce.

(b) A person does not do business in this state solely by being an interest holder or governor of a foreign entity that does business in this state.

(c) This section does not apply in determining the contacts or activities that may subject a foreign filing entity or foreign limited liability partnership to service of process, taxation, or regulation under law of this state other than this [Code].

### **Comment**

The Code does not attempt to formulate an inclusive definition of what constitutes doing business in a state. Rather, the concept is defined in a negative fashion by subsections (a) and (b), which state that certain activities do not constitute doing business. In general terms, any conduct more regular, systematic, or extensive than that described in subsection (a) constitutes doing business and requires the foreign entity to register to do business. Typical conduct requiring registration includes maintaining an office to conduct local intrastate business, selling personal property not in interstate commerce, entering into contracts relating to the local business or sales, and owning or using real estate for general purposes. But the passive owning of real estate for investment purposes does not constitute doing business. *See* subsection (a)(10).

The test of “doing business” defined in a negative way in subsections (a) and (b) applies only to the question whether the entity’s contacts with the state are such that it must register under this part. It is not applicable to other questions such as whether the entity is amenable to service of process under state “long-arm” statutes or liable for state or local taxes. An entity that has registered (or is required to register) will generally be subject to suit and state taxation in the state, while an entity that is subject to service of process or state taxation in a state will not necessarily be required to register.

The list of activities set forth in subsection (a) is not exhaustive.

## **1. Engaging in Litigation**

A foreign entity is not “doing business” solely because it resorts to the courts of the state to recover an indebtedness, enforce an obligation, recover possession of personal property, obtain the appointment of a receiver, intervene in a pending proceeding, bring a petition to compel arbitration, file an appeal bond, or pursue appellate remedies. Similarly, a foreign entity is not required to register merely because it files a complaint with a governmental agency or participates in an administrative proceeding within the state.

## **2. Internal Affairs**

A foreign entity does not “do business” within a state under this section merely because some of its internal affairs occur within a state. Thus, an entity may hold meetings of its governors or interest holders within a state without first registering. It also may maintain offices or agencies within a state relating solely to the transfer, exchange or registration of its interests without registering. Other activities relating to the internal affairs of the entity that do not constitute doing business under this section include having officers or representatives who reside within or are physically present in the state; while there, the officers or representatives may make executive decisions relating to the internal affairs of the entity without imposing on the entity the requirement that it register, if these activities are not so regular and systematic as to cause the residence to be viewed as a business office.

## **3. Sales through Independent Contractors**

Under subsection (a)(5), a foreign entity need not register if it sells goods in the state through independent contractors. These transactions are viewed as transactions by the independent contractors, not by the entity itself even though the entity sets some limits or ground rules for its contractors. If these controls are sufficiently pervasive, however, the entity may be deemed to be selling for itself in intrastate commerce, and not through the independent contractors and therefore engaged in doing business in the state.

## **4. Creating, Acquiring, or Collecting Debts**

The mere act of making a loan by a foreign entity that is not in the business of making loans does not constitute doing business in the state in which the loan is made. On the same theory a foreign entity may obtain security for the repayment of a loan, and foreclose or enforce the lien or security interest to collect the loan, without being deemed to be doing business. Similarly, a refunding or “roll over” of a loan or its adjustment or compromise does not involve doing business.

## **5. Isolated Transactions**

The concept of “doing business” involves regular, repeated, and continuing business contacts of a local nature. A single agreement or isolated transaction within a state does not constitute doing business if there is no intention to repeat the transaction or engage in similar transactions. The Code does not impose the limitation found in some statutes, such as Section

15.01(b)(10) of the Model Business Corporation Act, that the isolated transaction be completed within 30 days. A foreign entity should not be required to register simply because it engages in an isolated transaction that takes longer than 30 days to complete.

## **6. Interstate Transactions**

A foreign entity is not “doing business” within the meaning of this section if it is transacting business in interstate commerce (subsection (a)(11)) or soliciting or obtaining orders that must be accepted outside the state before they become contracts (subsection (a)(6)). These limitations reflect the provisions of the United States Constitution that grant to the United States Congress exclusive power over interstate commerce, and preclude states from imposing restrictions or conditions upon this commerce. These sections should be construed in a manner consistent with judicial decisions under the United States Constitution. Under these decisions, a foreign entity is not required to register even though it sells goods within the state if they are shipped to the purchasers in interstate commerce. An entity need not register even if it also does work and performs acts within the state incidental to the interstate business, *e.g.*, if it takes or enforces a security interest incidental to these transactions. Nor is it required to register merely because it sends traveling salesmen or solicitors into a state so long as contracts are not made within the state. Similarly, an office may be maintained by an entity in a state without registering if the office’s functions relate solely to interstate commerce.

Purchases of goods may of course be in interstate commerce as readily as sales. Thus, the purchase of personal property by a foreign entity for shipment in interstate commerce out of the state does not require the entity to register.

### **SECTION 1-506. NONCOMPLYING NAME OF FOREIGN ENTITY.**

(a) A foreign filing entity or foreign limited liability partnership whose name does not comply with Section 1-301 for an entity of its type may not register to do business in this state until it adopts, for the purpose of doing business in this state, an alternate name that complies with Section 1-301. A foreign entity that registers under an alternate name under this subsection need not comply with [this state’s assumed or fictitious name statute]. After registering to do business in this state with an alternate name, a foreign entity shall do business in this state under:

- (1) the alternate name;
- (2) the foreign entity’s name, with the addition of its jurisdiction of formation; or
- (3) a name the foreign entity is authorized to use under [this state’s assumed or fictitious name statute].

(b) If a registered foreign entity changes its name to one that does not comply with Section 1-301, it may not do business in this state until it complies with subsection (a) by amending its registration to adopt an alternate name that complies with Section 1-301.

### **Comment**

A foreign entity must register under its true name if that name satisfies the requirements of Section 1-301. If the true name is unavailable because it is not distinguishable upon the records of the filing office from a name already in use or reserved or registered, the entity may use an alternate name.

Because the alternate name under which a foreign entity registers will be part of the records of the filing office, subsection (a) provides that an assumed or fictitious name filing with respect to the alternate name is not required. However, the assumed or fictitious name statute will apply to any other name under which the foreign entity does business in the state.

A foreign entity that registers to do business in the state may do business under a fictitious name to the same extent as a domestic entity.

## **SECTION 1-507. WITHDRAWAL OF REGISTRATION OF REGISTERED FOREIGN ENTITY.**

(a) A registered foreign entity may withdraw its registration by delivering a statement of withdrawal to the [Secretary of State] for filing. The statement of withdrawal must be signed by the entity and state:

- (1) the name of the entity and its jurisdiction of formation;
- (2) that the entity is not doing business in this state and that it withdraws its registration to do business in this state;
- (3) that the entity revokes the authority of its registered agent to accept service on its behalf in this state; and
- (4) an address to which service of process may be made under subsection (b).

(b) After the withdrawal of the registration of an entity, service of process in any action or proceeding based on a cause of action arising during the time the entity was registered to do

business in this state may be made pursuant to Section 1-412.

#### **Comment**

The statement of withdrawal must set forth an address where service of process may be made on the entity pursuant to Section 1-412. There is no limit on how long the withdrawn entity must keep that address up to date.

### **SECTION 1-508. WITHDRAWAL DEEMED ON CONVERSION TO DOMESTIC FILING ENTITY OR DOMESTIC LIMITED LIABILITY PARTNERSHIP.**

A registered foreign entity that converts to any type of domestic filing entity or to a domestic limited liability partnership is deemed to have withdrawn its registration on the effective date of the conversion.

#### **Comment**

When a registered foreign entity has converted to a domestic filing entity or domestic limited liability partnership, information about the entity in its capacity as a domestic entity will continue to be of record in the filing office. At that point, there is no further reason for it to be registered and this section automatically treats its prior registration as withdrawn.

### **SECTION 1-509. WITHDRAWAL ON DISSOLUTION OR CONVERSION TO NONFILING ENTITY OTHER THAN LIMITED LIABILITY PARTNERSHIP.**

(a) A registered foreign entity that has dissolved and completed winding up or has converted to a domestic or foreign nonfiling entity other than a limited liability partnership shall deliver a statement of withdrawal to the [Secretary of State] for filing. The statement must be signed by the dissolved or converted entity and state:

(1) in the case of a foreign entity that has completed winding up:

(A) its name and jurisdiction of formation; and

(B) that the foreign entity surrenders its registration to do business in this

state; and

(2) in the case of a foreign entity that has converted to a domestic or foreign

nonfiling entity other than a limited liability partnership:

(A) the name of the converting foreign entity and its jurisdiction of formation;

(B) the type of nonfiling entity to which it has converted and its jurisdiction of formation;

(C) that it withdraws its registration to do business in this state and revokes the authority of its registered agent to accept service on its behalf; and

(D) a mailing address to which service of process may be made under subsection (b).

(b) After a withdrawal under this section is effective, service of process in any action or proceeding based on a cause of action arising during the time the foreign filing entity was registered to do business in this state may be made pursuant to Section 1-412.

### **Comment**

When a registered foreign entity has dissolved and completed winding up, or has converted to a nonfiling entity other than a limited liability partnership, there is no further reason for information about it to appear in the records of the filing office. This section thus requires delivery of a statement of withdrawal for the purpose of removing the entity from the rolls of active entities.

### **SECTION 1-510. TRANSFER OF REGISTRATION.**

(a) If a registered foreign entity merges into a nonregistered foreign entity or converts to a foreign entity required to register with the [Secretary of State] to do business in this state, the foreign entity shall deliver to the [Secretary of State] for filing an application for transfer of registration. The application must be signed by the surviving or converted entity and state:

(1) the name of the registered foreign entity before the merger or conversion;

(2) the type of entity it was before the merger or conversion;

(3) the name of the applicant entity and, if the name does not comply with Section 1-301, an alternate name adopted pursuant to Section 1-506(a);

(4) the type of entity of the applicant entity and its jurisdiction of formation; and

(5) the following information regarding the applicant entity, if different than the information for the foreign entity before the merger or conversion:

(A) the street and mailing addresses of the principal office of the entity and, if the law of the entity's jurisdiction of formation requires it to maintain an office in that jurisdiction, the street and mailing addresses of that office; and

(B) the information required pursuant to Section 1-404(a).

(b) When an application for transfer of registration takes effect, the registration of the registered foreign entity to do business in this state is transferred without interruption to the entity into which it has merged or to which it has been converted.

### **Comment**

The purpose of this section is to clarify the status of the registered foreign entity in the public records of the state. A filing under this section has the two-fold effect of canceling the authority of the foreign entity to do business in the state while at the same time reregistering it as the new type of foreign entity. If the reregistered foreign entity subsequently wishes to withdraw its registration to do business in the state, it may do so under Section 1-507.

### **SECTION 1-511. TERMINATION OF REGISTRATION.**

(a) The [Secretary of State] may terminate the registration of a registered foreign entity in the manner provided in subsections (b) and (c) if the entity does not:

(1) pay, not later than [60] days after the due date, any fee, tax, interest, or penalty required to be paid to the [Secretary of State] under this [Code ] or law of this state other than this [Code];

(2) deliver to the [Secretary of State] for filing, not later than [60] days after the

due date, [an annual] [a biennial] report;

(3) have a registered agent as required by Section 1-402; or

(4) deliver to the [Secretary of State] for filing a statement of change under Section 1-407 not later than [30] days after a change occurs in the name or address of the entity's registered agent.

(b) The [Secretary of State] may terminate the registration of a registered foreign entity by:

(1) filing a notice of termination or noting the termination in the records of the [Secretary of State]; and

(2) delivering a copy of the notice or the information in the notation to the entity's registered agent or, if the entity does not have a registered agent, to the entity's principal office.

(c) The notice must state or the information in the notation under subsection (b) must include:

(1) the effective date of the termination, which must be at least [60] days after the date the [Secretary of State] delivers the copy; and

(2) the grounds for termination under subsection (a).

(d) The registration of a registered foreign entity to do business in this state ceases on the effective date of the notice of termination or notation under subsection (b), unless before that date the entity cures each ground for termination stated in the notice or notation. If the entity cures each ground, the [Secretary of State] shall file a record so stating.

### **Comment**

This section is analogous to the procedures for administrative dissolution under Part 6.



**[SECTION 1-512. ACTION BY [ATTORNEY GENERAL].** The [Attorney General] may maintain an action to enjoin a foreign filing entity or foreign limited liability partnership from doing business in this state in violation of this [Code].]

**Comment**

The authority stated here has been part of corporate law for more than a century and has been carried over into the law of unincorporated business entities. Nowadays, the authority is rarely if ever invoked in either realm of entity law.

**[PART] 6**

**ADMINISTRATIVE DISSOLUTION**

**SECTION 1-601. GROUNDS.** The [Secretary of State] may commence a proceeding under Section 1-602 to dissolve a domestic filing entity administratively if the entity does not:

- (1) pay any fee, tax, interest, or penalty required to be paid to the [Secretary of State] not later than [six months] after it is due;
- (2) deliver [an annual] [a biennial] report to the [Secretary of State] not later than [six months] after it is due; or
- (3) have a registered agent in this state for [60] consecutive days.

**Comment**

Administrative dissolution permits the filing office to clear its records of “dead wood” and free up names.

Limited liability partnerships are not filing entities and thus this part does not apply to them. Similar provisions apply to limited liability partnerships under Sections 3-903 through 3-905.

**SECTION 1-602. PROCEDURE AND EFFECT.**

(a) If the [Secretary of State] determines that one or more grounds exist under Section 1-601 for administratively dissolving a domestic filing entity, the [Secretary of State] shall serve the entity pursuant to Section 1-212 with notice in a record of the [Secretary of State’s]

determination.

(b) If a domestic filing entity, not later than [60] days after service of the notice required by subsection (a), does not cure or demonstrate to the satisfaction of the [Secretary of State] the nonexistence of each ground determined by the [Secretary of State], the [Secretary of State] shall administratively dissolve the entity by signing a statement of administrative dissolution that recites the grounds for dissolution and the effective date of dissolution. The [Secretary of State] shall file the statement and serve a copy on the entity pursuant to Section 1-212.

(c) A domestic filing entity that is dissolved administratively continues its existence as the same type of entity but may not carry on any activities except as necessary to wind up its activities and affairs and liquidate its assets in the manner provided in its organic law or to apply for reinstatement under Section 1-603.

(d) The administrative dissolution of a domestic filing entity does not terminate the authority of its registered agent.

### **Comment**

Many failures to comply with statutory requirements that may give rise to administrative dissolution occur because of oversight or inadvertence and are usually corrected promptly when brought to the entity's attention. Subsections (a) and (b) therefore provide a mandatory notice by the filing office to each entity subject to administrative dissolution and a 60-day grace period following the notice before the statement of administrative dissolution may be filed.

In most instances, the issue whether the entity is subject to administrative dissolution will not be controverted. If an entity is administratively dissolved, it may petition the filing office for reinstatement under Section 1-603 and, if this is denied, it may appeal to the courts under Section 1-604.

### **SECTION 1-603. REINSTATEMENT.**

(a) A domestic filing entity that is dissolved administratively under Section 1-602 may apply to the [Secretary of State] for reinstatement [not later than [two] years after the effective

date of dissolution]. The application must be signed by the entity and state:

(1) the name of the entity at the time of its administrative dissolution and, if needed, a different name that satisfies Section 1-301;

(2) the address of the principal office of the entity and the name and address of its registered agent;

(3) the effective date of the entity's administrative dissolution; and

(4) that the grounds for dissolution did not exist or have been cured.

(b) To be reinstated, an entity must pay all fees, taxes, interest, and penalties that were due to the [Secretary of State] at the time of the entity's administrative dissolution and all fees, taxes, interest, and penalties that would have been due to the [Secretary of State] while the entity was dissolved administratively.

(c) If the [Secretary of State] determines that an application under subsection (a) contains the required information, is satisfied that the information is correct, and determines that all payments required to be made to the [Secretary of State] by subsection (b) have been made, the [Secretary of State] shall:

(1) cancel the statement of administrative dissolution and prepare a statement of reinstatement that states the [Secretary of State's] determination and the effective date of reinstatement;

(2) file the statement of reinstatement; and

(3) serve a copy on the entity.

(d) When reinstatement under this section is effective, the following rules apply:

(1) The reinstatement relates back to and takes effect as of the effective date of the administrative dissolution.

(2) The domestic filing entity resumes carrying on its activities and affairs as if the administrative dissolution had never occurred.

(3) The rights of a person arising out of an act or omission in reliance on the dissolution before the person knew or had notice of the reinstatement are not affected.

### **Comment**

Some states require that reinstatement be sought within two years of administrative dissolution. Other states provide a longer time, or do not impose any time limit. The concern with not imposing any time limit is that the process of reinstatement may be abused by unscrupulous people seeking to reinstate a dormant entity that has been abandoned by its original interest holders and that they wish to appropriate for improper ends. On the other hand, the concern with imposing a time limit is that if those in charge of an entity have neglected to file an annual report or otherwise subjected the entity to administrative dissolution, they may also not realize that the two year period is running against them and thus do not learn of the administrative dissolution until after it is too late to correct.

Subsection (a) will apply if, before an entity is reinstated, another entity has taken the name of the entity seeking reinstatement.

### **SECTION 1-604. JUDICIAL REVIEW OF DENIAL OF REINSTATEMENT.**

(a) If the [Secretary of State] denies a domestic filing entity's application for reinstatement following administrative dissolution, the [Secretary of State] shall serve the entity with a notice in a record that explains the reasons for denial.

(b) An entity may seek judicial review of denial of reinstatement in [the appropriate court] not later than [30 days] after service of the notice of denial.

### **Comment**

Because the grounds for administrative dissolution under Section 1-601 are limited and straight-forward, it is unlikely there will be a dispute about whether an entity has corrected the reasons for its administrative dissolution. But in the event a dissolved entity disagrees with a determination by the filing office to deny the entity's application for reinstatement, this section gives the entity a limited right to seek judicial review of the denial of reinstatement.

## **[PART] 7**

### **MISCELLANEOUS PROVISIONS**

**SECTION 1-701. RESERVATION OF POWER TO AMEND OR REPEAL.** The [legislature of this state] has power to amend or repeal all or part of this [Code] at any time, and all domestic and foreign entities subject to this [Code] are governed by the amendment or repeal.

#### **Comment**

Provisions similar to this section have their genesis in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 518 (1819), which held that the United States Constitution prohibited the application of newly enacted statutes to existing corporations while suggesting the efficacy of a reservation of power similar to this section. This section is a generalized form of the type of provision found in many entity organic laws, the purpose of which is to avoid any possible argument that an entity has contractual or vested rights in any specific statutory provision of its organic law and to ensure that the state may in the future modify its entity statutes as it deems appropriate and require existing entities to comply with the statutes as modified.

All public organic documents of domestic entities organized under the Code and the registration of foreign entities under Part 5 of Article 1 of the Code are subject to the reservation of power set forth in this section. Further, entities formed or registered under earlier statutes superseded by the Code that contained a reservation of power are also subject to the reservation of power in this section and bound by subsequent amendments to the Code.

**SECTION 1-702. SUPPLEMENTAL PRINCIPLES OF LAW.** Unless displaced by particular provisions of this [Code], the principles of law and equity supplement this [Code].

#### **Comment**

The supplemental principles of law encompass not only the law of agency, contracts, and estoppel and the law merchant, but all of the other principles listed in UCC § 1-103(b): the law relative to capacity to contract, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other common law validating or invalidating causes, such as unconscionability.

**SECTION 1-703. UNIFORMITY OR CONSISTENCY OF APPLICATION AND CONSTRUCTION.** In applying and construing the [articles] of this [Code] based on uniform or model acts, consideration must be given to the need to promote uniformity or consistency of the law with respect to its subject matter among states that enact it.

## Comment

This section differs from the usual provision in uniform acts because of the inclusion of the concept of “consistency” – in addition to “uniformity” – of application. In a state that enacts the full Code, it will include articles based on the Model Entity Transactions Act (2007) (Last Amended 2013), Model Business Corporation Act, and Model Nonprofit Corporation Act, which are not uniform acts. The same basic principle of interpretation should apply to those acts as found in the Code.

**SECTION 1-704. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT.** This [Code] modifies, limits, and supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

## Comment

This section responds to specific language of the Electronic Signatures in Global and National Commerce Act and is designed to avoid preemption of state law under that federal legislation.

**SECTION 1-705. SAVINGS CLAUSE.** The repeal of a statute by this [Code] does not affect:

- (1) the operation of the statute or an action taken under it before its repeal;
- (2) a ratification, right, remedy, privilege, obligation, or liability acquired, accrued, or incurred under the statute before its repeal;
- (3) a violation of the statute or any penalty, forfeiture, or punishment incurred because of the violation before its repeal; or
- (4) an action commenced or proceeding brought before [the effective date of this [Code]].

**Legislative Note:** *If a provision of Part 3 regarding names represents a substantive change in the state’s law, for example, by imposing a new limitation on the name that may be used by a type of entity, the text of Section 1-705 may be designated subsection (a) and a new provision*

*added reading as follows:*

*“(b) An entity formed under a statute repealed by this [Code] which was lawfully using a name or, as part of its name, a word that could not be used as or included in the name of an entity formed under this [Code] may continue to use the name or word as part of its name if the use or inclusion of the word or name was lawful when first adopted by the entity in this state.”*

### **Comment**

This section continues the prior laws replaced by the Code after the effective date of the Code with respect to rights accrued and proceedings. But for this section the new law of the Code would displace the old laws in some circumstances. The power of a new act to displace the old statute with respect to conduct occurring before the new act’s enactment is substantial. Millard H. Ruud, *The Savings Clause – Some Problems in Construction and Drafting*, 33 Tex. L. Rev. 285, 286-293 (1955). A court generally applies the law that exists at the time it acts.

**[SECTION 1-706. SEVERABILITY CLAUSE.** If any provision of this [Code] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Code] which can be given effect without the invalid provision or application, and to this end the provisions of this [Code] are severable.]

***Legislative Note:*** *Include this section only if this state lacks a general severability statute or decision by the highest court of this state stating a general rule of severability.*

**SECTION 1-707. REPEALS.** The following acts and parts of acts are repealed:

- (1)
- (2)
- (3) .

**SECTION 1-708. EFFECTIVE DATE.** This [Code] takes effect . . .

### **Comment**

Sections 3-110, 4-112, 5-110, and 8-108 contain transition provisions for the applicability of the Code to general partnerships, limited partnerships, limited liability companies, and statutory trusts formed before the effective date of the Code.

**ARTICLE 2**  
**ENTITY TRANSACTIONS**

**[PART] 1**

**GENERAL PROVISIONS**

**SECTION 2-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Entity Transactions.

**Comment**

Except as provided in Section 2-110, this article replaces the state’s current statutes governing merger, interest exchange, conversion, and domestication transactions.

**SECTION 2-102. DEFINITIONS.**

(a) In this [article]:

(1) “Acquired entity” means the entity, all of one or more classes or series of interests of which are acquired in an interest exchange.

(2) “Acquiring entity” means the entity that acquires all of one or more classes or series of interests of the acquired entity in an interest exchange.

(3) “Approve” means, in the case of an entity, for its governors and interest holders to take whatever steps are necessary under the entity’s organic rules, organic law, and other law to:

(A) propose a transaction subject to this [article];

(B) adopt and approve the terms and conditions of the transaction; and

(C) conduct any required proceedings or otherwise obtain any required votes or consents of the governors or interest holders.

(4) “Conversion” means a transaction authorized by [Part] 4.

(5) “Converted entity” means the converting entity as it continues in existence



after a conversion.

(6) “Converting entity” means the domestic entity that approves a plan of conversion pursuant to Section 2-403 or the foreign entity that approves a conversion pursuant to the law of its jurisdiction of formation.

(7) “Domesticated entity” means the domesticating entity as it continues in existence after a domestication.

(8) “Domesticating entity” means the domestic entity that approves a plan of domestication pursuant to Section 2-503 or the foreign entity that approves a domestication pursuant to the law of its jurisdiction of formation.

(9) “Domestication” means a transaction authorized by [Part] 5.

(10) “Interest exchange” means a transaction authorized by [Part] 3.

(11) “Interest holder liability” means:

(A) personal liability for a liability of an entity which is imposed on a person:

(i) solely by reason of the status of the person as an interest holder;

or

(ii) by the organic rules of the entity which make one or more specified interest holders or categories of interest holders liable in their capacity as interest holders for all or specified liabilities of the entity; or

(B) an obligation of an interest holder under the organic rules of an entity to contribute to the entity.

(12) “Merger” means a transaction in which two or more merging entities are combined into a surviving entity pursuant to a record filed by the [Secretary of State].

(13) “Merging entity” means an entity that is a party to a merger and exists immediately before the merger becomes effective.

(14) “Plan” means a plan of merger, plan of interest exchange, plan of conversion, or plan of domestication.

(15) “Plan of conversion” means a plan under Section 2-402.

(16) “Plan of domestication” means a plan under Section 2-502.

(17) “Plan of interest exchange” means a plan under Section 2-302.

(18) “Plan of merger” means a plan under Section 2-202.

(19) “Protected agreement” means:

(A) a record evidencing indebtedness and any related agreement in effect on [the effective date of this [article]];

(B) an agreement that is binding on an entity on [the effective date of this [article]];

(C) the organic rules of an entity in effect on [the effective date of this [article]]; or

(D) an agreement that is binding on any of the governors or interest holders of an entity on [the effective date of this [article]].

(20) “Statement of conversion” means a statement under Section 2-405.

(21) “Statement of domestication” means a statement under Section 2-505.

(22) “Statement of interest exchange” means a statement under Section 2-305.

(23) “Statement of merger” means a statement under Section 2-205.

(24) “Surviving entity” means the entity that continues in existence after or is created by a merger under [Part] 2.

(b) The following definitions outside this [article] apply to this [article]:

- (1) “Distributional interest” – Section 1-102(7).
- (2) “Domestic” – Section 1-102(8).
- (3) “Entity” – Section 1-102(10).
- (4) “Filing entity” – Section 1-102(13).
- (5) “Foreign” – Section 1-102(14).
- (6) “Governance interest” – Section 1-102(17).
- (7) “Governor” – Section 1-102(18).
- (8) “Interest” – Section 1-102(19).
- (9) “Interest Holder” – Section 1-102(20).
- (10) “Jurisdiction” – Section 1-102(21).
- (11) “Jurisdiction of formation” – Section 1-102(22).
- (12) “Organic law” – Section 1-102(32).
- (13) “Organic rules” – Section 1-102(33).
- (14) “Person” – Section 1-102(34).
- (15) “Private organic rules” – Section 1-102(36).
- (16) “Property” – Section 1-102(38).
- (17) “Public organic record” – Section 1-102(39).
- (18) “Receipt” – Section 1-102(40).
- (19) “Record” – Section 1-102(41).
- (20) “Registered foreign entity” – Section 1-102(43).
- (21) “Sign” – Section 1-102(44).
- (22) “State” – Section 1-102(45).

(23) “Transfer” – Section 1-102(47).

(24) “Type of entity” – Section 1-102(48).

### **Comment**

Subsection (a) defines certain terms that are used in this article. Other defined terms used in this articles are listed in subsection (b).

**“Acquired entity” [(a)(1)]** – This definition recognizes that an interest exchange may involve only the acquisition of a particular “class” or “series” of interests in an entity. Model Business Corporation Act § 6.01 does not expressly define “class” or “series.” Because the interests of members in an unincorporated business organization often tend to be distinctive, it may be that each member’s interest will comprise a separate class or series. For an explanation of a new and different meaning of the word “series,” see the comment to Section 2-301(a). The term “acquired entity” does not encompass series under that new meaning.

**“Acquiring entity” [(a)(2)]** – An “acquiring entity” is an entity that acquires the interests of the acquired entity in an interest exchange governed by Part 3.

**“Approve” [(a)(3)]** – The term “approve” encompasses all of the steps necessary for an entity to propose a transaction, adopt and approve the terms and conditions of the transaction, and obtain the necessary action on the transaction by the governors and interest holders of the entity. The term includes procedural requirements such as notice to interest holders, preparation of voting lists, etc. The principal laws that will govern approval by an entity of a transaction under this article are the entity’s organic law and this article, but regulatory laws may also apply.

**“Conversion” [(a)(4)]** – The term “conversion” means a transaction authorized by Part 4 pursuant to which an entity of one type is converted into an entity of another type. As used in this article, the term “conversion” does not include a transaction in which an entity changes the jurisdiction in which it is organized but does not change to a different form of entity; that type of transaction is referred to in this article as a “domestication” and is governed by Part 5.

**“Converted entity” [(a)(5)]** – This term is used in Part 4 to refer to the entity that results from a conversion.

**“Converting entity” [(a)(6)]** – A converting entity is the entity that becomes the converted entity under Part 4.

**“Domesticated entity” [(a)(7)]** – This term is used in Part 5 and means the entity that is domesticated pursuant to Part 5. By the nature of the transaction, the domesticated entity will be of the same type as the domesticating entity.

**“Domesticating entity” [(a)(8)]** – This term is used in Part 5 and means the entity that is domesticated pursuant to Part 5.

**“Domestication” [(a)(9)]** – The term “domestication” means a transaction of the kind

authorized by Part 5 pursuant to which an entity may change its *jurisdiction* of formation *but not its type* so long as the laws of the foreign jurisdiction permit the domestication. The legal effect of the domestication of an entity out of an adopting state will be governed by the laws of both the adopting state and the foreign jurisdiction. Some statutes include what is described in this article as “domestication” in their definition of a “conversion.” *See, e.g.*, Colo. Rev. Stat § 7-90-201(2) and (3). It is intended that the domestication provisions of this article will apply to a transaction that may be characterized under another act as a “conversion” if it meets the definition of “domestication” under this article.

**“Interest exchange” [(a)(10)]** – The term “interest exchange” means a transaction authorized by Part 3 pursuant to which an entity may acquire interests in another entity. The consideration that may be provided to the interest holders whose interests are being acquired in an exchange may consist in whole or part of interests in a third party that is not one of the two parties to the exchange itself. *See* Section 2-301(a).

**“Interest holder liability” [(a)(11)]** – This term is used to describe the vicarious liability of an interest holder, by virtue of being an interest holder, for liabilities of the entity. The term includes only personal liability of an interest holder for a debt of the entity imposed on the interest holder either by statute or by the organic rules to the extent authorized pursuant to the organic law. Liabilities that an interest holder incurs in any other fashion are not interest holder liabilities for purposes of this article. Thus, for example, if a state’s business corporation law makes shareholders personally liable for unpaid wages because of their status as shareholders, that liability would be an “interest holder liability.” If, on the other hand, a shareholder were to guarantee payment of an obligation of a corporation, that liability would not be an “interest holder liability” because it is a direct liability and not based on the status of being a shareholder. Similarly, the liability to return an improper distribution is not an interest holder liability because it is a direct liability of the interest holder based on receipt of the distribution.

**“Merger” [(a)(12)]** – The term means a transaction in which two or more entities are combined into a single entity pursuant to a filing with the filing office. The term “merger” in this article includes the transaction known as a consolidation in which a new entity results from the combination of two or more pre-existing entities.

**“Merging entity” [(a)(13)]** – The term “merging entity” refers to each entity that is in existence immediately before a merger and is a party to the merger. It will include the surviving entity if the surviving entity exists before the merger becomes effective. It does not include an entity that provides consideration to be received by interest holders if that entity is not a party to the merger.

**“Plan” [(a)(14)]** – The term “plan” is a short-hand way of referring to the plan of merger, interest exchange, conversion, or domestication, as the case may be, depending on which form of transaction is taking place. *See* Sections 2-202 (plan of merger), 2-302 (plan of interest exchange), 2-402 (plan of conversion), and 2-502 (plan of domestication).

**“Protected agreement” [(a)(19)]** – The term “protected agreement” refers to evidences of indebtedness and agreements binding on the entity or any of its governors or interest holders

that are unpaid or executory in whole or in part on the effective date of this article. Thus a revolving line of credit from a bank to a corporation would constitute a protected agreement even if advances were not made until after the effective date of this article. If a protected agreement has provisions that apply if an entity merges, those provisions will apply if the entity enters into an interest exchange, conversion, or domestication even though the agreement does not mention those other types of transactions. *See* Sections 2-301(d) (interest exchanges), 2-401(c) (conversions), and 2-501(d) (domestications).

**“Surviving entity” [(a)(24)]** – The term “surviving entity” refers to either a merging entity that survives the merger or the new entity created by the merger.

### **SECTION 2-103. RELATIONSHIP OF [ARTICLE] TO OTHER LAWS.**

(a) This [article] does not authorize an act prohibited by, and does not affect the application or requirements of, law other than this [article].

(b) A transaction effected under this [article] may not create or impair a right, duty, or obligation of a person under the statutory law of this state relating to a change in control, takeover, business combination, control-share acquisition, or similar transaction involving a domestic merging, acquired, converting, or domesticating business corporation unless:

(1) if the corporation does not survive the transaction, the transaction satisfies any requirements of the law; or

(2) if the corporation survives the transaction, the approval of the plan is by a vote of the shareholders or directors which would be sufficient to create or impair the right, duty, or obligation directly under the law.

### **Comment**

This section works in concert with Section 1-702 (supplemental principles of law).

**Subsection (a)** – Subsection (a) preserves existing regulatory law in an enacting state in general terms. Enacting states should consider more carefully integrating this article with their various regulatory laws. For example, in some states certain professions are limited in their use of limited liability entities. *See also* Section 2-104.

Laws other than this article that will apply to transactions under this article include, for example, the various uniform fraudulent transfer and fraudulent conveyance acts; state

insolvency statutes; federal bankruptcy law; and Articles 8 and 9 of the UCC.

**Subsection (b)** – Many states have enacted “antitakeover” statutes intended to make it more difficult to acquire control of a publicly-traded corporation. Those statutes often provide that their application to a particular corporation cannot be changed unless the corporation obtains certain specified approvals, such as a vote of disinterested directors or a supermajority vote by the shareholders. The purpose of the special requirements in subsection (b) on varying the application of an antitakeover statute is to protect against a hostile acquirer or group of shareholders seeking to use this article to avoid the application of the antitakeover statute.

Subsection (b) protects the application of antitakeover statutes from being affected by a transaction under this article by requiring that the transaction be approved in a manner that would be sufficient to approve changing the application of the antitakeover statute. If a transaction is approved in that manner, there is no policy reason to prohibit the application of the antitakeover statute from being varied by a transaction under this article. If the application of an antitakeover statute cannot be varied by action of an entity subject to it, then a transaction under this article will be permissible only if the antitakeover provision continues to apply after the transaction or the transaction itself is permissible under the antitakeover statute.

#### **SECTION 2-104. REQUIRED NOTICE OR APPROVAL.**

(a) A domestic or foreign entity that is required to give notice to, or obtain the approval of, a governmental agency or officer of this state to be a party to a merger must give the notice or obtain the approval to be a party to an interest exchange, conversion, or domestication.

(b) Property held for a charitable purpose under the law of this state by a domestic or foreign entity immediately before a transaction under this [article] becomes effective may not, as a result of the transaction, be diverted from the objects for which it was donated, granted, devised, or otherwise transferred unless, to the extent required by or pursuant to the law of this state concerning cy pres or other law dealing with nondiversion of charitable assets, the entity obtains an appropriate order of [the appropriate court] [the Attorney General] specifying the disposition of the property.

(c) A bequest, devise, gift, grant, or promise contained in a will or other instrument of donation, subscription, or conveyance which is made to a merging entity that is not the surviving entity; and which takes effect or remains payable after the merger inures to the surviving entity.

(d) A trust obligation that would govern property if transferred to a nonsurviving entity applies to property that is transferred to the surviving entity under this section.

**Legislative Note:** *As an alternative to enacting subsection (a), a state may identify each of its regulatory laws that requires prior approval for a merger of a regulated entity, decide whether regulatory approval should be required for an interest exchange, conversion, or domestication, and make amendments as appropriate to those laws.*

*As with subsection (a), an adopting state may choose to amend its various laws with respect to the nondiversion of charitable property to cover the various transactions authorized by this article as an alternative to enacting subsection (b).*

### Comment

**Subsection (a)** – Because at least some of the provisions of this article will be new in most states, it is likely that existing state laws that require regulatory approval of transactions by businesses such as banks, insurance companies, or public utilities may not be worded in a fashion that will include at least some of the transactions authorized by this article. The purpose of subsection (a) is to ensure that transactions under this article will be subject to the same regulatory approval as mergers. This section is based on whether a merger by a regulated entity requires prior approval because the transactions authorized by this article may be effectuated indirectly in many cases under existing law by establishing a wholly-owned subsidiary of the desired type and then merging into it.

The consequence of violating subsection (a) should be the same as in the case of a merger consummated without the required approval.

**Subsection (b)** – This article applies generally to nonprofit corporations and unincorporated nonprofit associations. As in the case of laws regulating particular industries, a state's laws governing the nondiversion of charitable property to other uses may not cover some of the transactions authorized by this article. To prevent the procedures in this article from being used to avoid restrictions on the use of charitable property held by nonprofit entities, subsection (b) requires approval of the effect of transactions under this article by the appropriate arm of government having supervision of nonprofit entities.

An approval or order obtained under this section may impose conditions or specify the disposition of assets or liabilities in a manner different than would otherwise be the case. In such an instance, the approval or order will control over the provisions of this article specifying the effects of a transaction. *See* Sections 2-206 (effect of merger), 2-306 (effect of interest exchange), 2-406 (effect of conversion), and 2-506 (effect of domestication).

**Subsections (c) and (d)** – These subsections clarify the legal effect of a merger on bequests, etc. that were originally made to an entity that does not survive the merger. These issues do not arise in an interest exchange, conversion, or domestication transaction because the entity to which the bequest, etc. was made survives in some form after the transaction.



**SECTION 2-105. STATUS OF FILINGS.** A filing under this [article] signed by a domestic entity becomes part of the public organic record of the entity if the entity’s organic law provides that similar filings under that law become part of the public organic record of the entity.

**Comment**

Articles of merger and other similar documents filed under the Model Business Corporation Act are made a part of the articles of incorporation of each domestic business corporation that is a party to the merger by Section 1.40(1) of the Model Business Corporation Act. This section provides that filings under this article will similarly become part of the public organic document of a domestic corporation. It should be noted that some state statutes no longer require filed documents to be “signed” in order to facilitate electronic filing. *See, e.g.,* Colorado Rev. Stat. § 7-90-301 *et seq.* In such cases, this section should be modified to delete the reference to “signed” and merely refer to being filed (or accepted for filing).

**SECTION 2-106. NONEXCLUSIVITY.** The fact that a transaction under this [article] produces a certain result does not preclude the same result from being accomplished in any other manner permitted by law other than this [article].

**Comment**

This section allows a transaction that has the same end result as one of the transactions governed by this article, but that is accomplished in a manner not within the scope of this article, to be exempt from this article. For example, a sale of assets and transfer of liabilities by two entities to a third entity followed by the liquidation of the two transferring entities can be accomplished pursuant to sale of assets statutory provisions rather than under Part 2 of this article, even though the end result of the transaction is essentially the same as if the two entities had merged into a third entity.

**SECTION 2-107. REFERENCE TO EXTERNAL FACTS.** A plan may refer to facts ascertainable outside the plan if the manner in which the facts will operate upon the plan is specified in the plan. The facts may include the occurrence of an event or a determination or action by a person, whether or not the event, determination, or action is within the control of a party to the transaction.

**Comment**

This section is based on, but more concise than, Section 1.20(k) of the Model Business

Corporation Act.

**SECTION 2-108. ALTERNATIVE MEANS OF APPROVAL OF TRANSACTIONS.** Except as otherwise provided in the organic law or organic rules of a domestic entity, approval of a transaction under this [article] by the affirmative vote or consent of all its interest holders satisfies the requirements of this [article] for approval of the transaction.

**Comment**

This section makes it clear that a unanimous vote by the interest holders of an entity constitutes the only approval needed of a transaction under this article. That is consistent with the default rules on approval in Sections 2-203 (approval of a merger), 2-303 (approval of an interest exchange), 2-403 (approval of a conversion), and 2-503 (approval of a domestication).

**SECTION 2-109. APPRAISAL RIGHTS.**

(a) An interest holder of a domestic merging, acquired, converting, or domesticating entity is entitled to appraisal rights in connection with the transaction if the interest holder would have been entitled to appraisal rights under the entity's organic law in connection with a merger in which the interest of the interest holder was changed, converted, or exchanged unless:

(1) the organic law permits the organic rules to limit or eliminate the availability of appraisal rights; and

(2) the organic rules provide such a limit or elimination.

(b) An interest holder of a domestic merging, acquired, converting, or domesticating entity is entitled to contractual appraisal rights in connection with a transaction under this [article] to the extent provided in:

(1) the entity's organic rules;

(2) the plan; or

(3) in the case of a business corporation, by action of its governors.

(c) If an interest holder is entitled to contractual appraisal rights under subsection (b) and

the entity's organic law does not provide procedures for the conduct of an appraisal rights proceeding, [Chapter 13 of the Model Business Corporation Act] applies to the extent practicable or as otherwise provided in the entity's organic rules or the plan.

**Legislative Note:** *Subsection (a) preserves appraisal rights (sometimes referred to as “dissenters’ rights”) granted by other laws. As an alternative to enacting subsection (a), a state may amend the appraisal rights provisions of its organic laws to specify which transactions under this article will give rise to appraisal rights. If that alternative approach is adopted, subsections (b) and (c) should be designated as subsections (a) and (b).*

### Comment

In this section, the term “appraisal rights” is intended to refer to any provision in the entity's organic law providing for the buy-out of an interest holder that objects to a transaction under this article.

**Subsection (a)** – If an entity's organic law permits the organic rules to limit the availability of appraisal rights, such a provision of the organic rules will apply to the availability of appraisal rights under this section. This section, however, does not authorize the organic rules to limit the availability of appraisal rights in a transaction under this article if the entity's organic law does not authorize such a provision of the organic rules.

Section 13.02(a)(1)(i) of the Model Business Corporation Act does not provide for appraisal rights in connection with a merger for shares that remain outstanding after consummation of the merger. Appraisal rights will similarly not be available under Section 2-109(a) for shares that are not changed or converted in connection with a merger.

**Subsection (b) and (c)** – This article permits a plan to set forth the terms and conditions of a transaction. A domestic entity may thus choose to grant optional appraisal rights as part of the terms of a transaction in circumstances where appraisal rights would not be available under this section. Subsection (b) validates the grant of such contractual appraisal rights. *Cf.* 6 Del. Code §§ 15-120 (general partnerships), 17-212 (limited partnerships), and 18-210 (limited liability companies) which validate “contractual appraisal rights”; and Model Business Corporation Act § 13.02(a)(5) which permits the articles of incorporation, bylaws, or a resolution of the board of directors to confer appraisal rights in contexts in which they would otherwise not be available. Legislative authorization in subsection (b) of the grant of contractual appraisal rights removes any question as to whether a court would have jurisdiction to hear a case in which the parties were attempting to create jurisdiction in the court by private agreement. The procedures to be followed in a contractual appraisal rights proceeding under subsection (b) will be the appraisal rights procedures in the entity's organic law if that law provides such procedures. If the entity's organic law does not provide procedures for conducting an appraisal rights proceeding, subsection (c) makes the appraisal rights procedures in the state's business corporation law applicable unless the entity's organic rules or the plan provide otherwise.

**[SECTION 2-110. EXCLUDED ENTITIES AND TRANSACTIONS.**

(a) The following entities may not participate in a transaction under this [article]:

(1)

(2).

(b) This [article] may not be used to effect a transaction that:

(1)

(2).]

***Legislative Note:** Subsection (a) may be used by states that have special statutes restricted to the organization of certain types of entities. A common example is banking statutes that prohibit banks from engaging in transactions other than pursuant to those statutes.*

*Nonprofit entities may participate in transactions under this article with for-profit entities, subject to compliance with Section 2-104. If a state desires, however, to exclude entities with a charitable purpose or to exclude other types of entities from the scope of this article, that may be done by referring to those entities in subsection (a).*

*Subsection (b) may be used to exclude certain types of transactions governed by more specific statutes. A common example is the conversion of an insurance company from mutual to stock form. There may be other types of transactions that vary greatly among the states.*

**SECTION 2-111. SUBJECTS COVERED OUTSIDE THIS ARTICLE.** The

following subjects are covered in whole or in part outside this [article]:

(1) Delivery of record – Section 1-104.

(2) Filing with [Secretary of State] – Part 2 of Article 1.

(3) Name of entity – Part 3 of Article 1.

(4) Registered agent of entity – Part 4 of Article 1.

(5) Miscellaneous provisions, including reservation or power to amend or repeal and supplemental principles of law – Part 7 of Article 1.

**Comment**

This section lists the other principal parts of the Code that are applicable to Article 2

transactions.

## **[PART] 2**

### **MERGER**

#### **SECTION 2-201. MERGER AUTHORIZED.**

(a) Except as otherwise provided in this section, by complying with this [part]:

(1) one or more domestic entities may merge with one or more domestic or foreign entities into a domestic or foreign surviving entity; and

(2) two or more foreign entities may merge into a domestic entity.

(b) Except as otherwise provided in this section, by complying with the provisions of this [part] applicable to foreign entities, a foreign entity may be a party to a merger under this [part] or may be the surviving entity in such a merger if the merger is authorized by the law of the foreign entity's jurisdiction of formation.

(c) This [part] does not apply to a transaction under:

(1) [Chapter 11 of the Model Business Corporation Act];

(2) [Chapter 11 of the Model Nonprofit Corporation Act]; or

(3) [Cite provisions of any other organic law that has merger provisions for entities of the same type].

**Legislative Note:** *Subsection (c) as drafted assumes that none of the state's unincorporated entity laws has a provision for same species mergers (e.g., a merger of one partnership with another partnership). If any of the state's unincorporated entity laws authorizes same species mergers and those provisions are not repealed when the Code is enacted, those laws should be added to the list in subsection (c). Chapter 11 of the Model Business Corporation Act and Chapter 11 of the Model Nonprofit Corporation Act are listed in subsection (c) because those acts contain provisions for same species mergers.*

#### **Comment**

The merger transaction authorized by this part involves the combination of one or more domestic entities with or into one or more other domestic or foreign entities. It also

contemplates the consolidation of two or more foreign entities into a single domestic surviving entity. Upon the effective date of the merger, all the assets and liabilities of the constituent entities vest in the surviving entity as a matter of law. As such, mergers require the existence of at least two separate entities before the transaction and only one entity may survive the merger. If independent existence of the constituent entities is desired following the conclusion of the transaction, a restructuring transaction other than a merger must be used to accomplish the transfer of assets and liabilities.

**Subsection (a)** – Subsection (a)(1) states the general rule that subject to subsection (c) one or more domestic entities may merge with or into a domestic or foreign surviving entity. Subsection (a)(2) provides that two or more foreign entities may merge into a domestic surviving entity so long as the requirements of subsection (b) are met.

**Subsection (b)** – Subsection (b) provides that a foreign entity may be a party to a merger or may be the surviving entity in a merger only if the merger is authorized by the laws of the foreign entity's jurisdiction of formation.

**Tax Considerations** – This article authorizes a merger for state entity law purposes. Federal law and other state law will independently determine how a merger transaction will be taxed.

## **SECTION 2-202. PLAN OF MERGER.**

(a) A domestic entity may become a party to a merger under this [part] by approving a plan of merger. The plan must be in a record and contain:

(1) as to each merging entity, its name, jurisdiction of formation, and type of entity;

(2) if the surviving entity is to be created in the merger, a statement to that effect and the entity's name, jurisdiction of formation, and type of entity;

(3) the manner of converting the interests in each party to the merger into interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing;

(4) if the surviving entity exists before the merger, any proposed amendments to:

(A) its public organic record, if any; and

(B) its private organic rules that are, or are proposed to be, in a record;

(5) if the surviving entity is to be created in the merger:

(A) its proposed public organic record, if any; and

(B) the full text of its private organic rules that are proposed to be in a record;

(6) the other terms and conditions of the merger; and

(7) any other provision required by the law of a merging entity's jurisdiction of formation or the organic rules of a merging entity.

(b) In addition to the requirements of subsection (a), a plan of merger may contain any other provision not prohibited by law.

### Comment

**Subsection (a)** – The requirements for the plan of merger are set forth in subsection (a). They are similar to plan of merger provisions in corporation statutes. *See* Model Business Corporation Act § 11.02(c). The requirements stated in this subsection are mandatory.

**Subsection (a)(1)** – Subsection (a)(1) requires that the plan of merger identify the parties to the merger. The name of a merging entity as it appears in the plan of merger will be its name in its jurisdiction of formation. *See* the comment to Section 2-205(b)(1) and (2).

**Subsection (a)(3)** – The language of subsection (a)(3) is similar to Model Business Corporation Act § 11.02(c)(3), and similar provisions in the uniform unincorporated entity acts (*see e.g.*, Uniform Partnership Act (1997) (Last Amended 2013) § 1122(a)(3)). Although subsection (a)(3) and these other provisions are all phrased in similar language, what may be done under subsection (a)(3) with respect to providing for continuing interests in the surviving entity for some holders of interests of a class or series of a party to the merger while paying some other form of consideration to other holders of the same class or series of interests in that entity will vary depending on the type of entity involved and the extent to which its organic rules provide for non-uniform treatment of interest holders in a manner that is permissible under its organic law. Similarly the ability to use a merger to reorganize the capital structure of the surviving entity will vary depending on the type of entity involved and whether the entity has appropriately adopted relevant provisions in its organic rules.

If the organic law and organic rules of an unincorporated entity permit a non-uniform “equity shuffle” to be accomplished in a merger involving the unincorporated entity, the minority owners of the unincorporated entity will not necessarily be entitled to the statutory appraisal rights currently afforded to minority stockholders in merging corporate entities. Any perceived unfairness in the shuffle would be addressed either (i) under principles of fiduciary duties and the

contractual obligations of good faith and fair dealing, assuming, of course, that such duties and obligations have not been contractually modified or eliminated to the extent permitted by the applicable organic law, or (ii) by the exercise of whatever rights the minority owners may have to veto the transaction or to withdraw or to dissociate and be paid the value of their interests.

The Model Business Corporation Act generally requires that shares of the same class or series be treated in the same manner in a merger unless the corporation has adopted an applicable provision of its articles of incorporation pursuant to Section 6.01(e) of that act providing for variations in the treatment of holders of the same class or series of shares. Thus a determination of what may be done by way of an equity shuffle in the case of a corporation will require reference to its organic law and organic rules.

The consideration paid to the interest holders of the merging parties may be supplied in whole or part by a person who is not a party to the merger.

**Subsection (b)** – Subsection (b) provides the statutory authority for a merging party to include a provision in a plan of merger that is not specifically listed in subsection (a). One such possibility is contractual appraisal rights as provided in Section 2-109(b).

#### **SECTION 2-203. APPROVAL OF MERGER.**

(a) A plan of merger is not effective unless it has been approved:

(1) by a domestic merging entity:

(A) in accordance with the requirements, if any, in its organic law and organic rules for approval of:

(i) in the case of an entity that is not a limited cooperative association, the merger; or

(ii) in the case of a limited cooperative association, a transaction under this [part]; or

(B) by all of the interest holders of the entity entitled to vote on or consent to any matter if:

(i) in the case of an entity that is not a business corporation or limited cooperative association, neither its organic law nor organic rules provide for approval of the merger; or



(ii) in the case of an entity that is a limited cooperative association, neither its organic law nor organic rules provide for approval of a transaction under this [part]; and

(2) in a record, by each interest holder of a domestic merging entity which will have interest holder liability for debts, obligations, and other liabilities that are incurred after the merger becomes effective, unless, in the case of an entity that is not a business corporation or nonprofit corporation:

(A) the organic rules of the entity provide in a record for the approval of a merger in which some or all of its interest holders become subject to interest holder liability by the affirmative vote or consent of fewer than all the interest holders; and

(B) the interest holder consented in a record to or voted for that provision of the organic rules or became an interest holder after the adoption of that provision.

(b) A merger under this [part] involving a foreign merging entity is not effective unless the merger is approved by the foreign entity in accordance with the law of the foreign entity's jurisdiction of formation.

### **Comment**

**Subsection (a)** – Approval under this section includes whatever actions or procedures by the governors and interest holders of an entity are required by its organic law, as modified by its organic rules, to effectuate the merger. In the case of a business corporation, those procedures will include provisions for approval of a “short form” merger without a vote of the shareholders if a merger under this part satisfies the tests for being a short form merger. If the organic rules of an entity prescribe a procedure for the proposal, adoption and/or approval of a merger, the term “approval” includes compliance with all of those rules. *See* the definition of “approve” in Section 2-102(3).

If the organic law of an entity is silent with respect to procedures for approval of a merger, the organic rules may be amended to provide those procedures. Otherwise, the default procedure in subsection (a)(1)(B) requires approval by the interest holders entitled to vote on any matter.

The incorporation into this part of the merger procedures in the organic law of a party to a merger should be construed broadly to include not only express statutory procedures, but also applicable common law principles such as fiduciary duty standards of governors and majority interest holders. Statutory provisions on voting by classes or voting groups in a merger will also be applicable.

**Subsection (a)(2)** – Subsection (a)(2) deals with the situation where an interest holder of an entity that is a party to a merger will have vicarious liability for the liabilities of the surviving entity that are incurred after the merger is effective. The special approval requirement in subsection (a)(2) will be applicable, for example, to shareholders of a corporation that merges into a general partnership that is not a limited liability partnership if the shareholders become general partners of the surviving general partnership. If such a shareholder were to exercise appraisal rights, however, the shareholder would not become subject to owner liability because one effect of exercising appraisal rights is that the shareholder would not become a general partner in the surviving entity; and, in that case, the consent of that shareholder would not be required under subsection (a)(2).

The consent of an interest holder required by subsection (a)(2)(B) may be given either by (i) signing or agreeing generally to the terms of organic rules that include the required provision permitting less than unanimous approval of a merger in which interest holders become subject to owner liability, or (ii) voting for or consenting to an amendment to add such a provision.

**Subsection (b)** – Where a foreign entity is a party to a merger under this part, subsection (b) defers to the laws of the foreign jurisdiction for the requirements for approval of the merger by the foreign entity. Those laws will include the organic law of the foreign entity and other applicable laws, such as this article if it has been adopted in the foreign jurisdiction. The laws of the foreign jurisdiction will also control the application of any special approval requirements found in the organic rules of the foreign entity.

## **SECTION 2-204. AMENDMENT OR ABANDONMENT OF PLAN OF MERGER.**

(a) A plan of merger may be amended only with the consent of each party to the plan, except as otherwise provided in the plan.

(b) A domestic merging entity may approve an amendment of a plan of merger:

(1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or

(2) by its governors or interest holders in the manner provided in the plan, but an interest holder that was entitled to vote on or consent to approval of the merger is entitled to vote on or consent to any amendment of the plan that will change:

(A) the amount or kind of interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing, to be received by the interest holders of any party to the plan;

(B) the public organic record, if any, or private organic rules of the surviving entity that will be in effect immediately after the merger becomes effective, except for changes that do not require approval of the interest holders of the surviving entity under its organic law or organic rules; or

(C) any other terms or conditions of the plan, if the change would adversely affect the interest holder in any material respect.

(c) After a plan of merger has been approved and before a statement of merger is effective, the plan may be abandoned as provided in the plan. Unless prohibited by the plan, a domestic merging entity may abandon the plan in the same manner as the plan was approved.

(d) If a plan of merger is abandoned after a statement of merger has been delivered to the [Secretary of State] for filing and before the statement is effective, a statement of abandonment, signed by a party to the plan, must be delivered to the [Secretary of State] for filing before the statement of merger is effective. The statement of abandonment takes effect on filing, and the merger is abandoned and does not become effective. The statement of abandonment must contain:

(1) the name of each party to the plan of merger;

(2) the date on which the statement of merger was filed by the [Secretary of State]; and

(3) a statement that the merger has been abandoned in accordance with this section.

## **Comment**

This section sets out the requirements for amending or abandoning the plan of merger. They are similar to provisions for amending or abandoning mergers found in existing corporation merger statutes. *See* Model Business Corporation Act §§ 11.02(e) and 11.08.

### **SECTION 2-205. STATEMENT OF MERGER; EFFECTIVE DATE OF MERGER.**

(a) A statement of merger must be signed by each merging entity and delivered to the [Secretary of State] for filing.

(b) A statement of merger must contain:

(1) the name, jurisdiction of formation, and type of entity of each merging entity that is not the surviving entity;

(2) the name, jurisdiction of formation, and type of entity of the surviving entity;

(3) if the statement of merger is not to be effective upon filing, the later date and time on which it will become effective, which may not be more than 90 days after the date of filing;

(4) a statement that the merger was approved by each domestic merging entity, if any, in accordance with this [part] and by each foreign merging entity, if any, in accordance with the law of its jurisdiction of formation;

(5) if the surviving entity exists before the merger and is a domestic filing entity, any amendment to its public organic record approved as part of the plan of merger;

(6) if the surviving entity is created by the merger and is a domestic filing entity, its public organic record, as an attachment;

(7) if the surviving entity is created by the merger and is a domestic limited liability partnership, its statement of qualification, as an attachment; and

(8) if the surviving entity is a foreign entity that is not a registered foreign entity, a mailing address to which the [Secretary of State] may send any process served on the [Secretary of State] pursuant to Section 2-206(e).

(c) In addition to the requirements of subsection (b), a statement of merger may contain any other provision not prohibited by law.

(d) If the surviving entity is a domestic entity, its public organic record, if any, must satisfy the requirements of the law of this state, except that the public organic record does not need to be signed and may omit any provision that is not required to be included in a restatement of the public organic record.

(e) A plan of merger that is signed by all the merging entities and meets all the requirements of subsection (b) may be delivered to the [Secretary of State] for filing instead of a statement of merger and on filing has the same effect. If a plan of merger is filed as provided in this subsection, references in this [article] to a statement of merger refer to the plan of merger filed under this subsection.

(f) A statement of merger is effective on the date and time of filing or the later date and time specified in the statement of merger.

(g) If the surviving entity is a domestic entity, the merger becomes effective when the statement of merger is effective. If the surviving entity is a foreign entity, the merger becomes effective on the later of:

- (1) the date and time provided by the organic law of the surviving entity; or
- (2) when the statement is effective.

### **Comment**

**Subsection (a)** – When the statement of merger is effective under subsection (f), the merger transaction occurs. The filing of a statement of merger also makes the transaction a

matter of public record.

**Subsection (b)(1) and (2)** – The names of foreign entities set forth in the statement of merger will generally be their names in their jurisdiction of formation, except that if a foreign entity has been required to adopt a different name in order to register to do business in the adopting state, the foreign qualification statute will likely require that when the entity does business in the state it must use the name adopted for purposes of registering to do business. Engaging in a merger under this part will be part of the business done by the entity in the state and the name of the entity set forth in the statement of merger will thus need to be the name under which the entity has registered to do business. Use of the name under which the entity has registered to do business will allow the records in the filing office to associate the registration of the entity to do business with the statement of merger.

**Subsection (b)(4)** – The statement in subsection (b)(4) that the plan of merger was approved by each entity in accordance with this part necessarily presupposes that the plan was approved in accordance with any valid, special requirements in the organic rules of each merging entity.

**Subsection (b)(6) and (7)** – The public organic record of a domestic surviving entity created by the merger that is attached to the statement of merger becomes the original, officially filed text of the public organic record of the surviving entity when the statement of merger takes effect. It is not necessary, or appropriate, to make any other filing to create the surviving entity.

Similarly, a statement of qualification for a domestic limited liability partnership created by the merger that is attached to the statement of merger does not need to be filed separately.

**Subsection (d)** – Organic laws typically require an initial filing that creates an entity to be signed by the person serving as the incorporator or other organizer. Subsection (d), however, provides that the public organic record of the surviving entity does not need to be signed since it is itself attached to a signed record.

Subsection (d) also permits the public organic record of the surviving entity to omit any provision that is not required to be included in a restatement of the public organic record. Pursuant to this provision, for example, the public organic record of a business corporation created as the surviving entity in the merger would not need to state the name and address of each incorporator even though that information would be required by Section 2.02(a)(4) of the Model Business Corporation Act if the corporation were being incorporated outside the context of the merger.

**Subsection (e)** – A plan of merger that contains all the information required in the statement of merger may be filed instead of the statement of merger. The plan must be in a record and signed by each merging party.

**Subsection (f)** – The effective time of the statement is the effective time of its filing, unless otherwise specified. A statement may specify a delayed effective time and date, and if it does so the statement becomes effective at the time and date specified. Subsection (f) is subject

to the 90-day delayed effective date filing limitation in subsection (b)(3).

**Subsection (g)** – A merger in which the surviving entity is a domestic entity takes effect when the statement of merger takes effect. A merger in which the surviving entity is a foreign entity will usually also take effect when the statement of merger takes effect because the practice is to coordinate the filings that need to be made when a merger involves both a domestic entity and also a foreign entity so that the filings in each jurisdiction take effect at the same time. Because of the possibility, however, that the filing in the foreign jurisdiction will take effect at a different time, subsection (g) provides that the merger transaction itself will take effect at the later of (i) when the statement of merger takes effect, and (ii) when the merger takes effect under the law of the foreign jurisdiction. That rule avoids the possibility that the merger will take effect in the domestic jurisdiction before it takes effect in the foreign jurisdiction, which would produce the undesirable result that the domestic entity would cease to exist before it has been merged into the foreign entity.

It is only necessary for the filing office to record the effective date of the statement of merger and the filing office does not need to be concerned with the effective date of the merger itself. Persons wishing to determine the effective date of a merger involving both a domestic and a foreign entity will be able to do so by consulting the records of the filing offices in each jurisdiction.

## **SECTION 2-206. EFFECT OF MERGER.**

(a) When a merger under this [part] becomes effective:

- (1) the surviving entity continues or comes into existence;
- (2) each merging entity that is not the surviving entity ceases to exist;
- (3) all property of each merging entity vests in the surviving entity without transfer, reversion, or impairment;
- (4) all debts, obligations, and other liabilities of each merging entity are debts, obligations, and other liabilities of the surviving entity;
- (5) except as otherwise provided by law or the plan of merger, all the rights, privileges, immunities, powers, and purposes of each merging entity vest in the surviving entity;
- (6) if the surviving entity exists before the merger:
  - (A) all its property continues to be vested in it without transfer, reversion, or impairment;

(B) it remains subject to all its debts, obligations, and other liabilities; and  
(C) all its rights, privileges, immunities, powers, and purposes continue to be vested in it;

(7) the name of the surviving entity may be substituted for the name of any merging entity that is a party to any pending action or proceeding;

(8) if the surviving entity exists before the merger:

(A) its public organic record, if any, is amended to the extent provided in the statement of merger; and

(B) its private organic rules that are to be in a record, if any, are amended to the extent provided in the plan of merger;

(9) if the surviving entity is created by the merger, its private organic rules are effective and:

(A) if it is a filing entity, its public organic record is effective; and

(B) if it is a limited liability partnership, its statement of qualification is effective; and

(10) the interests in each merging entity which are to be converted in the merger are converted, and the interest holders of those interests are entitled only to the rights provided to them under the plan of merger and to any appraisal rights they have under Section 2-109 and the merging entity's organic law.

(b) Except as otherwise provided in the organic law or organic rules of a merging entity, a merger under this [part] does not give rise to any rights that an interest holder, governor, or third party would have upon a dissolution, liquidation, or winding up of the merging entity.

(c) When a merger under this [part] becomes effective, a person that did not have interest



holder liability with respect to any of the merging entities and becomes subject to interest holder liability with respect to a domestic entity as a result of the merger has interest holder liability only to the extent provided by the organic law of that entity and only for those debts, obligations, and other liabilities that are incurred after the merger becomes effective.

(d) When a merger becomes effective, the interest holder liability of a person that ceases to hold an interest in a domestic merging entity with respect to which the person had interest holder liability is subject to the following rules:

(1) The merger does not discharge any interest holder liability under the organic law of the domestic merging entity to the extent the interest holder liability was incurred before the merger became effective.

(2) The person does not have interest holder liability under the organic law of the domestic merging entity for any debt, obligation, or other liability that is incurred after the merger becomes effective.

(3) The organic law of the domestic merging entity continues to apply to the release, collection, or discharge of any interest holder liability preserved under paragraph (1) as if the merger had not occurred.

(4) The person has whatever rights of contribution from any other person as are provided by law other than this [article] or the organic rules of the domestic merging entity with respect to any interest holder liability preserved under paragraph (1) as if the merger had not occurred.

(e) When a merger under this [part] becomes effective, a foreign entity that is the surviving entity may be served with process in this state for the collection and enforcement of any debts, obligations, or other liabilities of a domestic merging entity in accordance with

applicable law.

(f) When a merger under this [part] becomes effective, the registration to do business in this state of any foreign merging entity that is not the surviving entity is canceled.

### **Comment**

With the exception of subsections (c) and (d), this section is similar to statutory provisions on the effect of a merger of a corporation with a corporation. *See* Model Business Corporation Act § 11.07.

Subsections (c) and (d) set forth rules for two circumstances that typically do not exist in a merger where all the entities involved are corporations. Subsection (c) deals with the situation where an interest holder that does not have vicarious liability for the obligations of a merging entity before the merger has interest holder liability after the merger. An example would be a corporate shareholder who agrees to be a general partner in a limited partnership that is the surviving entity in a merger between a corporation and a limited partnership that is not a limited liability limited partnership. Subsection (d) deals with the situation where an interest holder has vicarious liability for the obligations of one of the merging parties before the merger but ceases to have any interest holder liability for the obligations of the surviving entity after the merger is effective. An example would be a general partner in a general partnership that merges into a corporation.

Under Section 2-203(a)(2), a merger cannot have the effect of making an interest holder of a domestic merging entity subject to interest holder liability for the debts, obligations, or other liabilities of any other person or entity unless the interest holder has executed a separate written consent to become subject to such liability or previously agreed to the effectuation of a transaction having that effect without the interest holder's consent.

**Subsection (a)** – Subsection (a) states the general understanding that in a merger the assets and liabilities of the merging entities automatically vest in the surviving entity. The surviving entity becomes the owner of all real and personal property of the merged entities and is subject to all debts, obligations, and liabilities of the merging entities. A merger does not constitute a transfer, assignment, or conveyance of any property held by the merging entities prior to the merger. A merger also does not give rise to a claim that a contract with a merging entity is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a merger. The contract rights that are vested in the surviving entity include the right to enforce subscription agreements for interests and obligations to make capital contributions entered into or incurred before the merger. *See also* Section 2-104(c) which deals with the surviving entity's rights in trust obligations of a nonsurviving party in a merger and transactions such as bequests made to a nonsurviving party to a merger that take effect after the merger.

After a merger becomes effective, the law of the surviving entity's jurisdiction of formation governs the surviving entity.

*See* Sections 2-103(b) and 2-104(b) which modify the provisions of this section with respect to the effects of a merger to the extent a regulatory law provides otherwise or any of the parties holds property committed to charitable purposes.

**Subsection (a)(7)** – All pending proceedings involving either the survivor or a party whose separate existence ceased as a result of the merger are continued. Under subsection (a)(7), the name of the survivor may be, but need not be, substituted in any pending proceeding for the name of a party to the merger whose separate existence ceased as a result of the merger. The substitution may be made whether the survivor is a complainant or a respondent, and may be made at the instance of either the survivor or an opposing party. Such a substitution has no substantive effect because, whether or not the survivor's name is substituted, the survivor succeeds to the claims, and is subject to the liabilities, of any party to the merger whose separate existence ceased as a result of the merger.

**Subsection (a)(8)** – The private organic rules of an unincorporated entity typically may be either oral or written. The plan of merger is not required to set forth amendments to oral provisions of the private organic rules of the surviving entity, and thus subsection (a)(8)(B) is limited in scope just to amendments to the private organic rules that are to be in a record, if any.

**Subsection (a)(10)** – *See* Section 2-109 and the comments to Section 2-109.

**Subsection (c)** – Subsection (c) sets forth the general rule that an interest holder that was not liable for the liabilities of a merging entity before the merger but will have personal liability for the obligations of the surviving entity after the merger will be personally liable only for the liabilities of a domestic surviving entity that are incurred after the effective date of a merger. When a liability is incurred will be determined by other applicable law.

Subsection (c) is limited to situations in which a person becomes personally liable with respect to a domestic entity. Personal liability with respect to a foreign entity will be controlled by the law of the foreign jurisdiction.

**Subsection (d)** – Subsection (d) provides four rules with respect to an interest holder who ceases to have interest holder liability after the effective date of the merger:

- (1) the interest holder remains personally liable for any obligations that were incurred before the effective date of the merger;
- (2) the interest holder does not have any personal liability for obligations of the surviving entity;
- (3) the pre-existing personal liability of the interest holder is enforced against the interest holder on the same basis as if the merger had not taken place; and
- (4) the interest holder has the same rights of contribution from other interest holders of the merging entity as the interest holder would have had if the merger had not occurred.

**Subsection (e)** – When a merger becomes effective, subsection (e) provides that a foreign entity that is the surviving entity may be served with process in this state. The proceedings covered by subsection (e) include a proceeding to enforce the rights of any interest holders of each domestic merging entity who are entitled to and exercise appraisal rights. One of the liabilities that a foreign surviving entity succeeds to is the obligation of a merging entity to pay the amount, if any, to which its interest holders who assert appraisal rights are entitled.

### **[PART] 3**

#### **INTEREST EXCHANGE**

##### **SECTION 2-301. INTEREST EXCHANGE AUTHORIZED.**

(a) Except as otherwise provided in this section, by complying with this [part]:

(1) a domestic entity may acquire all of one or more classes or series of interests of another domestic entity or a foreign entity in exchange for interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing; or

(2) all of one or more classes or series of interests of a domestic entity may be acquired by another domestic entity or a foreign entity in exchange for interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing.

(b) Except as otherwise provided in this section, by complying with the provisions of this [part] applicable to foreign entities, a foreign entity may be the acquiring or acquired entity in an interest exchange under this [part] if the interest exchange is authorized by the law of the foreign entity's jurisdiction of formation.

(c) If a protected agreement contains a provision that applies to a merger of a domestic entity but does not refer to an interest exchange, the provision applies to an interest exchange in which the domestic entity is the acquired entity as if the interest exchange were a merger until the provision is amended after [the effective date of this [article]].

[(d) This [part] does not apply to a transaction under:

- (1) [Chapter 11 of the Model Business Corporation Act];
- (2) [Chapter 11 of the Model Nonprofit Corporation Act]; or
- (3).]

### Comment

An interest exchange is the same type of transaction as the share exchange provided for in Section 11.03 of the Model Business Corporation Act. The effect of an interest exchange is that: (1) the separate existence of the acquired entity is not affected; and (2) the acquiring entity acquires all of the interests of one or more classes or series of the acquired entity. An interest exchange also allows an indirect acquisition through the use of consideration in the exchange that is not provided by the acquiring entity (*e.g.*, consideration from another or related entity).

Neither share exchanges nor interest exchanges are universally recognized in either corporation or unincorporated entity laws. The effect of an interest exchange can be achieved through a triangular merger in which the acquiring entity forms a new subsidiary and the acquired entity is then merged into the new subsidiary. Part 3 allows the transaction to be accomplished directly in a single step, rather than indirectly through the triangular merger route.

**Subsection (a)** – The acquiring entity is not required to acquire all of the interests in the acquired entity. For example, assume that an LLC with three classes of membership interests enters into an interest exchange with an acquiring entity. The acquiring entity need only acquire all of the ownership interests of one or more classes of the LLC membership interests.

The “classes or series” referenced in Section 2-301(a) are commonly found in corporation law, and a class or series of shares in a corporation may be the subject of a transaction under this article. *See, e.g.*, MBCA § 6.02. Specific provisions authorizing classes and series are less common in unincorporated entity law; but if classes or series of interests are created in an unincorporated entity, the interests of one or more of those classes or series may be the subject of a transaction under this article. *See* 6 Del.C. §§ 15-407 (general partnerships), 17-208 (limited partnerships), and 18-215 (limited liability companies).

Some states have authorized the creation of “series” entities in which assets and liabilities of the entity may be segregated in different “series” and different interests may be associated with each series. *See, e.g.*, 6 Del. Code § 18-215 (series limited liability company). If the adopting state has authorized series entities, a series in such an entity may be the subject of an interest exchange. This section also authorizes a domestic entity to acquire a series of a foreign series entity regardless of whether the adopting state has authorized domestic series entities.

**Subsection (b)** – Subsection (b) allows a foreign entity to effectuate an interest exchange with a domestic entity if the interest exchange is authorized by the organic law of the foreign entity.

**Subsection (c)** – This subsection deals with rights of parties to protected agreements (defined in Section 2-102(19)) when an interest exchange takes place. Because the concept of an interest exchange is relatively new, a person contracting with an entity or loaning it money who drafted and negotiated special rights relating to the transaction before the enactment of this article should not be charged with the consequences of not having dealt with the concept of an interest exchange in the context of those special rights. Similarly, when the governance structure of an entity has been negotiated before the enactment of this article, the concept of an interest exchange may not have been reflected in any special governance arrangements; for example, special approval rights may have been provided for fundamental transactions, but those rights fail to include language that would make them applicable to an interest exchange. Subsection (c) accordingly provides a transitional rule that is intended to protect such special rights. If, for example, an entity is a party to a contract that provides that the entity cannot participate in a merger without the consent of the other party to the contract, the requirement to obtain the consent of the other party will also apply to an interest exchange in which the entity is the exchanging entity. If the entity fails to obtain the consent, the result will be that the other party will have the same rights it would have had if the entity were to participate in a merger without the required consent.

The transitional rule in subsection (c) ceases to make sense at such time as the provisions of the agreement giving rise to the special rights is first amended after the effective date of this article because at that time the provision may be amended to address expressly an interest exchange. The transitional rule will continue to apply, however, if a provision other than the specific provisions giving rise to the special rights is amended.

**Subsection (d)** – The statutes that should be listed in Section 2-301(d) are interest exchange statutes that already exist or are added to the state’s various entity statutes when this article is adopted.

## **SECTION 2-302. PLAN OF INTEREST EXCHANGE.**

(a) A domestic entity may be the acquired entity in an interest exchange under this [part] by approving a plan of interest exchange. The plan must be in a record and contain:

- (1) the name and type of entity of the acquired entity;
- (2) the name, jurisdiction of formation, and type of entity of the acquiring entity;
- (3) the manner of converting the interests in the acquired entity into interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing;
- (4) any proposed amendments to:

(A) the public organic record, if any, of the acquired entity; and

(B) the private organic rules of the acquired entity that are, or are proposed to be, in a record;

(5) the other terms and conditions of the interest exchange; and

(6) any other provision required by the law of this state or the organic rules of the acquired entity.

(b) In addition to the requirements of subsection (a), a plan of interest exchange may contain any other provision not prohibited by law.

### **Comment**

This section sets forth the requirements for the plan of interest exchange, which must be approved by the acquired entity in accordance with Section 2-303. The content of the plan of interest exchange is similar to the content of a plan of merger. *See* Section 2-202. Subsection (a) lists the mandatory provisions that must be in the plan. Subsection (b) authorizes the plan to contain any other provision the parties wish to include, unless the provision is prohibited by law.

The plan of interest exchange may, but need not, be filed instead of the statement of interest exchange (Section 2-305) so long as it contains all the information required to be in the statement and is delivered to the filing office for filing after the plan has been adopted and approved. *See* Section 2-305(d).

**Subsection (a)(3)** – Under this subsection, interest holders in the acquired entity may receive interests or securities of the acquiring entity or of a party other than the acquiring entity, obligations, rights to acquire interests, or securities, cash, or other property.

### **SECTION 2-303. APPROVAL OF INTEREST EXCHANGE.**

(a) A plan of interest exchange is not effective unless it has been approved:

(1) by a domestic acquired entity:

(A) in accordance with the requirements, if any, in its organic law and organic rules for approval of an interest exchange;

(B) if neither its organic law nor organic rules provide for approval of an interest exchange, in accordance with the requirements, if any, in its organic law and organic

rules for approval of:

(i) in the case of an entity that is not a business corporation or a limited cooperative association, a merger, as if the interest exchange were a merger; or

(ii) in the case of a business corporation, a merger requiring approval by a vote of the interest holders of the business corporation, as if the interest exchange were that type of merger; or

(iii) in the case of a limited cooperative association, a transaction under this [part]; or

(C) by all of the interest holders of the entity entitled to vote on or consent to any matter if:

(i) in the case of an entity that is not a business corporation or limited cooperative association, neither its organic law nor organic rules provide for approval of an interest exchange or merger; or

(ii) in the case of a limited cooperative association, neither its organic law nor organic rules provide for approval of an interest exchange or a transaction under this [part]; and

(2) in a record, by each interest holder of a domestic acquired entity that will have interest holder liability for debts, obligations, and other liabilities that are incurred after the interest exchange becomes effective, unless, in the case of an entity that is not a business corporation or nonprofit corporation:

(A) the organic rules of the entity provide in a record for the approval of an interest exchange or a merger in which some or all of its interest holders become subject to interest holder liability by the vote or consent of fewer than all the interest holders; and



(B) the interest holder consented in a record to or voted for that provision of the organic rules or became an interest holder after the adoption of that provision.

(b) An interest exchange involving a foreign acquired entity is not effective unless it is approved by the foreign entity in accordance with the law of the foreign entity's jurisdiction of formation.

(c) Except as otherwise provided in its organic law or organic rules, the interest holders of the acquiring entity are not required to approve the interest exchange.

**Legislative Note:** *An issue that needs to be analyzed under this section is what approval requirements apply to an interest exchange if there are no interest exchange provisions for entities of the same type in the organic law for a particular type of entity. If an entity's organic law, and also its organic rules, are silent on approving an interest exchange, subsection (a)(1)(B) provides that the required approval is the approval required for a merger under the entity's organic law. If the entity's organic law required a majority vote of the entity's interest holders to approve a merger, the approval of an interest exchange if the entity is the acquired entity would also require a majority vote of its interest holders. If the organic law, on the other hand, required a unanimous vote of the entity's interest holders to approve a merger, a unanimous vote would also be required to approve an interest exchange. As a result, differences between entity laws on the vote required to approve a merger will be carried over into this part. It is important, therefore, that states review any differences in the merger approval requirements in their organic laws to determine if those differences are supported by appropriate policy considerations.*

*If an entity's organic law does not provide for approval of either a merger or an interest exchange, and if the entity's organic rules are also silent on approval of a merger or interest exchange, then subsection (a)(1)(C) requires approval of an interest exchange by all of the entity's interest holders. States should evaluate how that approval requirement compares to any approval requirements it has adopted for mergers or interest exchanges in any of its other organic laws.*

*This part permits the organic rules of an acquired entity to be amended in the context of an interest exchange. The other parts in this article also permit the organic rules to be amended in the contexts of the other types of transactions that may be accomplished under this article. When states conduct the analysis described in this Legislative Note of what approval requirement to adopt, they should also evaluate that question from the perspective of what approval requirements they provide in their organic laws for amending the organic rules of each type of entity.*

*The analysis described in this Legislative Note needs to be undertaken with respect to Sections 2-403 and 2-503 as well.*

*See the Legislative Note following Section 2-606 for additional information about these issues.*

### **Comment**

This section sets forth the required approval of an interest exchange. An interest exchange transaction governed by this part only requires approval by the acquired entity, unless the applicable organic law or the organic rules of the acquiring entity otherwise provide (*see* subsection (c)), a condition that rarely exists.

If the acquired entity is a domestic entity, one of three possibilities will be applicable:

(1) if the organic law (*see* Section 1-102(32)) governing the acquired domestic entity has specific provisions for approval of an interest exchange, or even if there are no such provisions, the organic rules (*see* Section 1-102(33)) of the acquired entity have specific provisions for approval of an interest exchange, then the approval provisions in the organic law or organic rules apply;

(2) if there are no specific provisions for approval of an interest exchange in the acquired entity's organic law or organic rules but either the organic law governing the acquired entity or the acquired entity's organic rules contain provisions for approval of mergers, then those merger provisions (except for any provisions that allow approval of a merger without a vote of the shareholders in the case of an acquired entity that is a corporation) apply; and

(3) if neither (1) or (2) are applicable, then unanimous consent of the acquired entity's interest holders will be required.

A three-tiered approval scheme is necessary because specific provisions for interest exchanges do not exist in many state corporation and unincorporated entity statutes or in the various types of entity organic rules.

If the acquired entity is a foreign entity, then approval is in accordance with the laws of the acquired entity's jurisdiction of formation. *See* subsection (b).

**Subsection (a)(1)(B)(ii)** – Many business corporation laws permit a corporation that owns a specified percentage of the shares of another corporation (typically 80 or 90%) to merge with the subsidiary corporation without a vote of the subsidiary's shareholders. Some corporation laws also permit a merger to be effected without a vote of the shareholders in other situations as well; for example, 8 Del. Code § 251(g) and 15 Pa.C.S. § 1924(b)(4) permit a holding company structure to be formed through the device of a merger without the approval of the shareholders. Section 2-303(a)(1)(b)(ii) makes clear that those "short form" and other merger rules do not apply and a vote of the shareholders of an acquired entity that is a corporation is always required to approve an interest exchange under Part 3.

**Subsection (a)(2)** – See the comment to Section 2-203(a)(2) for an explanation of this interest holder liability provision.

**SECTION 2-304. AMENDMENT OR ABANDONMENT OF PLAN OF INTEREST EXCHANGE.**

(a) A plan of interest exchange may be amended only with the consent of each party to the plan, except as otherwise provided in the plan.

(b) A domestic acquired entity may approve an amendment of a plan of interest exchange:

(1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or

(2) by its governors or interest holders in the manner provided in the plan, but an interest holder that was entitled to vote on or consent to approval of the interest exchange is entitled to vote on or consent to any amendment of the plan that will change:

(A) the amount or kind of interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing, to be received by any of the interest holders of the acquired entity under the plan;

(B) the public organic record, if any, or private organic rules of the acquired entity that will be in effect immediately after the interest exchange becomes effective, except for changes that do not require approval of the interest holders of the acquired entity under its organic law or organic rules; or

(C) any other terms or conditions of the plan, if the change would adversely affect the interest holder in any material respect.

(c) After a plan of interest exchange has been approved and before a statement of interest exchange is effective, the plan may be abandoned as provided in the plan. Unless prohibited by the plan, a domestic acquired entity may abandon the plan in the same manner as the plan was

approved.

(d) If a plan of interest exchange is abandoned after a statement of interest exchange has been delivered to the [Secretary of State] for filing and before the statement is effective, a statement of abandonment, signed by the acquired entity, must be delivered to the [Secretary of State] for filing before the statement of interest exchange is effective. The statement of abandonment takes effect on filing, and the interest exchange is abandoned and does not become effective. The statement of abandonment must contain:

(1) the name of the acquired entity;

(2) the date on which the statement of interest exchange was filed by the [Secretary of State]; and

(3) a statement that the interest exchange has been abandoned in accordance with this section.

### **Comment**

This section parallels analogous provisions in Parts 2 (mergers), 4 (conversions), and 5 (domestications). *See* Sections 2-204 (mergers), 2-404 (conversions), and 2-504 (domestications).

## **SECTION 2-305. STATEMENT OF INTEREST EXCHANGE; EFFECTIVE DATE OF INTEREST EXCHANGE.**

(a) A statement of interest exchange must be signed by a domestic acquired entity and delivered to the [Secretary of State] for filing.

(b) A statement of interest exchange must contain:

(1) the name and type of entity of the acquired entity;

(2) the name, jurisdiction of formation, and type of entity of the acquiring entity;

(3) if the statement of interest exchange is not to be effective upon filing, the later

date and time on which it will become effective, which may not be more than 90 days after the date of filing;

(4) a statement that the plan of interest exchange was approved by the acquired entity in accordance with this [part]; and

(5) any amendments to the acquired entity's public organic record, if any, approved as part of the plan of interest exchange.

(c) In addition to the requirements of subsection (b), a statement of interest exchange may contain any other provision not prohibited by law.

(d) A plan of interest exchange that is signed by a domestic acquired entity and meets all the requirements of subsection (b) may be delivered to the [Secretary of State] for filing instead of a statement of interest exchange and on filing has the same effect. If a plan of interest exchange is filed as provided in this subsection, references in this [article] to a statement of interest exchange refer to the plan of interest exchange filed under this subsection.

(e) A statement of interest exchange is effective on the date and time of filing or the later date and time specified in the statement.

(f) An interest exchange in which the acquired entity is a domestic entity becomes effective when the statement of interest exchange is effective.

### **Comment**

The filing of a statement of interest exchange makes the transaction a matter of public record. The requirements for a statement of interest exchange are set forth in subsection (b). They are essentially the same as the requirements for a statement of merger in Section 2-205.

**Subsection (b)(3) and (e)** – The effective date and time of a statement of interest exchange are the date and time of its filing, unless otherwise specified. If a delayed effective date is specified, the statement is effective on that date and time, subject to the 90 day maximum delayed effective date in Section 2-305(b)(3).

**Subsection (d)** – A plan of interest exchange can be used as a substitute for the statement

of interest exchange so long as the plan satisfies the requirements in subsection (d).

**Subsection (f)** – When the statement of interest exchange is effective under subsection (e), the interest exchange transaction occurs under subsection (f) if the acquired entity is a domestic entity. If the acquired entity is a foreign entity, the effectiveness of the interest exchange will occur when provided by the law of its jurisdiction of formation.

#### **SECTION 2-306. EFFECT OF INTEREST EXCHANGE.**

(a) When an interest exchange in which the acquired entity is a domestic entity becomes effective:

(1) the interests in the domestic acquired entity which are the subject of the interest exchange are converted, and the interest holders of those interests are entitled only to the rights provided to them under the plan of interest exchange and to any appraisal rights they have under Section 2-109 and the acquired entity's organic law;

(2) the acquiring entity becomes the interest holder of the interests in the acquired entity stated in the plan of interest exchange to be acquired by the acquiring entity;

(3) the public organic record, if any, of the acquired entity is amended to the extent provided in the statement of interest exchange; and

(4) the private organic rules of the acquired entity that are to be in a record, if any, are amended to the extent provided in the plan of interest exchange.

(b) Except as otherwise provided in the organic law or organic rules of the acquired entity, the interest exchange does not give rise to any rights that an interest holder, governor, or third party would have upon a dissolution, liquidation, or winding up of the acquired entity.

(c) When an interest exchange becomes effective, a person that did not have interest holder liability with respect to the acquired entity and becomes subject to interest holder liability with respect to a domestic entity as a result of the interest exchange has interest holder liability only to the extent provided by the organic law of the entity and only for those debts, obligations,

and other liabilities that are incurred after the interest exchange becomes effective.

(d) When an interest exchange becomes effective, the interest holder liability of a person that ceases to hold an interest in a domestic acquired entity with respect to which the person had interest holder liability is subject to the following rules:

(1) The interest exchange does not discharge any interest holder liability under the organic law of the domestic acquired entity to the extent the interest holder liability was incurred before the interest exchange became effective.

(2) The person does not have interest holder liability under the organic law of the domestic acquired entity for any debt, obligation, or other liability that is incurred after the interest exchange becomes effective.

(3) The organic law of the domestic acquired entity continues to apply to the release, collection, or discharge of any interest holder liability preserved under paragraph (1) as if the interest exchange had not occurred.

(4) The person has whatever rights of contribution from any other person as are provided by law other than this [article] or the organic law or organic rules of the domestic acquired entity with respect to any interest holder liability preserved under paragraph (1) as if the interest exchange had not occurred.

### **Comment**

**Subsection (a)** – In contrast to a merger, an interest exchange does not in and of itself affect the separate existence of the parties, vest in the acquiring entity the assets of the acquired entity, or render the acquiring entity liable for the liabilities of the acquired entity. Thus, subsection (a) is significantly simpler than Section 2-206(a) with respect to the effects of a merger.

When an interest exchange becomes effective: (1) the interests of the acquired entity are exchanged, converted, or canceled as provided in the plan; (2) the only rights of the former interest holders of the acquired entity whose interests are affected by the interest exchange are those rights related to the exchange, conversion, or cancellation; (3) the acquiring entity becomes

the owner of the acquired entity's interests as provided in the plan; and (4) the organic rules of the acquired entity are amended as provided in the statement of interest exchange, thus obviating the need for repetitive filings (*i.e.*, a filing as to the entity interest exchange and another filing to reflect amendments to the public organic record as required by the laws governing the acquired entity).

**Subsection (c)** – Subsection (c) provides the rule for future interest holder liability and parallels analogous provisions in Parts 2 (mergers), 4 (conversions), and 5 (domestications). *See* the comment to Section 2-206(c).

**Subsection (d)** – Subsection (d) provides the rule for past interest holder liability and parallels analogous provisions in Parts 2 (mergers), 4 (conversions), and 5 (domestications). *See* the comment to Section 2-206(d).

## **[PART] 4**

### **CONVERSION**

#### **SECTION 2-401. CONVERSION AUTHORIZED.**

(a) By complying with this [part], a domestic entity may become:

(1) a domestic entity that is a different type of entity; or

(2) a foreign entity that is a different type of entity, if the conversion is authorized

by the law of the foreign entity's jurisdiction of formation.

(b) By complying with the provisions of this [part] applicable to foreign entities, a foreign entity may become a domestic entity that is a different type of entity if the conversion is authorized by the law of the foreign entity's jurisdiction of formation.

(c) If a protected agreement contains a provision that applies to a merger of a domestic entity but does not refer to a conversion, the provision applies to a conversion of the entity as if the conversion were a merger until the provision is amended after [the effective date of this [article]].

#### **Comment**

The procedure in this part permits an entity to change to a different type of entity in its jurisdiction of formation or in a foreign jurisdiction. A transaction in which an entity changes its



jurisdiction of formation but does not change its type is a domestication and is the subject of Part 5.

**Subsection (a)(2)** – Under subsection (a)(2) a conversion of a domestic entity into a foreign entity must be authorized by the law of the foreign jurisdiction. If this is not the case, it may be possible to achieve the same result by forming an entity of the type desired in the foreign jurisdiction and then merging the domestic entity into the new foreign entity under Part 2.

**Subsection (b)** – Subsection (b) allows a foreign entity to effectuate a conversion into a domestic entity only if the conversion is permitted by the laws of the foreign entity’s jurisdiction of formation. *See* Section 1-102(22) for the definition of “jurisdiction of formation.” When a foreign entity becomes a domestic entity pursuant to this part, the effect of the conversion will be as provided in Section 2-406. The procedures by which the conversion is approved, however, will be determined by the laws of the foreign entity’s jurisdiction of formation.

## **SECTION 2-402. PLAN OF CONVERSION.**

(a) A domestic entity may convert to a different type of entity under this [part] by approving a plan of conversion. The plan must be in a record and contain:

- (1) the name and type of entity of the converting entity;
- (2) the name, jurisdiction of formation, and type of entity of the converted entity;
- (3) the manner of converting the interests in the converting entity into interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing;
- (4) the proposed public organic record of the converted entity if it will be a filing entity;
- (5) the full text of the private organic rules of the converted entity which are proposed to be in a record;
- (6) the other terms and conditions of the conversion; and
- (7) any other provision required by the law of this state or the organic rules of the converting entity.

(b) In addition to the requirements of subsection (a), a plan of conversion may contain

any other provision not prohibited by law.

### **Comment**

This section sets forth the requirements for the plan of conversion, which must be approved by the converting entity in accordance with Section 2-403. The content of a plan of conversion is similar to the content of a plan of merger. *See* Section 2-202. Subsection (a) lists the mandatory provisions that must be in the plan. Subsection (b) authorizes the plan to contain any other provision the parties wish to include, unless the provision is prohibited by law.

The plan of conversion may, but need not, be filed instead of the statement of conversion, so long as it contains all of the information required to be in the statement of conversion and is delivered to the filing office for filing after the plan has been adopted and approved. *See* Section 2-405(e).

**Subsection (a)(3)** – Interest holders in the converting entity may receive interests or other securities of the converted entity or of any other person, obligations, rights to acquire interests or other securities, cash, or other property. *See also* Sections 2-202(a)(3) (mergers), 2-302(a)(3) (interest exchanges), and 2-502(a)(3) (domestications).

### **SECTION 2-403. APPROVAL OF CONVERSION.**

(a) A plan of conversion is not effective unless it has been approved:

(1) by a domestic converting entity:

(A) in accordance with the requirements, if any, in its organic rules for approval of a conversion;

(B) if its organic rules do not provide for approval of a conversion, in accordance with the requirements, if any, in its organic law and organic rules for approval of:

(i) in the case of an entity that is not a business corporation or limited cooperative association, a merger, as if the conversion were a merger;

(ii) in the case of a business corporation, a merger requiring approval by a vote of the interest holders of the business corporation, as if the conversion were that type of merger;

(iii) in the case of a limited cooperative association, a transaction

under this [part] or

(C) by all of the interest holders of the entity entitled to vote on or consent to any matter if:

(i) in the case of any entity that is not a business corporation or limited cooperative association, neither its organic law nor organic rules provide for approval of a conversion or a merger; or

(ii) in the case of a limited cooperative association, neither its organic law nor organic rules provide for approval of a conversion or a transaction under this [part]; and

(2) in a record, by each interest holder of a domestic converting entity which will have interest holder liability for debts, obligations, and other liabilities that are incurred after the conversion becomes effective, unless, in the case of an entity that is not a business or nonprofit corporation:

(A) the organic rules of the entity provide in a record for the approval of a conversion or a merger in which some or all of its interest holders become subject to interest holder liability by the vote or consent of fewer than all the interest holders; and

(B) the interest holder voted for or consented in a record to that provision of the organic rules or became an interest holder after the adoption of that provision.

(b) A conversion of a foreign converting entity is not effective unless it is approved by the foreign entity in accordance with the law of the foreign entity's jurisdiction of formation.

***Legislative Note:*** *The analysis of approval requirements in the Legislative Note to Section 2-303 should also be undertaken with respect to conversions.*

### **Comment**

As is the case with the other types of transactions authorized by this article, there are

three possible ways to obtain approval of a conversion by a domestic entity. The first is to determine if the organic rules (defined in Section 1-102(33)) of the converting entity contain specific approval provisions for conversions. If they exist, then those provisions apply to approval of the plan of conversion. If there are no provisions in the organic rules for approval of a conversion, then the provisions for approval of a merger in either the organic law (defined in Section 1-102(32)) or organic rules of the entity will apply. If there are no approval provisions for conversions in the entity's organic rules and no approval provisions for mergers in the entity's organic law or organic rules, then unanimous consent of all the entity's interest holders is required.

In the case of a foreign entity that is converting into another type of entity in this jurisdiction, subsection (b) provides that the required approval is determined by the laws of the foreign entity's jurisdiction of formation.

**Subsection (a)(1)(B)** – Subsection(a)(1)(B) requires that a conversion be approved by a business corporation in the same manner as a merger that requires approval by a vote of the shareholders. *See* the comment to Section 2-303(a)(1)(b)(ii).

**Subsection (a)(2)** – See the comment to Section 2-203(a)(2) for an explanation of this interest holder liability provision.

## **SECTION 2-404. AMENDMENT OR ABANDONMENT OF PLAN OF CONVERSION.**

(a) A plan of conversion of a domestic converting entity may be amended:

(1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or

(2) by its governors or interest holders in the manner provided in the plan, but an interest holder that was entitled to vote on or consent to approval of the conversion is entitled to vote on or consent to any amendment of the plan that will change:

(A) the amount or kind of interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing, to be received by any of the interest holders of the converting entity under the plan;

(B) the public organic record, if any, or private organic rules of the converted entity which will be in effect immediately after the conversion becomes effective,

except for changes that do not require approval of the interest holders of the converted entity under its organic law or organic rules; or

(C) any other terms or conditions of the plan, if the change would adversely affect the interest holder in any material respect.

(b) After a plan of conversion has been approved and before a statement of conversion is effective, the plan may be abandoned as provided in the plan. Unless prohibited by the plan, a domestic converting entity may abandon the plan in the same manner as the plan was approved.

(c) If a plan of conversion is abandoned after a statement of conversion has been delivered to the [Secretary of State] for filing and before the statement is effective, a statement of abandonment, signed by the converting entity, must be delivered to the [Secretary of State] for filing before the statement of conversion is effective. The statement of abandonment takes effect on filing, and the conversion is abandoned and does not become effective. The statement of abandonment must contain:

- (1) the name of the converting entity;
- (2) the date on which the statement of conversion was filed by the [Secretary of State]; and
- (3) a statement that the conversion has been abandoned in accordance with this section.

### **Comment**

This section parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 5 (domestications). *See* Sections 2-204 (mergers), 2-304 (interest exchanges), and 2-504 (domestications).

**SECTION 2-405. STATEMENT OF CONVERSION; EFFECTIVE DATE OF CONVERSION.**

(a) A statement of conversion must be signed by the converting entity and delivered to the [Secretary of State] for filing.

(b) A statement of conversion must contain:

(1) the name, jurisdiction of formation, and type of entity of the converting entity;

(2) the name, jurisdiction of formation, and type of entity of the converted entity;

(3) if the statement of conversion is not to be effective upon filing, the later date and time on which it will become effective, which may not be more than 90 days after the date of filing;

(4) if the converting entity is a domestic entity, a statement that the plan of conversion was approved in accordance with this [part] or, if the converting entity is a foreign entity, a statement that the conversion was approved by the foreign entity in accordance with the law of its jurisdiction of formation;

(5) if the converted entity is a domestic filing entity, its public organic record, as an attachment;

(6) if the converted entity is a domestic limited liability partnership, its statement of qualification, as an attachment; and

(7) if the converted entity is a foreign entity, a mailing address to which the [Secretary of State] may send any process served on the [Secretary of State] pursuant to Section 2-406(e).

(c) In addition to the requirements of subsection (b), a statement of conversion may contain any other provision not prohibited by law.

(d) If the converted entity is a domestic entity, its public organic record, if any, must satisfy the requirements of the law of this state, except that the public organic record does not need to be signed and may omit any provision that is not required to be included in a restatement of the public organic record.

(e) A plan of conversion that is signed by a domestic converting entity and meets all the requirements of subsection (b) may be delivered to the [Secretary of State] for filing instead of a statement of conversion and on filing has the same effect. If a plan of conversion is filed as provided in this subsection, references in this [article] to a statement of conversion refer to the plan of conversion filed under this subsection.

(f) A statement of conversion is effective on the date and time of filing or the later date and time specified in the statement of conversion.

(g) If the converted entity is a domestic entity, the conversion becomes effective when the statement of conversion is effective. If the converted entity is a foreign entity, the conversion becomes effective on the later of:

- (1) the date and time provided by the organic law of the converted entity; or
- (2) when the statement is effective.

### **Comment**

The filing of a statement of conversion makes the transaction a matter of public record. The requirements for a statement of conversion are set forth in subsection (b). They are essentially the same as the requirements for a statement of merger in Section 2-205.

**Subsection (b)(3) and (f)** – The effective date and time of a statement of conversion are the date and time of its filing, unless otherwise specified. If a delayed effective date is specified, the statement of conversion is effective on that date and time, subject to the 90 day maximum delayed effective date in Section 2-405(b)(3).

**Subsection (e)** – A plan of conversion can be used as a substitute for the statement of conversion so long as the plan satisfies the requirements in subsection (e).

**Subsection (g)** – When the statement of conversion is effective under subsection (f), the conversion transaction occurs if the converted entity is a domestic entity. A conversion in which the converted entity is a foreign entity will usually also take effect when the statement of conversion takes effect because the best practice will be to coordinate the filings that need to be made when a conversion involves both a domestic entity and also a foreign entity so that the filings in each jurisdiction take effect at the same time. Because of the possibility, however, that the filing in the foreign jurisdiction will take effect at a different time, subsection (g) provides that the conversion transaction itself will take effect at the later of (i) when the statement of conversion takes effect, and (ii) when the conversion takes effect under the law of the foreign jurisdiction. That rule avoids the possibility that the conversion will take effect in the domestic jurisdiction before it takes effect in the foreign jurisdiction, which would produce the undesirable result that the converting domestic entity would cease to exist before it has been converted into the foreign entity.

It is only necessary for the filing office to record the effective date of the statement of conversion and the filing office does not need to be concerned with the effective date of the conversion itself. Persons wishing to determine the effective date of a conversion involving both a domestic and a foreign entity will be able to do so by consulting the records of the filing offices in each jurisdiction.

#### **SECTION 2-406. EFFECT OF CONVERSION.**

(a) When a conversion becomes effective:

(1) the converted entity is:

(A) organized under and subject to the organic law of the converted entity;

and

(B) the same entity without interruption as the converting entity;

(2) all property of the converting entity continues to be vested in the converted entity without transfer, reversion, or impairment;

(3) all debts, obligations, and other liabilities of the converting entity continue as debts, obligations, and other liabilities of the converted entity;

(4) except as otherwise provided by law or the plan of conversion, all the rights, privileges, immunities, powers, and purposes of the converting entity remain in the converted entity;



(5) the name of the converted entity may be substituted for the name of the converting entity in any pending action or proceeding;

(6) if a converted entity is a filing entity, its public organic record is effective;

(7) if the converted entity is a limited liability partnership, its statement of qualification is effective;

(8) the private organic rules of the converted entity which are to be in a record, if any, approved as part of the plan of conversion are effective; and

(9) the interests in the converting entity are converted, and the interest holders of the converting entity are entitled only to the rights provided to them under the plan of conversion and to any appraisal rights they have under Section 2-109 and the converting entity's organic law.

(b) Except as otherwise provided in the organic law or organic rules of the converting entity, the conversion does not give rise to any rights that an interest holder, governor, or third party would have upon a dissolution, liquidation, or winding up of the converting entity.

(c) When a conversion becomes effective, a person that did not have interest holder liability with respect to the converting entity and becomes subject to interest holder liability with respect to a domestic entity as a result of the conversion has interest holder liability only to the extent provided by the organic law of the entity and only for those debts, obligations, and other liabilities that are incurred after the conversion becomes effective.

(d) When a conversion becomes effective, the interest holder liability of a person that ceases to hold an interest in a domestic converting entity with respect to which the person had interest holder liability is subject to the following rules:

(1) The conversion does not discharge any interest holder liability under the

organic law of the domestic converting entity to the extent the interest holder liability was incurred before the conversion became effective.

(2) The person does not have interest holder liability under the organic law of the domestic converting entity for any debt, obligation, or other liability that is incurred after the conversion becomes effective.

(3) The organic law of the domestic converting entity continues to apply to the release, collection, or discharge of any interest holder liability preserved under paragraph (1) as if the conversion had not occurred.

(4) The person has whatever rights of contribution from any other person as are provided by other law or the organic rules of the domestic converting entity with respect to any interest holder liability preserved under paragraph (1) as if the conversion had not occurred.

(e) When a conversion becomes effective, a foreign entity that is the converted entity may be served with process in this state for the collection and enforcement of any of its debts, obligations, and other liabilities in accordance with applicable law.

(f) If the converting entity is a registered foreign entity, its registration to do business in this state is canceled when the conversion becomes effective.

(g) A conversion does not require the entity to wind up its affairs and does not constitute or cause the dissolution of the entity.

### **Comment**

A converted entity is the same entity as it was before the conversion; it just has a different legal form. The legal effects of this are set forth in subsection (a). The converted entity remains the owner of all real and personal property and remains subject to all the liabilities, actual or contingent, of the converted entity. A conversion is not a conveyance, transfer, or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance or transfer. It does not give rise to a claim that a contract with the converting entity is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a conversion. The contract rights that remain in the

converted entity include, without limitation, the right to enforce subscription agreements for interests and obligations to make capital contributions entered into or incurred before the conversion.

When a conversion becomes effective, the internal affairs of the converting entity are no longer governed by its former organic law but instead by the organic law of the converted entity. As a result, filings that may have been made under the organic law of the converting entity, such as the following, will no longer be effective: a statement of qualification as a limited liability partnership under Section 3-901, a statement of partnership authority under Section 3-303, a statement of authority under Section 5-302 with respect to a limited liability company, or a statement of authority under Section 7-107 with respect to an unincorporated nonprofit association.

**Subsection (a)(5)** – All pending proceedings involving the converting entity are continued. The name of the converted entity may be, but need not be, substituted in any pending proceeding for the name of the converting entity.

**Subsection (c)** – Subsection (c) provides the rule for future interest holder liability and parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 5 (domestications). *See* the comment to Section 2-206(c).

**Subsection (d)** – Subsection (d) provides the rule for past interest holder liability and parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 5 (domestications). *See* the comment to Section 2-206(d).

**Subsection (e)** – When a domestic converting entity becomes a foreign entity as a result of a conversion, some mechanism is needed to facilitate the enforcement of claims by the creditors and interest holders of the converting entity. Section 2-406(e), which parallels analogous provisions in Parts 2 (mergers) and 5 (domestications), authorizes service of process for all such claims in this state.

**Subsection (g)** – When a conversion takes effect, the entity continues to exist – simply in a different form. Subsection (g) thus makes clear that the conversion does not require the entity to wind up its affairs and does not constitute or cause the dissolution of the entity.

## **[PART] 5**

### **DOMESTICATION**

#### **SECTION 2-501. DOMESTICATION AUTHORIZED.**

(a) Except as otherwise provided in this section, by complying with this [part], a domestic entity may become a domestic entity of the same type of entity in a foreign jurisdiction if the domestication is authorized by the law of the foreign jurisdiction.

(b) Except as otherwise provided in this section, by complying with the provisions of this [part] applicable to foreign entities a foreign entity may become a domestic entity of the same type of entity in this state if the domestication is authorized by the law of the foreign entity's jurisdiction of formation.

(c) If a protected agreement contains a provision that applies to a merger of a domestic entity but does not refer to a domestication, the provision applies to a domestication of the entity as if the domestication were a merger until the provision is amended after [the effective date of this [article]].

[(d) This [part] does not apply to the domestication of:

(1) [a business corporation, if the state has adopted Subchapter 9B of the Model Business Corporation Act]; [or]

(2) [a nonprofit corporation, if the state has adopted Subchapter 9B of the Model Nonprofit Corporation Act]; [or]

(3).]

### **Comment**

A domestication authorized by Part 5 differs from a conversion in that a domestication requires that the domesticating entity be the same type of entity as the domesticated entity. In a conversion, by contrast, the converting entity changes its type.

As with a conversion, all rights and privileges, debts, obligations, and other liabilities, and actions or proceedings of a domesticating entity vest unimpaired in the domesticated entity. A domestication is not a sale, transfer, assignment, or conveyance and does not give rise to a claim of reverter or impairment of title.

Part 5 governs the legal effect of a foreign entity domesticating in a jurisdiction adopting this article. On the other hand, the organic laws of the foreign jurisdiction, and not Part 5, will govern the legal effect of most aspects of a domestication of a domestic entity in another jurisdiction. In the latter scenario, Part 5 authorizes the domestication of the domestic entity in the foreign jurisdiction, but Part 5 does not create a right in the domestic entity to be received in the foreign jurisdiction. Similarly, Section 2-501 does not provide a right on the part of a foreign entity to become a domestic entity if the domestication is not authorized by the laws of the

foreign jurisdiction. If the foreign jurisdiction does not authorize a domestication, the same result can be accomplished by forming a new entity of the same type in the new state and merging the existing entity into the new entity.

## **SECTION 2-502. PLAN OF DOMESTICATION.**

(a) A domestic entity may become a foreign entity in a domestication by approving a plan of domestication. The plan must be in a record and contain:

- (1) the name and type of entity of the domesticating entity;
- (2) the name and jurisdiction of formation of the domesticated entity;
- (3) the manner of converting the interests in the domesticating entity into interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing;
- (4) the proposed public organic record of the domesticated entity if it is a filing entity;
- (5) the full text of the private organic rules of the domesticated entity that are proposed to be in a record;
- (6) the other terms and conditions of the domestication; and
- (7) any other provision required by the law of this state or the organic rules of the domesticating entity.

(b) In addition to the requirements of subsection (a), a plan of domestication may contain any other provision not prohibited by law.

### **Comment**

This section sets forth the requirements for the plan of domestication, which must be approved by the domesticating entity in accordance with Section 2-503. The content of a plan of domestication is similar to the content of a plan of merger. *See* Section 2-202. Subsection (a) lists the mandatory provisions that must be in the plan. Subsection (b) authorizes the plan to contain any other provision the parties wish to include, unless the provision is prohibited by law.

The plan of domestication, may, but need not, be filed instead of the statement of domestication, so long as it contains all of the information required to be in the statement and is delivered to the filing office for filing after the plan has been adopted and approved. *See* Section 2-505(e).

**Subsection (a)(3)** – Interest holders in the domesticating entity may receive interests or other securities of the domesticated entity or any other person, obligations, rights to acquire interests or other securities, cash, or other property.

### **SECTION 2-503. APPROVAL OF DOMESTICATION.**

(a) A plan of domestication is not effective unless it has been approved:

(1) by a domestic domesticating entity:

(A) in accordance with the requirements, if any, in its organic rules for approval of a domestication;

(B) if its organic rules do not provide for approval of a domestication, in accordance with the requirements, if any, in its organic law and organic rules for approval of:

(i) in the case of an entity that is not a business corporation or limited cooperative association, a merger, as if the domestication were a merger;

(ii) in the case of a business corporation, a merger requiring approval by a vote of the interest holders of the business corporation, as if the domestication were that type of merger;

(iii) in the case of a limited cooperative association, a transaction under this [part]; or

(C) by all of the interest holders of the entity entitled to vote on or consent to any matter if:

(i) in the case of an entity that is not a business corporation or limited cooperative association, neither its organic law nor organic rules provide for approval of a domestication or a merger;

(ii) in the case of a limited cooperative association, neither its organic law nor organic rules provide for approval of a domestication or a transaction under this [part]; and

(2) in a record, by each interest holder of a domestic domesticating entity that will have interest holder liability for debts, obligations, and other liabilities that are incurred after the domestication becomes effective, unless, in the case of an entity that is not a business corporation or nonprofit corporation:

(A) the organic rules of the entity in a record provide for the approval of a domestication or merger in which some or all of its interest holders become subject to interest holder liability by the vote or consent of fewer than all the interest holders; and

(B) the interest holder consented in a record to or voted for that provision of the organic rules or became an interest holder after the adoption of that provision.

(b) A domestication of a foreign domesticating entity is not effective unless it is approved in accordance with the law of the foreign entity's jurisdiction of formation.

***Legislative Note:*** *The analysis of approval requirements in the Legislative Note to Section 2-303 should also be undertaken with respect to domestications.*

### **Comment**

**Subsection (a)** – As is the case with the other types of transactions authorized by this article, there are three possible ways to obtain approval of a domestication by a domestic entity. The first is to determine if the organic rules (defined in Section 1-102(33)) of the domesticating entity contain specific approval provisions for a domestication. If they exist, then those provisions apply to approval of the plan of domestication. If there are no domestication approval provisions, then the approval process for a merger in either the entity's organic law (defined in Section 1-102(32)) or organic rules will apply. If there are no specific domestication approval provisions in the entity's organic rules and no merger approval provisions in the entity's organic law or organic rules, then unanimous consent of all the entity's interest holders is required.

In the case of a foreign entity that is domesticating in this state, subsection (b) provides that the required approval is determined by the laws of the foreign entity's jurisdiction of formation.

**Subsection (a)(1)(B)(ii)** – Subsection(a)(1)(B) requires that a domestication be approved by a business corporation in the same manner as a merger that requires approval by a vote of the shareholders. *See* the comment to Section 2-303(a)(1)(B)(ii).

**Subsection (a)(2)** – See the comment to Section 2-203(a)(2) for an explanation of this interest holder liability provision.

## **SECTION 2-504. AMENDMENT OR ABANDONMENT OF PLAN OF DOMESTICATION.**

(a) A plan of domestication of a domestic domesticating entity may be amended:

(1) in the same manner as the plan was approved, if the plan does not provide for the manner in which it may be amended; or

(2) by its governors or interest holders in the manner provided in the plan, but an interest holder that was entitled to vote on or consent to approval of the domestication is entitled to vote on or consent to any amendment of the plan that will change:

(A) the amount or kind of interests, securities, obligations, money, other property, rights to acquire interests or securities, or any combination of the foregoing, to be received by any of the interest holders of the domesticating entity under the plan;

(B) the public organic record, if any, or private organic rules of the domesticated entity that will be in effect immediately after the domestication becomes effective, except for changes that do not require approval of the interest holders of the domesticated entity under its organic law or organic rules; or

(C) any other terms or conditions of the plan, if the change would adversely affect the interest holder in any material respect.

(b) After a plan of domestication has been approved by a domestic domesticating entity and before a statement of domestication is effective, the plan may be abandoned as provided in the plan. Unless prohibited by the plan, a domestic domesticating entity may abandon the plan in



the same manner as the plan was approved.

(c) If a plan of domestication is abandoned after a statement of domestication has been delivered to the [Secretary of State] for filing and before the statement is effective, a statement of abandonment, signed by the entity, must be delivered to the [Secretary of State] for filing before the statement of domestication is effective. The statement of abandonment takes effect on filing, and the domestication is abandoned and does not become effective. The statement of abandonment must contain:

- (1) the name of the domesticating entity;
- (2) the date on which the statement of domestication was filed by the [Secretary of State]; and
- (3) a statement that the domestication has been abandoned in accordance with this section.

### **Comment**

This section parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 4 (conversions). *See* Sections 2-204 (mergers), 2-304 (interest exchanges), and 2-404 (conversions).

## **SECTION 2-505. STATEMENT OF DOMESTICATION; EFFECTIVE DATE OF DOMESTICATION.**

(a) A statement of domestication must be signed by the domesticating entity and delivered to the [Secretary of State] for filing.

(b) A statement of domestication must contain:

- (1) the name, jurisdiction of formation, and type of entity of the domesticating entity;
- (2) the name and jurisdiction of formation of the domesticated entity;

(3) if the statement of domestication is not to be effective upon filing, the later date and time on which it will become effective, which may not be more than 90 days after the date of filing;

(4) if the domesticating entity is a domestic entity, a statement that the plan of domestication was approved in accordance with this [part] or, if the domesticating entity is a foreign entity, a statement that the domestication was approved in accordance with the law of its jurisdiction of formation;

(5) if the domesticated entity is a domestic filing entity, its public organic record, as an attachment;

(6) if the domesticated entity is a domestic limited liability partnership, its statement of qualification, as an attachment; and

(7) if the domesticated entity is a foreign entity that is not a registered foreign entity, a mailing address to which the [Secretary of State] may send any process served on the [Secretary of State] pursuant to Section 2-506(e).

(c) In addition to the requirements of subsection (b), a statement of domestication may contain any other provision not prohibited by law.

(d) If the domesticated entity is a domestic entity, its public organic record, if any, must satisfy the requirements of the law of this state, but the public organic record does not need to be signed and may omit any provision that is not required to be included in a restatement of the public organic record.

(e) A plan of domestication that is signed by a domesticating domestic entity and meets all the requirements of subsection (b) may be delivered to the [Secretary of State] for filing instead of a statement of domestication and on filing has the same effect. If a plan of

domestication is filed as provided in this subsection, references in this [article] to a statement of domestication refer to the plan of domestication filed under this subsection.

(f) A statement of domestication is effective on the date and time of filing or the later date and time specified in the statement of domestication.

(g) A domestication in which the domesticated entity is a domestic entity becomes effective when the statement of domestication is effective. A domestication in which the domesticated entity is a foreign entity becomes effective on the later of:

- (1) the date and time provided by the organic law of the domesticated entity; or
- (2) when the statement is effective.

### **Comment**

The filing of a statement of domestication makes the transaction a matter of public record. The requirements for a statement of domestication are set forth in subsection (b). They are essentially the same as the requirements for a statement of merger in Section 2-205.

**Subsection (b)(3) and (f)** – The effective date and time of a statement of domestication are the date and time of its filing, unless otherwise specified. If a delayed effective date is specified, the statement of domestication is effective on that date and time, subject to the 90 day maximum delayed effective date in subsection (b)(3).

**Subsection (e)** – A plan of domestication can be used as a substitute for the statement of domestication so long as the plan satisfies the requirements in subsection (e).

**Subsection (g)** – When the statement of domestication is effective under subsection (f), the domestication transaction occurs if the domesticated entity is a domestic entity. A domestication in which the domesticated entity is a foreign entity will usually also take effect when the statement of domestication takes effect because the best practice will be to coordinate the filings that need to be made in each jurisdiction so that they take effect at the same time. Because of the possibility, however, that the filing in the foreign jurisdiction will take effect at a different time, subsection (g) provides that the domestication transaction itself will take effect at the later of (i) when the statement of domestication takes effect, and (ii) when the domestication takes effect under the law of the foreign jurisdiction. This rule avoids the possibility that the domestication will take effect in the domestic jurisdiction before it takes effect in the foreign jurisdiction, which would produce the undesirable result that the domesticating domestic entity would cease to appear as an active entity on the records of this state before it appears as its active domesticated self on the records of the foreign jurisdiction.

It is only necessary for the filing office to record the effective date of the statement of domestication and the filing office does not need to be concerned with the effective date of the domestication itself. Persons wishing to determine the effective date of a domestication will be able to do so by consulting the records of the filing offices in each jurisdiction.

## **SECTION 2-506. EFFECT OF DOMESTICATION.**

(a) When a domestication becomes effective:

(1) the domesticated entity is:

(A) organized under and subject to the organic law of the domesticated entity; and

(B) the same entity without interruption as the domesticating entity;

(2) all property of the domesticating entity continues to be vested in the domesticated entity without transfer, reversion, or impairment;

(3) all debts, obligations, and other liabilities of the domesticating entity continue as debts, obligations, and other liabilities of the domesticated entity;

(4) except as otherwise provided by law or the plan of domestication, all of the rights, privileges, immunities, powers, and purposes of the domesticating entity remain in the domesticated entity;

(5) the name of the domesticated entity may be substituted for the name of the domesticating entity in any pending action or proceeding;

(6) if the domesticated entity is a filing entity, its public organic record is effective;

(7) if the domesticated entity is a limited liability partnership, its statement of qualification is effective simultaneously;

(8) the private organic rules of the domesticated entity that are to be in a record, if any, approved as part of the plan of domestication are effective; and

(9) the interests in the domesticating entity are converted to the extent and as approved in connection with the domestication, and the interest holders of the domesticating entity are entitled only to the rights provided to them under the plan of domestication and to any appraisal rights they have under Section 2-109 and the domesticating entity's organic law.

(b) Except as otherwise provided in the organic law or organic rules of the domesticating entity, the domestication does not give rise to any rights that an interest holder, governor, or third party would have upon a dissolution, liquidation, or winding up of the domesticating entity.

(c) When a domestication becomes effective, a person that did not have interest holder liability with respect to the domesticating entity and becomes subject to interest holder liability with respect to a domestic entity as a result of the domestication has interest holder liability only to the extent provided by the organic law of the entity and only for those debts, obligations, and other liabilities that are incurred after the domestication becomes effective.

(d) When a domestication becomes effective, the interest holder liability of a person that ceases to hold an interest in a domestic domesticating entity with respect to which the person had interest holder liability is subject to the following rules:

(1) The domestication does not discharge any interest holder liability under the organic law of the domesticating domestic entity to the extent the interest holder liability was incurred before the domestication became effective.

(2) A person does not have interest holder liability under the organic law of the domestic domesticating entity for any debt, obligation, or other liability that is incurred after the domestication becomes effective.

(3) The organic law of the domestic domesticating entity continues to apply to the release, collection, or discharge of any interest holder liability preserved under paragraph (1) as

if the domestication had not occurred.

(4) A person has whatever rights of contribution from any other person as are provided by other law or the organic rules of the domestic domesticating entity with respect to any interest holder liability preserved under paragraph (1) as if the domestication had not occurred.

(e) When a domestication becomes effective, a foreign entity that is the domesticated entity may be served with process in this state for the collection and enforcement of any of its debts, obligations, and other liabilities in accordance with applicable law.

(f) If a domesticating entity is a registered foreign entity, the registration to do business in this state of the domesticating entity is canceled when the domestication becomes effective.

(g) A domestication does not require the entity to wind up its affairs and does not constitute or cause the dissolution of the entity.

### **Comment**

**Subsection (a)(1)** – The domesticated entity is the same entity as the domesticating entity; it has merely changed its jurisdiction of formation.

**Subsection (a)(2)** – A domestication is not a sale, conveyance, transfer, or assignment and does not give rise to claims of reverter or impairment of title that may be based on a prohibition on transfer, assignment, or conveyance.

**Subsection (a)(5)** – All pending proceedings involving the domesticating entity are continued. The name of the domesticated entity may be, but need not be, substituted in any pending proceeding for the name of the domesticating entity.

**Subsection (a)(9)** – The interests of the domesticating entity are reclassified into whatever rights were negotiated in the domestication and the interest holders of the domesticating entity are only entitled to those rights. Subsection (a)(9), on its face, allows certain owners in the domesticating entity to be entitled to a continuing equity interest in the domesticated entity whereas other owners in the domesticating entity may be cashed out as a result of the transaction.

**Subsection (c)** – Subsection (c) provides the rule for future interest holder liability and parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 4 (conversions).

*See the comment to Section 2-206(c).*

**Subsection (d)** – Subsection (d) provides the rule for past interest holder liability and parallels analogous provisions in Parts 2 (mergers), 3 (interest exchanges), and 4 (conversions). *See the comment to Section 2-206(d).*

**Subsection (e)** – When a domestic domesticating entity becomes a foreign entity as a result of a domestication, some mechanism is needed to facilitate the enforcement of claims by the creditors and interest holders of the domesticating entity. Subsection (e), which parallels analogous provisions in Parts 2 (mergers) and 4 (conversions), authorizes service of process for all such claims in this state.

**Subsection (g)** – When a domestication takes effect, the entity continues to exist – simply as a domestic entity under the laws of a different state. Subsection (g) thus makes clear that the domestication does not require the entity to wind up its affairs and does not constitute or cause the dissolution of the entity.

## **ARTICLE 3**

### **GENERAL PARTNERSHIPS**

#### **[PART] 1**

#### **GENERAL PROVISIONS**

**SECTION 3-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – General Partnerships.

#### **Comment**

This article replaces a state’s current general partnership statute, whether or not that statute is based on UPA (1914) or UPA (1997). Section 3-110 contains transition provisions for the applicability of this article to general partnerships formed before the effective date of the Code (*see* Section 1-708).

#### **SECTION 3-102. DEFINITIONS.**

(a) In this [article]:

(1) “Business” includes every trade, occupation, and profession.

(2) “Contribution”, except in the phrase “right of contribution”, means property or a benefit described in Section 3-403 which is provided by a person to a partnership to become a partner or in the person’s capacity as a partner.

(3) “Distribution” means a transfer of money or other property from a partnership to a person on account of a transferable interest or in a person’s capacity as a partner. The term:

(A) includes:

(i) a redemption or other purchase by a partnership of a transferable interest; and

(ii) a transfer to a partner in return for the partner’s relinquishment of any right to participate as a partner in the management or conduct of the partnership’s business or have access to records or other information concerning the partnership’s business; and

(B) does not include amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.

(4) “Limited liability partnership” means a partnership that has filed a statement of qualification under Section 3-901 and does not have a similar statement in effect in any other jurisdiction.

(5) “Partner” means a person that:

(A) has become a partner in a partnership under Section 3-402 or was a partner in a partnership when the partnership became subject to this [article] under Section 3-110; and

(B) has not dissociated as a partner under Section 3-601.

(6) “Partnership” means an association of two or more persons to carry on as co-owners a business for profit formed under this [article] or that becomes subject to this [article] under [Article] 2 or Section 3-110. The term includes a limited liability partnership.

(7) “Partnership agreement” means the agreement, whether or not referred to as a



partnership agreement and whether oral, implied, in a record, or in any combination thereof, of all the partners of a partnership concerning the matters described in Section 3-105(a). The term includes the agreement as amended or restated.

(8) “Partnership at will” means a partnership in which the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking.

(9) “Transferable interest” means the right, as initially owned by a person in the person’s capacity as a partner, to receive distributions from a partnership, whether or not the person remains a partner or continues to own any part of the right. The term applies to any fraction of the interest, by whomever owned.

(10) “Transferee” means a person to which all or part of a transferable interest has been transferred, whether or not the transferor is a partner.

(b) The following definitions outside this [article] apply to this [article]:

(1) “Debtor in bankruptcy” – Section 1-102(6).

(2) “Foreign” – Section 1-102(14).

(3) “Jurisdiction” – Section 1-102(21).

(4) “Jurisdiction of formation” – Section 1-102(22).

(5) “Person” – Section 1-102(34).

(6) “Principal office” – Section 1-102(35).

(7) “Property” – Section 1-102(38).

(8) “Receipt” – Section 1-102(40).

(9) “Record” – Section 1-102(41).

(10) “Registered agent” – Section 1-102(43).

(11) “Sign” – Section 1-102(44).

(12) “State” – Section 1-102(45).

(13) “Transfer” – Section 1-102(47).

### Comment

Subsection (a) contains definitions for terms used throughout this article. Subsection (b) contains a list of definitions in Article 1 that are applicable to this article.

**“Business” [(a)(1)]**—This definition originated in UPA (1914) § 2 and is fundamentally important; a general partnership must have a business purpose. *See* Section 3-202(a) (referring to the association of two or more persons to carry on as co-owners a business for profit). *Compare* Section 3-102(1), *with* Section 4-110(b) (“A limited partnership may have any lawful purpose, regardless of whether for profit.”), *and* Section 5-108(a) (same as to a limited liability company).

**“Contribution” [(a)(2)]**—This definition is based on ULPA (2001) § 102(2) and serves to distinguish capital contributions from other circumstances under which a partner or would-be partner might provide benefits to a general partnership (*e.g.*, providing services to the partnership as an employee or independent contractor, leasing property to the partnership).

This definition also distinguishes “contributions” from capital raised from transferees who invest; to be a contribution, the property or benefit must be “provided by a person ... to become a partner or in the person’s capacity as a partner.” This definition is ubiquitous in the law of unincorporated business organizations. *See, e.g.*, ULPA (2001) § 102(2) (“Contribution”); N.Y. LTD.LIAB. CO.LAW § 102(f) (McKinney 2013) (“‘Contribution’ means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to render services that a member contributes to a limited liability company in his or her capacity as a member.”).

In contrast, partnership agreements sometimes provide for contributions from transferees. In such circumstances, the default rules for liquidating distributions should be altered accordingly. *See* Section 3-806(b)(1) (referring to distributions to be made “to each person owning a transferable interest that reflects *contributions* made and not previously returned.”) (emphasis added).

**“Distribution” [(a)(3)(A)—redemptions included]**—This provision specifically refers to transactions between a general partnership and one of its partners, which in the corporate context would be labeled “redemption.” The paragraph has subparts because ownership interests in a partnership are conceptually bifurcated into economic rights (“transferable interests”), and governance and information rights.

Under Section 3-405(a), “[a]ny distribution made by a partnership before its dissolution and winding up must be in equal shares among partners, except to the extent necessary to comply

with a transfer effective under Section 3-503 or charging order in effect under Section 3-504.” Since a redemption is a distribution, absent authorization in the partnership agreement a partnership may not redeem the interest of one partner or transferee without redeeming (or at least offering to redeem) the interests of all other partners and transferees to a comparable extent.

The law of close corporations has flirted with a similar notion. *See, e.g., Donahue v. Rodd Electrottype Co. of New England, Inc.*, 328 N.E.2d 505, 518 (Mass. 1975) (stating, with regard to closely held corporations, “if the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price”); *cf. Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976) (stating that “untempered application of the strict good faith standard enunciated in *Donahue* . . . will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned”). *See also Toner v. Baltimore Envelope Co.*, 498 A.2d 642, 650 (Md. 1985) (rejecting the “per se breach of duty” approach).

A partnership agreement can override Section 3-405(a)’s equal treatment requirement without specifically mentioning redemptions.

EXAMPLE: Ryan Company is a general partnership whose partnership agreement: (i) includes a list (the “protected list”) of decisions or actions that may be taken only with the consent of all partners; and (ii) provides that all other decisions and acts may be taken as the Management Committee determines. The protected list does not include redemptions. The partnership agreement overrides the Section 3-404(a)’s equal treatment requirement.

**Subsection (a)(3)(B) [exclusion]**—This exclusion affects the reach of: (i) the charging order remedy under Section 3-504; and (ii) Section 3-407’s clawback provision applicable to distributions made by a limited liability partnership. The effect on the clawback provision reflects the law in several states, *see, e.g.,* DEL. CODE ANN. tit. 6, § 15-309(a) (2014); VA. CODE ANN. § 13.1-1036 (2014), and makes sense conceptually and as a matter of policy. *See In re Tri-River Trading, L.L.C.*, 329 B.R. 252, 266 (B.A.P. 8th Cir. 2005), *aff’d*, 452 F.3d 756 (8th Cir. 2006) (“We know of no principle of law which suggests that a manager of a company is required to give up agreed upon salary to pay creditors when business turns bad.”). UPA (1997) provides no clawback provision, an omission that disadvantaged creditors of an LLP compared to creditors of other entities with a liability shield.

**“Limited liability partnership” [(a)(4)]**—Under this article (and most, if not all, LLP statutes), a general partnership obtains its LLP status from only one jurisdiction. The resulting LLP is “domestic” with regard to that jurisdiction and “foreign” with regard to all others.

Sections 3-901(f) (cancellation of statement of qualification) and 3-903 (administrative revocation of statement of qualification) limit this paragraph’s open-ended definition of a “limited liability partnership” as “a partnership that has filed a statement of qualification under Section 3-901.” Under this article, LLP status depends on a statement of qualification being in

effect. *See* Section 3-903(d) and its comment.

**“Partner” [(a)(5)]**—Under Section 3-202(a), any “person” can be a partner. Section 1-102(34) defines “person” very broadly to include individuals and “any . . . legal or commercial entity.” At common law, “[t]he general rule . . . [was] that every person of sound mind, *sui juris*, and not otherwise restrained by law, may enter into a contract of partnership.” JOSEPH STORY, COMMENTARIES ON THE LAW ON PARTNERSHIP § 7, at 10 (2d ed. 1850). The phrase “sound mind” and the term “*sui juris*” suggest that at common law a partner was necessarily an individual. *See* BLACK’S LAW DICTIONARY (9th ed. 2009) (defining *sui juris* as one “[o]f full age and capacity”). UPA (1914) § 2 defined “person” to include “partnerships, corporations, and other associations.” *See, e.g., Williams v. Mammoth of Alaska, Inc.*, 890 P.2d 581, 584 n.8 (Alaska 1995) (stating that under UPA (1914) “[a] partner need not be a natural person”).

After a person has been dissociated as a partner under Section 3-602, the term “partner” continues to apply to the person’s conduct while a partner. *See* Section 3-603(b).

**“Partnership” [(a)(6)]**—This definition, combined with Section 3-202(a), makes clear that a general partnership is a *business* organization. This definition makes no reference to a partnership having partners upon formation, but Section 3-202(a) does.

**“Partnership agreement” [(a)(7)]**—This definition must be read in conjunction with Sections 3-105 through 3-107, which further describe the partnership agreement. In particular, although this definition refers to “the agreement . . . of all the partners,” the partnership itself is bound by and may enforce the agreement. Section 3-106(a).

A partnership agreement is a contract, and therefore all statutory language pertaining to the partnership agreement must be understood in the context of the law of contracts.

The definition in Paragraph 12 is very broad and recognizes a wide scope of authority for the partnership agreement: “the matters described in Section 3-105(a).” Those matters include not only all relations *inter se* the partners and the partnership but also “the business of the partnership and the conduct of that business.” Section 3-105(a)(2). Moreover, the definition puts no limits on the form of the partnership agreement. To the contrary, the definition contains the phrase “whether oral, implied, in a record, or in any combination thereof.”

Unless the partnership agreement itself provides otherwise:

- A partnership agreement may comprise a number of separate documents (or records), however denominated; and
- Subject to Section 3-106(b) (deeming new partners to assent to the then-existing partnership agreement), a document, record, understanding, etc. can be part of the partnership agreement only with the assent of all persons then partners.

An agreement among less than all partners might well be enforceable among those partners as parties, but would not be part of the partnership agreement. However, under Section 3-105(a)(3), an amendment to a partnership agreement can be made with less than unanimous

consent if the partnership agreement itself so provides.

An agreement to form a partnership is not itself a partnership agreement. The term “partnership agreement” presupposes “partners,” and a person cannot be a partner in a partnership before the partnership exists. However, as soon as a partnership comes into existence, it perforce has a partnership agreement. For example, suppose: (i) two persons orally and informally agree to join their activities in a manner that satisfies Section 3-202 (formation of partnership); (ii) the partnership is thus formed; and (iii) without further ado or agreement, the persons become the partnership’s initial partners. A partnership agreement exists. In the words of Paragraph 12 “all the partners” have agreed who the partners are and that, as “all the partners,” they will conduct a business. That agreement—no matter how informal or rudimentary—is an agreement “concerning the matters described in Section 3-105(a).” To the extent the agreement does not provide the *inter se* “rules of the game,” the “default rules” of this article “fill in the gaps.” Section 3-105(b).

This article states no rule as to whether the statute of frauds applies to partnership agreements. Case law suggests that the answer is yes:

Partnership agreements, like other contracts, are subject to the Statute of Frauds. A contract of partnership for a term exceeding one year is within the Statute of Frauds and is void unless it is in writing [and signed by the party to be bound]; however, a contract establishing a partnership terminable at the will of any partner is generally held to be capable of performance by its terms within one year of its making and, therefore, to be outside the Statute of Frauds.

*Abbott v. Hurst*, 643 So. 2d 589, 592 (Ala. 1994) (citations omitted).

Likewise, the land provision of the statute of frauds:

applies to an oral contract to transfer or convey partnership real property, and the interest of the other partners therein, to one partner as an individual, as well as to a parol contract by one of the parties to convey certain land owned by him individually to the partnership, or to another partner, or to put it into the partnership stock.

*Froiseth v. Nowlin*, 287 P. 55, 56 (Wash. 1930) (quoting 27 C.J.S. § 220); *see also E. Piedmont 120 Associates, L.P. v. Sheppard*, 434 S.E.2d 101, 102 (Ga. Ct. App. 1993) (same, stating that “the fact that promises covered by the Statute of Frauds are made in the context of a partnership or joint venture agreement does not render the statute inapplicable”); *Filippi v. Filippi*, 818 A.2d 608, 618 (R.I. 2003) (applying the statute of frauds to an alleged oral agreement to transfer land owned by a limited partnership to one of its partners).

In contrast, the land provision does not apply to a partner’s interest in a partnership, no matter how much the partnership owns or deals in real property. Interests in a partnership are personal property and reflect no direct interest in the entity’s assets. *See* Sections 3-102(23), 3-501. Thus, the real property issues pertaining to a partnership ownership of land do not “flow through” to the partners and partnership interests. *See, e.g., Wooten v. Marshall*, 153 F. Supp.

759, 763–64 (S.D.N.Y. 1957) (involving an “oral agreement for a joint venture concerning the purchase, exploitation and eventual disposition of this 160 acre tract” and stating “[t]he real property acquired and dealt with by the venturers takes on the character of personal property as between the partners in the enterprise, and hence is not covered by [the Statute of Frauds]”); *see also* *Wade v. DeHart*, 1926 WL 2944 (Ohio Misc. 1926), *aff’d sub nom.*, *Wade v. De Hart*, 159 N.E. 838 (Ohio Ct. App. 1927) (same).

On the question of how far a written (or “in a record”) partnership agreement can go to prevent oral or implied-in-fact terms, see Section 3-105(a)(3), comment. For the effect of a pre-formation agreement, see Section 3-106(c). For the partnership’s status viz-a-viz the partnership agreement, see Section 3-106(a).

**“Partnership at will” [(a)(8)]**—This paragraph defines “partnership at will” in the negative (*i.e.*, by stating what the defined term is not). A partnership is “at will” if the partners’ agreement does not obligate them to remain in the partnership until the passage of a specified time (a term) or the completion of a specified task, job, project, etc. (an undertaking).

“Partnership at will” is thus the default mode under this article; that is, a partnership is “at will” unless the partners have agreed otherwise. Absent such agreement, a partner may rightfully leave the partnership at any time (dissociate), Sections 3-601(1), 3-602(b)(2), and rightfully cause or seek the winding up of the partnership and its business (dissolution), Section 3-801(1); *see Fleming v. Hagen Estate*, 702 N.W.2d 786, 789 (Minn. Ct. App. 2005) (rejecting “the [appellant] estate’s assertion that the district court erred by not concluding that [a partner’s] counterclaim unilaterally dissolved the agreement pursuant to [Minnesota Statutes section 323A.0801]”; noting that “section 323A.0801(1) is applicable only to an at-will partnership”).

This article does not directly define “partnership for a term” and “partnership for an undertaking,” but their respective meanings are clear from this paragraph’s wording and the case law. *E.g.*, *Girard Bank v. Haley*, 332 A.2d 443, 447 (Pa. 1975) (“A ‘particular undertaking’ under the statute must be capable of accomplishment at some time, although the exact time may be unknown and unascertainable at the date of the agreement.”). This paragraph thus suggests that a partnership under this article will fit into one of three conveniently labeled categories: at-will, for a term, for an undertaking. However, hybrid structures are possible.

**EXAMPLE:** The partnership agreement of a general partnership:

- states a minimum term of ten years;
- permits one particular partner to leave the partnership at any time upon thirty days advance written notice; and
- provides that that person’s dissociation as a partner will neither cause the partnership to dissolve nor entitle any other person to dissociate.

Hybrid structures cause no trouble, if the partnership agreement: (i) clearly and completely details the partners’ understanding as to dissociation and dissolution; and (ii) does not confuse matters by inaccurately labeling the partnership as if it were a pure form of one of the three categories.

**“Transferable interest” [(a)(23)]**—Absent a contrary provision in the partnership

agreement or the consent of the partners, a “transferable interest” is the only interest in a partnership which can be transferred to a non-partner. *See* the comment to Section 3-502. This article does not define any term to encompass the entirety of a partner’s rights in a partnership (*i.e.*, governance and information rights as well as economic rights).

UPA (1997) took a different approach, defining the entirety of a partner’s rights directly and identifying the economic aspect through a limit on transferability. *See* UPA (1997) §§ 101(9) (defining “[p]artnership interest” or “partner’s interest in the partnership” as “all of a partner’s interests in the partnership, including the partner’s transferable interest and all management and other rights”) and 502 (stating that “the only transferable interest of a partner in the partnership is the partner’s share of the profits and losses of the partnership and the partner’s right to receive distributions”).

This article defines “[t]ransferable interest” as an interest “initially owned by a person in the person’s capacity as a partner,” because this article does not contemplate a partnership directly creating interests that comprise only economic rights. *See* Sections 3-402 (addressing how a person becomes a partner), 3-503 (addressing how a person becomes a transferee).

### **SECTION 3-103. KNOWLEDGE; NOTICE.**

(a) A person knows a fact if the person:

- (1) has actual knowledge of it; or
- (2) is deemed to know it under subsection (d)(1) or law other than this [article].

(b) A person has notice of a fact if the person:

- (1) has reason to know the fact from all the facts known to the person at the time in question; or
- (2) is deemed to have notice of the fact under subsection (d)(2).

(c) Subject to Section 1-212, a person notifies another person of a fact by taking steps reasonably required to inform the other person in ordinary course, whether or not those steps cause the other person to know the fact.

(d) A person not a partner is deemed:

- (1) to know of a limitation on authority to transfer real property as provided in Section 3-303(g); and

(2) to have notice of:

(A) a person's dissociation as a partner 90 days after a statement of dissociation under Section 3-704 becomes effective; and

(B) a partnership's:

(i) dissolution 90 days after a statement of dissolution under Section 3-802 becomes effective;

(ii) termination 90 days after a statement of termination under Section 3-802 becomes effective; and

(iii) participation in a merger, interest exchange, conversion, or domestication, 90 days after articles of merger, interest exchange, conversion, or domestication under [Article] 2 become effective.

(e) A partner's knowledge or notice of a fact relating to the partnership is effective immediately as knowledge of or notice to the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

### **Comment**

The Harmonization Project made two important changes to UPA (1997) in this section. First, unlike UPA (1997), this article contains no generally applicable provisions determining when an organization other than a partnership is charged with knowledge or notice, because those imputation rules: (i) comprise core topics within the law of agency; (ii) are very complicated; (iii) should not have any different content under this article than in other circumstances; and (iv) are the subject of considerable attention in the Restatement (Third) of Agency (2006). However, Subsection (e) does provide a rule for attributing to a partnership knowledge or notice possessed by a partner.

Second, this article does not define "notice" to include "knowledge." Although conceptualizing the latter as giving the former makes logical sense and has a long pedigree, that conceptualization is counter-intuitive for the uninitiated. In ordinary usage, notice has a meaning separate from knowledge. This article follows ordinary usage and therefore contains some references to "knowledge or notice."

**Subsection (a)(2)**—In this context, the most important source of "law other than this



[article]” is the common law of agency.

**Subsection (b)(1)**—The “facts known to the person at the time in question” include facts the person is deemed to know under Subsection (a)(2).

**Subsection (c)**—If a person “notifies” another person of a fact, the other person has “reason to know” the fact and therefore has notice under Subsection (b)(1). However, a person can have “notice” of a fact without having been “notifie[d]” of the fact.

Section 1-212 pertains to delivery of records *by* the filing office.

**Subsection (d)**—Following the pioneering approach of UPA (1997), this subsection provides constructive notice of facts stated in specified filed public records. The subsection works in conjunction with other sections of this article to curtail the power to bind and personal liability of partners and persons dissociated as partners. *See* Sections 3-702, 3-703, 3-804, 3-805. The constructive notice begins ninety days after the effective date of the filed record. For rules on delayed effective dates, see Section 1-203.

UPA (1997) used an oblique and decentralized approach to constructive notice. *See, e.g.,* UPA (1997) § 704(c) (stating that “for the purposes of Sections 702(a)(3) [pertaining to the lingering power to bind the partnership of a person dissociated as a partner] and 703(b)(3) [pertaining to a the lingering liability for partnership obligations of a person dissociated as a partner], a person not a partner is deemed to have notice of the dissociation 90 days after [a] statement of dissociation is filed”). As revised by the Harmonization Project, this subsection provides directly for constructive notice and centralizes all of this article’s constructive notice provisions except for those pertaining to statements of authority under Section 3-303.

**Subsection (e)**—This subsection states the rule for imputing a partner’s knowledge or notice to the partnership. The rule was part of the common law. *Peoples’ Bank of Baltimore v. Keech*, 26 Md. 521, 533 (Md. 1867) (holding that “the firm is bound by notice to one of the co-partners; because each represents the firm and is general agent of all”). UPA (1914) § 12 codified the rule, and UPA (1997) § 102(f) carried forward the codified rule with some modification. The Harmonization Project did not change UPA (1997) § 102(f), except to delete “receipt of a notification”; the phrase “receipt of a notification” is no longer a term of art in the LLC and partnership acts.

**SECTION 3-104. GOVERNING LAW.** The internal affairs of a partnership and the liability of a partner as a partner for a debt, obligation, or other liability of the partnership are governed by:

- (1) in the case of a limited liability partnership, the law of this state; and
- (2) in the case of a partnership that is not a limited liability partnership, the law of the

jurisdiction in which the partnership has its principal office.

### Comment

This section states two choice-of-law rules: an invariable rule for limited liability partnerships, Paragraph 1, and a default rule for non-LLPs, Paragraph 2. Both rules address “internal affairs” and “the liability of a partner as a partner for the debts, obligations, or other liabilities of the partnership.”

Like any other legal concept, “internal affairs” may be indeterminate at its edges. However, the concept certainly includes interpretation and enforcement of the partnership agreement, relations among the partners as partners, and relations between the partnership and a partner as a partner. *Compare* Section 3-104, *with* 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”).

“Internal affairs” do not encompass the power *vel non* of a person to bind a partnership. RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 292(2) (1971) (“The principal will be held bound by the agent’s action if he would so be bound under the local law of the state where the agent dealt with the third person, provided at least that the principal had authorized the agent to act on his behalf in that state or had led the third person reasonably to believe that the agent had such authority.”), 295(1) (“Whether a partnership is bound by action taken on its behalf by an agent in dealing with a third person is determined by the local law of the state selected by application of the rule of § 292.”); RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 345, cmt. c (1934) (Law Governing Effect of Act of Agent or Partner) (“If . . . the principal or partner sends the agent or other partner into a state to act on his behalf, he assumes the risk of liability not only for authorized but for unauthorized conduct of the agent or partner in accordance with the law of that state.”); *see also Farm & Ranch Services, Ltd. v. LT Farm & Ranch, L.L.C.*, 779 F. Supp. 2d 949, 960 (S.D. Iowa 2011).

“Internal affairs” and the “liability of a partner as a partner” are mentioned separately, because it can be argued that the liability of partners to third parties is not an internal affair. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 (1971) (treating shareholders’ liability separately from the internal affairs doctrine). A few cases subsume owner/manager liability into internal affairs. *See, e.g., Kalb, Voorhis & Co. v. American Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993) (holding that the corporation’s “primary purpose is to insulate shareholders from legal liability” and therefore “the state of incorporation has the greater interest in determining when and if that insulation is to be stripped away” (quoting *Soviet Pan Am Travel Effort v. Travel Comm., Inc.*, 756 F. Supp. 126, 131 (S.D.N.Y. 1991) (internal quotation marks omitted)).

In any event, neither “internal affairs” nor the “liability of a partner as a partner” encompass a claim that a partner is liable to a third party for: (i) having purported inaccurately to have the actual authority to bind a partnership to the third party; or (ii) having committed a tort against the third party while acting on the partnership’s behalf or in the course of the partnership’s business. That liability is not by status (*i.e.*, not “as a partner”) but rather results from function or conduct.

Treating “liability of a partner as a partner” as a matter of domestic law comports generally with the law of business entities. For example, some (if not all) limited liability partnership statutes so provide. *E.g.*, DEL. CODE ANN. tit. 6, § 15-1101(a) (2013) (stating that “[t]he law under which a foreign limited liability partnership is formed governs . . . the liability of partners for obligations of the partnership”); N.Y. P’SHP LAW § 121-1502(l) (2014) (stating that “[t]he laws of the jurisdiction that govern a foreign limited liability partnership shall determine . . . the liability of partners for debts, obligations and liabilities of, or chargeable to, the foreign limited liability partnership”).

Moreover, “[t]he general rule [from the case law] is that a plaintiff’s alter ego theory is governed by the law of the state in which the business at issue is organized.” *Rual Trade Ltd. v. Viva Trade L.L.C.*, 549 F. Supp. 2d 1067, 1077 (E.D. Wis. 2008); *see also In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747, 787 (Bankr. W.D. La. 2013) (stating both conceptual and policy rationales for choosing the law of the state of formation); *In re Saba Enters., Inc.*, 421 B.R. 626, 648–51 (Bankr. S.D.N.Y. 2009) (examining the issue in detail and applying the state of formation rule).

**Paragraph 1**—The partnership agreement cannot alter this paragraph. *See* Section 105(c)(1). In essence, when a partnership chooses where to deliver for filing a statement of qualification, the partnership chooses its governing law. This approach comports with the law of other businesses entities whose formation or legal status depends at least in part on a publicly filed record. *See, e.g.*, Section 4-104 (stating that the law of the state of formation is the governing law of a domestic limited partnership); 5-104 (same for limited liability companies).

However, a partnership agreement may lawfully incorporate by reference the provisions of another state’s partnership act. If done correctly, this incorporation makes the foreign statutory language part of the partnership agreement, and the incorporated terms (together with the rest of the partnership agreement) then govern the partners (and those claiming through the partners) to the extent not prohibited by this article. *See* Section 3-105. This approach: (i) does not switch the limited liability partnership’s governing law to that of another state; (ii) instead takes the provisions of another state’s law and incorporates them by reference into the contract among the partners; (iii) raises complex drafting issues – *e.g.*, how to address subsequent changes to the incorporated law (whether occurring by statutory amendment or court decision); and (iv) thus is rarely, if ever, a good idea.

**Paragraph 2**—Section 1-102(35) defines “principal office.”

The partnership agreement may change the rule stated in this paragraph, although other law may limit a partnership’s options. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 294 (1971) (Relationship of Partners Inter Se), 187(2) (stating the limited bases for disregarding a contractual choice of law).

When a statement of qualification becomes effective under Section 3-901: (i) this paragraph no longer applies; and (ii) neither the partnership’s principal office nor the partnership agreement is relevant to determining the law governing the partnership’s internal affairs. Section 3-105(c)(1) (stating that the partnership agreement may not “vary the law applicable under

Section 3-104(1)’’).

*See also* Section 1-702 (Supplemental Principles of Law).

**SECTION 3-105. PARTNERSHIP AGREEMENT; SCOPE, FUNCTION, AND LIMITATIONS.**

(a) Except as otherwise provided in subsections (c) and (d), the partnership agreement governs:

(1) relations among the partners as partners and between the partners and the partnership;

(2) the business of the partnership and the conduct of that business; and

(3) the means and conditions for amending the partnership agreement.

(b) To the extent the partnership agreement does not provide for a matter described in subsection (a), this [article] governs the matter.

(c) A partnership agreement may not:

(1) vary the law applicable under Section 3-104(1);

(2) vary the provisions of Section 3-110;

(3) vary the provisions of Section 3-307;

(4) unreasonably restrict the duties and rights under Section 3-408, but the partnership agreement may impose reasonable restrictions on the availability and use of information obtained under that section and may define appropriate remedies, including liquidated damages, for a breach of any reasonable restriction on use;

(5) alter or eliminate the duty of loyalty or the duty of care, except as otherwise provided in subsection (d);

(6) eliminate the contractual obligation of good faith and fair dealing under

Section 3-409(d), but the partnership agreement may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured;

(7) unreasonably restrict the right of a person to maintain an action under Section 3-410(b);

(8) relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law;

(9) vary the power of a person to dissociate as a partner under Section 3-602(a), except to require that the notice under Section 3-601(1) to be in a record;

(10) vary the grounds for expulsion specified in Section 3-601(5);

(11) vary the causes of dissolution specified in Section 3-801(4) or (5);

(12) vary the requirement to wind up the partnership's business as specified in Section 3-802(a), (b)(1), and (d);

(13) vary the right of a partner under Section 3-901(f) to vote on or consent to a cancellation of a statement of qualification;

(14) vary the right of a partner to approve a merger, interest exchange, conversion, or domestication under Section 2-203(a)(2), 2-303(a)(2), 2-403(a)(2), or 2-503(a)(2);

(15) vary the required contents of a plan of merger under Section 2-202(a), plan of interest exchange under Section 2-302(a), plan of conversion under Section 2-402(a), or plan of domestication under Section 2-502(a);

(16) vary any requirement, procedure, or other provision of this [Code] pertaining to:

(A) registered agents; or

(B) the [Secretary of State], including provisions pertaining to records

authorized or required to be delivered to the [Secretary of State] for filing under this [Code]; or

(17) except as otherwise provided in Sections 3-106 and 3-107(b), restrict the rights under this [Code] of a person other than a partner.

(d) Subject to subsection (c)(8), without limiting other terms that may be included in a partnership agreement, the following rules apply:

(1) The partnership agreement may:

(A) specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts; and

(B) alter the prohibition in Section 3-406(a)(2) so that the prohibition requires only that the partnership's total assets not be less than the sum of its total liabilities.

(2) To the extent the partnership agreement expressly relieves a partner of a responsibility that the partner would otherwise have under this [Code] and imposes the responsibility on one or more other partners, the agreement also may eliminate or limit any fiduciary duty of the partner relieved of the responsibility which would have pertained to the responsibility.

(3) If not manifestly unreasonable, the partnership agreement may:

(A) alter or eliminate the aspects of the duty of loyalty stated in Section 3-409(b);

(B) identify specific types or categories of activities that do not violate the duty of loyalty;

(C) alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law; and

(D) alter or eliminate any other fiduciary duty.

(e) The court shall decide as a matter of law whether a term of a partnership agreement is manifestly unreasonable under subsection (c)(6) or (d)(3). The court:

(1) shall make its determination as of the time the challenged term became part of the partnership agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes and business of the partnership, it is readily apparent that:

(A) the objective of the term is unreasonable; or

(B) the term is an unreasonable means to achieve the term's objective.

### **Comment**

The Harmonization Project re-wrote this section, for the most part conforming this section to the corresponding section of ULLCA (2006).

#### *Principal Provisions of this Article Concerning the Partnership Agreement*

The partnership agreement is pivotal to a partnership, and Sections 3-105 through 3-107 are pivotal to this article. They must be read together, along with Section 3-102(12) (defining the partnership agreement).

This section performs five essential functions. Subsection (a) establishes the primacy of the partnership agreement in establishing *inter se* relations among the partners and partnership. Subsection (b) recognizes this article as comprising mostly default rules (*i.e.*, gap fillers for issues as to which the partnership agreement provides no rule). Subsection (c) lists the few mandatory provisions of this article. Subsection (d) lists some provisions frequently found in partnership agreements, authorizing some unconditionally and others so long as “not manifestly unreasonable.” Subsection (e) delineates in detail both the meaning of “not manifestly unreasonable” and the information relevant to determining a claim that a provision of a partnership agreement is manifestly unreasonable.

Section 3-106 details the effect of a partnership agreement on the partnership and on persons becoming partners. Section 3-107 concerns the effect of a partnership agreement on third parties.

#### *Role and Inevitability of Partnership Agreement*

Section 3-102(12) delineates a very broad scope for “partnership agreement.” As a result,

once a partnership comes into existence, a partnership agreement necessarily exists. *See* the comment to Section 3-102(12). Accordingly, this article refers to “the partnership agreement” rather than “a partnership agreement.” This phrasing should not, however, be read to require a partnership or its partners to take any formal action to adopt a partnership agreement.

The partnership agreement is the exclusive consensual process for modifying this article’s various default rules pertaining to relationships *inter se* the partners and between the partners and the partnership. Section 3-105(a). The partnership agreement also has power over “the obligations of a partnership and its partners to a person in the person’s capacity as a transferee or person dissociated as a partner.” Section 3-107(b). For the relationship between the partnership agreement and public records in the filing office, see Section 3-107(d).

### *The Partnership Agreement and the Fiduciary and Other Duties of Those Who Manage*

One of the most complex questions in the law of unincorporated business organizations is the extent to which an agreement among the organization’s owners can affect the fiduciary and other duties of those who have ultimate power to manage the organization—in a general partnership, the partners themselves. As explained in detail in the comment to Subsection (d)(3), this article rejects the notion that a contract can completely transform an inherently fiduciary relationship into a merely arm’s length association. Within that limitation, however, this section provides substantial power to the partnership agreement to reshape, limit, and eliminate fiduciary and other managerial duties.

Subsection (a) recognizes that the partnership agreement is the map to the parties’ deal and that any claim by a partner of managerial misconduct must be assessed first under the relevant terms of the partnership agreement. Subsection (d) specifically validates arrangements commonly used to reshape managerial duties and limit the consequences of breaching those duties. Subsection (c) contains relevant limitations, but those limitations: (i) must be read together with Subsection (d); and (ii) do not preclude the partnership agreement fundamentally redesigning the duties applicable to the partners. For this article’s design of those duties, see Sections 3-408 and 3-409.

**Subsection (a)**—This section describes the very broad scope of a partnership’s partnership agreement, which includes all matters constituting “internal affairs.” *Compare* Section 3-105(a), *with* Section 3-104 (using the phrase “internal affairs” in stating a choice of law rule). This broad grant of authority is subject to the restrictions stated in Subsection (c), including the broad restriction stated in Subsection (c)(17) (concerning the rights of third parties under this article).

**Subsection (a)(1)**—This paragraph encompasses all the rights and duties of each partner, including rights and duties pertaining to transactions under Article 2.

**Subsection (a)(3)**—Under this provision, the partnership agreement can control both the quantum of consent required (*e.g.*, majority of partners) and the means by which the consent is manifested (*e.g.*, prohibiting modifications except when consented to in writing). *See* the comment to Section 3-107(a).



Under Subsection (b), if the partnership agreement does not address the issue, Section 3-401(k) applies and requires the affirmative vote or consent of all the partners. Under Section 1-702 (Supplemental Principles of Law) the parol evidence rule will apply to a written partnership agreement when appropriate under contract law.

**Subsection (b)**—To the extent the partnership agreement does not determine an *inter se* matter, this article determines the matter. The partnership agreement may vary any provision of this article pertaining to *inter se* matters, except as provided in Subsections (c) and (d).

Sometimes—but not always—the comments to this article refer to a variable provision as a “default rule” and a non-waivable provision as “mandatory.” These references are merely to draw attention to the default/mandatory distinction in particular contexts and have neither the intent nor the power to affect the default/mandatory status of provisions of this article whose comments lack a comparable reference.

**Subsection (c)**—This subsection lists provisions of this article whose respective effects cannot be varied or may be varied subject to a stated limitation. For historical reasons, this subsection uses the words “vary” and “alter” interchangeably. No difference in meaning is intended.

If a person claims that a term of the partnership agreement violates this subsection, as a matter of ordinary procedural law the burden of proof is on the person making the claim.

**Subsection (c)(1)**—“[T]he law applicable under Section 3-104(1)” establishes the governing law for the internal affairs of a partnership. The organizers of a partnership make this choice of law by choosing to form a partnership under this article. Domestication to another jurisdiction will re-set the choice of law, *see* Sections 2-501 through 2-506, but the partnership agreement cannot. *See* the comment to Section 3-104(1).

Subsection (c) contains no parallel prohibition on varying Section 3-901 (stating the governing law for foreign limited liability partnerships), because a prohibition is unnecessary. As a matter of fundamental contract law, an agreement among partners of one partnership is powerless to govern the affairs of another partnership.

**Subsection (c)(3)**—Under this article, a partnership is emphatically an entity, and the partners lack the power to alter that characteristic.

The cited section pertains to “actions by and against partnership and partners,” arguably comes within Subsection (c)(17) (prohibiting the partnership agreement from “restrict[ing] the rights under this [Code] of a person other than a partner”), but is specifically noted for the avoidance of doubt.

**Subsection (c)(4)**—Although phrased as a restriction, this provision grants substantial power to the partnership agreement.

EXAMPLE: A law firm operates as a partnership, and the partnership agreement

provides that a “Compensation Committee” periodically decides each partner’s compensation. The agreement also states that only partners who are on the Compensation Committee may have access to the Committee’s compensation decisions pertaining to other partners. This restriction is reasonable.

This article also empowers the partnership “as a matter within the ordinary course of its business [to] impose reasonable restrictions and conditions on access to and use of information” obtained under Section 3-408. *See* Section 3-408(j).

In determining whether a restriction is reasonable, a court might consider: (i) the danger or other problem the restriction seeks to avoid; (ii) the purpose for which the information is sought; and (iii) whether, in light of both the problem and the purpose, the restriction is reasonably tailored.

**Subsection (c)(5)**—This limitation is less powerful than might first appear, because Subsection (d) specifically authorizes substantial alterations to the duties of loyalty and care, including restricting and substantially eliminating those duties.

**Subsection (c)(6)**—Section 3-409(d) refers to the “contractual obligation of good faith and fair dealing,” which contract law implies in every contract. The partnership agreement cannot eliminate this obligation, neither in whole (*i.e.*, generally) nor in part (*i.e.*, as applicable to specified situations).

However, a partnership agreement may “prescribe the standards . . . by which the performance of [that] obligation is to be measured.”

**EXAMPLE:** A partnership agreement designates a managing partner, provides that partner almost total control of the partnership’s operations, and grants the partner the discretion to cause the partnership to enter into contracts with affiliates of the partner (so-called “Conflict Transactions”). The agreement further provides: “When causing the Company to enter into a Conflict Transaction, the Managing Partner complies with Section 3-409(d) of [this article] if a disinterested person, knowledgeable in the subject matter, states in writing that the terms and conditions of the Conflict Transaction are equivalent to the terms and conditions that would be agreed to by persons at arm’s length in comparable circumstances.” This provision “prescribes[s] the standards by which the performance of the [Section 3-409(d)] obligation is to be measured.”

**EXAMPLE:** Same facts as the previous example, except that, during the performance of a Conflict Transaction, the managing partner causes the partnership to waive material protections under the applicable contract. The standard stated in the previous example is inapposite to this conduct. Section 3-409(d) therefore applies to the conduct without any direct contractual delineation. (However, other terms of the agreement may be relevant to determining whether the conduct violates Section 3-409(d). *See* the comment to Section 3-409(d).)

**EXAMPLE:** A partnership agreement designates a managing partner and gives that

partner “sole discretion” to make various decisions. The agreement further provides: “Whenever this agreement requires or permits the Managing Partner to make a decision that has the potential to benefit one class of partners to the detriment of another class, the Managing Partner complies with Section 3-409(d) of [this article] if the Managing Partner makes the decision with:

- a. the honest belief that the decision:
  - i. serves the best interests of the Partnership; or
  - ii. at least does not injure or otherwise disserve those interests; and
- b. the reasonable belief that the decision breaches no partner’s rights under this agreement.”

This provision “prescribe[s] the standards by which the performance of the [Section 3-409(d)] obligation is to be measured.” *Compare* Section 3-105(c)(6), *with Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010) (considering such a situation in the context of the right to call preferred stock and deciding by a three-two vote that exercising the call did not breach the implied covenant of good faith and fair dealing).

A partnership agreement that seeks to prescribe standards for measuring the contractual obligation of good faith and fair dealing under Section 3-409(d) should expressly refer to the obligation. *See Gerber v. Enter. Prods. Hldgs., L.L.C.*, 67 A.3d 400, 418 (Del. 2013) (distinguishing between the implied contractual covenant and an express contractual obligation of “good faith” as stated in a limited partnership agreement).

For an explanation of the function and role of the covenant of good faith and fair dealing, see the comment to Section 3-409(d). For the rules delimiting the “not manifestly unreasonable” requirement, see Subsection (e).

**Subsection (c)(7)**—Section 3-410(b) delineates a partner’s rights to “maintain an action against the partnership or another partner.” It would be unreasonable to frustrate these rights but not unreasonable to channel their exercise. For example, the partnership agreement might select a forum, require pre-suit mediation, provide for arbitration, or require a pre-suit demand on a management committee before a partner files suit against the partnership. Similarly, it is not unreasonable to provide for liquidated damages consonant with the law of contracts. In contrast, it would be unreasonable for a partnership agreement to both: (i) require a partner intending to sue the partnership to make demand on a management committee before filing suit against the partnership regardless of futility; and (ii) bar taking the claim to court no matter how long the management committee ponders the demand.

**Subsection (c)(8)**—These restrictions are ubiquitous in the law of business entities and, in conjunction with other provisions of this section, control the otherwise very broad power of a partnership agreement to affect fiduciary and other duties. The restrictions are central to the raft of exculpatory provisions that sprung up in corporate statutes in response to *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). Delaware led the response with Delaware Code Annotated title 8, section 102(b)(7), and a number of LLC statutes have similar provisions. *E.g.*, GA. CODE ANN. § 14-11-305(4)(A) (2011). For an extreme example, see Virginia Code Annotated § 13.1-1025 (B) (2012). In this context, “conduct” includes both acts and omissions. BLACK’S LAW DICTIONARY

(9th ed. 2009) (defining conduct as “[p]ersonal behavior, whether by action or inaction”).

The term “bad faith” has multiple meanings, and the context determines which meaning applies. In the context of the duty of loyalty, “bad faith” includes conduct motivated by ill will or other intent purposely to harm another person. The concept also includes conduct from which a person derives an improper personal benefit. *See, e.g., Mroz v. Hoaloha Na Eha, Inc.*, 410 F. Supp. 2d 919, 936–37 (D. Haw. 2005) (denying a motion to dismiss a claim that “the Majority Partners” were personally liable for the partnership’s wrongful termination of the plaintiff; quoting the complaint as alleging that “the Majority Partners, individually and as a group, acted with malice and/or ill will, and/or with an intent to serve their own personal interests and/or without an intent to serve company interests, and/or outside of the scope of their authority and/or without justification”); *BOGNC, LLC v. Cornelius NC Self-Storage L.L.C.*, 10 CVS 19072, 2013 WL 1867065, at \*9 (N.C. Super. [Business Court] May 1, 2013) (noting that “no . . . [exculpatory] provision may limit a manager’s liability for acts known to be in conflict with the interests of the limited liability company, or for acts from which the manager derived an improper personal benefit”) (citing N.C. GEN. STAT. § 57C-3-32(b)); *Lasica v. Savers Grp. of Minn., L.L.C.*, A12-0092, 2012 WL 3553246, at \*2 (Minn. Ct. App. Aug. 20, 2012) (noting that an “individual seeking indemnification [under statute providing for indemnification] must have acted in good faith and must not have received an improper personal benefit”) (citing MINN. STAT. § 322B.699, subdvs. 2(a)(2), (3) (2010)).

In the context of the duty of care, the concept of bad faith comes primarily from corporate law and means an extreme breach of the duty (*i.e.*, “the failure to exercise “*honest judgment* in the lawful and legitimate furtherance of corporate purposes”). *Deblinger v. Sani-Pine Products Co., Inc.*, 107 A.D.3d 659, 661 (N.Y. 2013) (quoting *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979)) (emphasis added) (internal quotation marks omitted).

Thus, when a plaintiff alleges bad faith as pertaining to the duty of care, “[t]he burden . . . is to show irrationality: a plaintiff must demonstrate that no reasonable business person could possibly authorize the action in good faith. Put positively, the decision must go so far beyond the bounds of reasonable business judgment that its only explanation is bad faith.” *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005) (discussing then prevailing Delaware law) (citation omitted); *see also KDW Restructuring & Liquidation Servs. L.L.C. v. Greenfield*, 874 F. Supp. 2d 213, 226 (S.D.N.Y. 2012) (referring to a lack of “a rationale corporate purpose” and “a disregard for the duty to examine all available information—*information that was readily at hand*”) (emphasis added).

With regard to both the duty of loyalty and the duty of care, “bad faith” is entirely distinct from the meaning of “good faith” in the contractual covenant of good faith and fair dealing. *See* the comment to Section 3-409(d).

Subsection (c)(8) pertains to indirect as well as direct efforts to “relieve or exonerate” and thus limits how far a partnership agreement can go in providing for indemnification. *See* Section 3-401(c) (stating a default rule for indemnification).

Although this paragraph does not expressly address contracts between a partnership and a

partner, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

**EXAMPLE:** A general partnership enters into a management contract with its sole managing partner, and the contract provides the partner exoneration for liability to the partnership even for willful and intentional misconduct. Most likely, contract law will treat the provision as against public policy and therefore unenforceable. RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981) (“A term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy.”). If not, a court should hold the provision unenforceable to avoid evisceration of Subsection (c)(8). (Or, the court could invoke the policy expressed in Subsection (c)(8) as grounds for holding the provision unenforceable under contract law.)

**Subsection (c)(9)**—As a result of this restriction, a partner always has the power to dissociate; the partnership agreement can only negate the right. This approach is consistent with the notions that: (i) a partnership is a voluntary association, *see, e.g., Gangl v. Gangl*, 281 N.W.2d 574, 580 (N.D. 1979) (stating that “[t]he term [association] connotes not only a group of two or more persons but also voluntariness”); (ii) the partnership relationship is essentially contractual, *see, e.g., Wallner v. Schmitz*, 239 Minn. 93, 95, 57 N.W.2d 821, 823 (1953) (stating that “[a] partnership is a contractual relationship as between the parties”); and (iii) only in exceptional circumstances does a party to a contract lack the power to breach, and courts will not enjoin a person to remain in an ongoing contractual relationship that involves trust and confidence. E. ALLAN FARNSWORTH, CONTRACTS § 12.7, at 781 (3d ed. 1999) (“A court will not grant specific performance of a contract to provide a service that is personal in nature. This refusal . . . is based [in part] of the undesirability of compelling the continuance of personal relations after disputes have arisen and confidence and loyalty have been shaken and the undesirability, in some instances, of imposing what might seem like involuntary servitude.”) (footnote omitted).

**Subsection (c)(10)**—The partnership agreement may not change the stated grounds for expulsion but may determine the forum in which a claim for expulsion under Section 3-601(5) is determined.

**Subsection (c)(11)**—The partnership agreement may not change the stated grounds for dissolution but may determine the forum in which a claim for dissolution under Section 3-801(4) or (5) is determined. For example, arbitration and forum selection clauses are commonplace in business relationships in general and in partnership agreements in particular.

The approach of this paragraph differs from the law of Delaware. *See Huatuco v. Satellite Healthcare*, CV 8465-VCG, 2013 WL 6460898, at \*1, n.2 (Del. Ch. Dec. 9, 2013) (stating that “the right to judicial dissolution is a default right which the parties may eschew by contract” but reserving the question of “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires—leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre’s *Huis Clos*”).

**Subsection (c)(12)**—The cited provisions comprise the non-waivable aspects of winding up a dissolved partnership. The other provisions of Section 3-802 are default rules and therefore waivable.

**Subsection (c)(13)**—Section 3-901(f) requires the “the affirmative vote or consent of all the partners.” The requirement is non-waivable, because canceling a statement of qualification eliminates the LLP liability shield and makes each partner automatically liable for partnership’s obligations subsequently incurred.

**Subsection (c)(14)**—Sections 2-203(a)(1), 2-303(a)(1), 2-403(a)(1), and 2-503(a)(1) each requires the consent or the affirmative vote of all partners. The partnership agreement may modify these requirements. In contrast, under the sections stated in this subsection:

- each partner is protected from being merged, exchanged, converted, or domesticated “into” the status of a partner in a general partnership that is not a limited liability partnership (or a comparable “unshielded” position in some other organization) without the partner having *directly* consented to either:
  - the merger, interest exchange, conversion, or domestication; or
  - a partnership agreement provision that permits such transactions to occur with less than unanimous consent of the partners; and
- merely consenting to a partnership agreement provision that permits amendment of the partnership agreement with less than unanimous consent of the partners does not qualify as the requisite direct consent.

**Subsection (c)(15)**—Because these plans are the basic “deal documents” for each of the organic transactions contemplated in Article 2, the partnership agreement may not vary the contents of these plans.

**Subsection (c)(16)**—This prohibition is arguably implicit in Subsection (c)(17) (affecting rights under this article of third parties) but is stated expressly to avoid any doubt.

**Subsection (c)(17)**—This limitation pertains only to “the rights under this [Code] of third parties” other than partners. Moreover, the limitation is subject to two major exceptions: Section 3-106 (pertaining to the partnership agreement’s relationship to the partnership itself and to persons becoming partners) and Section 3-107(b) (pertaining to the partnership agreement’s power over the rights of transferees).

**Subsection (d)**—The partnership agreement has plenipotentiary power over the matters described in Subsection (a), except as specifically limited by Subsections (c) and (d)(3). However, for the convenience of practitioners and the courts, Paragraphs 1 and 2 list various terms often found in partnership agreements. No negative inference should be drawn about terms not listed; the listing is provided “without limiting other terms that may be included in a partnership agreement.”

Paragraph 3 lists arrangements subject to the “not manifestly unreasonable” standard. Subsection (e) delineates that standard. The same standard applies to terms of a partnership

agreement which seek to “prescribe the standards . . . by which the performance of the [contractual] obligation [of good faith and fair dealing under Section 3-409(d)] is to be measured.” Subsection (c)(6).

**Subsection (d)(1)(A)**—An arrangement *not* involving “one or more disinterested and independent persons” acting “after full disclosure of all material facts” would “alter . . . the aspects of the duty of loyalty stated in Section 3-409(b)” and would therefore be subject to the “not manifestly unreasonable standard” of Subsection (d)(3)(A).

For the meaning of “material” as applied to information, see the comment to Section 3-409(f).

**Subsection (d)(1)(B)**—Section 3-405(a)(2) prohibits distributions by a limited liability partnership:

- *not merely* when, after the distribution, “the partnership’s total assets would be less than the sum of its total liabilities”;
- *but also* when, after the distribution, the assets would be less than the total liabilities “plus the amount that would be needed, if the partnership were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of partners and transferees whose preferential rights are superior to the rights of persons receiving the distribution.”

The second part of the solvency test pertains to preferential rights to distributions, is thus a matter *inter se* the partners and any transferees, and is therefore subject to change in the partnership agreement.

In contrast, the first part of the solvency test protects third parties—creditors of the partnership—and therefore cannot be changed by the partnership agreement. Section 3-105(c)(17). Likewise, the partnership agreement cannot change the solvency test stated in Section 3-406(a)(1) (that “the partnership would not be able to pay its debts as they become due in the ordinary course of the partnership’s business”).

**Subsection (d)(2)**—The “not manifestly unreasonable” standard does not apply to partnership agreement provisions within this paragraph.

EXAMPLE: ABC Company (“ABC”) has three partners. ABC has two entirely separate lines of business, the Alpha business and the Beta business. Under ABC’s partnership agreement:

- Partner 1’s responsibilities pertain exclusively to the Alpha business, while responsibility for:
  - the Beta business is allocated exclusively to Partner 2; and
  - ABC’s overall operation is allocated exclusively to Partner 3.
- Partner 2’s responsibilities pertain exclusively to the Beta business, while responsibility for:
  - the Alpha business is allocated exclusively to Partner 1; and

- ABC's overall operation is allocated exclusively to Partner 3.
- Partner 1 has no fiduciary duties pertaining to the Beta business.
- Partner 2 has no fiduciary duties pertaining to the Alpha business.

The elimination of Partner 1's fiduciary duties with regard to the Beta business and Partner 2's fiduciary duties with regard to the Alpha business are enforceable, without regard to the "manifestly unreasonable" standard of Subsection (d)(3).

**Section (d)(3)**—This article rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of "freedom of contract" against the dangers that inescapably exist when some persons have power over the interests of others.

Nonetheless, a properly drafted partnership agreement may substantially alter and even eliminate fiduciary duties. Two important limitations exist. First, arrangements subject to this subsection may not be "manifestly unreasonable." *See* Subsection (e) (delineating this standard).

Second, the partnership agreement may not transform the relationship *inter se* partners and the partnership into an entirely arm's length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. This rule is fundamental in the jurisprudence of fiduciary duty. *See, e.g., Paige Capital Mgmt., L.L.C. v. Lerner Master Fund, L.L.C.*, Civ. A. No. 5502-CS, 2011 WL 3505355, at \*31 (Del. Ch. Aug. 8, 2011) (stating that, even under a statute that "permits the waiver of fiduciary duties . . . such waivers must be set forth clearly"); *Kelly v. Blum*, Civ. A. No. 4516-VCP, 2010 WL 629850, at \*10 n.70 (Del. Ch. Feb. 24, 2010) ("Having been granted great contractual freedom by the LLC Act, drafters of or parties to an LLC agreement should be expected to provide . . . clear and unambiguous provisions when they desire to expand, restrict or eliminate the operation of traditional fiduciary duties"). It would therefore be manifestly unreasonable for a partnership agreement to negate this rule.

Although Subsection (d)(3) does not expressly address contracts between a partnership and a partner, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

**EXAMPLE:** A general partnership enters into a management contract with its sole managing partner, and the contract provides that the duties of loyalty stated in Section 3-409(b) are entirely eliminated. If the partnership agreement were to so provide, the provision would be subject to the "manifestly unreasonable standard." Section 3-105(d)(3)(A). Absent the authorization provided by Section 3-105(d)(3)(A), the management contract's attempt to waive fiduciary duties may be unenforceable as a matter of public policy and contract law. *See Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57, 133 Cal. Rptr. 2d 218 (2003) (stating that "waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void"). If not, a court should hold the provision unenforceable nonetheless so as to avoid eviscerating Subsection (d)(3).



**Subsection (d)(3)(A)**—Subject to the “not manifestly unreasonable” standard, this paragraph empowers the partnership agreement to eliminate *all* aspects of the duty of loyalty listed in Section 3-409(b). The obligation of good faith and fair dealing, Section 3-409(d), would remain. *See* Subsection (c)(6). As to any other, uncodified aspects of the duty of loyalty, see Subsection (d)(3)(D) (empowering the partnership agreement to “alter or eliminate any other fiduciary duty”).

EXAMPLE: Joint Venture Partnership (“JV”) is a general partnership, with two partners, Kappa, Inc. (“Kappa”) and Lambda, LLC (“Lambda”). The partnership agreement provides that:

- JV is managed by a “board” consisting of one person appointed by Kappa and one person appointed by Lambda;
- each appointee:
  - owes fiduciary and any other duties exclusively to the partner that made the appointment; and
  - owes no duties to the other partner and the partnership.

The “not manifestly unreasonable” standard applies to these provisions under Subsection (d)(3)(A) and (D), and the provisions are not manifestly unreasonable. Note that the provisions do not affect the duties of Kappa and Lambda to each other.

**Subsection (d)(3)(B)**—Under this paragraph, a partnership agreement might provide that an affiliate of a partner will provide compensated services to the partnership at a price not exceeding market price, or that the partner may pursue opportunities that otherwise would be partnership opportunities. Such arrangements are commonplace and permissible.

**Subsection (d)(3)(C)**—In this context, “conduct” includes both acts and omissions. BLACK’S LAW DICTIONARY (9th ed. 2009) (defining conduct as “[p]ersonal behavior, whether by action or inaction”). Subject to the “not manifestly unreasonable” standard and the bedrock requirements stated here and in Subsection (c)(8), the partnership agreement can reduce the duty of care substantially. In particular, the partnership agreement can eliminate the aspects of the duty of care pertaining to gross negligence and recklessness.

This provision replicates in a particular context the general rule stated in Subsection (c)(8). For the meaning of “bad faith” in the context of the duty of care, see Subsection (c)(8), comment.

**Subsection (e)**—The “not manifestly unreasonable” concept became part of uniform business entity statutes when UPA (1997) imported the concept from the Uniform Commercial Code. (In the current version of the Uniform Commercial Code, the concept appears in Section 1-302(b).)

This subsection provides rules for applying the concept, specifying:

- who decides the issue of “manifestly unreasonable”
  - “the court . . . as a matter of law,” Subsection (e);
- the framework for determining the issue

- determination to be made “in light of the purposes, activities, and affairs of the partnership,” Subsection (e)(2);
- the temporal setting for determining the issue
  - “[d]etermination [to be made] as of the time the challenged term became part of the partnership agreement,” Subsection (e)(1); and
- what information is admissible for determining the issue
  - “[o]nly circumstances existing” when “the challenged term became part of the partnership agreement,” Subsection (e)(1).

The subsection also provides a very demanding standard for persons claiming that a term of a partnership agreement is “manifestly unreasonable.” “The court . . . may invalidate the term only if, in light of the purposes, and business of the partnership, it is *readily apparent* that: (A) the objective of the term is unreasonable; or (B) the term is an unreasonable means to achieve the term’s objective.” Subsection (e)(2) (emphasis added).

Subsection (e) is fundamental to this article, because: (i) this article generally defers to the agreement among the partners; and (ii) Subsection (e) safeguards the partnership agreement in at least four ways:

- Determining manifest unreasonableness *inter se* owners of an organization is a different task than doing so in a commercial context, where concepts like “usages of trade” are available to inform the analysis. Each business organization must be understood in its own terms and context.
- If loosely applied, the concept of “manifestly unreasonable” would permit a court to rewrite the partners’ agreement, which would destroy the balance this article seeks to establish between freedom of contract and fiduciary duty.
- Case law has not adequately delineated the concept. *See, e.g., In re Brobeck, Phleger & Harrison L.L.P.*, 408 B.R. 318, 335 (Bankr. N.D. Cal. 2009) (“RUPA [UPA (1997)] does not define what is ‘manifestly unreasonable’ and the parties have not cited, nor can the court locate, a decision that defines the term. Absent case law or even a dictionary definition, the court must rely on its common sense to recognize something as manifestly unreasonable.”).
- In the context of statutes permitting stock transfer restrictions unless “manifestly unreasonable,” courts have often ignored the word “manifestly.” *See, e.g., Brandt v. Somerville*, 692 N.W.2d 144, 152 (N.D. 2005) (stating that “in close corporations, a majority of courts have sustained restrictions that are determined to be reasonable in light of the relevant circumstances”); *Roof Depot, Inc. v. Ohman*, 638 N.W.2d 782, 786 (Minn. Ct. App. 2002) (stating that “the restrictions [on share transfer] are not ‘manifestly unreasonable’ because they are reasonable means to ensure that the management and control of the business remains in the group of investors or with people well known to them”); *Castriota v. Castriota*, 633 A.2d 1024, 1027–28 (N.J. App. Div. 1993) (“We are obliged to apply the statute in a manner consonant with its essential purpose to permit reasonable restrictions upon alienation.”).

**Subsection (e)(1)**—The significance of the phrase “as of the time the term as challenged became part of the partnership agreement” is best shown by example.

EXAMPLE: When a particular partnership comes into existence, its business plan is quite unusual and its success depends on the willingness of a particular individual to serve as the partnership's sole managing partner. This individual has a rare combination of skills, experiences, and contacts, which are particularly appropriate for the partnership's start-up. In order to induce the individual to accept the position of sole managing partner, the other partners are willing to have the partnership agreement significantly limit the managing partner's fiduciary duties. Several years later, when the partnership's operations have turned prosaic and the managing partner's talents and background are not nearly so crucial, a partner challenges the fiduciary duty limitations as manifestly unreasonable. The relevant time under Subsection (e)(1) is when the partnership began. Subsequent developments are not relevant, except as they might inferentially bear on the circumstances in existence at the relevant time.

EXAMPLE: As initially adopted, a partnership agreement identifies a category of decisions ordinarily subject to the duty of loyalty and provides that "the managing partner's sole, reasonable discretion" satisfies the duty. A year later, the agreement is amended to delete the word "reasonable." Later, a partner claims that, without the word "reasonable," the provision is manifestly unreasonable. The relevant time under Subsection (e)(1) is when the agreement was amended, not when the agreement was initially adopted.

**Subsection (e)(2)**—If a person claims that a term of the partnership agreement is manifestly unreasonable under Subsections (c)(6) or (d)(3), as a matter of ordinary procedural law the person making the claim has the burden of proof.

### **SECTION 3-106. PARTNERSHIP AGREEMENT; EFFECT ON PARTNERSHIP AND PERSON BECOMING PARTNER; PREFORMATION AGREEMENT.**

(a) A partnership is bound by and may enforce the partnership agreement, whether or not the partnership has itself manifested assent to the agreement.

(b) A person that becomes a partner is deemed to assent to the partnership agreement.

(c) Two or more persons intending to become the initial partners of a partnership may make an agreement providing that upon the formation of the partnership the agreement will become the partnership agreement.

#### **Comment**

**Subsection (a)**—This subsection resolves twin questions that have troubled some courts – namely, whether an unincorporated entity that has not signed its foundational agreement nonetheless is bound by and may enforce the agreement. The questions have been particularly troubling in the context of agreements to arbitrate. *See, e.g., Elkjer v. Scheef & Stone, L.L.P.*,

3:13-CV-1655-K, 2014 WL 1255844, at \*5–6 (N.D. Tex. Mar. 27, 2014) (concluding that a limited liability partnership “is a party to the Partnership Agreement,” even though the partnership itself never signed or otherwise assented to the agreement; enforcing arbitration provision to the benefit of the LLP). *Contra Trover v. 419 OCR, Inc.*, 921 N.E.2d 1249, 1255 (2010) (finding that “neither FODG [an LLC] nor the Golf Club [a related LLC] was a party to the operating agreements and that they are therefore not bound by the arbitration clauses therein”).

Developments pertaining to the Virginia LLC Act further illustrate the difficulties. In *Mission Residential, L.L.C. v. Triple Net Properties, L.L.C.*, 654 S.E.2d 888, 891 (Va. 2008), the Virginia Supreme Court held that an LLC member’s derivative claim was not subject to the arbitration provision in the operating agreement, because: (i) the LLC was “the real party in interest”; (ii) the LLC had not signed the operating agreement; and (iii) requiring the claim to be arbitrated would “ignore[] the separate existence of Holdings [the LLC].” The Virginia legislature promptly disagreed and amended the LLC act to state: “A limited liability company is bound by its operating agreement whether or not the limited liability company executes the operating agreement.” 2009 VA. ACTS 763 (S.B. 1241), codified as VA. CODE ANN. § 13.1-1023.A.1 (2012). The legislature left open the question of a limited liability company’s power to enforce an operating agreement that the company has not executed.

This subsection answers the twin questions, categorically and in the affirmative.

This subsection does not consider whether a partnership is an indispensable party to a suit concerning the partnership agreement. That question is one of procedural law, and the answer can determine whether federal diversity jurisdiction exists.

**Subsection (b)**—Given the possibility of oral and implied-in-fact terms in the partnership agreement, a person becoming a partner of an existing partnership should take precautions to ascertain fully the contents of the partnership agreement. *See* the comment to Section 105(a)(3).

**Subsection (c)**—A pre-formation arrangement is not a partnership agreement. A partnership agreement is among “partners,” and, under this article, the earliest a person can become a partner is upon the formation of the partnership. *See* Section 3-402.

## **SECTION 3-107. PARTNERSHIP AGREEMENT; EFFECT ON THIRD PARTIES AND RELATIONSHIP TO RECORDS EFFECTIVE ON BEHALF OF PARTNERSHIP.**

(a) A partnership agreement may specify that its amendment requires the approval of a person that is not a party to the agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.

(b) The obligations of a partnership and its partners to a person in the person's capacity as a transferee or person dissociated as a partner are governed by the partnership agreement. Subject only to a court order issued under Section 3-504(b)(2) to effectuate a charging order, an amendment to the partnership agreement made after a person becomes a transferee or is dissociated as a partner:

(1) is effective with regard to any debt, obligation, or other liability of the partnership or its partners to the person in the person's capacity as a transferee or person dissociated as a partner; and

(2) is not effective to the extent the amendment:

(A) imposes a new debt, obligation, or other liability on the transferee or person dissociated as a partner; or

(B) prejudices the rights under Section 3-701 of a person that dissociated as a partner before the amendment was made.

(c) If a record delivered by a partnership to the [Secretary of State] for filing becomes effective and contains a provision that would be ineffective under Section 3-105(c) or (d)(3) if contained in the partnership agreement, the provision is ineffective in the record.

(d) Subject to subsection (c), if a record delivered by a partnership to the [Secretary of State] for filing becomes effective and conflicts with a provision of the partnership agreement:

(1) the agreement prevails as to partners, persons dissociated as partners, and transferees; and

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

## Comment

**Subsection (a)**—This subsection, derived from Delaware Code Annotated title 6, § 18-302(e), permits the partnership agreement to: (i) accord a non-partner veto rights over amendments to the agreement; and (ii) establish other preconditions for amendments. An amendment made in derogation of a veto right or precondition is ineffective.

Veto rights are likely to be sought by lenders but may also be attractive to non-partner managers.

EXAMPLE: A non-partner manager enters into a management contract with a partnership, and that agreement provides in part that the partnership may remove the manager without cause only with the consent of partners holding two-thirds of the profits interests. The partnership agreement contains a parallel provision (the “quantum provision”), but the non-partner manager is not a party to the partnership agreement. Later, the partners amend the quantum provision to reduce the quantum to a simple majority of profits interests and thereafter purport to remove the manager without cause. Although the partnership has undoubtedly breached its contract with the manager and subjected itself to a damage claim, the partnership has the *power* under Section 3-105(a)(2) to effect the removal—unless the partnership agreement provides the manager a veto right over changes in the partnership agreement’s quantum provision.

This subsection does not refer to partner veto rights because, unless otherwise provided in the partnership agreement, the consent of each partner is necessary to effect an amendment. *See* Section 3-401(k).

Because “[a] partnership agreement may specify that its amendment requires . . . the satisfaction of a condition,” a partnership agreement can require that any amendment be made through a writing or a record signed by each partner. *See* Section 3-105(a)(3) (empowering the partnership agreement to determine “the means and conditions for amending the partnership agreement”).

**Subsection (b)**—The law of unincorporated business organizations is only beginning to grapple in a modern way with the tension between the rights of an organization’s owners to carry on their activities as they see fit (or have agreed) and the rights of transferees of the organization’s economic interests. If, as is often the situation, the partnership agreement overrides Section 3-701 (Purchase of Interest of Person Dissociated as Partner), such transferees can include the heirs of the partnership’s founders as well as former partners who, by agreement, are “locked in” as transferees of their own interests.

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.

There is little case law in this area, and almost all of it pertains to limited rather than

general partnerships. The case law clearly favors the remaining owners over former owners and other transferees. *See, e.g., Bauer v. Blomfield Co./Holden Joint Venture*, 849 P.2d 1365, 1367 n.2 (Alaska 1993) (holding that a mere assignee “was not entitled to complain about a decision made with the consent of all the partners” and stating “[w]e are unwilling to hold that partners owe a duty of good faith and fair dealing to assignees of a partner's interest”); *Bynum v. Frisby*, 311 P.2d 972, 975 (Nev. 1957) (“[A]n assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners nor require them to resort to dissolution in order to prevent such a relationship from arising. The stranger remains a stranger entitled only to share in the partnership's worth and to demand an accounting upon dissolution.”) (applying UPA (1914) § 27, which pertains to rights of an assignee). *See generally* Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 SUFFOLK L. REV. 587 (2009).

This subsection follows *Bauer* and other cases by expressly subjecting transferees (including a person dissociated as a partner) to partnership agreement amendments made after the transfer or dissociation, except amendments that increase obligations on transferees. For example, an amendment might extend the duration of a partnership but may not institute a new capital call obligation on transferees.

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. An unreported LLC case suggests the answer might be yes, but the decision rests primarily on the wording of the LLC's operating agreement. In *Kohannim v. Katoli*, 08-11-00155-CV, 2013 WL 3943078, at \*10–11 (Tex. App. July 24, 2013), the court: (i) noted that a limited liability company's “[r]egulations provide[] for the distribution of ‘available cash’ to members quarterly provided that the available cash is not needed for a reasonable working capital reserve”; (ii) also 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 Pavaneh.” In essence, the court upheld a finding that Jacob had breached (or caused the partnership 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.” *Id.* at \*11.

For the very limited statutory rights of transferees, see Section 3-503.

**Subsection (b)(1)**—This provision is inapposite when “a partner or transferee becomes entitled to receive a distribution.” Section 3-405(d). In that circumstance:

- “the partner or transferee has the status of . . . a creditor of the partnership with respect to the distribution,” *id.*; and

- the relevant obligation is not owed to “a person in the person’s capacity as a transferee or person dissociated as a partner,” Subsection (b), but rather to the person in the person’s capacity as a creditor.

**Subsection (c)**—This provision precludes using a filed record (*e.g.*, a statement of authority) to make an end run around the strictures of Section 3-105(c) and (d)(3).

**Subsection (d)**—It will be possible, albeit improvident, for a partnership agreement to be inconsistent with a public filing pertaining to the partnership. For those circumstances, this subsection provides rules for determining which source of information prevails.

- For partners and transferees, the partnership agreement is paramount.
- Third parties may invoke the public record upon a showing of reasonable reliance, which presupposes actual knowledge – *i.e.*, deemed knowledge under Section 3-103(d) does not suffice.

The mere fact that a term is present in a publicly filed record and not in the partnership agreement, or *vice versa*, does not automatically establish a conflict. This subsection does not expressly cover a situation in which: (i) one of the specified filed records contains information in addition to, but not inconsistent with, the partnership agreement, and (ii) a person, other than a partner or transferee, reasonably relies on the additional information. However, the policy reflected in this subsection seems equally applicable to that situation. Moreover, to argue that the partnership agreement prevails over the filed record is to argue that the additional term does conflict with the partnership agreement, at least in effect.

Section 3-105(a)(3) might also be relevant to the subject matter of this subsection. Absent a contrary provision in the partnership agreement, language in a record delivered to the filing office for filing on behalf of the partnership might be evidence of the partners’ agreement and might thereby constitute or at least imply a term of the partnership agreement.

This subsection does not apply to records delivered to the filing office for filing on behalf of persons other than a partnership.

## **SECTION 3-108. SIGNING OF RECORDS TO BE DELIVERED FOR FILING**

**TO [SECRETARY OF STATE].** A record delivered to the [Secretary of State] for filing pursuant to this [Code] must be signed as follows:

- (1) Except as otherwise provided in paragraphs (2) and (3), a record signed by a partnership must be signed by a person authorized by the partnership.
- (2) A record filed on behalf of a dissolved partnership that has no partner must be signed



by the person winding up the partnership's business under Section 3-802(c) or a person appointed under Section 3-802(d) to wind up the business.

(3) A statement of denial by a person under Section 3-304 must be signed by that person.

(4) Any other record delivered on behalf of a person to the [Secretary of State] for filing must be signed by that person.

### **Comment**

Section 1-102(44) defines "sign" broadly, including "an electronic symbol, sound, or process."

**Paragraph (1)**—From the perspective of the filing office, it is not necessary that a partner sign a record delivered for filing on behalf of a partnership. The partnership agreement can impose such a requirement as an *inter se* matter, but the requirement would not affect this provision. *See* Section 3-105(c)(16)(B) (stating that the partnership agreement may not "vary any requirement, procedure, or other provision of this [Code] pertaining to . . . the [Secretary of State], including provisions pertaining to records authorized or required to be delivered to the [Secretary of State] for filing under this [Code]").

The filing office will not check whether a person who purports to be authorized to sign a record on behalf of a partnership actually has that authority, even if a statement of authority pertaining to the matter is in effect. Indeed, even if the filing office somehow "knows" of a statement limiting authority, the office lacks the authority to reject a record on that basis. *See* the comment to Section 1-206(a) (stating the requirements for filing and noting that the filing office's review is ministerial and limited to information pertaining to the stated requirements).

### **SECTION 3-109. LIABILITY FOR INACCURATE INFORMATION IN FILED RECORD.**

(a) If a record delivered to the [Secretary of State] for filing under this [Code] and filed by the [Secretary of State] contains inaccurate information, a person that suffers loss by reliance on the information may recover damages for the loss from a partner if:

(1) the record was delivered for filing on behalf of the partnership; and

(2) the partner knew or had notice of the inaccuracy for a reasonably sufficient time before the information was relied upon so that, before the reliance, the partner reasonably

could have:

- (A) effected an amendment under Section 3-901(f);
- (B) filed a petition under Section 1-210; or
- (C) delivered to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

(b) To the extent the partnership agreement expressly relieves a partner of responsibility for maintaining the accuracy of information contained in records delivered on behalf of the partnership to the [Secretary of State] for filing under this [Code] and imposes that responsibility on one or more other partners, the liability stated in subsection (a)(2) applies to those other partners and not to the partner that the partnership agreement relieves of the responsibility.

### **Comment**

This section works in concert with Section 1-211, which addresses another aspect of liability for inaccurate information in a filed record.

**Subsection (a)(2)**—Although this article establishes the avoidance of gross negligence as the standard of care for partners viz-a-viz the partnership, this subsection encompasses liability to third parties. Accordingly, the standard here is more demanding. The phrases “reasonably sufficient time” and “reasonably could have” indicate a standard of ordinary care. “[N]otice of the inaccuracy” involves “reason to know.” Section 3-103(b)(1).

**Subsection (b)**—Section 3-105(d)(2) authorizes the partnership agreement to establish an analogous rule *inter se* the partners. This subsection goes where the partnership agreement cannot reach and affects the rights of third parties.

### **SECTION 3-110. APPLICATION TO EXISTING RELATIONSHIPS.**

(a) Before [all-inclusive date], this [article] governs only:

- (1) a partnership formed on or after [the effective date of this [article]]; and
- (2) except as otherwise provided in subsection (c), a partnership formed before [the effective date of this [article]] which elects, in the manner provided in its partnership agreement or by law for amending the partnership agreement, to be subject to this [article].

(b) Except as otherwise provided in subsection (c), on and after [all-inclusive date] this [article] governs all partnerships.

(c) With respect to a partnership that elects pursuant to subsection (a)(2) to be subject to this [article], after the election takes effect the provisions of this [article] relating to the liability of the partnership's partners to third parties apply:

(1) before [all-inclusive date], to:

(A) a third party that had not done business with the partnership in the year before the election took effect; and

(B) a third party that had done business with the partnership in the year before the election took effect only if the third party knows or has been notified of the election; and

(2) on and after [all-inclusive date], to all third parties, but those provisions remain inapplicable to any obligation incurred while those provisions were inapplicable under paragraph (1)(B).

***Legislative Note:***

***For states that have previously enacted UPA (1997):*** For these states this section is unnecessary. There is no need for a delayed effective date, even with regard to pre-existing partnerships. (Presumably, the “linkage” issue [discussed below] was addressed when UPA (1997) was enacted.)

***For states that have not previously enacted UPA (1997):*** Each enacting jurisdiction should consider whether: (i) this article makes material changes to the “default” (or “gap filler”) rules of the predecessor statute; and (ii) if so, whether Subsection (c) should carry forward any of those rules for pre-existing partnerships. In this assessment, the focus is on pre-existing partnerships that have left default rules in place, whether advisedly or not. The central question is whether, for such partnerships, expanding Subsection (c) is necessary to prevent material changes to the partners’ “deal.”

*The effective date of this article will be the effective date of the Code (Section 1-708) unless this article is specifically given a different effective date.*

*The “all-inclusive” date should be at least one year after the effective date of the Code,*

*Section 1-708, but no more than two years.*

***The “linkage” issue—for states that still have ULPA (1976) or ULPA (1976/1985) in effect:*** *These states should enact Article 4 to take effect in conjunction with this article. If not, a state’s current limited partnership act must be amended to link to this article.*

**SECTION 3-111. SUBJECTS COVERED OUTSIDE [ARTICLE] 3.** The following subjects are covered in whole or in part outside this [article]:

- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Name of entity – Part 3 of Article 1.
- (4) Registered agent of entity – Part 4 of Article 1.
- (5) Foreign entities – Part 5 of Article 1.
- (6) Administrative dissolution – Part 6 of Article 1.
- (7) Miscellaneous provisions, including supplemental principles of law and reservation of right to amend or repeal – Part 7 of Article 1.
- (8) Entity transactions generally – Part 1 of Article 2.
- (9) Merger – Part 2 of Article 2.
- (10) Interest exchange – Part 3 of Article 2.
- (11) Conversion – Part 4 of Article 2.
- (12) Domestication – Part 5 of Article 2.

### **Comment**

This section lists the principal parts of the Code outside of this article that are applicable to general partnerships, and most particularly limited liability partnerships.

## [PART] 2

### NATURE OF PARTNERSHIP

#### SECTION 3-201. PARTNERSHIP AS ENTITY.

(a) A partnership is an entity distinct from its partners.

(b) A partnership is the same entity regardless of whether the partnership has a statement of qualification in effect under Section 3-901.

#### Comment

**Subsection (a)**—The law of general partnerships long struggled with the question of whether a partnership is merely an aggregate of its partners or an entity distinct from its partners.

The common law took the aggregate approach. *X-L Liquors v. Taylor*, 111 A.2d 753, 759 (1955) (stating that “the common law did not recognize the separate existence of partnerships”); *Watson v. G.C. Associates Ltd. P'ship*, 691 P.2d 417, 418 (1984) (referring to the “common law or aggregate theory of partnership”); *McKinney v. Truck Ins. Exch.*, 324 S.W.2d 773, 776 (Mo. Ct. App. 1959) (referring to “the aggregate or common-law theory as to partnerships”).

Under UPA (1914), a general partnership had both entity and aggregate characteristics, in part because that act’s first reporter, who died during the lengthy drafting process, strongly favored the entity approach, while his replacement just as strongly favored the aggregate construct. *New England Herald Dev. Grp. v. Town of Falmouth*, 521 A.2d 693, 697 (Me. 1987) (“The draftsmen of the uniform act were divided over what effect it should have on the common law [aggregate] rule . . . . The result is the Act contains language that supports application of either [the entity or aggregate] theory.”).

According to the comment to this section, UPA (1997) “embrace[d] the entity theory of the partnership,” characterized “the entity theory as the dominant model” for the act, and highlighted a key problem arising from the aggregate aspect of UPA (1914)—namely, “the necessity of a deed to convey title from the ‘old’ partnership to the ‘new’ partnership every time there is a change of cast among the partners.” Under UPA (1997), “there [was] no ‘new’ partnership just because of membership changes,” thereby “avoid[ing] the result in cases such as *Fairway Development Co. v. Title Insurance Co.*, 621 F. Supp. 120 (N.D. Ohio 1985), which held that the ‘new’ partnership resulting from a partner’s death did not have standing to enforce a title insurance policy issued to the ‘old’ partnership.”

The Harmonization process made no changes to this aspect of UPA (1997). Note, however, that UPA (1997) retained several aspects of the aggregate construct: (i) joint and several liability of the partners for the obligations of a partnership that is not an LLP, Section 306(a); (ii) the concept of a partnership at-will, under which dissociation of any partner by “express will” dissolves the partnership, Section 801(1); and (iii) the susceptibility to dissolution

of a partnership for a term or undertaking following the dissociation of a person as a partner. Section 801(2). Those vestiges continue under the Harmonization amendments adopted in 2011 and 2013.

**Subsection (b)**—Neither becoming nor ceasing to be a limited liability partnership affects a partnership’s entity status. These changes merely add or subtract a characteristic. *Compare* Section 3-201(b), *with* Section 2-406(a)(1) (stating that “[w]hen a conversion becomes effective [] (1) the converted entity is: (A) organized under and subject to the organic law of the converted entity [and therefore a different type of entity]; and (B) the same entity without interruption as the converting entity”).

## **SECTION 3-202. FORMATION OF PARTNERSHIP.**

(a) Except as otherwise provided in subsection (b), the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.

(b) An association formed under a statute other than this [article], a predecessor statute, or a comparable statute of another jurisdiction is not a partnership under this [article].

(c) In determining whether a partnership is formed, the following rules apply:

(1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.

(2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.

(3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:

(A) of a debt by installments or otherwise;

(B) for services as an independent contractor or of wages or other compensation to an employee;

(C) of rent;

(D) of an annuity or other retirement or health benefit to a deceased or retired partner or a beneficiary, representative, or designee of a deceased or retired partner;

(E) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(F) for the sale of the goodwill of a business or other property by installments or otherwise.

### Comment

**Subsection (a)**—Consistent with the common law and UPA (1914), under this article “co-ownership” is a key concept. Ownership involves the power of ultimate control (albeit a power that can be substantially diminished by agreement) and a right to share in the profits of the co-owned business. To state that partners are co-owners of a business is to state that: (i) they share in the profits (if any) of the enterprise; and (ii) *ab initio* at least, they collectively have the power of ultimate control. Consequently:

- mere passive co-ownership of property, as distinguished from using the property to carry on a business, does not establish a partnership, Subsection (c)(1); and
- merely sharing gross revenues is likewise insufficient, Subsection (c)(2).

UPA (1997) added, “whether or not the persons intend to form a partnership” to the UPA (1914) formulation, thereby codifying a rule uniformly applied by courts: Subjective intent to create the legal relationship of “partnership” is irrelevant. What matters is the intent *vel non* to establish the business relationship that the law labels a “partnership.” Thus, a disclaimer of partnership status is ineffective to the extent the parties’ intended arrangements meet the criteria stated in this subsection.

**Subsection (b)**—This subsection continues the UPA (1914) concept that the general partnership is the residual form of business association. Accordingly, partnership-like organizations formed under specially applicable statutes are not within this article. *E.g.*, MONT. CODE ANN. §§ 35-13-101 to 102 (pertaining to mining partnerships).

An arrangement labeled a “joint venture” is a partnership if the arrangement meets the criteria stated in Subsection (a). In fact, in many jurisdictions, the law of general partnerships applies almost without analysis to joint ventures in which the co-venturers share profits. *See Jonathan Woodner Co. v. Laufer*, 531 A.2d 280, 285 n.7 (D.C. 1987) (stating that: (i) “[s]trictly

speaking, a joint venture is not the same as a partnership, but there is ‘very little law . . . applicable to one that does not apply to the other’”; (ii) “the rights and liabilities of joint venturers among themselves are generally governed by the laws of partnership”; and (iii) “[p]rinciples of partnership law, in particular the Uniform Partnership act, apply in most instances to joint ventures”) (quoting 46 AM. JUR. 2D JOINT VENTURES § 4, at 25 (1969) and collecting cases).

A limited partnership is not a partnership under this article; a limited partnership is “formed under a statute other than this [article].” *See* Section 1-102(27) (“Limited partnership” means a domestic limited partnership formed under or subject to [Article] 4 . . . “). Moreover, ULPA (2001) delinked the uniform limited partnership act from the uniform general partnership act. *See* ULPA (2001) (Last Amended 2013) Prefatory Note, *The Decision to “De-Link” and Create a Stand Alone Act*.

An unincorporated nonprofit organization is not a partnership under this article, because the organization is limited to “nonprofit purposes” and therefore cannot “carry on a business” in the traditional sense of that concept. *See* Section 7-102(11) (defining “unincorporated nonprofit association”).

**Subsection (c)**—UPA (1997) derived this subsection from UPA (1914) § 7 and with one exception, made no substantive change to the law. The substantive change pertains to the sharing of profits, which UPA (1997) recast as creating a rebuttable presumption of partnership rather merely constituting *prima facie* evidence. “*Prima facie*” means that the party with the burden of proof has adduced sufficient evidence to carry that burden, subject to the finder of fact’s view of any contrary evidence. The burden of persuasion is unchanged. In contrast, “rebuttable presumption” switches the burden of persuasion.

**Subsection (c)(3)**—The protected categories listed in this paragraph apply regardless of whether the profit share is a single, unvarying percentage or a ratio that varies; for example, after reaching a dollar floor or different levels of profits. Like UPA (1914), this article makes no attempt to answer in every case whether a partnership is formed. Whether a relationship is more properly characterized as that of borrower and lender, employer and employee, or landlord and tenant is left to the trier of fact. As under UPA (1914), a person may function in both partner and non-partner capacities.

**Subsection (c)(3)(E)**—UPA (1997) added this protected category, excepting from the rebuttable presumption a share of the profits received in payment of interest or other charges on a loan, “including a direct or indirect present or future ownership in the collateral, or rights to income, proceeds, or increase in value derived from the collateral.” The quoted language was taken from Section 211 of the Uniform Land Security Interest Act and is intended to protect shared-appreciation mortgages, contingent or other variable or performance-related mortgages, and other equity participation arrangements by clarifying that contingent payments do not presumptively convert lending arrangements into partnerships.



**SECTION 3-203. PARTNERSHIP PROPERTY.** Property acquired by a partnership is property of the partnership and not of the partners individually.

**Comment**

Although phrased differently, this section, which originated in UPA (1997), produces the same result as do UPA (1914) §§ 8(1) and 25. All property acquired by a partnership, by whatever manner acquired, becomes partnership property and belongs to the partnership as an entity, rather than to the individual partners.

Section 3-204 provides guidance concerning when property is “acquired by” the partnership.

UPA (1914) § 25(2)(c) and (e) also provides that partnership property is not subject to exemptions, allowances, or rights of a partner’s spouse, heirs, or next of kin. UPA (1997) omitted those provisions as unnecessary, because the exemptions and rights inure to the property of the partners, and not to partnership property.

**SECTION 3-204. WHEN PROPERTY IS PARTNERSHIP PROPERTY.**

(a) Property is partnership property if acquired in the name of:

(1) the partnership; or

(2) one or more partners with an indication in the instrument transferring title to the property of the person’s capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership.

(b) Property is acquired in the name of the partnership by a transfer to:

(1) the partnership in its name; or

(2) one or more partners in their capacity as partners in the partnership, if the name of the partnership is indicated in the instrument transferring title to the property.

(c) Property is presumed to be partnership property if purchased with partnership assets, even if not acquired in the name of the partnership or of one or more partners with an indication in the instrument transferring title to the property of the person’s capacity as a partner or of the existence of a partnership.

(d) Property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets, is presumed to be separate property, even if used for partnership purposes.

### Comment

Section 3-204 states the rules *inter se the partners and partnership* for determining when property is acquired by the partnership and so becomes partnership property. These rules apply to “all property, whether real, personal, or mixed or tangible or intangible, or any right or interest therein.” Section 3-102(38) (defining “property”).

These rules provide three separate approaches—according to:

- the name or names used in acquiring the property;
- when a partner's name appears as a transferee, the capacity in which the partner is acting; and
- for property acquired by purchase, whether the partnership provided the consideration for the property.

These approaches are complementary, not mutually exclusive.

This section omits any provision corresponding to UPA (1914) § 8(4), which states: “A conveyance to a partnership in the partnership name, even without words of inheritance, passes the entire estate of the grantor unless a contrary intent appears.” UPA (1997) omitted the provision as unnecessary because under modern conveyancing law all transfers pass the entire estate or interest of the grantor unless a contrary intent appears.

To what extent this section's *inter se* rules affect third party rights is a matter for other law, but in any event these rules yield automatically to statutes providing record title for particular types of property. For an example, see the comment to Subsection (c).

**Subsection (a) and (b)**—These subsections act in combination to provide the first two of the approaches listed above. Under these subsections, property becomes partnership property if acquired:

- in the name of the partnership; or
- in the name of one or more of the partners with an indication in the instrument transferring title of either:
  - their capacity as partners; or
  - of the existence of a partnership, even if the name of the partnership is not indicated.

Property acquired “in the name of the partnership” includes property acquired in the name of one or more partners in their capacity as partners, but only if the name of the partnership is indicated in the instrument transferring title.

Property transferred to a partner is partnership property, even though the name of the partnership is not indicated, if the instrument transferring title indicates either: (i) the partner’s capacity as a partner; or (ii) the existence of a partnership. This approach is consonant with the entity theory of partnership and resolves the troublesome issue of a conveyance to fewer than all the partners but that nevertheless indicates their partner status.

**Subsections (c) and (d)**—At least *inter se* the partners and partnership, it is the intention of the partners that controls whether property belongs to the partnership or to one or more of the partners in their individual capacities. These subsections each contain a rebuttable presumption as to the partners’ intent.

When applicable, the presumptions switch the burden of persuasion but are subject to an important limitation in favor of third parties. *See* Section 3-302(a)(3) (“Partnership property held in the name of one or more persons other than the partnership, without an indication in the instrument transferring the property to them of their capacity as partners or of the existence of a partnership, may be transferred by an instrument of transfer executed signed by the persons in whose name the property is held.”).

**Subsection (c)**—Under this subsection, property purchased with partnership property is presumed to be partnership property, notwithstanding the name in which title is held or any other indicia. In this context, a promise made by a partnership in exchange for property triggers the presumption, including a promise to perform services or to guarantee another person’s obligation with regard to the purchase of the property.

The presumption is entirely ineffective against third parties with regard to property with record title.

**EXAMPLE:** Using partnership funds, a partner purchases realty in the partner’s own name and records the purchase in the appropriate land records. The partner later transfers title to the realty to a third party that has neither knowledge nor notice of any rights the partnership may have in the property. The relevant real estate statute is the applicable law; this subsection is entirely inapposite.

**Subsection (d)**—Under this subsection, property acquired in the name of one or more of the partners, without an indication of their capacity as partners and without use of partnership funds or credit, is presumed to be the partners’ separate property, even if used for partnership purposes. In effect, this subsection presumes that only the use of the property is contributed to the partnership.

## [PART] 3

### RELATIONS OF PARTNERS TO PERSONS DEALING WITH PARTNERSHIP

**SECTION 3-301. PARTNER AGENT OF PARTNERSHIP.** Subject to the effect of a statement of partnership authority under Section 3-303, the following rules apply:

(1) Each partner is an agent of the partnership for the purpose of its business. An act of a partner, including the signing of an instrument in the partnership name, for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner did not have authority to act for the partnership in the particular matter and the person with which the partner was dealing knew or had notice that the partner lacked authority.

(2) An act of a partner which is not apparently for carrying on in the ordinary course the partnership's business or business of the kind carried on by the partnership binds the partnership only if the act was actually authorized by all the other partners.

#### Comment

At common law, a general partner was considered a general agent of the partnership. Joseph Story, COMMENTARIES ON THE LAW ON PARTNERSHIP § 101, at 153 (2d ed. 1850); RESTATEMENT (SECOND) OF AGENCY § 14A, cmt. a (1958). The mere status of a general partner “clothes” a person with apparent authority to carry on the partnership business. *Stockwell v. U.S.*, 80 U.S. 531, 567 (1871); *Lincoln Nat'l Bank v. Schoen*, 56 Mo. App. 160, 164 (Mo. Ct. App. 1894); *Kansallis Fin. Ltd. v. Fern*, 659 N.E.2d 731, 733, 740 (Mass. 1996). In 1914, the UPA codified this principle, UPA (1914) § 9, and “statutory apparent authority” has been part of uniform partnerships acts ever since. See Section 3-301 (Partnership Agent of Partnership); Section 4-402 (General Partner Agent of Limited Partnership).

This section's principal purpose is to delineate a partner's statutory apparent authority. The partnership agreement and Section 3-401 govern the rights of the partners among themselves, including the right to restrict a partner's actual authority.

**Paragraph (1)**—This paragraph retains the basic principles reflected in UPA (1914) § 9(1) and in effect characterizes a partner as a general managerial agent. Such agents have both actual and apparent authority, and this section delineates the apparent authority. For a discussion of the scope of actual authority, see Section 3-401(h), comment.

The agency law origins of statutory apparent authority has informed courts' application of UPA (1914) § 9(1), and that case law is equally applicable under this article. For example, although the statutory language does not appear to require that the appearance of authority be reasonable, the case law does so routinely. *See, e.g., In re Fox Hill Office Invs., Ltd.*, 101 B.R. 1007, 1019 (Bankr. W.D. Mo. 1989) (stating a third-party lender in possession of a copy of a limited partnership's partnership agreement was on notice of the general partner's lack of authority and therefore should have inquired as to the partner's authority), *aff'd*, 926 F.2d 752 (8th Cir. 1991); *Investors Title Ins. Co. v. Herzig*, 360 S.E.2d 786, 789 (N.C. 1987) (stating that "in order to hold the [partnership] liable, [a third party] must show that in the exercise of reasonable care under the circumstances, it was justified in believing that the principal had conferred . . . authority to [act] on behalf of the partnership"); *First Interstate Bank of Oregon, N.A. v. Bergendahl*, 723 P.2d 1005, 1010 (Or. Ct. App. 1986) (stating that bank in possession of management agreement was on notice of general partner's restricted authority and could not rely on a theory of apparent authority).

Likewise, per the law of apparent authority, a partner can bind a partnership under this section even if the partner intends to take and does take the resulting benefits for the partner's own benefit. *See Wolfe v. Harms*, 413 S.W.2d 204, 216 (Mo. 1967) (stating that partnership is liable for partner's acts "even if the predominant motive of the partner was to benefit himself or third persons"); *Rouse v. Pollard*, 18 A.2d 5, 7 (N.J. Eq. 1941) ("All the partners are responsible for the act of one of their number as agent, even though he acts for some secret purpose of his own, and not really for the benefit of the [partnership]."), *aff'd*, 21 A.2d 801 (N.J. Eq. 1941); *Investors Title Ins. Co. v. Herzig*, 360 S.E.2d 786, 788 (N.C. 1987) (stating that the mere fact that the partner's act was for personal gain was not enough to justify summary judgment for the partnership on the subject of the partnership's liability for the act).

UPA (1997) § 301(1) effected three changes from UPA (1914) § 9(1). First, Section 301(1) clarified that a partner's apparent authority includes acts for carrying on in the ordinary course "business of the kind carried on by the partnership," not just the business of the particular partnership in question. UPA (1914) is ambiguous on this point, but the drafters of UPA (1997) found some authority for an expanded construction in accordance with the so-called English rule. *See, e.g., Burns v. Gonzalez*, 439 S.W.2d 128, 131 (Tex. Civ. App. 1969) (dictum); *Comm'l Hotel v. Weeks*, 254 S.W. 521 (Tex. Civ. App. 1923).

The Harmonization Project preserved this UPA (1997) change, the significance of which depends on how broadly courts construe "business of the kind carried on by the partnership." For example, does a partnership that acts as a grain broker (never taking a position in grain) do business "of the kind carried on" by a partnership that buys grain for resale?

Second, UPA (1997) used "carrying on in the ordinary course" in lieu of the UPA (1914) phrase "in the usual way." The 1997 comments stated that: (i) "[t]he UPA and the case law use both terms without apparent distinction"; and (ii) "[n]o substantive change [was] intended by use of the more customary phrase." *See* the comment to UPA (1997) § 301.

The change in language had the benefit of aligning Section 3-301(1) with Section 3-305 (establishing attribution rules for a partner's wrongful conduct and referring to "ordinary course

of business of the partnership” and “the ordinary course of the partnership’s business”). The Harmonization Project also preserved this UPA (1997) change. For a discussion of the relationship between the ordinary course of the partnership’s business and a partner’s ordinary duties, see the comment to Section 3-305(a).

UPA (1997)’s third change to UPA (1914) § 9(1) concerned the allocation of risk of a partner’s lack of authority. Under UPA (1914) § 9(1) and (4), a restriction on a partner’s authority binds only a person with knowledge of the restriction. In contrast, UPA (1997) § 301(1) provides that a person who has received a notification of a restriction is also bound. Thus, UPA (1997) shifted the risk of lack of authority somewhat away from the partnership and somewhat toward third parties dealing with partners.

The Harmonization Project shifted the risk a bit further, binding third parties who know or *have reason to know* of a restriction. Section 3-301(1). (However, it is arguable that the Harmonization Project merely made explicit a rule implicit in the case law. As noted above, the case law requires a third party to show a *reasonable* belief in the partner’s authority. A third party who has reason to know of a partner’s lack of authority will be hard pressed to make that showing.)

Statements of partnership authority, Section 3-303, affect the application of this paragraph only in two ways. First, under Section 3-303(e) all persons (other than partners) are deemed to know of a limitation on the authority of a partner to transfer real property contained in a statement recorded in the appropriate land records. Second, a person (other than a partner) with actual knowledge of a grant or limitation of a partner’s authority may rely on that knowledge.

**Paragraph (2)**—UPA (1997) drew this paragraph directly from UPA (1914) § 9(2), with conforming changes to mirror the new language of Paragraph (1). Consistent with the law of agency, a partnership is bound by a partner’s actual authority, even if the partner lacks apparent authority. Under general agency principles, a partnership can subsequently ratify a partner’s unauthorized act. *See* Section 1-702 (Supplemental Principles of Law).

**UPA (1914) § 9(3) and (4)**—UPA (1997) omitted UPA (1914) § 9(3), which lists five acts requiring unanimous consent of the partners to bind the partnership. Most of the listed acts probably remain outside the apparent authority of a partner under this article, such as disposing of the goodwill of the business, but the drafters of UPA (1997) believed that eliminating categorical rules affords useful flexibility. In particular, it seemed “archaic to always require unanimous consent to submit a partnership claim to arbitration.” UPA (1997) § 301, comment.

UPA (1914) § 9(4) provides that a partnership is not bound by an act of a partner in contravention of a restriction on a partner’s authority known to the other party. UPA (1997) omitted that provision as being entirely redundant of UPA (1997) § 301(1).

The Harmonization Project preserved UPA (1997)’s approach to both UPA (1914) § 9(3) and (4).

## **SECTION 3-302. TRANSFER OF PARTNERSHIP PROPERTY.**

(a) Partnership property may be transferred as follows:

(1) Subject to the effect of a statement of partnership authority under Section 3-303, partnership property held in the name of the partnership may be transferred by an instrument of transfer signed by a partner in the partnership name.

(2) Partnership property held in the name of one or more partners with an indication in the instrument transferring the property to them of their capacity as partners or of the existence of a partnership, but without an indication of the name of the partnership, may be transferred by an instrument of transfer signed by the persons in whose name the property is held.

(3) Partnership property held in the name of one or more persons other than the partnership, without an indication in the instrument transferring the property to them of their capacity as partners or of the existence of a partnership, may be transferred by an instrument of transfer signed by the persons in whose name the property is held.

(b) A partnership may recover partnership property from a transferee only if it proves that signing of the instrument of initial transfer did not bind the partnership under Section 3-301 and:

(1) as to a subsequent transferee who gave value for property transferred under subsection (a)(1) and (2), proves that the subsequent transferee knew or had been notified that the person who signed the instrument of initial transfer lacked authority to bind the partnership; or

(2) as to a transferee who gave value for property transferred under subsection (a)(3), proves that the transferee knew or had been notified that the property was partnership property and that the person who signed the instrument of initial transfer lacked authority to bind

the partnership.

(c) A partnership may not recover partnership property from a subsequent transferee if the partnership would not have been entitled to recover the property, under subsection (b), from any earlier transferee of the property.

(d) If a person holds all the partners' interests in the partnership, all the partnership property vests in that person. The person may sign a record in the name of the partnership to evidence vesting of the property in that person and may file or record the record.

### **Comment**

UPA (1997) § 302 replaced UPA (1914) §10 and provides rules for the transfer and recovery of partnership property. While UPA (1914) § 10 covers only real property, this section applies also to personal property acquired by instrument and held in the name of the partnership or one or more of the partners.

The language of this section was adapted in part from the Georgia partnership statute in effect during the UPA (1997) drafting process. *See* GA. CODE ANN. § 14-8-10. Rules stated in this section necessarily parallel the rules stated in Section 3-203.

**Subsection (a)**—Subsection (a)(1) deals with the transfer of partnership property held in the name of the partnership and Subsection (a)(2) deals with property held in the name of one or more of the partners with an indication either of their capacity as partners or of the existence of a partnership. Subsection (a)(3) deals with partnership property held in the name of one or more of the partners without an indication of their capacity as partners or of the existence of a partnership. Like Section 3-301, Subsection (a)(1) is subject to statements of partnership authority under Section 3-303. *See* the comment to Section 3-301(1).

**Subsection (b)**—This subsection deals with the right of a partnership to recover partnership property transferred by a partner without actual authority. The subsection's structure corresponds to the structure of Subsection (a).

**Subsection (b)(1)**—This paragraph deals with the recovery of “property transferred under subsection (a)(1) [or] (2).”

**Subsection (b)(2)**—This paragraph deals with the recovery of “property transferred under subsection (a)(3).”

**Subsection (c)**—UPA (1997) added this subsection, which parallels Uniform Fraudulent Transfer Act, section 8(a) (subsequent transferee from bona fide purchaser protected), 8(b)(2) (same).



**Subsection (d)**—UPA (1997) added this subsection. So that this provision does not destroy transferee rights, “all the partners interests” must be read to mean “each interest that originated as a partner interest—which includes all transferable interests, by whomever owned.”

The UPA (1997) comment to this subsection took a noteworthy position on the consequences of all the partners’ interests in the partnership being held by one person:

Subsection (d) allows for clear record title, even though the partnership no longer exists as a technical matter. When a partnership becomes a sole proprietorship by reason of the dissociation of all but one of the partners, title vests in the remaining “partner,” although there is no “transfer” of the property. The remaining “partner” may execute a deed or other transfer of record in the name of the non-existent partnership to evidence vesting of the property in that person’s individual capacity.

Section 3-801(6), added during the Harmonization Project, changes the analysis. The paragraph states that dissolution is caused by “the passage of 90 consecutive days during which the partnership does not have at least two partners.” Consequently, for at least eighty-nine consecutive days a partnership remains un-dissolved although having only one partner, and even at ninety days the partnership remains a partnership, albeit dissolved and compelled to wind up its business. Subsection (d) remains quite useful if the sole remaining partner winds up the partnership by becoming a sole proprietor, but it is no longer accurate to state that a partnership with only one partner “no longer exists as a technical matter.”

### **SECTION 3-303. STATEMENT OF PARTNERSHIP AUTHORITY.**

(a) A partnership may deliver to the [Secretary of State] for filing a statement of partnership authority. The statement:

(1) must include the name of the partnership and:

(A) if the partnership is not a limited liability partnership, the street and mailing addresses of its principal office; or

(B) if the partnership is a limited liability partnership, the name and street and mailing addresses of its registered agent;

(2) with respect to any position that exists in or with respect to the partnership, may state the authority, or limitations on the authority, of all persons holding the position to:

(A) sign an instrument transferring real property held in the name of the

partnership; or

(B) enter into other transactions on behalf of, or otherwise act for or bind, the partnership; and

(3) may state the authority, or limitations on the authority, of a specific person to:

(A) sign an instrument transferring real property held in the name of the partnership; or

(B) enter into other transactions on behalf of, or otherwise act for or bind, the partnership.

(b) To amend or cancel a statement of authority filed by the [Secretary of State], a partnership must deliver to the [Secretary of State] for filing an amendment or cancellation stating:

(1) the name of the partnership;

(2) if the partnership is not a limited liability partnership, the street and mailing addresses of the partnership's principal office;

(3) if the partnership is a limited liability partnership, the name and street and mailing addresses of its registered agent;

(4) the date the statement being affected became effective; and

(5) the contents of the amendment or a declaration that the statement is canceled.

(c) A statement of authority affects only the power of a person to bind a partnership to persons that are not partners.

(d) Subject to subsection (c) and Section 3-103(d)(1), and except as otherwise provided in subsections (f), (g), and (h), a limitation on the authority of a person or a position contained in an effective statement of authority is not by itself evidence of any person's knowledge or notice of

the limitation.

(e) Subject to subsection (c), a grant of authority not pertaining to transfers of real property and contained in an effective statement of authority is conclusive in favor of a person that gives value in reliance on the grant, except to the extent that if the person gives value:

(1) the person has knowledge to the contrary;

(2) the statement has been canceled or restrictively amended under subsection (b);

or

(3) a limitation on the grant is contained in another statement of authority that became effective after the statement containing the grant became effective.

(f) Subject to subsection (c), an effective statement of authority that grants authority to transfer real property held in the name of the partnership, a certified copy of which statement is recorded in the office for recording transfers of the real property, is conclusive in favor of a person that gives value in reliance on the grant without knowledge to the contrary, except to the extent that when the person gives value:

(1) the statement has been canceled or restrictively amended under subsection (b), and a certified copy of the cancellation or restrictive amendment has been recorded in the office for recording transfers of the real property; or

(2) a limitation on the grant is contained in another statement of authority that became effective after the statement containing the grant became effective, and a certified copy of the later-effective statement is recorded in the office for recording transfers of the real property.

(g) Subject to subsection (c), if a certified copy of an effective statement containing a limitation on the authority to transfer real property held in the name of a partnership is recorded

in the office for recording transfers of that real property, all persons are deemed to know of the limitation.

(h) Subject to subsection (i), an effective statement of dissolution is a cancellation of any filed statement of authority for the purposes of subsection (f) and is a limitation on authority for purposes of subsection (g).

(i) After a statement of dissolution becomes effective, a partnership may deliver to the [Secretary of State] for filing and, if appropriate, may record a statement of authority that is designated as a post-dissolution statement of authority. The statement operates as provided in subsections (f) and (g).

(j) Unless canceled earlier, an effective statement of authority is canceled by operation of law five years after the date on which the statement, or its most recent amendment, becomes effective. The cancellation is effective without recording under subsection (f) or (g).

(k) An effective statement of denial operates as a restrictive amendment under this section and may be recorded by certified copy for purposes of subsection (f)(1).

### **Comment**

UPA (1997) § 303 pioneered this concept, which was refined in ULLCA (2006) and further refined in the Harmonization Project. This section is conceptually divided into two realms: (i) statements pertaining to the power to transfer interests in the partnership real property; and (ii) statements pertaining to other matters. In the latter realm, statements are filed only in the records of the filing office and operate only to the extent the statements are actually known and relied on by a third party. Section 3-303(d), (e).

As to interests in real property, in contrast, this section: (i) requires double filing—with the filing office and in the appropriate land records; and (ii) provides for constructive knowledge of statements limiting authority. Thus, a properly filed and recorded statement can protect the partnership, Section 3-303(g), and, in order for a statement pertaining to real property to be a sword in the hands of a third party, the statement must have been both filed and properly recorded, Section 3-303(f). Experience suggests that statements of authority will most often be used in connection with transactions in real estate.

The requirements for filing documents with the filing office are found in Part 2 of Article

1. *See also* Section 1-104 (Delivery of Record).

By its terms, this section applies only to domestic general partnerships. The section refers throughout to “partnership,” which means a domestic general partnership. *See* Section 3-102(a)(6) (“‘Partnership’ . . . means an association of two or more persons to carry on as co-owners a business for profit formed under this [article] or that becomes subject to this [article] under [Article] 2 [mergers and other organic transactions] or Section 3-110 [transition provision that eventually makes pre-existing general partnerships subject to this act].”). *Cf. Fannie Mae v. Heather Apartments Ltd. P’ship*, A13-0562, 2013 WL 6223564, at \*6 (Minn. Ct. App. Dec. 2, 2013) (considering the remedies available to a judgment creditor with respect to the judgment debtor’s interest in a Cook Islands LLC; rejecting the debtor’s argument that the creditor’s “only remedy is to obtain a charging order under” [the Minnesota LLC statute]; explaining that “this argument fails because that statute only applies to Minnesota limited liability companies” which that statute “defines . . . as ‘a limited liability company, other than a foreign limited liability company, *organized or governed by this chapter*’”) (emphasis added) (statutory citations omitted).

**Subsection (a)(2)**—This paragraph permits a statement to designate authority by position (or office) rather than by specific person, thus avoiding the need to file anew whenever a new person assumes the position or the office. This type of a statement will enable partnerships to provide evidence of ongoing power to enter into transactions without having to disclose to third parties the entirety of the partnership agreement.

Here and elsewhere in the section, the phrase “real property” includes all types of interests in real property, such as mortgages, easements, etc.

**Subsection (a)(2)(A) and (a)(3)(A)**—The authority to “sign” an instrument includes the authority to commit the partnership to the transfer reflected in the agreement. *See* Subsection (f) (referring not merely to signing but also to “an effective statement of authority that grants authority to transfer real property”).

**Subsection (c)**—This subsection expresses a very important limitation – *i.e.*, that this section’s rules do not operate *viz-a-viz* partners. For partners, the partnership agreement is controlling. Section 3-107(d). However, like any other record delivered for filing on behalf of a partnership, a statement of authority might be some evidence of the contents of the partnership agreement. *See* the comment to Section 3-107(d).

Another important limitation exists. The filing office is not affected by a statement of authority that purports to delineate the authority of persons to sign documents to be delivered for filing on behalf of a partnership. The Code does define “[p]erson” to include a “government or governmental subdivision, agency, or instrumentality,” Section 1-102(34), but “a limitation on the authority of a person or a position contained in an effective statement of authority is not by itself evidence of knowledge or notice of the limitation by any person,” Subsection (d).

Moreover, even if an employee of the filing office happened to see that a statement of authority purported to delineate the authority of persons to sign records to be delivered on behalf

of a partnership, that information would not pertain to a “fact [that] is material to the agent's duties to the principal” and therefore would not be attributed to the filing office. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006).

**Subsection (d)**—The phrase “by itself” is important, because the existence of a limitation of authority could be evidence if, for example, the person in question reviewed the public record at a time when the limitation was of record.

**Subsection (e)(2)**—This paragraph by its terms does not affect a claim of lingering apparent authority. A person could: (i) assert knowledge of a statement of authority as the statement existed before a cancellation or restrictive amendment; and (ii) characterize the original statement as a manifestation of authority traceable to the partnership. RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. b (2006) (“Apparent authority is present only when a third party's belief is traceable to manifestations of the principal.”).

However, for apparent authority to exist, the purported agent must *reasonably* appear to be authorized. RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006) (stating that apparent authority can only exist when “a third party reasonably believes the actor has authority to act on behalf of the principal”). Given the possibility of cancellation or restrictive amendment, how reasonable can it be for a person to know of a statement of authority, let time pass, and then rely on the statement without re-checking the public record?

**Subsections (f)–(h)**—These subsections: (i) pertain to transactions in real property; (ii) provide a mechanism by which authority to transfer a partnership’s real property can be made to appear in the real estate records; and (iii) thus address the principal concerns (raised by real estate lawyers) that led the drafters of UPA (1997) to provide for statements of authority.

**Subsection (f)**—This subsection provides a sword for a vendee of real property. If the vendee has “give[n] value in reliance on the grant without knowledge to the contrary,” the statement of authority protects the vendee against claims that contradict the grant.

**Subsection (f)(1) and (2)**—As to a claim of lingering apparent authority, see Subsection (e)(2), comment. The analysis stated there applies even more strongly in the context of customary practices involving land transfers.

**Subsection (g)**—This subsection provides a shield for the partnership as alleged vendor. If a vendee’s claim contradicts the stated limitation, constructive notice knowledge (“deemed to know”) defeats the claim even if the vendee gave value and lacked actual knowledge.

**Subsection (h)**—This subsection integrates statements of dissolution, Section 3-802(b)(2)(A), and termination, Section 3-802(b)(2)(F), into the operation of this section.

The effect of a statement of dissolution depends on the circumstances.

EXAMPLE: ABC, a general partnership, has in effect a properly filed and recorded statement of authority authorizing ABC’s CEO to transfer real estate owned by the partnership. The proper filing and recording by ABC of a statement of dissolution

cancels the statement of authority. Subsequently, Buyer gives value in return for a deed signed by the CEO on behalf of ABC. Due to Subsections (h) and (f)(1), Subsection (f) does not protect Buyer. Moreover, under Subsections (g) and (h), Buyer is “deemed to know” of the dissolution. Whether that deemed knowledge functions to deprive the CEO of authority to bind ABC depends on agency law and additional facts. For example, the CEO might have had actual or apparent authority to transfer the real estate despite the dissolution of the partnership.

In contrast, the effect of a statement of termination, Section 3-802(b)(2)(f), is categorical. If properly filed with the filing office and properly recorded in the office for land records, the statement eliminates the power of any person to transfer real property owned in the name of the partnership. No one can have the authority to act for a non-existent entity. *Cf.* RESTATEMENT (THIRD) OF AGENCY § 4.04(1)(a) (2006) (precluding ratification by a principal that did not exist at the time of the unauthorized act).

**Subsection (i)**—This provision permits a partnership to use statements of authority during winding up. As an additional protection for third parties, a statement must be “designated as a post-dissolution statement of authority” to be effective under this provision.

**Subsection (k)**—Presumably, when real property is involved, a person who obtains the filing of a statement of denial under Section 3-304 will cause a certified copy of the statement to be “recorded by certified copy for purposes of subsection (f)(1)” [undercutting constructive notice as to authority to transfer real property]. However, nothing in this subsection prevents the partnership from causing a certified copy to appear in the land records; due the section’s use of the passive voice (“may be recorded”), this article does not delimit who has the authority to act under this subsection.

**SECTION 3-304. STATEMENT OF DENIAL.** A person named in a filed statement of authority granting that person authority may deliver to the [Secretary of State] for filing a statement of denial that:

- (1) provides the name of the partnership and the caption of the statement of authority to which the statement of denial pertains; and
- (2) denies the grant of authority.

### **Comment**

A person whose powers are delineated in the public record by another person should have the right to dissent from that delineation. This section takes an “all or nothing” approach; a person may not deny in part and confirm in part. For the effect of a statement of denial, see Section 3-303(c), comment, and Section 3-303(k).

Section 3-308(c) makes clear that a person does not become a partner solely because he is named as a partner in a statement of partnership authority filed by another person.

### **SECTION 3-305. PARTNERSHIP LIABLE FOR PARTNER'S ACTIONABLE CONDUCT.**

(a) A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with the actual or apparent authority of the partnership.

(b) If, in the course of the partnership's business or while acting with actual or apparent authority of the partnership, a partner receives or causes the partnership to receive money or property of a person not a partner, and the money or property is misapplied by a partner, the partnership is liable for the loss.

#### **Comment**

**Subsection (a)**—This provision is derived from UPA (1914) § 13 (Partnership Bound by Partner's Wrongful Act), as modernized by UPA (1997) § 305(a) (Partnership Liable for Partner's Actionable Conduct) and for the most part parallels the agency law doctrine of *respondeat superior*. See RESTATEMENT (SECOND) OF AGENCY § 14A, cmt. a (1958) ("When one of the partners is in active management of the business or is otherwise regularly employed in the business, he is a servant of the partnership."). The liability is vicarious and without regard to the fault of those managing the partnership.

UPA (1997) expanded this attribution rule in two ways. First, the 1997 language omitted the 1914 phrase "not being a partner in the partnership," thereby permitting a partner to sue the partnership under this subsection during the term of the partnership, rather than being limited to the remedies of dissolution and an accounting. This change was consistent with UPA(1997) § 410(b) (stating "[a] partner may maintain an action against the partnership or another partner, with or without an accounting as to partnership business, to enforce the partner's rights and protect the partner's interests"). Second, adding "or other actionable conduct" broadens the subsection to cover no-fault torts.

To successfully invoke this provision, a plaintiff must show: (i) "a wrongful act or omission or other actionable conduct" by a partner; (ii) that caused "loss or injury"; and (iii) that at the relevant moment, the partner was acting with actual authority, apparent authority (if relevant), or within "the ordinary course of business of the partnership."



Extrapolating from agency law, apparent authority is relevant only when the appearance of authority augments the impact of the wrongful act. *See* RESTATEMENT (THIRD) OF AGENCY, § 7.08 (2006) (“A principal is subject to vicarious liability for a tort committed by an agent in dealing or communicating with a third party on or purportedly on behalf of the principal when actions taken by the agent with apparent authority constitute the tort or enable the agent to conceal its commission.”).

An act or omission may be “in the ordinary course of business of the partnership” even though the act is wrongful. Any other interpretation would vitiate the “ordinary course” element. “The proper question . . . is not whether the specific wrongful act is ‘ordinary course’ . . . , but rather whether that type of act, if done rightfully, would be.” DANIEL S. KLEINBERGER, AGENCY, PARTNERSHIP AND LLCs: EXAMPLES AND EXPLANATIONS § 10.5.1, at 350 (4th ed. 2012) (emphasis omitted). However, in *Jackson v. Jackson*, 201 S.E.2d 722, 724 (N.C. App. 1974), the North Carolina Court of Appeals stated that, while “[a]dvising the initiation of a criminal prosecution is clearly within the normal range of activities for a typical law partnership, . . . taking such action maliciously and without probable cause is quite a different matter.” The court held that “[i]n view of [ethics] rules, which clearly forbid any attempt by a lawyer to prosecute a person without cause, it cannot be held that malicious prosecution is within the ordinary course of business of a law partnership.” *Id.* It is difficult to identify a reasonable limit to this approach. Presumably, at least, a partner’s “plain vanilla” malpractice is within a law firm’s ordinary course of business despite the ethical rules requiring lawyers to act zealously and competently.

In any event, Subsection (a) refers to “the ordinary course of business of the *partnership*” (emphasis added); thus, the proper question is whether the conduct is in the ordinary course for the partnership and not whether the particular partner ordinarily plays a role in that part of the partnership’s business. *See Vanacore v. Kennedy*, 86 F. Supp. 2d 42, 51 (D. Conn. 1998), *aff’d sub nom.*, *Vanacore v. Space Realty, Inc.*, 208 F.3d 204 (2d Cir. 2000) (stating that “Kennedy [a partner] committed his misdeeds, which led directly to plaintiff’s injuries, within the ordinary course of the business of E & K [the partnership]”); *Sheridan v. Desmond*, 697 A.2d 1162, 1166 (Conn. App. Ct. 1997) (stating that to be considered “in ordinary course of the business,” a partner’s action must be “the kind of thing *a . . . partner would do*”) (emphasis added); *In Moren ex. rel. Moren v. JAX Rest.*, 679 N.W.2d 165, 167–68 (Minn. Ct. App. 2004) (stating, as part of its analysis under UPA (1997) § 305, that “[i]t is undisputed that one of the cooks scheduled to work that evening [at the partnership’s restaurant] did not come in, and that [one] partner asked [another partner] to help in the kitchen . . . [and] that [the other partner] was making pizzas for the partnership when” her negligence injured the plaintiff).

**Subsection (b)**—This provision is derived from UPA (1914) § 14 (Partnership Bound by Partner’s Breach of Trust) and UPA (1997) § 305(b) (Partnership Liable for Partner’s Actionable Conduct). It is not necessary that the partner “receiv[ing] or caus[ing] the partnership to receive money or property” do so wrongfully. Culpability is necessary at the second phase—*i.e.* when “the money or property is misapplied by a partner.”

### **SECTION 3-306. PARTNER'S LIABILITY.**

(a) Except as otherwise provided in subsections (b) and (c), all partners are liable jointly and severally for all debts, obligations, and other liabilities of the partnership unless otherwise agreed by the claimant or provided by law.

(b) A person that becomes a partner is not personally liable for a debt, obligation, or other liability of the partnership incurred before the person became a partner.

(c) A debt, obligation, or other liability of a partnership incurred while the partnership is a limited liability partnership is solely the debt, obligation, or other liability of the limited liability partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the limited liability partnership solely by reason of being or acting as a partner. This subsection applies:

(1) despite anything inconsistent in the partnership agreement that existed immediately before the vote or consent required to become a limited liability partnership under Section 3-901(b); and

(2) regardless of the dissolution of the limited liability partnership.

(d) The failure of a limited liability partnership to observe formalities relating to the exercise of its powers or management of its business is not a ground for imposing liability on a partner for a debt, obligation, or other liability of the partnership.

(e) The cancellation or administrative revocation of a limited liability partnership's statement of qualification does not affect the limitation in this section on the liability of a partner for a debt, obligation, or other liability of the partnership incurred while the statement was in effect.

## Comment

**Derivation**—This section was derived from UPA (1997) § 306, which was also the source for ULPA (2001) § 404 and ULLCA (2006) § 304. The Harmonization Project brought the two partnership acts and the limited liability company act into accord to the extent the three acts overlap.

**Subsection (a)**—Until the advent of limited liability partnerships and limited liability limited partnerships, one hallmark of general partner status was strict, vicarious liability for the debts, obligations, and other liabilities of the partnership. This subsection states that venerable rule, albeit with two changes:

- Under UPA (1914) § 15, the nature of the general partners' liability depended on the claim, giving rise to the partnership's liability. If the partnership's liability sounded in tort, the general partners' liability was joint and several. If the partnership's liability sounded in contract, the general partners' liability was only several. UPA (1997) § 306(a) dispensed with that distinction.
- UPA (1997) § 307(d) generally requires a judgment creditor to exhaust the partnership's assets before enforcing a judgment against the separate assets of a partner. Prior law was to the contrary.

The Harmonization Project made no substantive changes to this subsection.

**Subsection (b)**—UPA (1997) continued the approach of UPA (1914) §§17 and 41(7) to the vicarious liability of an incoming partner, but used a simpler and clearer formulation. The Harmonization Project made no substantive changes to this subsection.

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 is *Conklin Farm v. Leibowitz*, 658 A.2d 1257 (N.J. 1995), which 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.

*Conklin* concerned a partnership loan obligation that was: (i) entered into before a particular partner joined the partnership; but (ii) for the most part, was payable afterwards. The court held that “interest is part of the contractual debt, and the obligation to pay interest on a loan arises, if at all, at the time that the parties execute the note or other debt instrument. *Conklin*, 658 A.2d at 1261. The court indicated that the same analysis applies to the obligation to repay principal. *Id.* at 1263 (stating that “the decisive issue before this court . . . [is that] [p]ayment of interest, like repayment of advances, is an obligation that arises at the time the debt instrument is executed”).

*Conklin* discussed the lease issue in response to the creditor's argument that “just as a rent obligation arises for current use of property, an interest obligation arises for current use of

principal.” *Id.* at 1261. Rejecting that argument, the court: (i) noted “the *common-law* obligation to pay rent based on current tenancy [which] . . . arises with each period of tenancy, and . . . arises even in the absence of a lease”; (ii) described “the common-law obligation to pay rent [as] entirely independent of the contractual obligation under the lease”; and (iii) held that, for purposes of partnership law, the rule for “incurring” a lease obligation rests on the common law duty in tenancy and not on the lease as a contract. *Id.* at 1262 (citing *Ellingson v. Walsh, O'Connor & Barneson*, 104 P.2d 507, 508 (Cal. 1940)).

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. “Although the courts have not been consistent . . . , the interpretation of [when] a . . . statute [of limitations begins to run] as applied to torts has been such that the statute does not usually begin to run until the tort is complete . . . . A tort is ordinarily not complete until there has been an invasion of a legally protected interest of the plaintiff.” RESTATEMENT (SECOND) OF TORTS § 899, cmt c (1979); *see also Loehr v. Ventura Cnty. Cmty. Coll. Dist.*, 147 Cal. App. 3d 1071, 1078 (Cal. Ct. App. 1983). By analogy, a partnership would incur liability for a tort when the harm occurs. *See, e.g., Jones v. Cox*, 828 P.2d 218, 224 (Colo. 1992) (“A cause of action has commonly been understood to ‘accrue’ when a suit may be maintained thereon.”) (quoting BLACK’S LAW DICTIONARY 19 (5th ed. 1979)); *Loehr*, 147 Cal. App. 3d at 1078.

However, a policy argument exists to the contrary. Vicarious liability for a partnership's torts should be confined to persons who are partners when the wrongful conduct occurs. It is the conduct, not the consequences, that is wrongful; therefore, the occurrence of the wrongful conduct should determine which set of partners is liable for the conduct's consequences.

For further discussion of the “incurred” issue, see Subsection (c), comment (The Temporal Nexus—When Claim Incurred).

**Subsection (c)**—This subsection provides a corporate/LLC-like liability shield for partners, protecting them from (and only from) the debts, obligations and liabilities of the partnership – *i.e.*, against a partner’s alleged vicarious liability for the obligations of the entity.

### *Full Liability Shield*

This article provides a full liability shield – *i.e.*, the shield applies regardless of the law giving rise to a claim against an LLP. A few jurisdictions provide only a partial shield. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 8204 (2013) (providing the partners of an LLP a shield for claims against the partnership “whether sounding in contract or tort or otherwise,” but only the claims that “arise from any negligent or wrongful acts or misconduct committed by another partner or other representative of the partnership”). The resulting partial shield does not protect partners against liability for the partnership’s ordinary commercial debts, such as liability for lease payments.

### *Shield Applicable Regardless of the Identity of the Plaintiff*

What makes the shield relevant is the nature of the claim. If the complaint seeks to hold

a partner vicariously liability for the LLP's obligations, the shield applies. If not, not. Thus, there is no distinction among a claim arising from an LLP's debt to a commercial creditor, a partner's claim that the LLP has failed to return a contribution as required by the partnership agreement, and a claim by a former partner that the LLP has failed to follow through on a buy-out agreement. *See Rappaport v. Gelfand*, 197 Cal. App. 4th 1213, 1230–32 (Cal. Ct. App. 2011) (involving a claim by a former partner). *Accord Ederer v. Gursky*, 881 N.E.2d 204, 212–13 (N.Y. 2007) (Smith, J., dissenting).

*Shield Inapposite for Claims Arising from a Partner's Own Conduct*

Because the partner liability at issue is solely vicarious, the LLP shield is irrelevant to claims seeking to hold a partner directly liable on account of the partner's own conduct. Case law on this issue comes from the analogous context of limited liability companies, and in that context a few judges have failed to understand this point. *See* the comment to Section 5-304(a) (Shield Inapposite for Claims Arising from a Member's or Manager's Own Conduct). However, the overwhelming weight of case law is contrary, as are the actual words of shield provisions (immunizing only for obligations of the entity and making no reference to direct obligations of an owner or manager) and public policy (which recoils from the idea of immunizing a person's misconduct solely because the person acts on behalf of an organization).

EXAMPLE: A partner personally guarantees a debt of a limited liability partnership. Subsection (c) is irrelevant to the partner's liability as guarantor.

EXAMPLE: A partner purports to bind a limited liability partnership while lacking any agency law power to do so. The LLP is not bound, but the partner is liable for having breached the "warranty of authority" (an agency law doctrine). Subsection (c) does not apply. The liability is not *for* a debt, obligation, or other liability of the LLP, but is rather the partner's own, direct liability. Indeed, the liability exists because the LLP is *not* indebted, obligated or liable. RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006).

EXAMPLE: A partner of a limited liability partnership defames a third party in circumstances that render an LLP vicariously liable under Section 3-305(a). Under Subsection (c), the third party cannot hold the partner accountable for the *partnership's* liability, but that protection is immaterial. The partner is the tortfeasor and in that role is directly liable to the third party.

EXAMPLE: A limited liability partnership provides professional services, and one of its partners commits malpractice. The liability shield is irrelevant to the partner's direct liability in tort. However, if the partner's malpractice liability is attributed to the partnership under Section 3-305(a), the liability shield will protect the other partners against a claim that they must make good on the LLP's liability. The same analysis applies if the plaintiff also successfully claims that another partner was negligent in supervising the first partner.

EXAMPLE: A limited liability partnership with two partners enters into a contract to build a home, and the partners perform substantial amounts of the work. The homeowner

sues both the LLP and the partners for allegedly defective work, but the complaint sounds in contract rather than in tort. The LLP may be liable, but the partners are not. *See Ogea v. Merritt*, 130 So. 3d 888, 905 (La. 2013).

Subsection (c) pertains only to claims based on the LLP's liability and is irrelevant to claims by a limited liability partnership or a partner against another partner and *vice versa*. *See* Sections 3-307 (pertaining to actions by partners), 3-409 (pertaining to management duties).

### *Shield Inapposite to Role Liability Claims*

Provisions of regulatory law may impose liability on a partner of an LLP due to a role the partner plays in the partnership. *See, e.g., Food Team Intern., Ltd. v. Unilink, L.L.C.*, 872 F. Supp. 2d 405, 424 (E.D. Pa. 2012) (holding several individuals “subject to secondary individual liability under PACA [Perishable Agricultural Commodities Act]” because their roles within a limited liability company enabled them to control the relevant assets) (citing *Bear Mountain Orchards, Inc. v. Mich–Kim, Inc.*, 623 F.3d 163, 172 (3d Cir. 2010)). Subsection (c) does not affect this “role liability.”

### *The Temporal Nexus—When Claim Incurred*

The LLP shield functions only with respect to obligations incurred while the partnership is a limited liability partnership. The shield does not protect partners from vicarious liability for partnership obligations incurred before a partnership becomes an LLP or after the partnership cancels its LLP status. *See* Section 3-903(d). The same is true initially when LLP status has been administratively revoked, but reinstatement of LLP status resurrects the shield retroactively, except as to persons who relied on the revocation. Section 3-903(d).

For a preliminary discussion of when a partnership obligation is incurred, see the comment to Subsection (b). It could well be argued that “incurred” under Subsection (c) has the same meaning as “incurred” under Subsection (b). *IBP, Inc. v. Alvarez*, 546 U.S. 21, 34 (2005) (referring to “the normal rule of statutory interpretation that identical words used in different parts of the same statute are generally presumed to have the same meaning”); *Timberline Air Serv., Inc. v. Bell Helicopter-Textron, Inc.*, 884 P.2d 920, 925 (1994) (stating that “[w]hen the same words are used in different parts of the same statute, it is presumed that the Legislature intended that the words have the same meaning”).

However, the argument should yield if the subsections’ different contexts raise different issues of policy. 1A SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 45:12 (7th ed.) (stating that “departure from the literal construction of a statute is justified when such a construction would produce an absurd and unjust result and would clearly be inconsistent with the purposes and policies of the act in question”); *see, e.g., S.V. v. R.V.*, 933 S.W.2d 1, 4 (Tex. 1996) (“[W]e have held that a cause of action accrues when a wrongful act causes some legal injury, even if the fact of injury is not discovered until later, and even if all resulting damages have not yet occurred. We have not applied this rule without exception, however, and have sometimes held that an action does not accrue until the plaintiff knew or in the exercise of reasonable diligence should have known of the wrongful act and resulting injury.”) (citations

omitted).

The case law 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, Section 3-306(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.

A similar issue exists with regard to tort liability. 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. *Cf. Savini v. Univ. of Haw.*, 153 P.3d 1144, 1150 (Haw. 2007) (addressing the question of when a statute of limitations begins to run for bodily injury, when another statute precludes bringing a claim until the amount of damages has reached a specified threshold).

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 – *i.e.*, none. *See, e.g., Foxchase, L.L.L.P. v. Cliatt*, 562 S.E.2d 221, 224 (Ga. Ct. App. 2002) (holding that a partnership’s liability shield did not protect partners from claims of property damage caused by the construction of a golf course, where the jury could have found that the “damage ... occurred when they, not the partnership, owned the course”).

From the same perspective, *Evanston Ins. Co. v. Dillard Dept. Stores, Inc.*, 602 F.3d 610 (5th Cir. 2010) makes no sense. Interpreting the Texas LLP statute, the court held that a partner’s liability for a partnership debit is incurred only when judgment is entered against the partnership. Although the decision itself benefitted creditors, the holding invites the type of gamesmanship shown in the leasing example, above. Moreover, the decision: (i) has been criticized by the Texas Court of Appeals, *Am. Star Energy & Minerals Corp. v. Stowers*, 405 S.W.3d 905, 907 (Tex. App. 2013); (ii) ignores the precedent discussed in Subsection (b), comment and Section 3-307(c), comment; and (iii) can be distinguished as depending on the particular (non-uniform) language of the Texas statute. *Evanston Ins. Co. v. Dillard Dep’t Stores, Inc.*, 602 F.3d 610, 615–16 (5th Cir. 2010) (contrasting “incurred” with “committed”).

### *Effect of LLP Status on Relations Inter Se the Partners*

Although the most noticeable consequence of LLP status is the corporate/LLC-like liability shield, there are two *inter se* consequences as well. One is straightforward; the other is complex.

- When a partnership chooses the jurisdiction in which to deliver for filing a statement of qualification, the partnership chooses its governing law. Section 3-104(1). The partnership agreement cannot override that choice. Section 3-105(c)(1).
- When a partnership becomes a limited liability partnership, several related default rules change (going forward):
  - Partners no longer share losses. Capital losses “lay where they fall.”
  - Except for contributions promised but not made, partners no longer have contribution obligations.
    - Due to:
      - the liability shield, partners are no longer required to contribute capital to enable the partnership to meet its obligations to creditors; and
      - the elimination of loss sharing, partners are no longer required to contribute capital to adjust capital losses *inter se*.

In this context, a partnership’s obligations include a duty to indemnify partners (and others). Thus, indemnification provisions (whether as provided by this article, Section 3-401(c), or the partnership agreement) are no longer “backstopped” by the partners. *See* the comment to Subsection (c)(1).

**Subsection (c)(1)**—The main part of Subsection (c) overrides contribution obligations under this article. Paragraph 1 overrides contribution obligations created by the partnership agreement.

**EXAMPLE:** The partnership agreement of a non-LLP partnership requires partners to contribute additional capital as necessary to fund the partnership’s obligations to indemnify partners. When the partnership becomes an LLP, Paragraph 1 overrides that requirement.

Paragraph 1 does not, however, override contribution and indemnification requirements running directly from partner to partner. These obligations are not obligations of the LLP but rather personal to each partner. If such obligations remain in the partnership agreement, they might disable the shield as to partnership liability arising from the misconduct of a partner.

**EXAMPLE:** The partnership agreement of a non-LLP partnership requires partners to contribute additional capital as necessary to fund the partnership’s obligations to indemnify the Managing Partner and also states:

To the extent the partnership lacks sufficient funds to perform the partnership’s indemnification obligation, each partner shall indemnify the Managing Partner to the same extent and under the same conditions as the partnership. As among themselves, the indemnifying partners shall share the indemnification obligation



proportional to their rights to distributions of then current profits as of the time the Managing Partner's conduct gave rise to the claim for which the Managing Partner is to be indemnified.

The partnership becomes an LLP. Subsequently, the Managing Partner is held liable in tort for conduct within the scope of the Managing Partner's responsibility and the partnership is held liable under Section 3-305(a). The partnership has no funds to pay the judgment or indemnify the Managing Partner. Paragraph 1 overrides the contribution requirement but does not change each partner's obligation to indemnify the Managing Partner.

The Managing Partner's right to be indemnified is an asset of the Managing Partner, and the judgment creditor can levy on that asset, thereby defeating the liability shield in effect if not in form.

**Subsection (c)(2)—*The Shield and Dissolution.*** The rule stated here is inherent in the nature of partnership dissolution. “[D]issolution does not end a partnership’s existence but rather changes the purpose of that existence.” Section 3-801, comment. “A dissolved partnership shall wind up its business and... continues after dissolution ... for the purpose of winding up.” Section 3-802(a). Put another way: dissolution and winding up are part of the life cycle of a partnership – sometimes the most complicated part. There is no logical reason to remove the shield during the last part of an LLP’s life cycle.

This subsection makes this point expressly, because it is possible to misinterpret some outlying cases as holding to the contrary. *See, e.g., Carolina Cas. Ins. Co. v. L.M. Ross Law Grp., LLP*, 151 Cal. Rptr. 3d 628, 635 (2012) (affirming the trial court’s decision to hold an LLP’s named partner liable for a judgment against his limited liability partnership; noting that “[c]entral to the decision to amend the judgment to add Ross [the named partner] as a judgment debtor ... is the trial court’s finding that Ross Law Group dissolved”; recognizing, however, that, before the partnership incurred the liability, Ross had signed and filed with the California Secretary of State a form stating that the law firm had “cease[d] to be a registered limited liability partnership and is hereby filing this notice with the California Secretary of State that [it] is no longer a registered limited partnership”) (quotation marks omitted).

*The Shield and Termination.* This subsection does not expressly provide that, when a limited liability partnership’s existence terminates, the LLP shield remains in place as to any debt, obligation, or other liability of the partnership incurred before the termination. However, the point follows ineluctably from Subsection 3-306(a). That subsection adopts an “occurrence” rather than a “claims made” basis for determining whether the shield applies. *See* the comment to Subsection 3-306(b). (The Temporal Nexus –When Claim Incurred).

Moreover, any other result would: (i) create huge holes in the shield; (ii) put the law of unincorporated businesses at odds with the law of corporations; (iii) render surplus this article’s distribution recapture provision, Section 3-407; (iv) render meaningless the exception to the notice requirement as stated in Sections 3-807(b)(5) and 3-808(b)(4); and (v) render nonsensical the otherwise logical extension of the equitable trust fund theory to limited liability partnerships. *Cf. Velasquez v. Franz*, 589 A.2d 143, 146 (N.J. 1991) (explaining that “the trust-fund doctrine... renders shareholders who receive distributed assets of the corporation liable as ‘trustees’ for claims of the corporation’s creditors”).

**Subsection (d)**—This subsection was added during the Harmonization Project and pertains to the equitable doctrine of “piercing the veil” – *i.e.*, conflating an entity and its owners to hold one liable for the obligations of the other. The doctrine of “piercing the corporate veil” is well established, and courts should apply the doctrine to limited liability partnerships for the same reasons that courts have regularly (and sometimes almost reflexively) applied the doctrine to limited liability companies. *Cf. Axtmann v. Chillemi*, 740 N.W.2d 838, 847 (N.D. 2007) (stating that “the shield of a limited liability partnership may be pierced under ‘the case law that states the conditions and circumstances under which the corporate veil or limited liability shield of a corporation may be pierced under North Dakota law . . . .’”) (quoting N.D.C.C. § 45-22-09(1)).

However, as with LLC piercing, LLP piercing involves one important distinction from the corporate realm. While under corporate law “disregard of corporate formalities” is a key piercing factor, that factor is inapposite in the law of unincorporated organizations. Corporate formalities reflect statutory mandates. LLP formalities derive for the most part from the agreement among the partners. From a policy perspective, disregarding formalities adopted by agreement differs substantially from disregarding formalities imposed by law. *See e.g. In re Packer*, Bankruptcy No. 13–41304, 2014 WL 5100095 (Bankr. E.D. Tex. Oct. 10, 2014) (noting the informality of LLC governance, recognizing that “the disregard of corporate formalities . . . [is] one of the key factors in [corporate] veil-piercing determinations”; but holding that “‘it makes no sense to imperil the shield simply because the members do not undergo meaningless formalities such as formal meetings’”) (citing Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 6.03 at \*3 (Thomson Reuters Tax and Accounting 2014)).

Moreover, because the terms of a partnership agreement may be “implied,” Section 3-102(a)(7), an LLP’s ongoing disregard of formalities may well constitute an amendment to the partnership agreement. If so, disregard equals amendment, and the concept of “disregard of formalities” makes no sense.

In contrast, this subsection is inapposite to another key piercing factor – disregard of the separateness between entity and owner. *Cf. Vanderford Co. v. Knudson*, 165 P.3d 261, 271 (Idaho 2007) (noting that managing member and “his accountant testified that the LLC’s checking account was so confusing that the accountant could not be sure whose money was in the account at what times”); *Utzler v. Braca*, 972 A.2d 743 (Conn. App. Ct. 2009) (holding that veil piercing was appropriate under alter-ego theory when owner deposited LLC funds into a commingled bank account from which he made withdrawals for personal needs and unrelated projects).

**EXAMPLE:** A partner in a limited liability partnership uses a car titled in the partnership’s name for personal purposes and writes checks on the partnership’s account to pay for personal expenses. These facts are relevant to a piercing claim; they pertain to economic separateness, not Subsection (b) formalities.

This subsection addresses claims to “impos[e] liability on a partner for a debt, obligation, or other liability of the partnership” – *i.e.*, for what is sometimes termed a “direct pierce.” Whether the same approach should apply to claims for a “reverse pierce” is a question for the

courts. *See Comm'r of Envtl. Prot. v. State Five Indus. Park, Inc.*, 37 A.3d 724, 732–33 (Conn. 2012) (stating that “[a]lthough some courts have adopted reverse veil piercing with little distinction as a logical corollary of traditional veil piercing, because the two share the same equitable goals, others wisely have recognized important differences between them”).

This subsection is inapposite to a member’s claim that the disregard of agreed-upon formalities is a breach of the partnership agreement.

**Subsection (e)**—The rule stated here is implicit in Subsection (c) but is stated expressly for the avoidance of doubt.

### **SECTION 3-307. ACTIONS BY AND AGAINST PARTNERSHIP AND PARTNERS.**

(a) A partnership may sue and be sued in the name of the partnership.

(b) To the extent not inconsistent with Section 3-306, a partner may be joined in an action against the partnership or named in a separate action.

(c) A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from a partner’s assets unless there is also a judgment against the partner.

(d) A judgment creditor of a partner may not levy execution against the assets of the partner to satisfy a judgment based on a claim against the partnership unless the partner is personally liable for the claim under Section 3-306 and:

(1) a judgment based on the same claim has been obtained against the partnership and a writ of execution on the judgment has been returned unsatisfied in whole or in part;

(2) the partnership is a debtor in bankruptcy;

(3) the partner has agreed that the creditor need not exhaust partnership assets;

(4) a court grants permission to the judgment creditor to levy execution against the assets of a partner based on a finding that partnership assets subject to execution are clearly insufficient to satisfy the judgment, that exhaustion of partnership assets is excessively

burdensome, or that the grant of permission is an appropriate exercise of the court's equitable powers; or

(5) liability is imposed on the partner by law or contract independent of the existence of the partnership.

(e) This section applies to any debt, liability, or other obligation of a partnership which results from a representation by a partner or purported partner under Section 3-308.

### Comment

Section 3-307 reflects the entity construct, Section 3-201(a), was new in UPA (1997), and cannot be varied by the partnership agreement. *See* Section 3-105(c)(3). The Harmonization Project made no substantive changes to this section.

**Subsection (a)**—UPA (1997) § 307 clarified and simplified an “entity versus aggregate” question that had been at best complicated under the common law and UPA (1914) (*i.e.*, whether a general partnership could sue and be sued in its own name and without joining all the partners).

“[A]t common law, . . . a partnership could neither sue or be sued in its name. The individual partners were required to be named as plaintiffs in an action brought by the partnership and as defendants in an action against a partnership.” *Telamarketing Commc'ns, Inc. v. Liberty Partners*, 798 S.W.2d 462, 463 (Ky. 1990) (discussing Kentucky law); *see also* JOSEPH STORY, COMMENTARIES ON THE LAW ON PARTNERSHIP § 241, at 373–74 (2d ed. 1850) (“It is a general rule, that in all such suits at law [between a partnership and a third party] all the partners should join.”).

UPA (1914) was silent on the point, although some courts inferred capacity to sue (and presumably to be sued) from other entity-like characteristics reflected in that act. *E.g.*, *Decker Coal Co. v. Commonwealth Edison Co.*, 714 P.2d 155, 157 (Mont. 1986) (agreeing with a party's contention that “[a]lthough . . . the UPA does not expressly deal with the question of a partnership's capacity to sue, . . . the UPA does show the modern tendency to treat a partnership as a legal entity distinct from and independent of the individuals composing it”; citing as an example, a partnership's ability to “own property in its own name”; and holding that “it is clear that a partnership is indeed a legal entity distinct from its partners [and] [t]herefore, . . . has the capacity to sue in its own name”).

The situation was further complicated by “common name” statutes enacted in many states. *See Silliman v. DuPont*, 302 A.2d 327, 331 (Del. Super. 1972), *aff'd sub nom.*, *F. I. Du Pont, Glore Forgan & Co. v. Silliman*, 310 A.2d 128 (Del. 1973) (“The basic purpose of [common name] statutes was to permit a non-corporate entity to be sued in the name it presented to the public without the necessity of joining the many individuals who composed it.”).

The rule stated here is perhaps implicit in Section 3-201(a) (“A partnership is an entity distinct from its partners.”). It is a hallmark of a legal entity that it can sue and be sued. In any event, this subsection leaves no room for doubt.

**Subsection (b)**—The phrase “not inconsistent with Section 3-306” means:

- If a debt, obligation, or other liability is incurred by a limited liability partnership, this subsection does not permit joinder of a partner.
- Likewise, if a debt, obligation, or other liability is incurred by an ordinary partnership before a person becomes a partner, this subsection does not permit joinder of that person.

As for when a claim is incurred, see the comments to Section 3-307(c) and (d).

The reference to “not inconsistent with Section 3-306” is the procedural analog to the substantive protections of Section 3-306(b) (incoming partner not liable for pre-existing partnership obligations) and (c) (partners not liable for partnership obligations incurred by an LLP). When a partner has personally guaranteed a partnership obligation, naming that partner in a suit against the partnership is “not inconsistent with Section 3-306.” See the comment to Section 3-306(c) (Shield Inapposite for Claims Arising from a Partner’s Conduct); cf. *Bank of Bos. Conn. v. Schlesinger*, 595 A.2d 872, 875 (Conn. 1991) (upholding pre-judgment attachment of a partner’s assets, where the partner had personally guaranteed the partnership’s obligations).

**Subsection (c)**—Reflecting the entity construct, Section 3-201(a), this subsection provides that a judgment against the partnership: (i) is not, standing alone, a judgment against the partners; and (ii) cannot be satisfied from a partner’s personal assets absent a judgment against the partner.

As did UPA (1914) and UPA (1997), this article leaves to the law of judgments to determine the collateral effects to be accorded a prior judgment for or against the partnership in a subsequent action against a partner individually. See RESTATEMENT (SECOND) OF JUDGMENTS § 60, cmts. (1982); see also *Detrio v. U.S.*, 264 F.2d 658 (5th Cir. 1959); *Brunson v. Seltz*, 414 N.W.2d 547 (Minn. Ct. App. 1987) (Lansing, J.). *Contra* *Evanston Ins. Co. v. Dillard Dep’t Stores, Inc.*, 602 F.3d 610, 618 (5th Cir. 2010) (disregarding *sub silentio* the separateness of partner and partnership, overlooking therefore the issue of collateral estoppel, discussing with approval a bankruptcy case in which “the trustee sought to enforce the partnership judgment against [partners] simply by virtue of their status as partner”; and quoting with approval that case’s holding that “[o]nce the liability of the partnership became fixed, the only issue remaining was whether the Defendants are partners of [the partnership]” (quoting *In re Jones*, 161 B.R. 180, 183–84 (Bankr. N.D. Tex. 1993)).

This subsection and Subsection (d) combine to create a trap for the unwary. For statute of limitations purposes, a creditor’s claim against the partners accrues simultaneously with the claim against the partnership. If a creditor chooses not to sue the partners in its suit against the partnership, the statute of limitations may run before the creditor commences suit against the partners. *Am. Star Energy & Minerals Corp. v. Stowers*, 405 S.W.3d 905, 907 (Tex. App. 2013)

(holding that the partnership creditor “was obligated to sue the partners of S & J . . . within the same limitations period it had to sue S & J, the partnership” and that “[b]ecause, [the creditor] did not, the trial court correctly held that limitations ran”); *Sunseri v. Proctor*, 487 F. Supp. 2d 905, 908 (E.D. Mich. 2007), *aff’d*, 286 F. App’x 930 (6th Cir. 2008) (“While the plaintiff may use collateral estoppel to prevent the partner from relitigating the issue of liability, the plaintiff must still bring suit within the applicable limitations period for the underlying wrong.”)

**Subsection (d)**—Subject to the five listed exceptions, this subsection prevents a partner’s assets from being the first recourse for a judgment creditor of the partnership, even if the partner is liable for the judgment debt under Section 3-306.

Although this subsection is silent with respect to pre-judgment remedies, as a matter of policy the subsection should guide courts as they apply the law of pre-judgment remedies. *Compare Sec. Pac. Nat’l Bank v. Matek*, 175 Cal. App. 3d 1071, 1077 (Cal. Ct. App. 1985) (granting a pre-judgment remedy against a partner because there is “no distinction between those sued individually as partners and those sued as sole proprietors”), *with Bank of Bos. Conn. v. Schlesinger*, 595 A.2d 872, 875 (Conn. 1991) (upholding pre-judgment attachment of a partner’s assets, because the partner had personally guaranteed the partnership’s obligations).

**Subsection (e)**—The effect of this subsection depends on whether Section 3-308 applies to produce a partnership obligation or a joint and several obligation. *See* Section 3-308(a) (“If partnership liability results [under the subsection], the purported partner is liable with respect to that liability as if the purported partner were a partner. If no partnership liability results, the purported partner is liable with respect to that liability jointly and severally with any other person consenting to the representation.”), (b) (“If all the partners of the existing partnership consent to the representation, a partnership act or obligation results. If fewer than all the partners of the existing partnership consent to the representation, the person acting and the partners consenting to the representation are jointly and severally liable.”).

### **SECTION 3-308. LIABILITY OF PURPORTED PARTNER.**

(a) If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership. If the representation, either by the purported partner or by a person with the purported partner’s consent, is made in a public manner, the purported partner is liable to a person who relies upon the purported partnership even if the purported partner is not aware of being held out as a partner to the claimant. If partnership liability results, the purported partner is liable with respect to that

liability as if the purported partner were a partner. If no partnership liability results, the purported partner is liable with respect to that liability jointly and severally with any other person consenting to the representation.

(b) If a person is thus represented to be a partner in an existing partnership, or with one or more persons not partners, the purported partner is an agent of persons consenting to the representation to bind them to the same extent and in the same manner as if the purported partner were a partner with respect to persons who enter into transactions in reliance upon the representation. If all the partners of the existing partnership consent to the representation, a partnership act or obligation results. If fewer than all the partners of the existing partnership consent to the representation, the person acting and the partners consenting to the representation are jointly and severally liable.

(c) A person is not liable as a partner merely because the person is named by another as a partner in a statement of partnership authority.

(d) A person does not continue to be liable as a partner merely because of a failure to file a statement of dissociation or to amend a statement of partnership authority to indicate the person's dissociation as a partner.

(e) Except as otherwise provided in subsections (a) and (b), persons who are not partners as to each other are not liable as partners to other persons.

### **Comment**

UPA (1997) § 308 continued the basic principles of partnership by estoppel stated in UPA (1914) § 16. To the extent a partnership liability results under Section 3-308, Section 3-307 applies. *See* Section 3-307(e). The Harmonization Project made no substantive changes to this section.

**Subsections (a) and (b)**—Even though these subdivisions refer to “reliance” without expressly imposing a reasonableness requirement, the requirement exists in the case law. *See, e.g., In re Cay Clubs*, 319 P.3d 625, 633 (Nev. 2014) (adopting the requirement and stating that,

although the requirement is not explicitly stated in [the statute,] [g]enerally, jurisdictions provide that the partnership-by-estoppel doctrine conditions liability on the plaintiff having reasonably relied on the representation of partnership, which often involves an exercise of due diligence to ascertain the facts”).

**Subsection (a)**—This subsection continues the distinction between representations made to specific persons and those made in a public manner. In both circumstances, the claimant must show reliance.

Like UPA (1914) § 16, this section imposes no duty of denial; thus, a person held out by another as a partner is not liable without having actually consented to the representation. *See* Subsection (c) (no duty to file statement of denial); Subsection (d) (no duty to file statement of dissociation or to amend statement of partnership authority).

**Subsections (c) and (d)**—These subsections were new in UPA (1997) and preclude negative inferences from outdated information in filed statements.

**Subsection (e)**—Derived from UPA (1914) § 7(1), this subsection circumscribes the circumstances in which a person can be liable as a partner to third parties for the obligations of the partnership – *i.e.*, only if (i) the person is a partner in the partnership; or (ii) the person is liable under Section 3-308(a) or (b).

## **[PART] 4**

### **RELATIONS OF PARTNERS TO EACH OTHER AND TO PARTNERSHIP**

#### **SECTION 3-401. PARTNER’S RIGHTS AND DUTIES.**

(a) Each partner is entitled to an equal share of the partnership distributions and, except in the case of a limited liability partnership, is chargeable with a share of the partnership losses in proportion to the partner’s share of the distributions.

(b) A partnership shall reimburse a partner for any payment made by the partner in the course of the partner’s activities on behalf of the partnership, if the partner complied with this section and Section 3-409 in making the payment.

(c) A partnership shall indemnify and hold harmless a person with respect to any claim or demand against the person and any debt, obligation, or other liability incurred by the person by reason of the person’s former or present capacity as a partner, if the claim, demand, debt,



obligation, or other liability does not arise from the person's breach of this section or Section 3-407 or 3-409.

(d) In the ordinary course of its business, a partnership may advance reasonable expenses, including attorney's fees and costs, incurred by a person in connection with a claim or demand against the person by reason of the person's former or present capacity as a partner, if the person promises to repay the partnership if the person ultimately is determined not to be entitled to be indemnified under subsection (c).

(e) A partnership may purchase and maintain insurance on behalf of a partner against liability asserted against or incurred by the partner in that capacity or arising from that status even if, under Section 3-105(c)(7), the partnership agreement could not eliminate or limit the person's liability to the partnership for the conduct giving rise to the liability.

(f) A partnership shall reimburse a partner for an advance to the partnership beyond the amount of capital the partner agreed to contribute.

(g) A payment or advance made by a partner which gives rise to a partnership obligation under subsection (b) or (f) constitutes a loan to the partnership which accrues interest from the date of the payment or advance.

(h) Each partner has equal rights in the management and conduct of the partnership's business.

(i) A partner may use or possess partnership property only on behalf of the partnership.

(j) A partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership.

(k) A difference arising as to a matter in the ordinary course of business of a partnership

may be decided by a majority of the partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the affirmative vote or consent of all the partners.

### Comment

For the most part, Section 3-401 merely restates the rules of UPA (1914) § 18, thereby establishing many of the default rules that govern the relations among partners. All of these rules are, however, subject to contrary agreement of the partners as provided in Sections 3-105 through 3-107.

UPA (1997) § 401(a) experimented with providing a default configuration for capital accounts. For the reasons stated in Section 3-405, comment, the Harmonization Project ended the experiment and eliminated the configuration.

**Subsection (a)**—This subsection continues the approach of UPA (1914) § 18(a), although for the reasons stated in Section 3-405, comment, the Harmonization Project substituted “distribution” for “profits.” Distributions are shared equally and losses are shared in proportion to each partner’s share of distributions. Thus, under this default rule, partners share distributions per capita and not in proportion to capital contribution (per capital).

If partners agree to share distributions other than equally, losses will be shared in the same proportion as distributions, absent agreement to do otherwise. This rule, carried over from UPA (1914) rests on the assumption that partners would likely agree to share losses on the same basis as distributions, but may fail to say so. Of course, by agreement, they may share losses on a different basis from distributions.

Subject to contrary agreement and the effect of Section 3-806(e), this subsection’s loss sharing rules apply, even where one or more of the partners contribute no capital. The rule was the same under UPA (1914) § 18(a), although there is some case law to the contrary. *See, e.g., Kovacik v. Reed*, 315 P.2d 314 (Cal. 1957); *Becker v. Killarney*, 523 N.E.2d 467 (Ill. App. Ct. 1988). It may seem unfair that the contributor of services, who contributes little or no capital, should be obligated to contribute toward the capital loss of the large contributor who contributed no services. In entering a partnership with such a capital structure, the partners should foresee that application of the default rule might bring about unusual results and take advantage of their power to vary by agreement the allocation of capital losses.

**Subsections (b) and (c)**—A partnership’s obligation, if any, to reimburse or indemnify others (*e.g.*, employees, other agents, and independent contractors) is a question for other law, including the law of agency, contract, and restitution. The fact a person has dissociated as a partner does not affect any obligations incurred by the partnership under these subsections for conduct occurring before the dissociation.

To the extent a partnership agreement modifies or displaces the default rules stated in

Sections 3-401 and 3-409, the agreement should also address these sections. For example, if the partnership agreement establishes a duty of ordinary care (modifying Section 3-409(c)), the agreement should specify which level of care is necessary to satisfy Subsections (b) and (c). It is not necessary that the levels of care be the same, only that the partnership agreement make the situation clear and thereby avoid difficult issues of interpretation.

**Subsection (b)**—UPA (1997) derived this subsection from UPA (1914) § 18(b). The Harmonization Project made two changes: (i) deleting “for the preservation of its business or property” as a separate category for reimbursement, because that category is a subset of the category of “payments made . . . in the course of the partner’s activities on behalf of the partnership”; and (ii) conditioning reimbursement on the partner’s having complied with the duties stated in Section 3-409.

The reimbursement obligation stated here is a default rule and roughly parallels a rule of agency law. Restatement (Third) of Agency § 8.14(2) (2006) (stating that “[a] principal has a duty to indemnify an agent . . . when the agent makes a payment (i) within the scope of the agent’s actual authority, or (ii) that is beneficial to the principal, unless the agent acts officiously in making the payment”).

**Subsection (c)**—This subsection provides for indemnification, but the provision is a default rule.

The rule’s eligibility requirements correspond to the default rules on management duties, which is appropriate because otherwise the statutory default rule on indemnification could undercut or even vitiate the statutory default rules on duty. However, subject only to Section 3-105(c)(8), the partnership agreement can substantially relax the eligibility requirements. The agreement can also impose stricter preconditions.

Although referring broadly to any “person,” this subsection is actually limited to present and former partners. The indemnification obligation applies to only a “debt, obligation, or other liability incurred by the person by reason of the person’s former or present capacity as a partner.” Thus, by its terms this subsection does not apply to a person in the capacity of an officer, manager, etc.

Of course, the partnership agreement may mandate indemnification to persons in such positions, as well as to other persons providing services to or acting for the partnership. Within the limitations stated in Section 3-105(c)(8), a partnership agreement may obligate a partnership to indemnify a person even though the person has breached a duty to the partnership.

A separate agreement between a partnership and another person may also provide for indemnification. For example, a management contract between a partnership and its managing partner may contain an indemnification provision. The limitations stated in Section 3-105(c)(8) apply to such separate agreements, for the reasons stated in the comment to that paragraph.

**Subsection (d)**—This subsection authorizes but does not require a partnership to provide advances to cover expenses. *Cf. Majkowski v. Am. Imaging Mgmt. Servs., L.L.C.*, 913 A.2d 572, 589 (Del. Ch. 2006) (“Because rights to indemnification and advancement differ in important

ways, our courts have refused to recognize claims for advancement not granted in specific language clearly suggesting such rights.”). The phrase “hold harmless” likewise does not encompass advances. *Id.* The authorization applies only to those persons eligible for indemnification under Subsection (c), but the partnership agreement certainly can authorize a broader scope and can also make advances obligatory.

The reference to “ordinary course” pertains to Subsection (k) (stating that any “difference arising in the ordinary course of the business of the partnership may be decided by a majority of the partners”).

**Subsection (e)**—This subsection’s language is very broad and authorizes a partnership to purchase insurance to cover (*e.g.*, a partner’s intentional misconduct). It is unlikely that such insurance would be available. This authorization comes from this article, not the partnership agreement, and therefore is not subject to Section 3-105(c)(8) (precluding the partnership agreement from “reliev[ing] or exonerate[ing] a person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law”).

**Subsection (f)**—This subsection was UPA (1997) § 401(d) and is based on UPA (1914) § 18(c).

**Subsection (g)**—This subsection was UPA (1997) § 401(c) and is based on UPA (1914) § 18(c).

**Subsection (h)**—This subsection was UPA (1997) § 401(f) and is based on UPA (1914) § 18(e). UPA (1997) § 401, comment 7, suggests that UPA (1914) § 18(e) case law continues to be relevant and notes that Section 18(e) “has been interpreted broadly to mean that, absent contrary agreement, each partner has a continuing right to participate in the management of the partnership and to be informed about the partnership business, even if, per the partnership agreement, the partner’s assent to partnership business decisions is not required.”

Note also that for some decisions this article requires the affirmative vote or consent of all partners. *See, e.g.*, Subsection (k) (“an act outside the ordinary course of business of a partnership and an amendment to the partnership agreement”); Section 3-402(b)(3) (becoming a partner after formation of the partnership).

The subsection has important implications for a partner’s actual authority to act on behalf of the partnership. The actual authority of a partner is a question of agency law and depends fundamentally on the contents of the partnership agreement. If, however, the partnership agreement is silent on the issue, this subsection helps delineate that actual authority. Acting individually, a partner:

- has no actual authority to commit the partnership to any matter for which this article requires the affirmative vote or consent of all partners;
- has the actual authority to commit the partnership to usual and customary matters, unless the partner has reason to know that: (i) other partners might disagree; or (ii) for some other reason consultation with fellow partners is appropriate; and
- has no actual authority to take unusual or non-customary actions that will have a

substantial effect on the partnership.

The first point follows self-evidently from the language of this article. Where this article requires unanimity, no partner could reasonably believe to the contrary (unless the partnership agreement provided otherwise).

The second point follows because:

- Subsection (h) serves as the gap-filler manifestation from the partnership to its partners and does *not* require partners to act *only* in concert or after consultation. To the contrary, subject to the partnership agreement, this subsection expressly provides that “each partner has equal rights in the management and conduct of the partnership’s business.”
- It would be impractical to require collective action on even the smallest of decisions.
- However, to the extent a partner has reason to know of a possible difference of opinion among the partner, Subsection (k) requires a decision by at least “a majority of the partners” and by unanimous consent if the matter is “outside the ordinary course of the business.”

The third point is a matter of common sense. The more serious the matter, the less likely it is that a partner has actual authority to act unilaterally. *Cf.* RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. c (2006) (noting the unreasonableness 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”).

Finally, the authority granted by this subsection includes the authority to delegate. Delegation does not relieve the delegating partner or partners of their duties under Section 3-409. However, the fact of delegation is a fact relevant to any breach of duty analysis.

**EXAMPLE:** A partner personally handles all important paperwork for a partnership. The partner neglects to renew the fire insurance coverage on a building owned by the partnership, despite having received and read a warning notice from the insurance company. The building subsequently burns to the ground and is a total loss. The partner might be liable for breach of the duty of care under Section 3-409(c) (gross negligence).

**EXAMPLE:** A partner delegates responsibility for insurance renewals to the partnership’s office manager, and that manager neglects to renew the fire insurance coverage on the building. Even assuming that the office manager has been grossly negligent, the partner is not necessarily liable under Section 3-409(c). The office manager’s gross negligence is not automatically attributed to the partner. Under Section 3-409(c), the question is whether the partner was grossly negligent (or worse) in selecting the office manager, delegating insurance renewal matters to the general manager, and supervising the office manager after the delegation.

The partnership agreement may also provide for delegation and, subject to Section 3-105(c), may modify a partner's duties under Section 3-409 accordingly.

**Subsection (i)**—This subsection states directly what UPA (1914) § 25(2)(a) provides indirectly, through the “tenancy in partnership.” That tenancy reflected the aggregate view of partnership (in the extreme), stated management rights as property rights, and was eliminated by UPA (1997) 401(g). The Harmonization Project relocated the UPA (1997) provision into this subsection.

The substance of UPA (1997) § 401(i), which continued the substance of UPA (1914) § 18(g), now appears in Section 3-402(b)(3) (providing that no person can become a partner without the affirmative vote or consent of all partners).

**Subsection (j)**—This subsection (i) follows the default rule of UPA (1914) § 18(f) (providing that a partner is not entitled to remuneration for services performed, except in winding up the partnership); while (ii) expanding the exception to include any partner who undertakes winding up. “[R]easonable compensation” includes reimbursement for reasonable expenses. *Moran v. Willensky*, 339 S.W.3d 651, 663 (Tenn. Ct. App. 2010) (stating that “the winding up partner . . . [is] entitled to recover costs associated with the winding up process); *see also O'Reilly's Adm'r v. Brady*, 28 Ala. 530, 535 (1856) (holding that “the surviving partner is entitled, at least, to an allowance and deduction for ‘tavern bills,’ [sic] and ‘other expenses incurred’ ‘in the adjustment and settling up’ of the affairs of the partnership.”). Reasonable expenses include reasonable attorney's fees, even when the winding up partner has (rightfully) caused the partnership to sue one of the partners. *Moran*, 339 S.W.3d at 663 (“Because Mr. Willensky's capital account had a negative balance, Ms. Moran was well within her rights to sue him to make up that balance.”).

In UPA (1997), this subsection was Subsection (h). The Harmonization Project made no change except to relocate the provision.

**Subsection (k)**—UPA (1997) continued the allocation of management authority stated by UPA (1914) § 18(h), with one important clarification. UPA (1914) § 18(h) requires majority consent for ordinary matters and unanimous consent for amending the partnership but is silent regarding extraordinary matters. Courts have generally required the consent of all partners for those matters. *See, e.g., Paciaroni v. Crane*, 408 A.2d 946 (Del. Ch. 1989); *Thomas v. Marvin E. Jewell & Co.*, 440 N.W.2d 437 (Neb. 1989); *Duell v. Hancock*, 83 A.D.2d 762 (N.Y. 1981). UPA (1997) codified those cases in § 401(j). The Harmonization Project made no substantive change but relocated the provision to Subsection (k).

Other provisions of this article also contain default rules providing for unanimous consent. *E.g.*, Sections 3-402(b)(3) (for a person to become a partner), 3-504(c) (for compromising a person's obligation to make a contribution). In addition, absent a contrary provision in the partnership agreement, the transactions authorized under Article 2 each require unanimous consent.

## **SECTION 3-402. BECOMING PARTNER.**

- (a) Upon formation of a partnership, a person becomes a partner under Section 3-202(a).
- (b) After formation of a partnership, a person becomes a partner:
  - (1) as provided in the partnership agreement;
  - (2) as a result of a transaction effective under [Article] 2; or
  - (3) with the affirmative vote or consent of all the partners.
- (c) A person may become a partner without:
  - (1) acquiring a transferable interest; or
  - (2) making or being obligated to make a contribution to the partnership.

### **Comment**

This section was adopted in the 2011 and 2013 Harmonization amendments and changes UPA (1997) both in style and substance.

**Subsection (b)(2)**—Article 2 deals with entity transactions (*e.g.*, mergers and conversions). This reference is new, although UPA (1997) Article 9 did contemplate mergers and conversions.

**Subsection (b)(3)**—A partnership being a creature of contract, consent is determined on an objective basis (*i.e.*, contract law’s “reasonable person” standard). Depending on the terms of the partnership agreement, the partners’ manifestation of consent might involve detailed formalities, entirely informal activities, or anything in between. Moreover, the partnership agreement might reduce the quantum of consent necessary or shift the consent right to a management committee or managing partner.

A partnership being a voluntary association, a person cannot become a partner without manifesting consent to do so. That consent also is judged objectively.

Under Section 3-106(b), “[a] person that becomes a partner is deemed to assent to the partnership agreement,” and the agreement binds the partner regardless of whether the partner has actually indicated assent in any way.

**Subsection (c)(1)**—To accommodate business practices, this provision permits so-called “non-economic partners.”

**SECTION 3-403. FORM OF CONTRIBUTION.** A contribution may consist of property transferred to, services performed for, or another benefit provided to the partnership or

an agreement to transfer property to, perform services for, or provide another benefit to the partnership.

### **Comment**

This section is derived from ULLCA (2006) § 402, was adopted as part of the 2011 and 2013 Harmonization amendments, is intentionally quite broad, and encompasses past, present, and promised benefits.

Partnership law and practice are in accord. *E.g.*, *Canet v. Gooch Ware Travelstead*, 917 F. Supp. 969, 974 (E.D.N.Y. 1996) (referring to “Travelstead’s acknowledged use of ‘sweat equity’ participations” in two projects); *In re Jones*, 445 B.R. 677, 717 (Bankr. N.D. Tex. 2011) (stating that “Ex-Mrs. Mullen essentially put ‘sweat equity’ (*i.e.*, the provision of modeling services and related consultation) into Simple Beaute and not a significant monetary investment”); *Tumminaro v. Tumminaro*, 556 N.E.2d 293, 299 (Ill. App. Ct. 1990) (“A partner’s contribution to the partnership may consist of ‘services, skill, know-how, or “sweat equity.”””) (quoting *Becker v. Killarney*, 532 N.E.2d 931 (Ill. App. Ct. 1988)).

This article does not contain a statute of frauds specifically applicable to promised contributions. Generally applicable statutes of fraud might apply, however. For example, a promise to contribute land to a partnership would be subject to the statute of frauds pertaining to land transfers. Likewise, a promise that by its terms requires performance that extends beyond one year from the making of the contract would be subject to the one-year provision of the statute of frauds. *See* the comment to Section 3-102(a)(7).

### **SECTION 3-404. LIABILITY FOR CONTRIBUTION.**

(a) A person’s obligation to make a contribution to a partnership is not excused by the person’s death, disability, termination, or other inability to perform personally.

(b) If a person does not fulfill an obligation to make a contribution other than money, the person is obligated at the option of the partnership to contribute money equal to the value of the part of the contribution which has not been made.

(c) The obligation of a person to make a contribution may be compromised only by the affirmative vote or consent of all the partners. If a creditor of a limited liability partnership extends credit or otherwise acts in reliance on an obligation described in subsection (a) without knowledge or notice of a compromise under this subsection, the creditor may enforce the



obligation.

### Comment

**Subsection (a)**—Under common law principles of impracticability, an individual’s death or incapacity will sometimes discharge a duty to render performance. RESTATEMENT (SECOND) OF CONTRACTS §§ 261 (Discharge by Supervening Impracticability), 262 (Death or Incapacity of Person Necessary For Performance) (1981). This subsection overrides those principles. Moreover, the reference to “perform personally” is not limited to individuals but rather may refer to any legal person (including an entity) that has a non-delegable duty.

**Subsection (b)**—This subsection is a statutory liquidated damage provision, exercisable at the option of the partnership, with the damage amount set according to the value of the promised, non-monetary contribution.

EXAMPLE: In order to become a partner, a person promises to contribute to the partnership various assets “free and clear,” which the partnership agreement values at \$150,000. In return for the person’s promise, and in light of the agreed value, the partnership admits the person as a partnership with a right to receive twenty-five percent of the partnership’s distributions.

However, the promised assets are subject to a security agreement, and, before the partner can contribute the assets, the secured party forecloses on the security interest and sells the assets at a public sale for \$75,000. Even if the \$75,000 reflects the actual fair market value of the assets, under this subsection the partnership has a claim against the partner for “money equal to the value of the part of the contribution which has not been made” – *i.e.*, \$150,000.

EXAMPLE: Same facts as the previous example, except that the public sale brings \$225,000. The limited liability company is neither obliged to invoke this subsection nor limited to the \$150,000. The LLC may instead sue for breach of the promise to make the contribution, asserting the \$225,000 figure as evidence of the actual loss suffered as a result of the breach.

**Subsection (c)**—The unanimity requirement expressed in the first sentence might indirectly benefit creditors, but the requirement is nonetheless a default rule and therefore may be varied in the partnership agreement. The right of each partner to consent is not a “right[] under this [article] of a person other than a partner.” *See* Section 3-105(c)(17) (preventing the partnership agreement from affecting such rights). In contrast, the right stated in the second sentence fits squarely within Section 3-105(c)(17) and therefore may not be varied by the partnership agreement.

## **SECTION 3-405. SHARING OF AND RIGHT TO DISTRIBUTIONS BEFORE DISSOLUTION.**

(a) Any distribution made by a partnership before its dissolution and winding up must be in equal shares among partners, except to the extent necessary to comply with a transfer effective under Section 3-503 or charging order in effect under Section 3-504.

(b) Subject to Section 3-701, a person has a right to a distribution before the dissolution and winding up of a partnership only if the partnership decides to make an interim distribution.

(c) A person does not have a right to demand or receive a distribution from a partnership in any form other than money. Except as otherwise provided in Section 3-806, a partnership may distribute an asset in kind only if each part of the asset is fungible with each other part and each person receives a percentage of the asset equal in value to the person's share of distributions.

(d) If a partner or transferee becomes entitled to receive a distribution, the partner or transferee has the status of, and is entitled to all remedies available to, a creditor of the partnership with respect to the distribution. However, the partnership's obligation to make a distribution is subject to offset for any amount owed to the partnership by the partner or a person dissociated as partner on whose account the distribution is made.

### **Comment**

Past uniform unincorporated entity acts and many current limited liability company acts provide default rules for allocation of profits, and UPA (1997) even provides a default configuration for maintaining capital accounts. For the following reasons, this article, incorporating changes made by the Harmonization Project, provides a default rule only for rights to share in distributions:

- Capital accounts are maintained for one purpose, to determine how distributions will be made to partners. The rules for maintenance of capital accounts can be very complex. Generally, however, profits increase capital account balances (and increase the amounts that will be distributed to the partners) and losses reduce capital account balances (and reduce the amounts that will be distributed to the partners). If the statute has a simple default rule for how distributions are to be made to the partners, providing an additional

set of default profit and loss allocation provisions and capital account rules will be, at best, duplicative and, at worse, inconsistent with the distribution rules.

- Some argue that capital account rules and profit and loss allocation provisions are necessary to comply with tax requirements. Tax income or loss is allocated to partners according to the partners' economic interests in the partnership, and these interests are based on distributions that would be made to partners on liquidation of the partnership. By including default distribution provisions, this article includes the information necessary to make these tax determinations. To the extent the tax law allows partners to make further tax elections or satisfy alternative safe harbors, the partners may look to the tax law for guidance and include necessary provisions in their agreements.

**Subsection (a)**—The rule stated applies to redemptions as well as operating distributions but is a default rule in both contexts. *See* the comment to Section 3-102(a)(3)(A).

**Subsection (b)**—Section 3-701 provides a default rule for buying out a person dissociated as a partner when the dissociation does not lead to dissolution of the partnership.

**Subsection (d)**—For the rights of partners and transferees that receive a distribution in the form of indebtedness, see Section 3-406(d).

## **SECTION 3-406. LIMITATIONS ON DISTRIBUTIONS BY LIMITED LIABILITY PARTNERSHIP.**

(a) A limited liability partnership may not make a distribution, including a distribution under Section 3-806, if after the distribution:

(1) the partnership would not be able to pay its debts as they become due in the ordinary course of the partnership's business; or

(2) the partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the partnership were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of partners and transferees whose preferential rights are superior to the rights of persons receiving the distribution.

(b) A limited liability partnership may base a determination that a distribution is not prohibited under subsection (a) on:

(1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

(2) a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subsection (e), the effect of a distribution under subsection (a) is measured:

(1) in the case of a distribution as defined in Section 3-102(4)(A), as of the earlier of:

(A) the date money or other property is transferred or debt is incurred by the limited liability partnership; or

(B) the date the person entitled to the distribution ceases to own the interest or rights being acquired by the partnership in return for the distribution;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs not later than 120 days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(d) A limited liability partnership's indebtedness to a partner or transferee incurred by reason of a distribution made in accordance with this section is at parity with the partnership's indebtedness to its general, unsecured creditors, except to the extent subordinated by agreement.

(e) A limited liability partnership's indebtedness, including indebtedness issued as a distribution, is not a liability for purposes of subsection (a) if the terms of the indebtedness

provide that payment of principal and interest is made only if and to the extent that a payment of a distribution could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is made.

(f) In measuring the effect of a distribution under Section 3-806, the liabilities of a dissolved limited liability partnership do not include any claim that has been disposed of under Section 3-807, 3-808, or 3-809.

### Comment

Both this section and Section 3-407 were derived essentially from the Model Business Corporation Act § 6.40, and were added during the Harmonization Project. Both sections are necessary and appropriate because a limited liability partnership provides the partners a corporate-like liability shield. With the exception noted in the comment to Subsection (a)(2), the provisions of this section are non-waivable. Section 3-105(c)(17).

“Distribution” does not include “amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.” Section 3-102(a)(3)(B).

**Subsection (a)**—Insolvency is a fundamental issue under this section, and this subsection provides two tests of insolvency. The tests are disjunctive; a distribution violates this section if after the distribution the LLP fails either of the tests. The subsection applies both to interim and liquidating distributions.

Solvency is also a fundamental issue under bankruptcy and fraudulent transfer law, which provide their own respective definitions of the concept.

**Subsection (a)(2)**—The reference to “preferential rights upon dissolution and winding up” is a default rule, because removing this protection for preferred partners or transferees is an *inter se* matter. See Section 105(d)(1)(B). The rest of the section is not subject to change in the partnership agreement. Section 3-105(c)(17).

**Subsection (b)**—This subsection states a standard of ordinary care, in contrast with the generally applicable standard stated in Section 3-409(c) (gross negligence).

**Subsection (b)(2)**—This alternative valuation provision is likely to be both useful and fair when the partnership has appreciated assets but for accounting purposes these assets are valued at book value less depreciation.

**Subsection (c)**—This subsection provides three alternative rules for determining the point(s) in time of as which to apply the solvency tests stated in Subsection (a). The timing depends on which of three categories encompasses a distribution: (i) a distribution in the nature of a redemption (regardless of whether the distribution includes a distribution of indebtedness); (ii) any distribution of indebtedness other than a distribution in the nature of a redemption; and (iii) any distribution that involves neither a redemption nor a distribution of indebtedness. A requirement for additional solvency testing pertaining to distributions of indebtedness appears in Subsection (e).

**Subsection (c)(1)**—Section 3-102(a)(3)(A) encompasses distributions in the nature of a redemption.

**Subsection (c)(1)(A) and (B)**—Under Subparagraph (A), any beginning of payment activity triggers the rule and sets the date as of when to apply the solvency tests. Under Subparagraph (B), the partnership's complete acquisition of the rights is necessary to trigger the rule.

**Subsection (c)(2)**—This provision states the general rule for distributions in the form of debt and which are not connected with a redemption.

**Subsection (c)(3)**—This provision states alternative rules for all distributions of money or property (*i.e.*, not debt). The measuring date depends on the length of time between the authorization and payment of the distribution.

**Subsection (d)**—For a related provision, characterizing as a creditor a person who has become entitled to receive a distribution, see Section 3-405(d).

**Subsection (e)**—This subsection contains two rules pertaining to indebtedness issued as part of a distribution and the Subsection (a) solvency tests. The first sentence states the sensible rule that indebtedness that is essentially subordinated to the solvency requirement (*i.e.*, not payable if making payment would transgress that requirement) is not counted in determining liabilities for purposes of the solvency tests. The second sentence applies the solvency tests to each payment of principal and interest on any indebtedness issued as a distribution, in addition to any previous testing required by Subsection (c)(1)(A) or (c)(2).

**EXAMPLE:** A limited liability partnership and one of its partners agree that the LLP will buy out the person's entire ownership interest in the LLP in return for a promissory note from the LLP, payable in installments. Under the redemption agreement: (i) on January 15 the person surrenders all its interests and rights and dissociates as a partner; and (ii) the LLP signs and delivers the note to the person on February 15. Under the note, payment of interest is due monthly beginning March 15, with a balloon payment of the principal due December 30.

Under Subsection (c)(1)(B), the solvency tests are applied as of January 15. Under Subsection (e), the solvency tests are again applied on the March 15, April 15, etc., and again on December 30.

**Subsection (f)**—The cited sections provide methods for extinguishing or limiting the debts of an LLP that is winding up its affairs and activities and thus any debt affected by any of the cited sections is irrelevant for purposes of solvency testing.

**SECTION 3-407. LIABILITY FOR IMPROPER DISTRIBUTIONS BY LIMITED LIABILITY PARTNERSHIP.**

(a) Except as otherwise provided in subsection (b), if a partner of a limited liability partnership consents to a distribution made in violation of Section 3-406 and in consenting to the distribution fails to comply with Section 3-409, the partner is personally liable to the partnership for the amount of the distribution which exceeds the amount that could have been distributed without the violation of Section 3-406.

(b) To the extent the partnership agreement of a limited liability partnership expressly relieves a partner of the authority and responsibility to consent to distributions and imposes that authority and responsibility on one or more other partners, the liability stated in subsection (a) applies to the other partners and not to the partner that the partnership agreement relieves of the authority and responsibility.

(c) A person that receives a distribution knowing that the distribution violated Section 3-406 is personally liable to the limited liability partnership but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 3-406.

(d) A person against which an action is commenced because the person is liable under subsection (a) may:

(1) implead any other person that is liable under subsection (a) and seek to enforce a right of contribution from the person; and

(2) implead any person that received a distribution in violation of subsection (c)

and seek to enforce a right of contribution from the person in the amount the person received in violation of subsection (c).

(e) An action under this section is barred unless commenced not later than two years after the distribution.

### Comment

This section and Section 3-406 were derived essentially from Model Business Corporation Act § 6.40. The provisions of this section are non-waivable. Section 3-105(c)(17).

This section contemplates two categories of liability: liability of those who have authorized improper distributions (Subsection (a) – *i.e.*, the partners) and the liability of those who have received improper distributions (Subsection (c) – *i.e.*, partners and transferees). Neither dissociating as a partner nor ceasing to be a transferee affects liability previously incurred under this section.

The liability is to the LLP, not to the creditors of an insolvent LLP. *Weinstein v. Colborne Foodbotics, L.L.C.*, 302 P.3d 263, 268 (Colo. 2013); *Rev O, Inc. v. Woo*, 725 S.E.2d 45, 52 (N.C. Ct. App. 2012).

This section does not preclude or interfere with claims for fraudulent transfer. *See* the comment to Subsection (e).

**Subsection (a)**—The liability is not strict liability but rather attaches only to the extent a decision maker has failed to comply with the duties stated in Section 3-409. To the extent those duties have been permissibly revised by the partnership agreement, the revised standards apply to this subsection. *See* Section 3-406(b)(1) (permitting reasonable reliance on specified financial information).

**Subsection (b)**—*Compare* Section 3-407(b), *with* Section 3-105(d)(2) (generally permitting provisions of this type).

**Subsection (c)**—Actual knowledge is necessary to impose liability. Reason to know does not suffice. *Compare* Section 3-407(c), *with* Section 3-103(a), (b).

**Subsections (c) and (d)(2)**—Liability could apply to a person who receives a distribution under a charging order, but only if the person meets the knowledge requirement. That situation is very unlikely unless the person with the charging order is also a partner.

**Subsection (e)**—When the distribution is in the form of indebtedness, the distribution may occur on several different dates. *See* the comment to Section 3-406(e).

This statute of limitations applies only to actions “under this section” and does not affect



claims under other applicable law, which most often is fraudulent transfer law. For a different approach, see Delaware Code Annotated title 6, section 15-309(c) (West 2013) (applying a three-year statute of limitations to claims “under this chapter or other applicable law”); New York Limited Liability Company section 508(c) (2013) (same). *But see, e.g., In re The Heritage Org., L.L.C.*, 413 B.R. 438, 461 (Bankr. ND Tex. 2009) (invoking the Texas Uniform Fraudulent Transfers Act (TUFTA) to recover distributions made by a Delaware LLC headquartered in Texas; rejecting Delaware Code title 6, section 18-607(c) on choice of law grounds; stating that “the Delaware legislature cannot limit the reach of TUFTA”).

## **SECTION 3-408. RIGHTS TO INFORMATION OF PARTNERS AND PERSONS DISSOCIATED AS PARTNER.**

(a) A partnership shall keep its books and records, if any, at its principal office.

(b) On reasonable notice, a partner may inspect and copy during regular business hours, at a reasonable location specified by the partnership, any record maintained by the partnership regarding the partnership’s business, financial condition, and other circumstances, to the extent the information is material to the partner’s rights and duties under the partnership agreement or this [Code].

(c) The partnership shall furnish to each partner:

(1) without demand, any information concerning the partnership’s business, financial condition, and other circumstances which the partnership knows and is material to the proper exercise of the partner’s rights and duties under the partnership agreement or this [Code], except to the extent the partnership can establish that it reasonably believes the partner already knows the information; and

(2) on demand, any other information concerning the partnership’s business, financial condition, and other circumstances, except to the extent the demand or the information demanded is unreasonable or otherwise improper under the circumstances.

(d) The duty to furnish information under subsection (c) also applies to each partner to the extent the partner knows any of the information described in subsection (c).

(e) Subject to subsection (j), on 10 days' demand made in a record received by a partnership, a person dissociated as a partner may have access to information to which the person was entitled while a partner if:

- (1) the information pertains to the period during which the person was a partner;
- (2) the person seeks the information in good faith; and
- (3) the person satisfies the requirements imposed on a partner by subsection (b).

(f) Not later than 10 days after receiving a demand under subsection (e), the partnership in a record shall inform the person that made the demand of:

- (1) the information that the partnership will provide in response to the demand and when and where the partnership will provide the information; and
- (2) the partnership's reasons for declining, if the partnership declines to provide any demanded information.

(g) A partnership may charge a person that makes a demand under this section the reasonable costs of copying, limited to the costs of labor and material.

(h) A partner or person dissociated as a partner may exercise the rights under this section through an agent or, in the case of an individual under legal disability, a legal representative. Any restriction or condition imposed by the partnership agreement or under subsection (j) applies both to the agent or legal representative and to the partner or person dissociated as a partner.

(i) Subject to Section 3-505, the rights under this section do not extend to a person as transferee.

(j) In addition to any restriction or condition stated in its partnership agreement, a partnership, as a matter within the ordinary course of its business, may impose reasonable

restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient. In a dispute concerning the reasonableness of a restriction under this subsection, the partnership has the burden of proving reasonableness.

### Comment

Subsections (a) and (c) derive from UPA (1997). The other subsections are derived from the ULPA (2001) § 401 (rights to information of general partners and former general partners) and were adopted as part of the 2011 and 2103 Harmonization amendments. The rules stated here might be termed “quasi-default rules”—subject to some change by the partnership agreement. *See* Section 3-105(c)(4) (prohibiting unreasonable restrictions on the information rights stated in this section).

Although the rights and duties stated in this section are extensive, they are not necessarily all-inclusive. This article’s statement of fiduciary duties is not exhaustive, *see* the comment to Section 3-409(a), and some cases characterize owners’ information rights as reflecting a fiduciary duty of those with management power. *E.g. Bakerman v. Sidney Frank Importing Co., Inc.*, No. Civ.A. 1844–N, 2006 WL 3927242, at \*14 (Del. Ch. Oct. 16, 2006) (holding that an LLC manager owed “certain duties to members of the LLC” and stating that “[w]hen fiduciaries communicate with their beneficiaries in the context of asking the beneficiary to make a discretionary decision—such as whether to consent to a sale of substantially all the assets of an LLC—the fiduciary has a duty to disclose all material facts bearing on the decision at issue”) (citing *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 137 (Del. 1997)).

**Subsection (a)**—A general partnership is often a very informal organization. Accordingly, this subsection states a default-required location for any books and records a partnership may have but does not require that books and records be kept. Other law may so require, however—particularly tax law. This subsection applies to any books and records kept to satisfy other law.

**Subsection (b)**—This subsection states the rule pertaining to information memorialized in “any record maintained by the partnership.” For the meaning of “material” as applied to information, *see* Section 3-409(f), comment.

**Subsections (c) and (d)**—In appropriate circumstances, violation of either or both of these provisions might cause a court to enjoin or even rescind action taken by the partnership, especially when the violation has interfered with an approval or veto mechanism involving partner consent. *E.g., Blue Chip Emerald L.L.C. v. Allied Partners Inc.*, 299 A.D.2d 278, 279–80 (N.Y. App. Div. 2002) (invoking partnership law precedent as reflecting a duty of full disclosure and holding that “[a]bsent such full disclosure, the transaction is voidable”).

**Subsection (e)**—This subsection imposes a duty on the partnership, not the partners.

However, a partner could be liable in damages if the partner were to: (i) breach a duty under Section 409 or the partnership agreement; and (ii) in doing so cause or suffer the partnership to breach the duty stated in this paragraph.

**Subsection (c)(1)**—This provision imposes an affirmative duty to volunteer information. However, given the assumption that each partner will be active in management, the obligation ceases “to the extent the partnership can establish that it reasonably believes the partner already knows the information.”

In any event, the obligation is limited to information that is both material and known by the partnership. “Knowledge” is viewed subjectively (*i.e.*, actual knowledge). Section 3-103(a)(1). Materiality is viewed objectively. Thus, the duty applies to known, material information, even if the partnership does not know that the information is material.

A partnership will “know” what its partners know. Under Section 3-103(e), “[a] partner’s knowledge . . . of a fact relating to the partnership is effective immediately as knowledge of or notice to the partnership.” As to others acting or reasonably appearing to act on behalf of the partnership, common law agency rules will apply. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (Imputation of Notice of Fact to Principal).

Typically a partner’s duties are continuous, and therefore a partner’s right to information is not just transaction-specific. Ongoing managerial responsibilities require ongoing information—both periodically and *ad hoc* when a situation warrants.

For the meaning of “material” as applied to information, see Section 3-409(f), comment.

**Subsection (c)(2)**—Other law determines which party has the burden of proof as to the stated exception.

**Subsection (d)**—This subsection imposes a duty directly on each partner, “except to the extent the [partner] can establish that it reasonably believes [another] partner already knows the information.”

**EXAMPLE:** A partnership has two partners: each of whom is regularly engaged in conducting the partnership’s activities; both of which are aware of and have regular access to all significant partnership records; and neither of which has special responsibility for or knowledge of any particular aspect of those activities or the relevant partnership records. Most likely, neither partner is obliged to draw the other partner’s attention to information apparent in the partnership’s records.

**EXAMPLE:** Although a partnership has three partners, one is the managing partner with day-to-day responsibility for running the partnership’s activities. The other two meet periodically with the managing partner and together with that partner function in a manner analogous to a corporate board of directors. Most likely, the managing partner has a duty to draw the attention of the other partners to important information, even if that information would be apparent from a review of the partnership’s records.

Because this subsection imposes duties directly on partner, the duties are in the nature of a contractual obligation, and breach is a matter of strict liability. For example, it is no defense for a partner under this section to assert that, although the partner failed to furnish required information, the failure did not amount to gross negligence under Section 3-409(c).

**Subsection (e)**—Codifying the information rights of former owners began with UPA (1997) § 403(b).

For the additional information rights of the legal representative of a deceased partner, see Section 3-505.

**Subsection (e)(1)**—A person dissociated as a partner has information rights in that capacity only as to the period during which the person was a partner. To the extent that further information is accessible under Section 3-505(2) (providing access to the legal representative of a deceased partner), that access is limited both in purpose (“for purposes of settling the estate”) and in scope (“the rights the deceased partner had under Section 3-408”).

**Subsection (e)(2)**—A duty of good faith is needed here, because a person claiming access under this subsection is no longer a partner and is no longer subject to a partner’s obligation of good faith and fair dealing under Section 3-409(d). *See* Section 3-603(b)(2) (stating a person’s dissociation as a partner terminates as to subsequent events the person’s duties under Section 3-409, including the contractual obligation of good faith). *But see id.*, comment (noting that the common law implied covenant will continue to be relevant if the partnership agreement provides continuing rights and obligations for a person dissociated as a partner).

In the context of Subsection (e)(2), “good faith” is properly understood to mean an honest belief that the request is made for a proper purpose. *Associated Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 285 (Tex. 1998) (holding that “‘good faith’ in the surety agreement before us refers to conduct which is honest in fact, free of improper motive or wilful ignorance of the facts at hand”); *Andrews v. Bible*, 812 S.W.2d 284, 288 (Tenn. 1991) (describing “subjective good faith” as “[a] pure heart but an empty head”) (quoting *Whittington v. Ohio River Co.*, 115 F.R.D. 201, 209 (E.D.Ky.1987)). Willful ignorance includes being an ostrich. “While ‘honesty’ may require no more than a pure heart, it is questionable that a pure heart can co-exist with closed eyes. It is not honest to close one’s eyes so as to maintain an empty head.” *J.R. Hale Contracting Co. v. United New Mexico Bank at Albuquerque*, 799 P.2d 581, 591 (NM 1990). *See also* UPA (1914) § (3)(1) (“A person has ‘knowledge’ of a fact within the meaning of this act not only when he has actual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances shows bad faith.”).

**Subsection (h)**—For the avoidance of doubt, this subsection expressly authorizes taking action through an agent. The doubt might arise from old corporate cases in which the parties contested a shareholder’s right to exercise inspection rights through another person. *White v. Coeur D’Alene Big Creek Mining Co.*, 55 P.2d 720, 723 (Idaho 1936) (stating that “[t]he refusal to permit respondent [shareholder] to appoint his own attorney or agent to make the examination [of the corporation’s books] was in effect a denial of his right” of inspection); *State v. Monida & Yellowstone Stage Co.*, 124 N.W. 971, 972 (Minn. 1910) (upholding a trial court’s mandamus

order, “which shall provide that [the shareholder complainant], or such attorney or agent as he may select, ... shall be allowed to inspect the books, records, and papers of the defendant [corporation]”).

No negative inference should be drawn about using agents to take other action under this article.

**Subsection (j)**—This subsection provides fallback protection for gaps in the partnership agreement. For example, the partners may protect trade secrets from disclosure and prohibit various misuses of confidential information even if the partnership agreement omits to do so.

The reference to “ordinary course” pertains to Section 3-401(k) (stating that any “matter in the ordinary course of business of a partnership may be decided by a majority of the partners”). This approach is necessary, lest a requesting partner have the power to block imposition of a reasonable restriction or condition needed to prevent the requestor from abusing the partnership.

The burden of persuasion under this subsection contrasts with the burden of persuasion under Section 3-105(c)(4) (prohibiting unreasonable limitations on the information rights provided by this section). Under that paragraph, as a matter of ordinary procedural law the burden is on the person making the claim.

### **SECTION 3-409. STANDARDS OF CONDUCT FOR PARTNERS.**

(a) A partner owes to the partnership and the other partners the duties of loyalty and care stated in subsections (b) and (c).

(b) The fiduciary duty of loyalty of a partner includes the duties:

(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner:

(A) in the conduct or winding up of the partnership’s business;

(B) from a use by the partner of the partnership’s property; or

(C) from the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a person having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct of the partnership's business before the dissolution of the partnership.

(c) The duty of care of a partner in the conduct or winding up of the partnership business is to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law.

(d) A partner shall discharge the duties and obligations under this [Code] or under the partnership agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.

(e) A partner does not violate a duty or obligation under this [Code] or under the partnership agreement solely because the partner's conduct furthers the partner's own interest.

(f) All the partners may authorize or ratify, after full disclosure of all material facts, a specific act or transaction by a partner that otherwise would violate the duty of loyalty.

(g) It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the partnership.

(h) If, as permitted by subsection (f) or the partnership agreement, a partner enters into a transaction with the partnership which otherwise would be prohibited by subsection (b)(2), the partner's rights and obligations arising from the transaction are the same as those of a person that is not a partner.

### **Comment**

This section originated as UPA (1997) § 404. The 2011 and 2013 Harmonization amendments made one major substantive change; they “un-cabined” fiduciary duty. UPA (1997) § 404 had deviated substantially from UPA (1914) by purporting to codify all fiduciary duties owed by partners. This approach had a number of problems. Most notably, the exhaustive list of fiduciary duties left no room for the fiduciary duty owed by partners to each other – *i.e.*, “the punctilio of an honor the most sensitive”. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928). Although UPA (1997) § 404(b) purported to state “[a] partner’s duty of loyalty to the partnership *and the other partners*” (emphasis added), the three listed duties each protected the partnership

and not the partners.

“Un-cabining” harmonized this article to ULLCA (2006), and this section states some of the core aspects of the fiduciary duty of loyalty, provides a duty of care, and incorporates the contractual obligation of good faith and fair dealing. The duties stated in this section are subject to the partnership agreement, but Sections 3-105(c) and (d) contain important limitations on the power of the partnership agreement to affect fiduciary and other duties and the obligation of good faith and fair dealing.

For the effect of dissociation on a person’s duties under this section, see Section 3-603(b)(2).

**Subsection (a)**—This subsection recognizes two core managerial duties but, unlike UPA (1997), does not purport to be exhaustive. For example, many cases characterize a manager’s duty to disclose as a fiduciary duty. *E.g.*, *Loneragan v. EPE Holdings, L.L.C.*, 5 A.3d 1008, 1023 (Del. Ch. 2010) (stating that “in the limited partnership context, absent contractual modification, a general partner owes fiduciary duties that include a duty of full disclosure”) (quotation marks omitted) (citation omitted); *Exxon Corp. v. Burglin*, 4 F.3d 1294, 1298 (5th Cir. 1993) (“Under Alaska law, a general partner stands in a fiduciary relationship with the limited partnership and thereby owes ‘a fiduciary duty . . . to disclose information concerning partnership affairs.’”) (quoting *Parker v. N. Mixing Co.*, 756 P.2d 881, 894 (Alaska 1988)).

**Subsection (b)**—This subsection states three core aspects of the fiduciary duty of loyalty: (i) not “usurping” partnership opportunities or otherwise wrongly benefiting from the partnership’s operations or property; (ii) avoiding conflict of interests in dealing with the partnership (whether directly or on behalf of another); and (iii) refraining from competing with the partnership. Essentially the same duties exist in agency law and under the law of all types of business organizations.

This subsection applies beginning with “the partnership’s business,” which by definition cannot exist before the partnership does; thus the stated duties do not apply to pre-formation activities.

The stated duties comprise a default rule. Under Section 105(d)(3)(A): “If not manifestly unreasonable, the partnership agreement may . . . alter or eliminate the aspects of the duty of loyalty stated in Section 3-409(b).”

**Subsection (b)(1)**—The phrase “hold as trustee” dates back to UPA (1914) § 21 and reflects the availability of disgorgement remedies, such as a constructive trust. In contrast to an actual trustee, a person subject to this duty does not: (i) face the special obstacles to consent characteristic of trust law; or (ii) enjoy protection for decisions taken in reliance on the governing instrument and other sources of information. *Cf.* UNIFORM STATUTORY TRUST ENTITY ACT (2009) (Last Amended 2013) § 506 (“A trustee [of a statutory trust] . . . is not liable to the trust or to a beneficial owner for breach of any duty, *including a fiduciary duty*, to the extent the breach results from reasonable reliance on: (i) a term of the governing instrument; (ii) a record of the statutory trust; or (iii) an opinion, report, or statement of another person that the person to



which the opinion, report, or statement is made or delivered reasonably believes is within the other person's professional or expert competence and is made or delivered to the trustee . . . .") (emphasis added).

**Subsection (b)(1)(A)**—This provision is consistent with a basic principle of agency law—namely, that an agent may not benefit at all from the performance of the agency unless the principal consents. RESTATEMENT (THIRD) OF AGENCY § 8.06, cmt. c. (2006). Typically, however, the partnership agreement will legitimize particular benefits – *e.g.*, a management fee paid to a managing partner in addition to that partner's share of distributions. Also, an agreed allocation of distributions takes those benefits outside the reach of this provision.

**Subsection (b)(1)(B)**—For the expansive meaning of “property,” see Section 1-102(38). The term includes confidential information.

**Subsection (b)(1)(C)**—This article does not specify what constitutes “a partnership opportunity,” but ample case law exists. *See, e.g., Triple Five of Minn., Inc. v. Simon*, 404 F.3d 1088, 1096 (8th Cir. 2005) (“An opportunity that is closely related to the entity's existing or prospective line of business, would competitively advantage the partnership, and is one that the partnership has the financial ability, knowledge and experience to pursue is a partnership opportunity.”); *Knudson v. Kylo*, 831 N.W.2d 763, 767 (N.D. 2013) (explaining why conducting farming operations on land owned by others was a partnership opportunity while purchasing farmland was not).

The duty stated here continues through winding up, although in that context the scope of partnership opportunities inevitably narrows.

In most, if not all, situations, usurping a partnership opportunity also breaches the duty not to compete, Paragraph (b)(3), but not vice versa.

**Subsection (b)(2)**—In this context, the phrase “adverse interest” is a term of art, meaning “to be on the other side of the table” in some dealing with the partnership. Absent informed consent by the partnership, this duty is breached by the mere existence of the conflict of interest and the partnership need not prove that the outcome of the dealing was adverse to the partnership. *But see* Subsection (g) (permitting the defense of fairness). This duty continues through winding up.

**Subsection (b)(3)**—Although competition is often thought of in terms of potential customers, this duty applies equally to competition for resources, including employees. This duty ends when the partnership dissolves.

**Subsection (c)**—This article no longer refers to the duty of care as a fiduciary duty, because: (i) the duty of care applies in many non-fiduciary situations; and (ii) breach of the duty of care is remediable in damages while breach of a fiduciary duty gives rise also to equitable remedies, including disgorgement, constructive trust, and rescission.

The change in label is consistent with the Restatement (Third) of Agency § 8.02 (2006),

which refers to the agent's "fiduciary duty" to act loyally, but eschews the word "fiduciary" when stating the agent's duties of "care, competence, and diligence." *Id.* § 8.08. However, the label change is merely semantics; no change in the law is intended.

The partnership agreement can raise the standard of care, or subject to Sections 3-105(c)(8) and (d)(3)(C), lower it. A person's practical exposure for breaching the duty of care involves not only the standard of care but also any partnership agreement provision that: (i) exonerates the person from liability for breach of the duty of care, Section 3-105(c)(8); or (ii) entitles the person to indemnification despite such breach, Section 3-408(b), comment.

**Subsection (d)**—This subsection refers to the "*contractual* obligation of good faith and fair dealing" (emphasis added) and thereby invokes the implied obligation that exists in every contract. *See* RESTATEMENT (SECOND) CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). The adjective ("contractual") should help avoid decisions like *Phelps v. Frampton*, 170 P.3d 474, 483 (Mont. 2007) (holding that Montana's version of UPA (1997) creates a statutory obligation of good faith and fair dealing separate from the implied contractual covenant).

At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights – *i.e.*, duties and rights "under this [Code]." However, for the most part those duties and rights apply to relationships *inter se* the partners and the partnership and function only to the extent not displaced by the partnership agreement. Those statutory default rules are thus intended to function like a contract; applying the contractual notion of good faith and fair dealing therefore makes sense.

The contractual obligation of "good faith" has nothing to do with 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." DEL. CODE ANN. tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty. *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006).

Likewise, the contractual obligation of good faith and fair dealing has nothing to do with the "utmost good faith" sometimes used to describe the fiduciary duties that owners of closely held businesses owe each other. *See, e.g., Meinhard v. Salmon*, 477, 164 N.E. 545, 551 (NY 1928) ("[W]here parties engage in a joint enterprise each owes to the other the duty of the utmost good faith in all that relates to their common venture. Within its scope they stand in a fiduciary relationship."); *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) ("[S]tockholders 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 omitted) (citations omitted) (internal quotations omitted).

To the contrary, the contractual 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:

“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.

*Gerber v. Enter. Prods. Holdings, L.L.C.*, 67 A.3d 400, 418–19 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, L.L.C.*, 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); *see also* Subsection (e)).

Courts should not use the contractual obligation to change *ex post facto* the parties' or this article's allocation of risk and power. To the contrary, 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.

The partnership agreement or this article may grant discretion to a partner, and the contractual obligation of good faith and fair dealing is especially salient when discretion is at issue. However, a partner may properly exercise discretion even though another partner suffers as a consequence. Conduct does not violate the obligation of good faith and fair dealing merely because that conduct substantially prejudices a party. Indeed, parties allocate risk precisely because prejudice may occur.

The exercise of discretion constitutes a breach of the obligation of good faith and fair dealing only when the party claiming breach shows that the conduct has no honestly held purpose that legitimately comports with the parties' agreed-upon arrangements:

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.*

*Gerber v. Enter. Prods. Holdings, L.L.C.*, 67 A.3d 400, 418 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, L.L.C.*, 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)).

In sum, the purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.

As to the power of the partnership agreement to affect the contractual obligation of good

faith and fair dealing, see Section 3-105(c)(6) (prohibiting elimination but allowing the agreement to “prescribe standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured”). For examples, see Section 3-105(c)(6), comment. As to whether the obligation stated in this subsection applies to the benefit of transferees, see Section 3-107(b), comment.

**Subsection (e)**—A partner in a general partnership has at least two different roles: (i) as a party to the partnership agreement, with rights and obligations under that agreement; and (ii) as co-manager of the enterprise. This provision pertains to the first role. A partner’s exercise of rights under the partnership agreement is subject to the obligation of good faith and fair dealing, Subsection (d), but a partner does not breach that contractual obligation “solely because the partner’s conduct furthers the partner’s own interest.” In contrast, this provision is ineffective with regard to a partner’s duties as co-manager. For example, a partner’s liability under Section 3-409(b)(3) (prohibiting competition) is not “solely because the partner’s conduct furthers the partner’s own interest.” Rather, the liability results from the breach of a specific obligation – *i.e.*, the codified aspect of the duty of loyalty that prohibits competition.

**Subsection (f)**—Here and elsewhere in this article, information “is material if there is a substantial likelihood that a reasonable [decision maker] would consider it important in deciding how to vote” or take other action under this Code or the partnership agreements. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

The partnership agreement can provide additional or different methods of authorization or ratification, subject to the strictures of Section 3-105(c)(5), (d)(1), and (d)(3)(A)(B) and (D).

**Subsection (g)**—This subsection codifies judge-made law applicable to all business entities. *See, e.g., Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (discussing “entire fairness” in the context of a corporation’s merger with an affiliate); *Lonergan v. EPE Holdings, L.L.C.*, 5 A.3d 1008, 1019 (Del. Ch. 2010) (discussing “entire fairness” in the context of a limited partnership”); *Gottsacker v. Monnier*, 697 N.W.2d 436, 444 (Wis. 2005) (referring to “a willful failure to deal fairly with the LLC or its other members”).

**Subsection (h)**—This subsection is the modern, reformulated version of a language that sought to overturn the now-defunct notion that debts to partners were categorically inferior to debts to non-partner creditors. *See, e.g.,* ULPA (2001) § 112 (“A partner may lend money to and transact other business with the limited partnership and has the same rights and obligations with respect to the loan or other transaction as a person that is not a partner.”). The reformulation makes clear that this provision has nothing to do with the fiduciary duty pertaining to conflict of interests. *See BT-I v. Equitable Life Assurance Soc’y of the U.S.*, 75 Cal. App. 4th 1406, 1415 (Cal. Ct. App. 1999) (examining the prior formulation, explaining its history and stating “[w]e cannot discern anything in the purpose of [the prior formulation] that suggests an intent to affect a general partner’s fiduciary duty to limited partners”).

This subsection states a default rule. The partnership agreement may provide that debt to a partner (or partners generally) is subordinate to other partnership obligations. The agreement

that creates the debt may do likewise.

### **SECTION 3-410. ACTIONS BY PARTNERSHIP AND PARTNERS.**

(a) A partnership may maintain an action against a partner for a breach of the partnership agreement, or for the violation of a duty to the partnership, causing harm to the partnership.

(b) A partner may maintain an action against the partnership or another partner, with or without an accounting as to partnership business, to enforce the partner's rights and protect the partner's interests, including rights and interests under the partnership agreement or this [Code] or arising independently of the partnership relationship.

(c) A right to an accounting on dissolution and winding up does not revive a claim barred by law.

#### **Comment**

In UPA (1997) this section was Section 405. The Harmonization Project did not change the section other than to renumber it.

**Subsection (a)**—This subsection originated in UPA (1997) § 405(a) and reflects the entity theory of partnership.

**Subsection (b)**—This subsection is the successor to UPA (1914) § 22 but with significant changes.

UPA (1914) § 22 itself had made significant changes to the common law. “It . . . generally was established at common law that an equitable accounting was a condition precedent to an action in law between partners,” *Thompson v. Coughlin*, 997 P.2d 191, 194 (Or. 2000), and an accounting was generally not available before dissolution. Thus, claims among partners pertaining to the partnership could not be asserted except through an action for dissolution and accounting. UPA (1914) § 22 modified this “exclusivity rule,” specifying certain circumstances in which an accounting action is available without requiring an action to dissolve the partnership.

UPA (1997) eliminated the “exclusivity rule” entirely; an action of dissolution and accounting remains available but is no longer “a condition precedent” to other claims.

This subsection authorizes a partner to bring claims “to enforce the partner's rights and protect the partner's interests” – *i.e.*, direct claims. The statutory language does not contemplate derivative claims; thus, this article neither authorizes nor precludes such claims. *See Tzolis v. Wolff*, 884 N.E.2d 1005 (N.Y. 2008) (rejecting the argument that “members of a limited liability

company (LLC) may [not] bring derivative suits on the LLC's behalf, . . . [because] there are no provisions governing such suits in the Limited Liability Company Law").

The case law does generally recognize the direct/derivative distinction in the context of general partnerships, and some cases permit a partner to sue derivatively. *E.g.*, *Hill v. Vanderbilt Capital Advisors, L.L.C.*, 834 F. Supp. 2d 1228, 1246 (D.N.M. 2011) (stating that "[t]he Supreme Court of New Mexico extended the scope of derivative suits beyond the corporate context . . . and allowed a partner's derivative suit on behalf of a general partnership") (citations omitted).

In general, however, the cases are conflicting and somewhat confused. A decision of the Maryland Court of Special Appeals illustrates the situation. At one point the court states:

We agree that the term "derivative" is an inappropriate and confusing term to use in the general partnership context. "Derivative" actions are necessary in the corporate and limited partnership context, where the shareholders and limited partners have no managerial rights and thus must "derive" the right to sue from the entity itself. Unlike shareholders and limited partners, however, general partners all have the ability to act on behalf of the partnership, and all have management rights [citations omitted]. Thus, general partners have no need for "derivative" action.

*George Wasserman & Janice Wasserman Goldsten Family L.L.C. v. Kay*, 14 A.3d 1193, 1215 (Md. Ct. Spec. App. 2011) (citing the comment to the UPA (1997) version of this section). However, later in the opinion the court recognizes that the partners' "ability to act on behalf of the partnership, and . . . [the partners'] management rights" are ineffective when a partner with a controlling interest declines to cause the partnership to sue the controlling partner for alleged misconduct.

The court concludes that such a "partnership claim may be enforced by all of the *disinterested* partners." *Wasserman*, 14 A.3d at 1216. In addition, the court cites with approval *Cates v. International Tel. & Tel. Corp.*, 756 F.2d 1161 (5th Cir.1985), which includes a lengthy discussion of circumstances in which a partner in a general partnership might be entitled to bring a derivative claim on behalf of the partnership. *Cates*, 756 F.2d at 1178 (referring to the possible "availability of a derivative action" but cautioning "[w]e do not hold that Texas law would *necessarily* allow a derivative action on the part of a minority partner") (emphasis added).

Despite the conflict and confusion in the cases, one proposition does appear reasonably certain: A minority partner in a general partnership must have some right to sue "where the controlling partners, for improper, ulterior motives and not because of what they in good faith believe to be the best interests of the partnership, decline to sue on a valid, valuable *partnership cause of action* which it is advantageous to the partnership to pursue." *Cates*, F.2d at 1179 (emphasis added).

**Subsection (c)**—This subsection originated as UPA (1997) § 405(c) and reversed the rule stated in UPA (1914) § 43. This subsection inevitably implies that other law governs the accrual of a claim under Subsection (b) as well as the statute of limitations applicable to those claims. As a result, partners must take care not to "sit on their claims" waiting for the partnership to

dissolve. *Veloski v. State Farm Mut. Auto Ins. Co.*, 719 N.E.2d 574, 576 (Ohio Ct. App. 1998).

**SECTION 3-411. CONTINUATION OF PARTNERSHIP BEYOND DEFINITE TERM OR PARTICULAR UNDERTAKING.**

(a) If a partnership for a definite term or particular undertaking is continued, without an express agreement, after the expiration of the term or completion of the undertaking, the rights and duties of the partners remain the same as they were at the expiration or completion, so far as is consistent with a partnership at will.

(b) If the partners, or those of them who habitually acted in the business during the term or undertaking, continue the business without any settlement or liquidation of the partnership, they are presumed to have agreed that the partnership will continue.

**Comment**

This section originated as UPA (1997) § 406 and continues the approach of UPA (1997) (1914) § 23, with no substantive change.

**Subsection (a)**—Continuation beyond an agreed term or undertaking results in a partnership at will, not an automatic renewal of the term or extension of the undertaking. *See* the comment to Section 3-102(13) (partnership at will).

**Subsection (b)**—In general, a pattern of conduct can imply a term in a partnership agreement. Section 3-102(12) (defining partnership agreement and referring to an agreement among all the partners, “whether oral, implied, in a record, or in any combination thereof”). In particular, this subsection creates a presumption that by their conduct the partners have agreed to continue the business. The presumption shifts the burden of persuasion to the person claiming that the partnership is dissolved.

**[PART] 5**

**TRANSFERABLE INTERESTS AND RIGHTS OF TRANSFEREES AND CREDITORS**

**SECTION 3-501. PARTNER NOT CO-OWNER OF PARTNERSHIP PROPERTY.**

A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily.

### Comment

This section originated in UPA (1997), followed ineluctably from the concept of a partnership as an entity, Section 3-201, abolished the UPA (1914) construct of “partnership in tenancy,” and was retained during the Harmonization Project as a “belt and suspenders” approach to reinforcing the entity construct. *See* Section 3-203 (providing that property transferred to or otherwise acquired by the partnership is property of the partnership and not of the partners individually).

**SECTION 3-502. NATURE OF TRANSFERABLE INTEREST.** A transferable interest is personal property.

### Comment

For the definition of transferable interest, see Section 3-102(a)(9). Absent a contrary provision in the partnership agreement or the consent of the partners, a “transferable interest” is the only interest in a partnership that can be transferred to a person not already a partner. *See* Section 3-503. As to whether a partner may transfer governance rights to a fellow partner, the question is moot absent a provision in the partnership agreement changing the default rule, *see* Section 3-401(h) (allocating governance rights *per capita*). In the default mode, a partner’s transfer of governance rights to another partner: (i) does not increase the transferee’s governance rights; (ii) eliminates the transferor’s governance rights; (iii) and thereby changes the denominator but not the numerator in calculating governance rights.

EXAMPLE: LCN Company is a general partnership with three partners, Laura, Charles, and Nora. The partnership agreement does not displace this article’s default rule on the allocation of governance rights among general partners. Thus, each partner has 1/3 of those rights. Laura transfers her entire ownership interest to Charles. The transfer does not increase Charles’s governance rights but does eliminate Laura’s. After the transfer, Laura has no governance rights (regardless of whether Charles and Nora agree to expel Laura under Section 3-601(4)(B)). As a result, Charles and Nora each have 1/2 of the governance rights.

Whether a transferable interest pledged as security is governed by Article 8 or 9 of the Uniform Commercial Code depends on the rules stated in those Articles.

### **SECTION 3-503. TRANSFER OF TRANSFERABLE INTEREST.**

(a) A transfer, in whole or in part, of a transferable interest:

(1) is permissible;

(2) does not by itself cause a person’s dissociation as a partner or a dissolution

and winding up of the partnership business; and



(3) subject to Section 3-505, does not entitle the transferee to:

(A) participate in the management or conduct of the partnership's business; or

(B) except as otherwise provided in subsection (c), have access to records or other information concerning the partnership's business.

(b) A transferee has the right to:

(1) receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled; and

(2) seek under Section 3-801(5) a judicial determination that it is equitable to wind up the partnership business.

(c) In a dissolution and winding up of a partnership, a transferee is entitled to an account of the partnership's transactions only from the date of dissolution.

(d) A partnership need not give effect to a transferee's rights under this section until the partnership knows or has notice of the transfer.

(e) A transfer of a transferable interest in violation of a restriction on transfer contained in the partnership agreement is ineffective if the intended transferee has knowledge or notice of the restriction at the time of transfer.

(f) Except as otherwise provided in Section 3-601(4)(B), if a partner transfers a transferable interest, the transferor retains the rights of a partner other than the transferable interest transferred and retains all the duties and obligations of a partner.

(g) If a partner transfers a transferable interest to a person that becomes a partner with respect to the transferred interest, the transferee is liable for the partner's obligations under Sections 3-404 and 3-407 known to the transferee when the transferee becomes a partner.

## Comment

One of the most fundamental characteristics of partnership law is its fidelity to the “pick your partner” principle. *See, e.g., Bynum v. Frisby*, 311 P.2d 972, 975 (Nev. 1957) (stating that (i) “the assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners”; and (ii) absent consent by the remaining partners “[t]he stranger remains a stranger” with no rights to management or even information). This section is the core of this article’s provisions reflecting and protecting that principle. A partner’s rights in a partnership are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the partnership agreement otherwise provides, a partner acting without the consent of all other partners lacks both the power and the right to: (i) bestow partnership on a non-partner, Section 3-402(b)(3); or (ii) transfer to a non-partner anything other than some or all of the partner’s transferable interest, Section 3-503(a)(3). The rights of a mere transferee are quite limited (*i.e.*, to receive distributions), Section 3-503(b), and, if the partnership dissolves and winds up, to receive specified information pertaining to the partnership from the date of dissolution, Section 3-503(c).

This section applies regardless of whether the transferor is a partner, a transferee of a partner, a transferee of a transferee, etc. *See* Section 3-102(a)(9) (defining “transferable interest” in terms of a right “initially owned by a person in the person’s capacity as a partner” regardless of “whether or not the person remains a partner or continues to own any part of the right”).

This section does not directly consider whether a partner may transfer governance rights to another partner without obtaining consent from all the other partners. As noted in the comment to Section 3-502, the question is moot under this article’s default rule for allocating governance rights.

However, the question can be pivotal when the partnership agreement displaces the default rule on governance rights but does not determine whether transfer restrictions (whether contractual, statutory, or both) apply to transfers of governance rights from one partner to another. Case law is scant and pertains to limited liability companies. Nonetheless, the cases suggest that this article does not protect partners from control shifts that result from transfers among partners. *Blythe v. Bell*, No. 11 CVS 933, 2012 WL 7807800, at ¶ 6 (N.C. Dist. Dec. 10, 2012) (holding in a case of “first impression in North Carolina” that “in the absence of articles of incorporation or an operating agreement to the contrary . . . the assignment of control [*i.e.*, governance] interests between members is effective without unanimous member consent”); *Achaian, Inc. v. Leemon Family LLC*, 25 A.3d 800, 810 (Del. Ch. 2011) (Strine, Ch.) (holding that the terms of the LLC agreement did not preclude one member of a three-member LLC from transferring the member’s entire interest (including governance rights) to a second member without first having the consent of the third member; stating that the third member’s “argument relies on a very thinly sliced version of [the “pick-your-partner” principle, the strained version being] . . . that once one chooses his initial co-members, one continues to hold a veto over how much additional voting power they may acquire” explaining that “[t]he problem for [the third member] is that nothing in the LLC Agreement supports [that member’s] reading of it that would require an already admitted Member, like [the acquirer – *i.e.*, the second member], to become

once, twice (or even three times) a Member each and every time that Member acquires an additional block of Interests”).

Other law may affect the applicability of this section. *See* 11 U.S.C. § 541(c)(1) (providing that, initially at least, all property of a debtor becomes part of the bankruptcy estate regardless of restrictions on transfer); UCC §§ 9-406 and 9-408 (overriding specified restrictions on assignment in specified circumstances, regardless of whether state law or a contract imposes the restrictions).

In any event, this section does not apply to the transfer of ownership interests in a partner that is an entity.

**EXAMPLE:** ABC, Partnership (“ABC”) has three partners: Ralph (an individual), Alice, Inc. (“Alice”), and Norton, LLC (“Norton”). Section 3-502 applies to any attempt by Ralph, Alice, or Norton to transfer their respective partnership interest in ABC. Section 3-502 is inapplicable, however, to a change in control of Alice or Norton or even a complete change in their respective ownership.

**Subsection (a)**—The definition of “transfer,” Section 3-102(a)(9), and this subsection’s reference to “in whole or in part” combine to mean that this section encompasses not only unconditional, permanent, and complete transfers but also temporary, contingent, and partial ones. Thus, for example, a charging order under Section 3-504 effects a transfer of part of the judgment debtor’s transferable interest, as does the pledge of a transferable interest as collateral for a loan and the gift of a life-interest in a partner’s rights to distribution.

**Subsection (a)(2)**—The phrase “by itself” contemplates Section 3-601(4)(B), which creates a risk of dissociation via expulsion when a partner transfers all of the partner’s transferable interest.

**Subsection (a)(3)**—Mere transferees have no right to participate in management or otherwise intrude as the partners carry on the business of the partnership and their activities as partners.

Because Section 1-102(47)(G) defines “transfer” to include “a transfer by operation of law,” this section affects the power of other law to effect transfers of a partner’s ownership interest. For example, a divorce court lacks the power to award a partner’s spouse anything beyond the partner’s transferable interest. Nor does the partner have the power to enter into a property settlement purporting to effect any greater transfer.

For the divorce court, the best solution is to value the partner’s complete ownership interest (*i.e.*, the transferable interest as enhanced by the management and information rights and the standing to sue) and: (i) if possible, award the partner’s spouse marital property of equal value; or (ii) if not possible, award the partner’s spouse a money judgment and a charging order to enforce the judgment.

Granting the non-partner any part of a partner’s transferable interest is almost always

imprudent; marital discord will almost inevitably carry over into the business relationship. Granting the partner's ex-spouse the entire transferable interest is rarely a viable alternative. If the partner is active participant in the partnership, the approach is impossible. The partner's transferable interest will typically constitute much or all of the partner's remuneration for the partner's activity. Even if the partner is essentially passive, granting the transferable interest to the ex-spouse puts him or her at great risk as a "bare naked assignee." *See* the comment to Section 3-107(b).

When a partner dies, subject to the partnership agreement other law may effect a transfer of the partner's transferable interest to the partner's estate or personal representative. However, for the reasons just stated, other law lacks the power to transfer anything more than a transferable interest. (Section 3-505 does provide extra information rights for the purposes of settling the estate of the deceased partner.)

**Subsection (a)(3)(B)**—For a related provision, providing that that section's information rights do not apply to transferees, see Section 3-408(i).

**Subsection (b)**—Amounts due under this subsection are of course subject to offset for any amount owed to the partnership by the partner or person dissociated as a partner on whose account the distribution is made. Section 3-405(d). As to whether a partnership may properly offset for claims against a transferor that was never a partner is matter for other law, specifically the law of contracts dealing with assignments.

**Subsection (c)**—This very limited grant of information rights encompasses only transactions occurring at or after the date of the partnership's dissolution. The transferee has only the right to information as to the allocation of net assets among the partnership's creditors, partners, and transferees—and only from the date of dissolution.

This subsection does not prevent a transferee from contracting with a partner-transferor to require the partner-transferor to disclose further information to the transferee. Whether such an agreement would breach the partnership agreement, the implied contractual obligation of good faith and fair dealing, Section 3-409(d), or a fiduciary duty depends on the circumstances.

If a dissolved partnership rescinds its dissolution, Section 3-803, this subsection no longer applies.

**Subsection (e)**—This provision originated as UPA (1997) § 503(e), was then consistent with UCC § 9-318(3), and is now consistent with UCC § 9-406(a) (stating that "an account debtor . . . may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee").

The term "notice" includes "reason to know," Section 3-103(b)(1), and ordinarily a potential transferee has reason to inquire about transfer restrictions that might be contained in the partnership agreement.

**Subsection (f)**—Under this subsection, a partner remains a partner (with all attendant

rights and obligations) even after permanently transferring the entirety of the transferable interest, unless: (i) the other partners opt for expulsion under Section 3-601(4)(B); or (ii) as otherwise provided in the partnership agreement.

#### **SECTION 3-504. CHARGING ORDER.**

(a) On application by a judgment creditor of a partner or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the partnership to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a partner, and is subject to Section 3-503.

(d) At any time before foreclosure under subsection (c), the partner or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), a partnership or one or more partners whose transferable interests are not subject to the charging order may pay to the

judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) This [article] does not deprive any partner or transferee of the benefit of any exemption law applicable to the transferable interest of the partner or transferee.

(g) This section provides the exclusive remedy by which a person seeking in the capacity of a judgment creditor to enforce a judgment against a partner or transferee may satisfy the judgment from the judgment debtor's transferable interest.

### Comment

The charging order concept dates back to the English Partnership Act of 1890 and in the United States has been a fundamental part of law of unincorporated business organizations since 1914. *See* UPA (1914) § 28. As much a remedy limitation as a remedy, the charging order is the sole method by which a person acting as judgment creditor of a partner or transferee can extract value from the partner's or transferee's ownership interest in a partnership. *See* the comment to Subsection (g).

Under this section, the judgment creditor of a partner or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. However, the judgment creditor has no say in the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or to otherwise interfere with the management and activities of the partnership.

By its terms, this section does not apply to foreign partnerships. *See* Section 3-102(11) (defining "partnership" to mean "an association of two or more persons to carry on as co-owners a business for profit *formed under this [article]*") (emphasis added). *See also Fannie Mae v. Heather Apartments Ltd. P'ship*, A13-0562, 2013 WL 6223564, at \*6 (Minn. Ct. App. Dec. 2, 2013) (considering the remedies available to a judgment creditor with respect to the judgment debtor's interest in a Cook Islands LLC; rejecting the debtor's argument that the creditor's "only remedy is to obtain a charging order under" the Minnesota LLC statute; explaining that "this argument fails because that statute only applies to Minnesota limited liability companies" which that statute "defines . . . as 'a limited liability company, other than a foreign limited liability company, *organized or governed by this chapter*'") (emphasis added) (statutory citations omitted).

The partnership agreement has no power to alter the provisions of this section to the prejudice of third parties. Section 3-105(c)(17).

**Subsection (a)**—The phrase “judgment debtor” encompasses both partners and transferees. The lien pertains only to a distribution, which excludes “amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.” Section 3-102(a)(3)(B). A judgment creditor that wishes to levy on such amounts should use the appropriate creditor’s remedy, such as garnishment (which may be subject to exemptions or exclusions not relevant to a charging order). *Cf. PB Real Estate, Inc. v. Dem II Props.*, 719 A.2d 73, 76 (Conn. Ct. App. 1998) (rejecting the contention of an LLC’s two members that “payments of \$28,000 to each of them” should be treated “as expenses for wages” rather than as distributions).

Whether an application for a charging order must be served on the partnership, the judgment debtor, or both is a matter for other law, principally the law of remedies and civil procedure. The order itself must be served on the partnership. Whether the order must also be served on the judgment debtor is a matter for other law.

If a distribution consists of rights to acquire interests in a partnership, the charging order applies only to those rights within the definition of transferable interest. *See* Section 3-102(a)(9) (defining transferable interest).

**Subsection (b)**—Paragraph (2) refers to “other orders” rather than “additional orders.” Therefore, given appropriate circumstances, a court may invoke Paragraph (1), Paragraph (2), or both.

**Subsection (b)(1)**—The receiver contemplated here is emphatically not a receiver for the partnership, but rather a receiver for the distributions subject to the charging order. The principal advantage provided by this paragraph is an expanded right to information. However, that right goes no further than “the extent necessary to effectuate the collections of distributions pursuant to a charging order.” For a correctly narrow reading of this provision, see *Wells Fargo Bank, Nat. Ass’n v. Continuous Control Solutions, Inc.*, No. 11–1285, 2012 WL 3195759 (Iowa Ct. App. Aug. 8, 2012).

**Subsection (b)(2)**—This paragraph must be understood in the context of: (i) the very limited nature of the charging order; and (ii) the importance of preventing overreaching on behalf of a person that is not a judgment creditor of the partnership, has no claim on the partnership’s assets, and has no right to interfere in the activities, affairs, and management of the partnership. In particular, the court’s power to make “all other orders” is limited to “orders necessary to give effect to the charging order.”

**EXAMPLE:** A judgment creditor with a charging order believes that the partnership should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the partnership to restrict re-investment. Subsection (b)(2) does not authorize the court to grant the motion.

**EXAMPLE:** A judgment creditor with a judgment for \$10,000 against a partner obtains a charging order against the partner’s transferable interest. Having been properly served

with the order, the partnership nonetheless fails to comply and makes a \$3000 distribution to the partner. The court has the power to order the partnership to pay \$3000 to the judgment creditor to “give effect to the charging order.”

Under Subsection (b)(2), the court has the power to decide whether a particular payment is a distribution, because that decision determines whether the payment is part of a transferable interest subject to a charging order.

**EXAMPLE:** Partner A of ABC, a general partnership, has for some years received distributions from the partnership. However, when a judgment creditor of Partner A obtains a charging order against Partner A’s transferable interest, the partnership ceases to make distributions to Partner A and instead provides a salary to Partner A equivalent to former distributions. A court might deem this salary a disguised distribution. (In any event, the salary will be subject to garnishment.)

This article has no specific rules for determining the fate or effect of a charging order when the partnership undergoes a merger, conversion, interest exchange, or domestication under Article 2. In the proper circumstances, such an organic change might trigger an order under Subsection (b)(2).

**Subsection (c)**—The phrase “that distributions under the charging order will not pay the judgment debt within a reasonable period of time” comes from case law. *See, e.g., Nigri v. Lotz*, 453 S.E.2d 780, 783 (Ga. Ct. App. 1995); *Stewart v. Lanier Park Med. Office Bldg., Ltd.*, 578 S.E.2d 572, 574 (Ga. Ct. App. 2003) (“Judicial sale may be appropriate where . . . it is apparent that distributions under the charging order will not pay the judgment debt within a reasonable amount of time.”). A purchaser at a foreclosure sale obtains only the very limited rights of a transferee under Section 3-503 and is in some ways more vulnerable and less powerful than the holder of a charging order. After foreclosure and sale, Subsection (b) no longer applies. More generally, the court is no longer involved in the matter. For the vulnerability of a transferee, see Sections 3-503(a)(3) comment; 3-107(b), comment.

**Subsection (d)**—This provision allows the judgment debtor to end the charging order without need for a hearing.

**Subsection (e)**—Traditionally, charging order provisions referred to the possibility of “redeeming” an interest subject to a charging order. That usage was confusing, leaving several important questions unanswered. This article substitutes a far simpler approach, contemplating the partnership or its partners buying the underlying judgment and thereby dispensing with any interference the judgment creditor might seek to inflict on the partnership.

In many circumstances, buying the judgment is superior to the mechanism provided by this subsection, because: (i) this subsection requires full satisfaction of the underlying judgment; and (ii) the partnership or the other partners might be able to buy the judgment for less than face value. On the other hand, this subsection operates without need for the judgment creditor’s consent, so it remains a valuable protection in the event a judgment creditor seeks to do mischief to the partnership.



Whether a partnership’s decision to invoke this subsection is “ordinary course” or “outside the ordinary course,” Section 3-401(k), depends on the circumstances. However, the involvement of this subsection does not by itself make the decision “outside the ordinary course.”

**Subsection (f)**—This subsection preserves otherwise applicable exemptions but does not create any. *In re Foos*, 405 B.R. 604, 609 (Bankr. N. D. Ohio 2009) (interpreting the comparable provision in UPA (1997) and stating that “it is clear that [the provision] does not create an exemption”).

**Subsection (g)**—This subsection does not override Uniform Commercial Code, Article 9, which may provide different remedies for a secured creditor acting in that capacity. A secured creditor with a judgment might decide to proceed under Article 9 alone, under this section alone, or under both Article 9 and this section. In the last-mentioned circumstance, the constraints of this section would apply to the charging order but not to the Article 9 remedies.

This subsection is not intended to prevent a court from effecting a “reverse pierce” where appropriate. In a reverse pierce, the court conflates the entity and its owner to hold the entity liable for a debt of the owner. *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298, 312 (Conn. App. Ct. 2002) (approving a reverse pierce where a judgment debtor had established a partnership in a patent attempt to frustrate the judgment creditor), *overruled on other grounds by, Robinson v. Coughlin*, 830 A.2d 1114 (Conn. 2003). Likewise, this subsection does not supplant fraudulent transfer law.

## **SECTION 3-505. POWER OF LEGAL REPRESENTATIVE OF DECEASED**

**PARTNER.** If a partner dies, the deceased partner’s legal representative may exercise:

- (1) the rights of a transferee provided in Section 3-503(c); and
- (2) for purposes of settling the estate, the rights the deceased partner had under Section 3-408.

### **Comment**

The estate and those claiming through the estate are transferees, and as such they have very limited rights to information. This section provides temporary, additional information rights to the legal representative of the estate. Sections 3-408 and 3-503(c) pertain only to information rights.

## **[PART] 6**

### **DISSOCIATION**

**SECTION 3-601. EVENTS CAUSING DISSOCIATION.** A person is dissociated as a partner when:

(1) the partnership knows or has notice of the person's express will to withdraw as a partner, but, if the person has specified a withdrawal date later than the date the partnership knew or had notice, on that later date;

(2) an event stated in the partnership agreement as causing the person's dissociation occurs;

(3) the person is expelled as a partner pursuant to the partnership agreement;

(4) the person is expelled as a partner by the affirmative vote or consent of all the other partners if:

(A) it is unlawful to carry on the partnership business with the person as a partner;

(B) there has been a transfer of all of the person's transferable interest in the partnership, other than:

(i) a transfer for security purposes; or

(ii) a charging order in effect under Section 3-504 which has not been foreclosed;

(C) the person is an entity and:

(i) the partnership notifies the person that it will be expelled as a partner because the person has filed a statement of dissolution or the equivalent, the person has been administratively dissolved, the person's charter or the equivalent has been revoked, or the person's right to conduct business has been suspended by the person's jurisdiction of formation;

and

(ii) not later than 90 days after the notification, the statement of dissolution or the equivalent has not been withdrawn, rescinded, or revoked, or the person's charter or the equivalent or right to conduct business has not been reinstated; or

(D) the person is an unincorporated entity that has been dissolved and whose activities and affairs are being wound up;

(5) on application by the partnership or another partner, the person is expelled as a partner by judicial order because the person:

(A) has engaged or is engaging in wrongful conduct that has affected adversely and materially, or will affect adversely and materially, the partnership's business;

(B) has committed willfully or persistently, or is committing willfully or persistently, a material breach of the partnership agreement or a duty or obligation under Section 3-409; or

(C) has engaged or is engaging in conduct relating to the partnership's business which makes it not reasonably practicable to carry on the business with the person as a partner;

(6) the person:

(A) becomes a debtor in bankruptcy;

(B) signs an assignment for the benefit of creditors; or

(C) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the person or of all or substantially all the person's property;

(7) in the case of an individual:

(A) the individual dies;

(B) a guardian or general conservator for the individual is appointed; or

(C) a court orders that the individual has otherwise become incapable of performing the individual's duties as a partner under this [article] or the partnership agreement;

(8) in the case of a person that is a testamentary or inter vivos trust or is acting as a partner by virtue of being a trustee of such a trust, the trust's entire transferable interest in the partnership is distributed;

(9) in the case of a person that is an estate or is acting as a partner by virtue of being a personal representative of an estate, the estate's entire transferable interest in the partnership is distributed;

(10) in the case of a person that is not an individual, the existence of the person terminates;

(11) the partnership participates in a merger under [Article] 2 and:

(A) the partnership is not the surviving entity; or

(B) otherwise as a result of the merger, the person ceases to be a partner;

(12) the partnership participates in an interest exchange under [Article] 2 and, as a result of the interest exchange, the person ceases to be a partner;

(13) the partnership participates in a conversion under [Article] 2;

(14) the partnership participates in a domestication under [Article] 2 and, as a result of the domestication, the person ceases to be a partner; or

(15) the partnership dissolves and completes winding up.

### **Comment**

This section mostly states default rules, which the partnership agreement may vary. However, it makes no sense to vary some of the rules – *e.g.*, that the death of a partner who is an individual does *not* cause the individual's dissociation as a partner, Paragraph (7)(A), or that a entity remains a partner even *after* the existence of the entity has terminated, Paragraph (10).

**Paragraph (1)**—Partnership agreements often require notice of dissociation to be in

writing and to specify the effective date of the dissociation. The partnership cannot eliminate the power of a partner to dissociate by express will, Section 3-110(c)(9), but can eliminate the right and thereby make the dissociation wrongful.

**Paragraph (3)**—General partnership agreements often provide for “no cause” expulsion, and courts differ somewhat in how they approach such provisions. *Compare Gelder Med. Grp. v. Webber*, 363 N.E.2d 573, 576 (N.Y. 1977), with *Winston & Strawn v. Nosal*, 664 N.E.2d 239, 245 (Ill. App. Ct. 1996). *See also* the comment to Section 3-409(d) (stating and explaining the implied contractual covenant of good faith and fair dealing).

**Paragraph (4)(B)**—This paragraph permits expulsion when a partner no longer has any “skin in the game.” Although Part 7 provides for the buy-out of a dissociated partner’s transferable interest, in this context the dissociated partner has no transferable interest.

**Paragraph (5)**—For examples of conduct warranting an expulsion order, see *Della Ratta v. Dias*, 961 A.2d 629, 642 (Md. Ct. Spec. App. 2008), *aff’d*, 996 A.2d 382 (Md. 2010) (noting that “[t]he trial court expressly found that [two major capital] calls ‘were issued in bad faith’ . . . [and the] court also found that, ‘[by] another improper accounting movement’ in [the partnership], \$580,000 was taken for executive office expenses which was improper”); *Brennan v. Brennan Assocs.*, 977 A.2d 107, 117–18 (Conn. 2009) (referring to the expelled partner’s “moral turpitude, criminal fraud, and failure to be honest in court as to the extent of his criminal wrongdoing” as well as “his baseless claims of fraud” against a fellow partner; stating “he has rung the bell and it cannot be unrung”).

For an analysis that helps distinguish Paragraph (5)(C) from Paragraphs (5)(A) and (B), *see All Saints University of Medicine Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510, at \*15 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (interpreting predecessor law and noting that the “not reasonably practicable standard” does not require a showing of wrongful conduct). *Cf. Dunnagan v. Watson*, 204 S.W.3d 30, 40 (Tex. Ct. App. 2006) (same issue in the context of dissolution).

Where grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives. *Robertson v. Jacobs Cattle Co.*, 830 N.W.2d 191, 201–02 (Neb. 2013). “[T]here is no textual basis for imposing a higher burden of proof for dissociation than dissolution.” *Brennan v. Brennan Assocs.*, 977 A.2d 107, 121 (Conn. 2009).

The partnership agreement cannot vary the stated grounds for expulsion, Section 3-105(c)(10), but can choose an alternate forum – *e.g.*, arbitration. *Compare* Section 3-801(a)(4) (containing analogous grounds for dissolution by court order), with Section 3-105(c)(11) (making the Section 3-701(a)(4) grounds non-waivable).

**Paragraph (6)(A)**—This provision is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating “ipso facto” clauses, subject to some exceptions).

**Paragraphs (8) and (9)**—A change in trustee or personal representative does not cause dissociation.

**Paragraph (11)(A)**—If a partnership disappears as part of a merger, no person can

continue as a partner of the partnership. When the merger takes effect, those partners of the disappearing company are perforce dissociated. Depending on the plan of merger, those persons may become partners of a surviving partnership. In those circumstances, the merger will have dissociated them from one partnership and admitted them into partnership in the surviving partnership. *See* Sections 3-402(b)(2) and 2-206(a)(10).

**Paragraph (11)(B)**—It is possible for a plan of merger to “shuffle the equity” of the surviving entity, even to the extent of “taking out” some or all of the owners of the surviving entity. A reverse triangular merger involving a partnership as the surviving entity would dissociate all the partners of the partnership.

**Paragraph (13)**—By definition, a partnership that converts ceases to be a partnership. *See* Section 2-406. Thus, when the plan of conversion takes effect, all the partners of the converted entity are dissociated from that entity. In many cases, those persons will all be owners of the converted entity. In some cases, the conversion will “shuffle the equity” and “take out” some of the partners of the converting partnership.

**Paragraph (14)**—Domestication does not by itself dissociate a partner, because the domesticated entity remains both a partnership and “the same entity without interruption as the domesticating company.” Section 2-506(a)(1)(B). However, an “equity shuffle” could dissociate a partner.

## **SECTION 3-602. POWER TO DISSOCIATE AS PARTNER; WRONGFUL DISSOCIATION.**

(a) A person has the power to dissociate as a partner at any time, rightfully or wrongfully, by withdrawing as a partner by express will under Section 3-601(1).

(b) A person’s dissociation as a partner is wrongful only if the dissociation:

(1) is in breach of an express provision of the partnership agreement; or

(2) in the case of a partnership for a definite term or particular undertaking, occurs

before the expiration of the term or the completion of the undertaking and:

(A) the person withdraws as a partner by express will, unless the withdrawal follows not later than 90 days after another person’s dissociation by death or otherwise under Section 3-601(6) through (10) or wrongful dissociation under this subsection;

(B) the person is expelled as a partner by judicial order under Section 3-601(5);

(C) the person is dissociated under Section 3-601(6); or

(D) in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person is expelled or otherwise dissociated because it willfully dissolved or terminated.

(c) A person that wrongfully dissociates as a partner is liable to the partnership and to the other partners for damages caused by the dissociation. The liability is in addition to any debt, obligation, or other liability of the partner to the partnership or the other partners.

### Comment

**Subsection (a)**—A general partnership is a voluntary association, *see* Section 3-105(c)(9), and voluntary in this context means “proceeding from the will or from one’s own choice or consent . . . having power of free choice.” BLACK’S LAW DICTIONARY (9th ed. 2009). Necessarily therefore, a general partner always has the power to dissociate by express will. Accordingly, the partnership agreement cannot vary this subsection except to the extent of requiring the notice of dissociation to be in writing. Section 3-105(c)(9).

The phrase “rightfully or wrongfully” reflects the distinction between a partner’s *power* to withdraw in contravention of the partnership agreement and a partner’s *right* to do so. Thus, although a partner cannot be enjoined from exercising the power to dissociate, the dissociation may be wrongful under Subsection (b).

**Subsection (b)**—This subsection list exhaustively (“only if”) the dissociations that are “wrongful.” The label has three consequences:

- under Subsection (c) liability for resulting damages, which, under Section 3-701(c), may be offset against the amount of the buyout price due to the partner under Section 3-701(a);
- under Section 3-701(h) postponement of payment of the buyout price until the term expires or the undertaking is completed; and
- under Section 3-804, exclusion from the winding up process, if the dissociation results in dissolution of the partnership.

This subsection states a default rule. The partnership agreement can expand the list (*e.g.*, by making wrongful a dissociation that breaches the implied contractual covenant of good faith and fair dealing). In theory, the partnership agreement can provide for liquidated damages (subject to the requirements of contract law) and, in theory, can also shrink or even eliminate the list of wrongful dissociations.

**Subsection (b)(2)(A)**—This paragraph protects a partner’s reactive withdrawal from a term partnership after the premature departure of another partner, such as the partnership’s

rainmaker or main supplier of capital, under the same circumstances that may result in the dissolution of the partnership under Section 3-801(2)(A). Under that provision, a term partnership is dissolved ninety days after the bankruptcy, incapacity, death (or similar dissociation of a partner that is an entity), or wrongful dissociation of any partner, unless a majority in interest of the remaining partners agree to continue the partnership. Under this provision, a partner's exercise of the right of withdrawal by express will under those circumstances is rendered "rightful," even if the partnership is continued by others, and does not expose the withdrawing partner to damages for wrongful dissociation under Section 3-602(c).

**Subsection (b)(2)(C)**—This provision refers to Section 3-601(6), which involves *inter alia* dissociation on account of bankruptcy, which in turn is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating "ipso facto" clauses, subject to some exceptions).

**Subsection (c)**—A partner who prematurely dissociates from a partnership for an agreed term or undertaking risks liability for any resulting damages. For example, the partnership might incur substantial expenses in replacing the general partner's expertise, reputation, or creditworthiness.

In effect, this subsection equates wrongful dissociation with breach of contract. Accordingly, courts should look to contract law to determine what consequential damages are recoverable. *See Hadley v. Baxendale*, 9 Exch. 341 (1854); RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981); *see also Williams v. Hildebrand*, 247 S.W.2d 356, 358 (Ark. 1952) (interpreting UPA (1914) § 38(2)(a)(II), pertaining to wrongful dissolution, and stating that "the measure of damages, when the partnership was to have continued for a fixed term, is the profits that the injured partner would have received").

### **SECTION 3-603. EFFECT OF DISSOCIATION.**

(a) If a person's dissociation results in a dissolution and winding up of the partnership business, [Part] 8 applies; otherwise, [Part] 7 applies.

(b) If a person is dissociated as a partner:

(1) the person's right to participate in the management and conduct of the partnership's business terminates, except as otherwise provided in Section 3-802(c); and

(2) the person's duties and obligations under Section 3-409 end with regard to matters arising and events occurring after the person's dissociation, except to the extent the partner participates in winding up the partnership's business pursuant to Section 3-802.

(c) A person's dissociation does not of itself discharge the person from any debt,



obligation, or other liability to the partnership or the other partners which the person incurred while a partner.

### Comment

**Subsection (a)**—This subsection is a “switching” provision, invoking either Part 7 or 8 depending on whether a person’s dissociation as a partner results in dissolution.

**Subsection (b)**—This section originated as UPA (1997) § 603(b) and deals with some of the internal effects of a person’s dissociation as a partner.

**Subsection (b)(1)**—A person’s dissociation as a partner ends immediately the person’s right to participate in the management of the business, unless the dissociation results in dissolution of the partnership. *See* Section 3-802(c) (“A person whose dissociation as a partner resulted in dissolution may participate in winding up as if still a partner, unless the dissociation was wrongful.”).

**Subsection (b)(2)**—Unless a person’s dissociation as a partner results in dissolution and the person participates in winding up, Section 3-802(c), this provision establishes a dividing line, separating out “matters arising and events occurring after the person’s dissociation.” If the partnership has continuing projects with clients, ongoing relationships with clients, or both, the dividing line requires special attention with regard to non-competition and partnership opportunities duties. *See* Section 3-409(b)(1), (3).

Disputes involving law firms have generated much of the relevant case law. *See, e.g., Meehan v. Shaughnessy*, 535 N.E.2d 1255, 1257 (Mass. 1989); *Jewel v. Boxer*, 156 Cal. App. 3d 171, 175 (Cal. Ct. App. 1984). To a large extent a well-drawn partnership agreement can delineate the parties’ respective rights and responsibilities and thereby avoid problems. However, if the partnership becomes insolvent, the bankruptcy court may well scrutinize the partners’ *inter se* arrangements. *See Geron v. Robinson & Cole L.L.P.*, 476 B.R. 732, 743 (Bankr. S.D.N.Y. 2012) (considering whether a law firm had “fraudulently transferred . . . assets when its partners adopted the Jewel Waiver [releasing rights recognized by *Jewel v. Boxer*] on the eve of dissolution without consideration”).

This provision does not determine the effect of a person’s dissociation as a partner on the person’s future obligations or rights under the partnership agreement. Some contractual obligations typically extend beyond dissociation – *e.g.*, non-competition agreements, buyout arrangements. To the extent provisions of the partnership agreement continue to apply, the common law obligation of good faith continues to apply as well. *See* the comment to Section 3-409(d) (explaining that the subsection “invokes the implied obligation that exists in every contract” as a matter of common law).

**Subsection (c)**—A partner’s obligation to safeguard trade secrets and other confidential or proprietary information is incurred when the partner learns or otherwise obtains the information. This subsection preserves the obligation post-dissociation.

## **[PART] 7**

### **PERSON'S DISSOCIATION AS A PARTNER WHEN BUSINESS NOT WOUND UP**

#### **SECTION 3-701. PURCHASE OF INTEREST OF PERSON DISSOCIATED AS PARTNER.**

(a) If a person is dissociated as a partner without the dissociation resulting in a dissolution and winding up of the partnership business under Section 3-801, the partnership shall cause the person's interest in the partnership to be purchased for a buyout price determined pursuant to subsection (b).

(b) The buyout price of the interest of a person dissociated as a partner is the amount that would have been distributable to the person under Section 3-806(b) if, on the date of dissociation, the assets of the partnership were sold and the partnership were wound up, with the sale price equal to the greater of:

(1) the liquidation value; or

(2) the value based on a sale of the entire business as a going concern without the person .

(c) Interest accrues on the buyout price from the date of dissociation to the date of payment, but damages for wrongful dissociation under Section 3-602(b), and all other amounts owing, whether or not presently due, from the person dissociated as a partner to the partnership, must be offset against the buyout price.

(d) A partnership shall defend, indemnify, and hold harmless a person dissociated as a partner whose interest is being purchased against all partnership liabilities, whether incurred before or after the dissociation, except liabilities incurred by an act of the person under Section 3-702.

(e) If no agreement for the purchase of the interest of a person dissociated as a partner is reached not later than 120 days after a written demand for payment, the partnership shall pay, or cause to be paid, in money to the person the amount the partnership estimates to be the buyout price and accrued interest, reduced by any offsets and accrued interest under subsection (c).

(f) If a deferred payment is authorized under subsection (h), the partnership may tender a written offer to pay the amount it estimates to be the buyout price and accrued interest, reduced by any offsets under subsection (c), stating the time of payment, the amount and type of security for payment, and the other terms and conditions of the obligation.

(g) The payment or tender required by subsection (e) or (f) must be accompanied by the following:

- (1) a statement of partnership assets and liabilities as of the date of dissociation;
- (2) the latest available partnership balance sheet and income statement, if any;
- (3) an explanation of how the estimated amount of the payment was calculated;

and

(4) written notice that the payment is in full satisfaction of the obligation to purchase unless, not later than 120 days after the written notice, the person dissociated as a partner commences an action to determine the buyout price, any offsets under subsection (c), or other terms of the obligation to purchase.

(h) A person that wrongfully dissociates as a partner before the expiration of a definite term or the completion of a particular undertaking is not entitled to payment of any part of the buyout price until the expiration of the term or completion of the undertaking, unless the person establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership. A deferred payment must be adequately secured and bear

interest.

(i) A person dissociated as a partner may maintain an action against the partnership, pursuant to Section 3-410(b)(2), to determine the buyout price of that person's interest, any offsets under subsection (c), or other terms of the obligation to purchase. The action must be commenced not later than 120 days after the partnership has tendered payment or an offer to pay or within one year after written demand for payment if no payment or offer to pay is tendered. The court shall determine the buyout price of the person's interest, any offset due under subsection (c), and accrued interest, and enter judgment for any additional payment or refund. If deferred payment is authorized under subsection (h), the court shall also determine the security for payment and other terms of the obligation to purchase. The finding may be based on the partnership's failure to tender payment or an offer to pay or to comply with subsection (g).

### Comment

Part 7 originated in UPA (1997) and provides for the buyout of the interest of a person dissociated as a partner if the dissociation does not result in a dissolution and winding up of the partnership's business under Part 8. *See* Section 3-603(a). If there is no dissolution, the remaining partners have a right to continue the business and the person dissociated as a partner has a right to be bought out. These rights can, of course, be varied in the partnership agreement. *See* Section 3-105. A person dissociated as a partner has a continuing relationship with the partnership and third parties as provided in Sections 3-603(b), 3-702, and 3-703. *See* Section 3-408(e) (access to information of person dissociated as a partner).

The rules in this section are merely default rules. The partners may, in the partnership agreement, fix the method or formula for determining the buyout price and all of the other terms and conditions of the buyout right. Indeed, the very right to a buyout itself may be modified, although a provision providing for a complete forfeiture would probably not be enforceable. *See* Section 1-702 (Supplemental Principles of Law).

**Subsection (a)**—This subsection provides that, if a person's dissociation as a partner does not result in a windup of the business, the partnership shall cause the interest of the dissociating partner to be purchased for a buyout price determined pursuant to Subsection (b). The buyout is mandatory, unless the partnership provides otherwise. The "cause to be purchased" language is intended to accommodate a purchase by the partnership, one or more of the remaining partners, or a third party.

**Subsection (b)**—This subsection provides how the “buyout price” is to be determined. The terms “fair market value” or “fair value” were not used because they are often considered terms of art having a special meaning depending on the context, such as in tax or corporate law. “Buyout price” was a new term in UPA (1997). Under Subsection (b), the buyout price is the amount that would have been distributable to the dissociating partner under Section 3-807(b) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of liquidation value or going concern value without the departing partner. Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, may be appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010).

Since the buyout price is based on the value of the business at the time of dissociation, the partnership must pay interest on the amount due from the date of dissociation until payment to compensate the dissociating partner for the use of his interest in the firm. Under UPA (1914) § 42, the person dissociated as a partner could elect a share of the profits in lieu of interest. UPA (1997) eliminated that option.

UPA (1914) § 38(2)(c)(II) provides that the good will of the business not be considered in valuing a wrongfully dissociating partner’s interest. UPA (1997) implicitly rejected that approach. Under this section, unless the partnership’s goodwill is damaged by the wrongful dissociation, the value of the wrongfully dissociating partner’s interest will include any goodwill value of the partnership. If the firm’s goodwill is damaged, the amount of the damages suffered by the partnership and the remaining partners will be offset against the buyout price.

**Subsection (c)**—This subsection provides that the partnership may offset against the buyout price all amounts owing by the person dissociated as a partner to the partnership, whether or not presently due, including any damages for wrongful dissociation under Section 602(c). This rule has the effect of accelerating payment of amounts not yet due from the former partner to the partnership, including a long-term loan by the partnership to the former partner. Where appropriate, the amounts not yet due should be discounted to present value. A dissociating partner, on the other hand, is not entitled to an add-on for amounts owing to him by the partnership. Thus, a departing partner who has made a long-term loan to the partnership must wait for repayment, unless the terms of the loan agreement provide for acceleration upon dissociation.

The partnership’s right of setoff does not limit the amount of damages the partnership may claim for the wrongful dissociation and does not alter any other amounts owed to the partnership. Those amounts may result in a net sum due to the partnership from the person dissociated as a partner.

**Subsection (d)**—Following the rule stated in UPA (1914) § 38, this section requires the partnership to indemnify a person dissociated as a partner against all partnership liabilities,

whether incurred before or after the dissociation, except those incurred by the person under Section 3-702. The rationale for covering post-dissociation liabilities is the fact of dissociation; the person dissociated as a partner is no longer a co-owner of the enterprise. As for pre-existing liabilities, the determination of the buyout price necessarily assumes that these liabilities will be paid. Thus, in effect the person's share of these liabilities has already been paid through the valuation process.

**Subsection (e)**—If a person dissociated as a partner makes a written demand for payment and no agreement for the purchase of the interest is reached within 120 days after the demand, the partnership must pay, or cause to be paid, in cash the amount it estimates to be the buyout price, adjusted for any offsets allowed and accrued interest. Thus, the person dissociated as a partner will receive in cash within 120 days of dissociation the undisputed minimum value of the person's partnership interest. If the person claims that the buyout price should be higher, suit may thereafter be brought as provided in Subsection (i) to have the amount of the buyout price determined by the court. This is similar to the procedure for determining the value of dissenting shareholders' shares under the Model Business Corporation Act, §§13.20 through 13.28.

The "cause to be paid" language of Subsection (a) is repeated here to permit either the partnership, one or more of the continuing partners, or a third-party purchaser to tender payment of the estimated amount due.

**Subsection (f)**—Under this subsection, when deferred payment is authorized in the case of a wrongfully dissociating partner, a written offer stating the amount the partnership estimates to be the purchase price should be tendered within the 120-day period, even though actual payment of the amount may be deferred, possibly for many years. *See* the comment to Subsection (h). The dissociated partner is entitled to know at the time of dissociation what amount the remaining partners think is due, including the estimated amount of any damages allegedly caused by the partner's wrongful dissociation that may be offset against the buyout price.

**Subsection (g)**—This subsection provides that the payment of the estimated price (or tender of a written offer under Subsection (f)) by the partnership must be accompanied by: (i) a statement of the partnership's assets and liabilities as of the date of the person's dissociation as a partner; (ii) the latest available balance sheet and income statement, if the partnership maintains such financial statements; (iii) an explanation of how the estimated amount of the payment was calculated; and (iv) a written notice that the payment will be in full satisfaction of the partnership's buyout obligation unless the person dissociated as a partner commences an action to determine the price within 120 days of the notice. Subsection (g) is based in part on the dissenters' rights provisions of Model Business Corporation Act § 13.25(b).

Those disclosures should serve to identify and narrow substantially the items of dispute between the person dissociated as a partner and the partnership over the valuation of the partnership interest. The disclosures will also serve to pin down the parties as to their claims of partnership assets and values and as to the existence and amount of all known liabilities. Lastly, the disclosures will force the remaining partners to consider thoughtfully the difficult and important questions as to the appropriate method of valuation under the circumstances, and in

particular, whether they should use going concern or liquidation value. Simply getting that information on the record in a timely fashion should increase the likelihood of a negotiated resolution of the parties' differences during the 120-day period within which the person dissociated as a partner must bring suit.

**Subsection (h)**—UPA (1914) § 38 contemplates a buyout in the context of the partnership business being continued after a partner's wrongful dissociation has (inevitably) caused dissolution. UPA (1914) § 38(2)(c) entitles the wrongfully dissociating partner to have the buyout price "paid to him in cash, or the payment secured by bond approved by the court." UPA (1997) took a different approach, which the Harmonization Project did not change. Under Subsection (h), a wrongfully dissociating partner is not entitled to receive any portion of the buyout price before the expiration of the term or completion of the undertaking, unless the person dissociated as a partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership.

**Subsection (i)**—This subsection provides that a person dissociated as a partner may maintain an action against the partnership to determine the buyout price, any offsets, or other terms of the purchase obligation. The action must be commenced within 120 days after the partnership tenders payment of the amount it estimates to be due or, if deferred payment is authorized, its written offer. This provision creates a 120-day "cooling off" period. It also allows the parties an opportunity to negotiate their differences after disclosure by the partnership of its financial statements and other required information.

If the partnership fails to tender payment of the estimated amount due (or a written offer, if deferred payment is authorized), the person dissociated as a partner has one year after written demand for payment in which to commence suit.

## **SECTION 3-702. POWER TO BIND AND LIABILITY OF PERSON**

### **DISSOCIATED AS PARTNER.**

(a) After a person is dissociated as a partner without the dissociation resulting in a dissolution and winding up of the partnership business and before the partnership is merged out of existence, converted, or domesticated under [Article] 2, or dissolved, the partnership is bound by an act of the person only if:

(1) the act would have bound the partnership under Section 3-301 before dissociation; and

(2) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not know or have notice of the dissociation and reasonably believes that the person is a partner.

(b) If a partnership is bound under subsection (a), the person dissociated as a partner which caused the partnership to be bound is liable:

(1) to the partnership for any damage caused to the partnership arising from the obligation incurred under subsection (a); and

(2) if a partner or another person dissociated as a partner is liable for the obligation, to the partner or other person for any damage caused to the partner or other person arising from the liability.

### **Comment**

A person's dissociation as a partner ends immediately the person's actual authority to act for the partnership, unless the dissociation results in a dissolution and winding up of the business of the partnership. *See* Section 3-603(b)(1). However, the person's apparent authority may linger.

This section does not affect a person's power to bind a partnership in another capacity – *e.g.*, as an employee with actual authority.

**Subsection (a)**—This subsection codifies and constrains the lingering apparent authority of a person dissociated as a partner. The constraint is in the phrase “only if.”

The provision applies until the partnership dissolves or under Article 2 ceases to be governed by this article. Once a partnership dissolves, Section 3-804 applies.

With respect to authority of a person dissociated as a partner to transfer partnership real property, Section 3-303(e) provides that third parties are deemed to have knowledge of a limitation on the person's authority to transfer real property held in the partnership name upon the proper recording of a statement containing such a limitation. Section 3-704(b) provides that a statement of dissociation operates as a limitation on the person's authority for the purposes of Section 3-303(e). Thus, a properly recorded statement of dissociation provides, immediately upon recording, constructive knowledge of the lack of authority of a person dissociated as a partner to transfer real property held in the partnership name.

**Subsection (a)(1)**—It is the statutory apparent authority from Section 3-301 which lingers.



**Subsection (a)(2)(A)**—In any event, any lingering apparent authority ends two years after the dissociation.

**Subsection (a)(2)(B)**—A person might have notice under Section 3-103(d)(2)(A) (statement of dissociation) as well as under Section 3-103(b)(1) (person “ha[ving] reason to know the fact from all the facts known to the person at the time in question”).

**Subsection (b)**—The liability stated in this subsection is not exhaustive. For example, if a person dissociated as a partner causes a partnership to be bound under Subsection (a) and, due to a guaranty, some other person—not a partner nor a person dissociated as a partner—is liable on the resulting obligation, that other person may have a claim under other law against the person dissociated as a partner.

### **SECTION 3-703. LIABILITY OF PERSON DISSOCIATED AS PARTNER TO OTHER PERSONS.**

(a) Except as otherwise provided in subsection (b), a person dissociated as a partner is not liable for a partnership obligation incurred after dissociation.

(b) A person that is dissociated as a partner is liable on a transaction entered into by the partnership after the dissociation only if:

(1) a partner would be liable on the transaction; and

(2) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not have knowledge or notice of the dissociation

and reasonably believes that the person is a partner.

(c) By agreement with a creditor of a partnership and the partnership, a person dissociated as a partner may be released from liability for a debt, obligation, or other liability of the partnership.

(d) A person dissociated as a partner is released from liability for a debt, obligation, or other liability of the partnership if the partnership’s creditor, with knowledge or notice of the person’s dissociation but without the person’s consent, agrees to a material alteration in the

nature or time of payment of the debt, obligation, or other liability.

### **Comment**

To the extent a partnership has been a limited liability partnership throughout its existence, the liability rules stated in this section are moot. *See* Subsection (b)(1).

This section parallels Section 3-805.

**Subsection (a)**—As stated in Section 3-306(b), comment and 3-306(c), comment, other law determines when a partnership obligation is “incurred.”

**Subsection (b)**—The rule stated here for the “lingering liability” of a person dissociated a partner parallels the rule stated in Section 3-702 for the lingering apparent authority of a person dissociated as a partner.

**Subsection (b)(2)(A)**—In any event, the lingering liability ends two years after the dissociation.

**Subsection (b)(2)(B)**—A person might have notice under Section 3-103(d)(2)(A) (statement of dissociation) as well as under Section 3-103(b)(1) (person “ha[ving] reason to know the fact from all the facts known to the person at the time in question”).

**Subsections (c) and (d)**—These provisions trace back to UPA (1914) § 36(2), (3).

### **SECTION 3-704. STATEMENT OF DISSOCIATION.**

(a) A person dissociated as a partner or the partnership may deliver to the [Secretary of State] for filing a statement of dissociation stating the name of the partnership and that the person has dissociated from the partnership.

(b) A statement of dissociation is a limitation on the authority of a person dissociated as a partner for the purposes of Section 3-303.

### **Comment**

A partnership and a person dissociated as a partner each have the right (but not an obligation) to deliver to the filing office a statement of dissociation, and each has an incentive to do so. *See* Sections 3-702(a)(2)(B) (extinguishing the lingering apparent authority of a person dissociated as a partner as to any party that has notice of the dissociation), 3-703(b)(2)(B) (extinguishing the lingering liability of a person dissociated as a partner as to any party that has notice of the dissociation).

This section originated as UPA (1997) § 704 and was unchanged by the Harmonization

Project.

**Subsection (a)**—“A person not a partner is deemed . . . to have notice of a person’s dissociation as a partner 90 days after a statement of dissociation under Section 3-704 becomes effective.” Section 3-103(d)(2)(A). This constructive notice ends both the lingering apparent authority and lingering liability exposure of the person dissociated as a partner. *See* Sections 3-702(a)(2)(B), 3-703(b)(2)(B).

**Subsection (b)**—This subsection interrelates a statement of dissociation with this article’s intricate section on statements of authority. *See* Section 3-303.

**SECTION 3-705. CONTINUED USE OF PARTNERSHIP NAME.** Continued use of a partnership name, or the name of a person dissociated as a partner as part of the partnership name, by partners continuing the business does not of itself make the person dissociated as a partner liable for an obligation of the partners or the partnership continuing the business.

#### **Comment**

Section 3-705 originated in UPA (1997) and is an edited version of UPA (1914) § 41(10). The section merely protects a person dissociated as a person from liability in case the partnership continues to use the person’s name. Whether a partnership has a right to the continued use is a matter for the partnership agreement; this article states no rule on the subject.

If the partnership agreement does not expressly address the issue, custom may imply a term. *See Gignilliat v. Gignilliat, Savitz & Bettis, L.L.P.*, 684 S.E.2d 756, 762, n.6 (S.C. 2009) (“This Court takes judicial notice of the custom and practice in this state of law firms continuing to use the names of deceased members in their firm names. Heretofore, the basis has been the taking for granted that the deceased partner would consent. Hereafter, it is presumed, unless proven otherwise, that the deceased partner consented to the continued use of his or her name in the partnership’s name.”).

### **[PART] 8**

#### **DISSOLUTION AND WINDING UP**

**SECTION 3-801. EVENTS CAUSING DISSOLUTION.** A partnership is dissolved, and its business must be wound up, upon the occurrence of any of the following:

(1) in a partnership at will, the partnership knows or has notice of a person’s express will to withdraw as a partner, other than a partner that has dissociated under Section 3-601(2) through

(10), but, if the person has specified a withdrawal date later than the date the partnership knew or had notice, on the later date;

(2) in a partnership for a definite term or particular undertaking:

(A) within 90 days after a person's dissociation by death or otherwise under Section 3-601(6) through (10) or wrongful dissociation under Section 3-602(b), the affirmative vote or consent of at least half of the remaining partners to wind up the partnership business, for which purpose a person's rightful dissociation pursuant to Section 3-602(b)(2)(A) constitutes that partner's consent to wind up the partnership business;

(B) the affirmative vote or consent of all the partners to wind up the partnership business; or

(C) the expiration of the term or the completion of the undertaking;

(3) an event or circumstance that the partnership agreement states causes dissolution;

(4) on application by a partner, the entry by [the appropriate court] of an order dissolving the partnership on the grounds that:

(A) the conduct of all or substantially all the partnership's business is unlawful;

(B) the economic purpose of the partnership is likely to be unreasonably frustrated;

(C) another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with that partner; or

(D) it is otherwise not reasonably practicable to carry on the partnership business in conformity with the partnership agreement;

(5) on application by a transferee, the entry by [the appropriate court] of an order

dissolving the partnership on the ground that it is equitable to wind up the partnership business:

(A) after the expiration of the term or completion of the undertaking, if the partnership was for a definite term or particular undertaking at the time of the transfer or entry of the charging order that gave rise to the transfer; or

(B) at any time, if the partnership was a partnership at will at the time of the transfer or entry of the charging order that gave rise to the transfer; or

(6) the passage of 90 consecutive days during which the partnership does not have at least two partners.

### **Comment**

“Dissolution” has been a term of art in the law of unincorporated business organizations since at least the time of Roman law. JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 266, at 408 (2d ed. 1850) (“The Roman law . . . declared, that partnership might be dissolved in various ways . . .”). Dissolution does not end a partnership’s existence but rather changes the purpose of that existence: “A dissolved partnership shall wind up its business and . . . the partnership continues after dissolution only for the purpose of winding up.” Section 3-802(a). The partnership may, but need not, file a statement of dissolution. Section 3-802(b)(2)(A). The partnership terminates when winding up is complete. The partnership may, but need not, file a statement of termination. Section 3-802(b)(2)(F).

UPA (1914) took a strictly aggregate approach to dissolution; under UPA (1914) § 29, the departure of any partner under any circumstances inevitably caused the partnership to dissolve. A partnership agreement had no power to avoid this result, although many partnership agreements purported to do so. A partnership agreement could provide for the continuation of the partnership business in a successor partnership, UPA (1914) § 38(2)(b), but that approach was often problematic. *See* the comment to Section 3-201(a).

UPA (1997) fundamentally changed this aspect of the law of general partnerships, making the partnership entity much more durable than the UPA (1914) aggregate. For example, expelling a partner does not cause the partnership to dissolve, even if the partnership is at-will. Section 3-801(1). More generally, the grounds for dissolution stated in Section 3-801 are exhaustive, unless the partnership agreement states otherwise.

Given this article’s built-in transfer restrictions, Section 3-503, increasing the partnership’s durability necessarily decreases each partner’s exit rights. Under UPA (1914), each partner has a non-waivable power to exit the enterprise; dissociation inevitably causes dissolution, which in most instances will lead to a buyout of the dissociating partner, subject to any damages for wrongful dissolution. UPA (1914) § 38. Eliminating that power creates a risk

of “lock-in.”

UPA (1997) addressed the lock-in issue through UPA (1997) § 701. When a person dissociates as a partner, whether rightfully or wrongfully, the partnership is obligated to buy out the person’s interest. Note, however, that Section 3-701, like UPA (1997) § 701, is a default rule.

Except for Paragraphs 4 and 5, this section comprises default rules. Paragraphs 4 and 5 are mandatory only with regard to the stated grounds for dissolution. *See* the comment to Section 3-105(c)(11). Variations to the statutory causes of dissolution are commonplace.

Section 3-803 permits rescission of dissolution in some circumstances. In some circumstances, an amendment to the partnership agreement might avert dissolution – *e.g.*, by revising an agreed-upon deadline for selling the partnership assets and winding up the business. A retroactive amendment may also be possible. *See Kindred Ltd. P'ship v. Screen Actors Guild, Inc.*, CV082220PSGPJWX, 2009 WL 279080, at \*5–6 (C.D. Cal. Feb. 3, 2009) (giving effect to an amendment that retroactively eliminated an event of dissolution; noting that UPA (1997) § 802(b) permitted a partnership to rescind dissolution).

The Harmonization Project added Paragraph 6 but otherwise made no significant changes to this section.

**Paragraph (1)**—This paragraph: (i) recognizes the power of any partner in a partnership at will to dissolve the partnership at any time “by express will”; and (ii) provides that a partner who has already been dissociated under some other provision of this section lacks the power to dissolve the partnership. The latter proposition seems self-evident; a person dissociated as a partner is no longer a partner.

**Paragraph (2)**—This paragraph provides three ways in which a term partnership may be dissolved before the expiration of the term.

**Paragraph (2)(A)**—This provision: (i) originated in UPA (1997); (ii) helps make the partnership entity more durable; (iii) protects the remaining partners where the dissociating partner is crucial to the successful continuation of the business; and (iv) reverses the approach of UPA (1914).

Under UPA (1914), any dissociation dissolves the partnership, and unanimous consent of the remaining partners to continue the business. Thus each partner has the right to cause liquidation. *See* UPA (1914) § 38(2)(b). Under this article, a term partnership is more durable.

A person’s dissociation as a partner by death or otherwise under Section 3-601(6) to (10) or wrongful dissociation under Section 3-602(b), makes a term partnership *susceptible* to dissolution. If within ninety days after the dissociation at least half of the remaining partners express their will to dissolve the partnership, the partnership dissolves. Section 3-601(6) to (10) pertain, respectively, to a partner’s bankruptcy or similar financial impairment (6); a partner’s death or incapacity (7); the distribution by a trust-partner of its entire transferable interest (8); the distribution by an estate-partner of its entire transferable interest; and the termination of an

entity-partner (10).

During the same ninety-day window, Section 3-602(b)(2)(A) permits each remaining partner to withdraw rightfully by express will. A partner does not express a desire to withdraw solely by reason of voting for or consenting to the winding up of the partnership business. However, the converse is true: “[A] person’s rightful dissociation pursuant to Section 3-602(b)(2)(A) constitutes the expression of that partner’s consent to wind up the partnership business.” Section 3-801(2)(A).

**EXAMPLE:** A term partnership has seven partners, and one of the partners dissociates by dying before the end of the term. Section 3-601(7). The partnership will dissolve if within ninety days after the dissociation three of the remaining five partners affirmatively vote or consent to dissolution.

**EXAMPLE:** Same facts, except the partner dissociates in breach of the partnership agreement. Same result.

**EXAMPLE:** Same facts, except that the partner is “a person that . . . is acting as a partner by virtue of being a trustee of . . . a trust, [and] the trust’s entire transferable interest in the partnership [has been] distributed. Section 3-601(8). Same result.

**Paragraph (2)(B)**—This provision states that a term partnership may be dissolved and wound up at any time by the express will of all the partners. The provision merely reflects the general rule that the partnership agreement may override the statutory default rules and that the partnership agreement, like any contract, can be amended at any time by unanimous consent.

**Paragraph (2)(C)**—This rule is inherent in the concept of a partnership for a specified term or undertaking. This provision must be read in conjunction with Section 3-411. Under Section 3-411(a), if the partners continue the business after the expiration of the term or the completion of the undertaking, the partnership will be treated as a partnership at will. Moreover, if the partners continue the business without any settlement or liquidation of the partnership, under Section 3-411(b) they are presumed to have agreed that the partnership will continue, despite the lack of a formal agreement.

**Paragraph (3)**—The partners can avoid the effects of this paragraph either by amending the partnership agreement before dissolution occurs or using Section 3-803 to rescind dissolution. A retroactive amendment may also be possible. *See Kindred Ltd. P’ship v. Screen Actors Guild, Inc.*, CV082220PSGPJWX, 2009 WL 279080, at \*5–6 (C.D. Cal. Feb. 3, 2009) (giving effect to an amendment that retroactively eliminated an event of dissolution; noting that UPA (1997) § 802(b) permitted a partnership to rescind dissolution).

**Paragraph (4)**—The partnership agreement cannot vary the stated grounds for dissolution.

**Paragraph (4)(A)**—The “all or substantially all” proviso is intended to avoid dissolution for insubstantial or innocent regulatory violations.

**Paragraph (4)(B)–(D)**—The Virginia Supreme Court has referred to “these statutory bases for judicial dissolution as the economic purpose test, the partner conduct test, and the business operations test, respectively.” *Russell Realty Assocs. v. Russell*, 724 S.E.2d 690, 693 (Va. 2012). These tests somewhat overlap and are often pled together. *E.g.*, *Wood v. Apodaca*, 375 F. Supp. 2d 942, 948 (N.D. Cal. 2005).

Some courts have held that, if the trial court finds grounds for dissolution under one or more of these provisions, that court has no power to order a lesser remedy, such as a buyout. *Pankratz Farms, Inc. v. Pankratz*, 95 P.3d 671, 679–80 (Mont. 2004) (so holding even though: (i) “judicial dissolution of the Partnership would trigger significant adverse tax consequences to all the parties involved, including Marvin [who commenced the action seeking dissolution”]; and (ii) “Marvin [had] requested monetary damages as an alternative to dissolution”); *Navarro v. Perron*, 122 Cal. App. 4th 797, 801, 19 Cal. Rptr. 3d 198, 201 (2004) (“Where the court determines it is not reasonably practical to carry on the partnership, the court has no discretion to deny a partner’s application to dissolve it.”).

**Paragraph (4)(B)**—“[P]oor financial performance” is neither sufficient nor necessary to satisfy this provision. *Russell Realty Assocs. v. Russell*, 724 S.E.2d 690, 694 (Va. 2012). The provision’s history substantiates the first point (not by itself sufficient). *See* UPA (1997) § 801, comment 8 (“RUPA deletes UPA Section 32(1)(e) which provides for dissolution when the business can only be carried on at a loss. That provision might result in a dissolution contrary to the partners’ expectations in a start-up or tax shelter situation, in which case ‘book’ or ‘tax’ losses do not signify business failure.”).

As for the second point (not always necessary), *see Russell Realty Assocs. v. Russell*, 724 S.E.2d 690, 694–55 (Va. 2012) (noting that the partnership’s purpose was “to acquire, hold, invest in, and lease and sell investment properties”; stating with regard to the Virginia analog to Paragraph 4(B) that “[t]he partners’ expectations for realizing these purposes included not only expectations of economic success, but also the ability to undertake these activities in an efficient and productive manner to maximize return to the partnership”; and listing numerous ways in which the relationship between the partners frustrated the economic purpose of the partnership).

**Paragraph (4)(C)**—A partner can trigger this provision without necessarily breaching the partnership agreement. *E.g.*, *Robertson v. Jacobs Cattle Co.*, 830 N.W.2d 191, 202 (Neb. 2013) (stating that “the somewhat autocratic manner in which Ardith conducted the affairs of the partnership in recent years, even if not in violation of the partnership agreement, would constitute grounds for dissolution under [the UPA (1997) version of] this provision”).

**Paragraph (4)(D)**—The specific terms of the partnership agreement are the frame of reference for applying this provision. *Sriram v. Preferred Income Fund III Ltd. P’ship*, 22 F.3d 498, 502 (2d Cir. 1994) (“The issue is not whether the partnerships can effectively carry out the general purpose of the Agreements after considerable modification of their terms. Rather, the query . . . is whether the purpose of the Agreements can be carried out ‘in conformity with the partnership agreement,’ that is, in conformity with the terms and conditions of the Agreements to which the limited partners ascribed and on which they relied when choosing to part with their capital.”) (applying the provision of RULPA (1976/1985) that is analogous to Paragraph (4)(C)).



**Paragraph (5)**—This paragraph gives a transferee rights comparable to a partner who seeks dissolution because the other partners are continuing the business in derogation of the partner’s rights to obtain dissolution. The paragraph is based on UPA (1914) § 32(2) but UPA (1997) added the requirement that the court determine that it is equitable to wind up the business. The rights of a transferee under this section cannot be varied in the partnership agreement. *See* Section 3-105(c)(11). Neither ULPA (2001) (Last Amended 2013) nor ULLCA (2006) (Last Amended 2013) have a comparable provision, because both those acts provide for perpetual existence. *See* Sections 4-110 and 5-108.

**Paragraph (6)**—The Harmonization Project added this provision, which is consistent with Section 3-202(a) (stating that “the association of two or more persons to carry on as co-owners a business for profit forms a partnership”). *See* the comment to Section 3-302(d); *Pemstein v. Pemstein*, G030217, 2004 WL 1260034 (Cal. Ct. App. June 9, 2004) (““Can one person carry on a partnership?’ In short, the answer is no . . . Just as it takes two to form a marriage, it takes a minimum of two to run a viable partnership. We were unable to find any contrary authority, and appellants fail to provide any, holding a partnership can be carried on by less than two persons.”)

## **SECTION 3-802. WINDING UP.**

(a) A dissolved partnership shall wind up its business and, except as otherwise provided in Section 3-803, the partnership continues after dissolution only for the purpose of winding up.

(b) In winding up its business, the partnership:

(1) shall discharge the partnership’s debts, obligations, and other liabilities, settle and close the partnership’s business, and marshal and distribute the assets of the partnership; and

(2) may:

(A) deliver to the [Secretary of State] for filing a statement of dissolution stating the name of the partnership and that the partnership is dissolved;

(B) preserve the partnership business and property as a going concern for a reasonable time;

(C) prosecute and defend actions and proceedings, whether civil, criminal, or administrative;

(D) transfer the partnership’s property;

(E) settle disputes by mediation or arbitration;

(F) deliver to the [Secretary of State] for filing a statement of termination stating the name of the partnership and that the partnership is terminated; and

(G) perform other acts necessary or appropriate to the winding up.

(c) A person whose dissociation as a partner resulted in dissolution may participate in winding up as if still a partner, unless the dissociation was wrongful.

(d) If a dissolved partnership does not have a partner and no person has the right to participate in winding up under subsection (c), the personal or legal representative of the last person to have been a partner may wind up the partnership's business. If the representative does not exercise that right, a person to wind up the partnership's business may be appointed by the affirmative vote or consent of transferees owning a majority of the rights to receive distributions at the time the consent is to be effective. A person appointed under this subsection has the powers of a partner under Section 3-804 but is not liable for the debts, obligations, and other liabilities of the partnership solely by reason of having or exercising those powers or otherwise acting to wind up the partnership's business.

(e) On the application of any partner or person entitled under subsection (c) to participate in winding up, the [appropriate court] may order judicial supervision of the winding up of a dissolved partnership, including the appointment of a person to wind up the partnership's business, if:

(1) the partnership does not have a partner and within a reasonable time following the dissolution no person has been appointed under subsection (d); or

(2) the applicant establishes other good cause.

## Comment

Under the default rules of this article, dissolution does not change governance arrangements. However, dissolution does change the context for determining whether a matter is in or outside “the ordinary course of business of [the] partnership.” Section 3-401(k). In addition, dissolution triggers a default rule entitling each partner to “reasonable compensation for services rendered in winding up the business of the partnership.” Section 3-401(j).

Section 3-804 governs the post-dissolution power of a partner to bind the partnership, and Section 3-805 governs the “liability after dissolution of partner and person dissociated as general partner.”

**Subsection (a)**—For more information on the impact of a partnership’s dissolution, see Section 3-801, comment.

**Subsection (b)**—The particular circumstances determine how long winding up may continue without giving “good cause” for court intervention under Section 3-802(e). There is no “hard and fast” rule. *See, e.g., Mathis v. Meyeres*, 574 P.2d 447, 450 (Alaska 1978) (stating “we are aware of [no authority] requiring that deadlines be set in the winding up of a partnership”); *8182 Md. Assocs., Ltd. P’ship v. Sheehan*, 14 S.W.3d 576, 581 (Mo. 2000) (“The Uniform Partnership Law contemplates that dissolved partnerships may continue in business for a short, long or indefinite period of time.”) (quoting *Schoeller v. Schoeller*, 497 S.W.2d 860, 867 (Mo. Ct. App. 1973)).

“Winding up usually entails the time necessary for the partners to finish old business, collect and pay debts, and finally distribute remaining assets to the partners.” *Gibson v. Deuth*, 270 N.W.2d 632, 635 (Iowa 1978). “Generally the best interests of the partnership will be served by winding up the partnership affairs as quickly as possible.” *Doting v. Trunk*, 856 P.2d 536, 540 (Mont. 1993). However, in some circumstances, a long period of winding up is not only appropriate but necessary. *Lebanon Trotting Ass’n v. Battista*, 306 N.E.2d 769, 772 (Ohio Ct. App. 1972) (“[I]f the only means of availing the partners of the benefit of the value of the lease would be to continue to operate under such lease until its expiration, then such operation may continue as part of the winding up of the partnership affairs after dissolution. It is not necessary that a partnership, in the absence of the consent of all the partners, abandon a valuable asset upon dissolution merely because it may have no ready market value, but the value of such asset can continue to inure to the benefit of the partners through the continuation of the partnership after dissolution.”).

**Subsection (b)(2)(A) and (F)**—For the constructive notice effect of a statement of dissolution or termination, see Sections 3-103(d)(2)(A) and (B) and 3-303.

**Subsection (c)**—This provision applies only to “[a] partner whose [rightful] dissociation resulted in dissolution.”

**EXAMPLE:** Partner A dissociates from the Killarney Company (“Killarney”), a general partnership. Partner A’s dissociation does not result in dissolution, and, per the Killarney

partnership agreement, Partner A's transferable interest is being redeemed over five years. One year after Partner A's dissociation, Partner B dissociates rightfully, and dissolution results. Partner B may participate in Killarney's winding up; Partner A may not.

**EXAMPLE:** Partner A wrongfully dissociates from Killarney, and the dissociation results in the dissolution of Killarney. Partner A may not participate in winding up.

A partner's duties and obligation under Section 3-409 extend to winding up. Section 3-603(b)(2). However, under Section 3-409(b)(3), each partner's duty not to compete ends when the partnership dissolves.

**Subsection (d)**—A person appointed under this section will normally be an agent of the dissolved partnership, acting pursuant to a contract. Agency and contract law will determine the person's duties; by its terms Section 3-409 does not apply.

### **SECTION 3-803. RESCINDING DISSOLUTION.**

(a) A partnership may rescind its dissolution, unless a statement of termination applicable to the partnership has become effective or [the appropriate court] has entered an order under Section 3-801(4) or (5) dissolving the partnership.

(b) Rescinding dissolution under this section requires:

(1) the affirmative vote or consent of each partner; and

(2) if the partnership has delivered to the [Secretary of State] for filing a statement of dissolution and:

(A) the statement has not become effective, delivery to the [Secretary of State] for filing of a statement of withdrawal under Section 3-115 applicable to the statement of dissolution; or

(B) the statement of dissolution has become effective, delivery to the [Secretary of State] for filing of a statement of rescission stating the name of the partnership and that dissolution has been rescinded under this section.

(c) If a partnership rescinds its dissolution:

(1) the partnership resumes carrying on its business as if dissolution had never

occurred;

(2) subject to paragraph (3), any liability incurred by the partnership after the dissolution and before the rescission has become effective is determined as if dissolution had never occurred; and

(3) the rights of a third party arising out of conduct in reliance on the dissolution before the third party knew or had notice of the rescission may not be adversely affected.

### **Comment**

The Harmonization Project added this section, replacing UPA (1997) § 802(b) (permitting the partners to “waive the right to have the partnership’s business wound up and the partnership terminated” after which “the partnership resumes carrying on its business as if dissolution had never occurred”).

**Subsection (a)**—The first exclusion results inevitably from the effect of a statement of termination, Section 3-802(b)(2)(F) – *i.e.*, the partnership ceases to exist. A “dead” entity lacks both the capacity and power to bring itself back from the dead.

The second and third exclusions pertain to dissolutions effected by outsiders – *i.e.*, the court and the filing office.

**Subsections (b)(1)**—The requirement of unanimous consent protects any vested rights or reliance by partners. However, the partnership agreement may vary this provision.

**Subsection (c)(3)**—This paragraph protects third parties. *E.g.*, *Neurobehavioral Associates, P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 331 (Tex. App. 1999) (“If the Hospital had the right to terminate the Agreement when it did because the Association was then dissolved, then even though the Association can revoke articles of dissolution and have that relate back to the date of dissolution, it would be grossly unfair to let the Association assert its ex post facto change as a defense. Surely the Association would be estopped from doing so, having created the very conditions that gave the Hospital the correct impression that it was then dissolved.”).

### **SECTION 3-804. POWER TO BIND PARTNERSHIP AFTER DISSOLUTION.**

(a) A partnership is bound by a partner’s act after dissolution which:

(1) is appropriate for winding up the partnership business; or

(2) would have bound the partnership under Section 3-301 before dissolution if, at

the time the other party enters into the transaction, the other party does not know or have notice of the dissolution.

(b) A person dissociated as a partner binds a partnership through an act occurring after dissolution if:

(1) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not know or have notice of the dissociation and reasonably believes that the person is a partner; and

(2) the act:

(A) is appropriate for winding up the partnership's business; or

(B) would have bound the partnership under Section 3-301 before dissolution and at the time the other party enters into the transaction the other party does not know or have notice of the dissolution.

### Comment

This section provides the “power to bind” rules applicable once dissolution occurs. The section originated in UPA (1997), which significantly departed from the approach of UPA (1914). The Harmonization Project revised this section to conform to ULPA (2001). However, the revisions are essentially stylistic.

In general, this section parallels Section 3-702 (power to bind of a person dissociated as partner when dissolution does not result from the dissociation). However, one significant difference exists. Section 3-702(a)(2)(A) contains a provision analogous to a statute of repose. A person's power to bind the partnership terminates two years after the date of dissociation. Subsection (b) contains a comparable provision, but Subsection (a) does not.

**Subsections (a) and (b)**—Subsection (a) states the power-to-bind rules for persons still partners when dissolution occurs. Subsection (b) pertains to persons dissociated before dissolution, including a partner whose dissociation results in dissolution. *Compare* Section 3-804, *with* Section 3-802(c) (stating that as an *inter se* matter a person whose rightful dissociation results in dissolution may participate in winding up “as if still a partner.”).

**Subsection (a)(1)**—This paragraph states a rule of inherent agency power. *See*

RESTATEMENT (SECOND) OF AGENCY § 8A (defining “inherent agency power” as “the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent”). Thus, a partner might act without actual or apparent authority and still bind the partnership. The partnership agreement cannot change the stated rule because the rule pertains to the rights under this article of third parties. *See* Section 3-105(c)(17).

If a partner’s words or conduct trigger this paragraph, thereby binding the partnership, and the partner lacks the actual authority to do so, the partner breaches an agent’s duty to act within authority, and is liable to the partnership for any resulting damages. RESTATEMENT (THIRD) OF AGENCY § 8.09(1) (“An agent has a duty to take action only within the scope of the agent’s actual authority”). The partner might also be liable for breach of the partnership agreement.

**Subsection (a)(2)**—A person might have notice under Section 3-103(d)(2)(B)(i) (statement of dissolution) as well as under Section 3-103(b)(1) (reason to know).

**Subsection (b)**—This subsection deals with the post-dissolution power to bind of a person dissociated as a partner. For the most part: (i) Paragraph 1 replicates Section 3-702, pertaining to the pre-dissolution power to bind of a person dissociated as a partner; and (ii) Paragraph 2 replicates Subsection (a) of this section, which states the post-dissolution power to bind of a person is still a partner.

For a person dissociated as a partner to bind a dissolved partnership:

- the person’s dissociation must have:
  - been rightful; and
  - resulted in dissolution; and
- the person’s act must satisfy both Paragraphs 1 and 2.

**Subsection (b)(1)(B)**—A person might have notice under Section 3-103(d)(2)(B)(i) (statement of dissolution) as well as under Section 3-103(b)(1) (reason to know).

**Subsection (b)(2)(B)**—A person might have notice under Section 3-103(d)(2)(B)(i) (statement of dissolution) as well as under Section 3-103(b)(1) (reason to know).

## **SECTION 3-805. LIABILITY AFTER DISSOLUTION OF PARTNER AND PERSON DISSOCIATED AS PARTNER.**

(a) If a partner having knowledge of the dissolution causes a partnership to incur an obligation under Section 3-804(a) by an act that is not appropriate for winding up the partnership business, the partner is liable:

(1) to the partnership for any damage caused to the partnership arising from the

obligation; and

(2) if another partner or person dissociated as a partner is liable for the obligation, to that other partner or person for any damage caused to that other partner or person arising from the liability.

(b) Except as otherwise provided in subsection (c), if a person dissociated as a partner causes a partnership to incur an obligation under Section 3-804(b), the person is liable:

(1) to the partnership for any damage caused to the partnership arising from the obligation; and

(2) if a partner or another person dissociated as a partner is liable for the obligation, to the partner or other person for any damage caused to the partner or other person arising from the obligation.

(c) A person dissociated as a partner is not liable under subsection (b) if:

(1) Section 3-802(c) permits the person to participate in winding up; and

(2) the act that causes the partnership to be bound under Section 3-804(b) is appropriate for winding up the partnership's business.

### **Comment**

This section parallels Section 3-702. It is possible for more than one person to be liable under this section on account of the same partnership obligation. This article does not provide any rule for apportioning liability in that circumstance.

**Subsection (a)(2)**—If the partnership is not a limited liability partnership, the liability created by this paragraph includes liability under Sections 3-306(a) and 3-703(b). The paragraph also applies when a partner or person dissociated as a general partner suffers damage due to a contract of guaranty.

Other law determines liability (if any) to a person that is neither a partner nor dissociated as a partner.



**SECTION 3-806. DISPOSITION OF ASSETS IN WINDING UP; WHEN CONTRIBUTIONS REQUIRED.**

(a) In winding up its business, a partnership shall apply its assets, including the contributions required by this section, to discharge the partnership's obligations to creditors, including partners that are creditors.

(b) After a partnership complies with subsection (a), any surplus must be distributed in the following order, subject to any charging order in effect under Section 3-504:

(1) to each person owning a transferable interest that reflects contributions made and not previously returned, an amount equal to the value of the unreturned contributions; and

(2) among persons owning transferable interests in proportion to their respective rights to share in distributions immediately before the dissolution of the partnership.

(c) If a partnership's assets are insufficient to satisfy all its obligations under subsection (a), with respect to each unsatisfied obligation incurred when the partnership was not a limited liability partnership, the following rules apply:

(1) Each person that was a partner when the obligation was incurred and that has not been released from the obligation under Section 3-703(c) and (d) shall contribute to the partnership for the purpose of enabling the partnership to satisfy the obligation. The contribution due from each of those persons is in proportion to the right to receive distributions in the capacity of a partner in effect for each of those persons when the obligation was incurred.

(2) If a person does not contribute the full amount required under paragraph (1) with respect to an unsatisfied obligation of the partnership, the other persons required to contribute by paragraph (1) on account of the obligation shall contribute the additional amount necessary to discharge the obligation. The additional contribution due from each of those other

persons is in proportion to the right to receive distributions in the capacity of a partner in effect for each of those other persons when the obligation was incurred.

(3) If a person does not make the additional contribution required by paragraph (2), further additional contributions are determined and due in the same manner as provided in that paragraph.

(d) A person that makes an additional contribution under subsection (c)(2) or (3) may recover from any person whose failure to contribute under subsection (c)(1) or (2) necessitated the additional contribution. A person may not recover under this subsection more than the amount additionally contributed. A person's liability under this subsection may not exceed the amount the person failed to contribute.

(e) If a partnership does not have sufficient surplus to comply with subsection (b)(1), any surplus must be distributed among the owners of transferable interests in proportion to the value of the respective unreturned contributions.

(F) All distributions made under subsections (b) and (c) must be paid in money.

### Comment

**Subsection (a)**—This subsection is non-waivable as to creditors who are not partners. *See* Section 3-105(c)(17) (stating that the partnership agreement may not “restrict the rights under this [article] of a person other than a partner”). However, if a creditor is willing, a dissolved partnership may certainly make agreements with the creditor specifying the terms under which the partnership will “discharge its obligations” to the creditor. If under Section 3-306(a) one or more partners are also liable on a partnership obligation, any agreement between the partnership and the creditor should take in account Section 3-703(d).

**Subsection (b)**—For the most part, this subsection states default rules. For example, partnership agreements often provide for different distribution rights upon liquidation than during operations. However, distributions under this subsection (or otherwise under the partnership agreement) are subject to Section 3-504 (charging orders). As to the extent the partnership agreement can be amended to affect the distribution rights of persons already transferees, see Section 3-107(b).

**Subsection (c)**—This section applies obligation by obligation, because a person—*qua*

partner or person dissociated as a partner—is required to contribute to the partnership to satisfy a partnership obligation only if, when the obligation was incurred: (i) the person was a partner; and (ii) the partnership was not an LLP. *See* Section 3-306(b), (c). As for when a partnership obligation is incurred, see Section 3-306(b) and (c), comments.

The allocation of contribution obligations parallels the default rule stated in Section 3-401(a) (providing that, “except in the case of a limited liability partnership, [each partner] is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits”). The partnership agreement can change the allocation *inter se* partners and persons dissociated as partners but cannot prejudice the rights of non-partner creditors.

**EXAMPLE:** The A-B Partnership (the “Partnership”) owes Creditor \$150, an obligation incurred when Partners A and B were the only partners, sharing distributions equally, and the Partnership was not an LLP. The Partnership has no funds to pay Creditor. Although Subsection (c)(1) would require Partners A and B each to contribute equally (*i.e.*, \$75), the A-B Partnership Agreement provides that Partner A has the entire contribution obligation and Partner B has none. As between Partners A and B, Partner A is obligated to contribute \$150 and Partner B nothing. However, as to Creditor, Partner B still has a contribution obligation of \$75.

This formal distinction will have practical consequences only if A does not contribute the full \$150. Also, Creditor may have problems establishing standing. *Cf.* the comment to Section 3-407.

**Subsection (c)(2) and (3)**—These provisions are analogous to buy-sell provisions that: (i) provide that an owner’s effort to sell the ownership interest triggers an option to purchase allocated among all the other owners; (ii) make the option conditional on the entire interest being purchased; and (iii) provide for successive allocations to take up any previous allocations that were not unexercised.

**Subsection (e)**—If a partnership has been a limited liability partnership throughout the partnership’s existence, this subsection is consistent with this article’s approach to loss sharing. If a partnership has been a limited liability partnership during only part of the partnership’s existence, the issue of loss sharing upon dissolution: (i) can be exceedingly complicated, varying radically depending on the circumstances; (ii) is therefore not amenable to a statutory “gap filler”; and (iii) thus should always be addressed in the partnership agreement.

However, in case the partnership agreement does not address the issue, this article must provide a default rule. *See* the comment to Section 3-105(b) (“To the extent the partnership agreement does not determine an *inter se* matter, this article determines the matter.”). This subsection applies to fill the gap. This approach has the virtues of simplicity and certainty but in no way resembles what “typical” partners might agree if they were to consider the matter *ab initio*, especially if the partnership was never an LLP. *Cf.* Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 448 (1987) (“[T]he various norms established by the Act, applicable in the absence of agreements to the contrary, represent the supposed understandings partners most likely reach if they choose to bargain on the various issues.”).

**SECTION 3-807. KNOWN CLAIMS AGAINST DISSOLVED LIMITED  
LIABILITY PARTNERSHIP.**

(a) Except as otherwise provided in subsection (d), a dissolved limited liability partnership may give notice of a known claim under subsection (b), which has the effect provided in subsection (c).

(b) A dissolved limited liability partnership may in a record notify its known claimants of the dissolution. The notice must:

- (1) specify the information required to be included in a claim;
- (2) state that a claim must be in writing and provide a mailing address to which the claim is to be sent;
- (3) state the deadline for receipt of a claim, which may not be less than 120 days after the date the notice is received by the claimant;
- (4) state that the claim will be barred if not received by the deadline; and
- (5) unless the partnership has been throughout its existence a limited liability partnership, state that the barring of a claim against the partnership will also bar any corresponding claim against any partner or person dissociated as a partner which is based on Section 3-306.

(c) A claim against a dissolved limited liability partnership is barred if the requirements of subsection (b) are met and:

- (1) the claim is not received by the specified deadline; or
- (2) if the claim is timely received but rejected by the limited liability partnership:
  - (A) the partnership causes the claimant to receive a notice in a record stating that the claim is rejected and will be barred unless the claimant commences an action

against the partnership to enforce the claim not later than 90 days after the claimant receives the notice; and

(B) the claimant does not commence the required action not later than 90 days after the claimant receives the notice.

(d) This section does not apply to a claim based on an event occurring after the date of dissolution or a liability that on that date is contingent.

### **Comment**

**Source**—Added during the Harmonization Project, this section is derived almost verbatim from Model Business Corporation Act § 14.06.

**Subsection (b)(5)**—For additional information on when a claim against a partnership is barred, see Section 3-810, comment.

## **SECTION 3-808. OTHER CLAIMS AGAINST DISSOLVED LIMITED LIABILITY PARTNERSHIP.**

(a) A dissolved limited liability partnership may publish notice of its dissolution and request persons having claims against the partnership to present them in accordance with the notice.

(b) A notice under subsection (a) must:

(1) be published at least once in a newspaper of general circulation in the [county] in this state in which the dissolved limited liability partnership's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the partnership's registered agent is or was last located;

(2) describe the information required to be contained in a claim, state that the claim must be in writing, and provide a mailing address to which the claim is to be sent;

(3) state that a claim against the partnership is barred unless an action to enforce

the claim is commenced not later than three years after publication of the notice; and

(4) unless the partnership has been throughout its existence a limited liability partnership, state that the barring of a claim against the partnership will also bar any corresponding claim against any partner or person dissociated as a partner which is based on Section 3-306.

(c) If a dissolved limited liability partnership publishes a notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences an action to enforce the claim against the partnership not later than three years after the publication date of the notice:

(1) a claimant that did not receive notice in a record under Section 3-807;

(2) a claimant whose claim was timely sent to the partnership but not acted on;

and

(3) a claimant whose claim is contingent at, or based on an event occurring after, the date of dissolution.

(d) A claim not barred under this section or Section 3-807 may be enforced:

(1) against a dissolved limited liability partnership, to the extent of its undistributed assets;

(2) except as otherwise provided in Section 3-809, if assets of the partnership have been distributed after dissolution, against a partner or transferee to the extent of that person's proportionate share of the claim or of the partnership's assets distributed to the partner or transferee after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution; and

(3) against any person liable on the claim under Sections 3-306, 3-703, and 3-805.

### **Comment**

**Source**—Added during the Harmonization Project, this section is derived almost verbatim from Model Business Corporation Act § 14.07.

**Subsection (b)(4)**—For additional information on when a claim against a partnership is barred, see Section 3-810, comment

**Subsection (d)(2)**—Liability under this paragraph extends to those who have received distributions under a charging order. *See* the comment to Section 3-504(a) (explaining that the beneficiary of a charging order is a transferee). Unlike Section 3-407(c) (recapture of improper distributions), this paragraph contains no “knowledge” element.

**Subsection (d)(3)**—The referenced sections address the vicarious liability of partners and persons dissociated as partners for obligations of a partnership that is not an LLP.

### **SECTION 3-809. COURT PROCEEDINGS.**

(a) A dissolved limited liability partnership that has published a notice under Section 3-808 may file an application with [the appropriate court] in the [county] where the partnership’s principal office is located or, if the principal office is not located in this state, where the office of its registered agent is or was last located, for a determination of the amount and form of security to be provided for payment of claims that are reasonably expected to arise after the date of dissolution based on facts known to the partnership and:

(1) at the time of the application:

(A) are contingent; or

(B) have not been made known to the partnership; or

(2) are based on an event occurring after the date of dissolution.

(b) Security is not required for any claim that is or is reasonably anticipated to be barred under Section 3-807.

(c) Not later than 10 days after the filing of an application under subsection (a), the

dissolved limited liability partnership shall give notice of the proceeding to each claimant holding a contingent claim known to the partnership.

(d) In any proceeding under this section, the court may appoint a guardian ad litem to represent all claimants whose identities are unknown. The reasonable fees and expenses of the guardian, including all reasonable expert witness fees, must be paid by the dissolved limited liability partnership.

(e) A dissolved limited liability partnership that provides security in the amount and form ordered by the court under subsection (a) satisfies the partnership's obligations with respect to claims that are contingent, have not been made known to the partnership, or are based on an event occurring after the date of dissolution, and such claims may not be enforced against a partner or transferee on account of assets received in liquidation.

#### **Comment**

**Source**—Added during the Harmonization Project, this section is derived almost verbatim from Model Business Corporation Act § 14.08.

**SECTION 3-810. LIABILITY OF PARTNER AND PERSON DISSOCIATED AS PARTNER WHEN CLAIM AGAINST PARTNERSHIP BARRED.** If a claim against a dissolved partnership is barred under Section 3-807, 3-808, or 3-809, any corresponding claim under Section 3-306, 3-703, or 3-805 is also barred.

#### **Comment**

A partner's liability under Sections 3-306, 3-703 and 3-805 is vicarious liability—liability solely by status and solely for the “debts, obligations, and other liabilities of the partnership.” To the extent a claim pertaining to the underlying debt, obligation, or other liability is barred, a claim pertaining to the corresponding vicarious liability should likewise be barred.



## **[PART] 9**

### **LIMITED LIABILITY PARTNERSHIP**

#### **SECTION 3-901. STATEMENT OF QUALIFICATION.**

(a) A partnership may become a limited liability partnership pursuant to this section.

(b) The terms and conditions on which a partnership becomes a limited liability partnership must be approved by the affirmative vote or consent necessary to amend the partnership agreement except, in the case of a partnership agreement that expressly addresses obligations to contribute to the partnership, the affirmative vote or consent necessary to amend those provisions.

(c) After the approval required by subsection (b), a partnership may become a limited liability partnership by delivering to the [Secretary of State] for filing a statement of qualification. The statement must contain:

(1) the name of the partnership, which must comply with Sections 1-301, 1-302(c), and 3-902;

(2) the street and mailing addresses of the partnership's principal office and, if different, the street address of an office in this state, if any;

(3) the name and street and mailing addresses in this state of the partnership's registered agent; and

(4) a statement that the partnership elects to become a limited liability partnership.

(d) A partnership's status as a limited liability partnership remains effective, regardless of changes in the partnership, until it is canceled pursuant to subsection (f) or administratively revoked pursuant to Section 3-903.

(e) The status of a partnership as a limited liability partnership and the protection against

liability of its partners for the debts, obligations, or other liabilities of the partnership while it is a limited liability partnership is not affected by errors or later changes in the information required to be contained in the statement of qualification.

(f) A limited liability partnership may amend or cancel its statement of qualification by delivering to the [Secretary of State] for filing a statement of amendment or cancellation. The statement must be approved by the affirmative vote or consent of all the partners and state the name of the limited liability partnership and in the case of:

- (1) an amendment, state the text of the amendment; and
- (2) a cancellation, state that the statement of qualification is canceled.

### **Comment**

**Subsection (a)**—Every partnership governed by this article may become a limited liability partnership, and the necessary formalities are straightforward: approval of the decision by the partners and delivery to the filing office for filing of a simple statement of qualification. A partnership becomes a limited liability partnership when the filing office files the statement of qualification and the statement takes effect. For the consequences of LLP status, see Section 3-306(c), comment.

**Subsection (b)**—In the default mode, becoming a limited liability partnership requires the agreement of all partners, because in the default mode amending the partnership agreement requires the affirmative vote or consent of all partners, Section 3-401(k) (stating the voting/consent requirement to amend the partnership agreement). The unanimous vote/consent default rule reflects the significance of the transformation *inter se* the partners. See the comment to Section 3-306(c) (Effect of LLP Status on Relations Inter Se the Partners).

In the event a partnership agreement provides different quanta of consent for different matters, this subsection chooses (as a default rule) “the affirmative vote or consent necessary to amend those provisions” of “partnership agreement that expressly addresses obligations to contribute to the partnership.” This choice makes good sense, given the effect of LLP status on contribution obligations. See the comment to Section 3-306(c).

The requirements for filing documents with the filing office are in Part 2 of Article 1. See also Section 1-104 (Delivery of Record).

**Subsection (c)**—Although a statement of qualification does not create a new entity, Section 3-201(b), the requirements stated here are comparable to the requirements for a certificate of formation for a limited liability company, ULLCA (2006) (Last Amended 2013),

and a certificate of limited partnership, ULPA (2001) (Last Amended 2013). The liability shield—a privilege granted by state—justifies requiring an LLP to meet these requirements.

**Subsection (c)(3)**—The rules regarding registered agents are found in Part 4 of Article 1.

**Subsection (d)**—Under some early LLP statutes, an LLP’s failure to file an annual renewal ended LLP status and terminated the shield. This subsection eschews that draconian result. However, an LLP’s failure to file an annual/biennial report, Section 3-913, is grounds for administrative revocation. *See* Section 3-903(d); *see also* Section 3-306(c)(2) (stating that the liability shield continues despite dissolution).

Neither this subsection nor Section 3-306(c)(2) expressly addresses the effect of an LLP’s termination on the liability shield. However, neither logic nor policy supports the retroactive destruction of the shield.

**Subsection (f)**—The unanimity requirement for amending a statement of qualification is a default rule. The unanimity requirement for cancelling a statement of qualification is mandatory. Section 3-105(c)(13). The difference reflects the very different consequences of amendment and cancellation. Subsection (b) requires very little information in a statement of qualification and does not contemplate additional information. *Compare* Section 3-901(f), *with* Section 5-201(c) (authorizing a certificate of formation to include additional information) *and* Section 4-201(c) (same with respect to a certificate of limited partnership). Therefore, an amendment can do no substantial harm to any partner’s interest. In contrast, cancelling a statement of qualification makes every partner vicariously liable for all partnership obligations. *Compare* Section 3-901(f), *with* Section 3-105(c)(14) (stating that the partnership agreement may not “vary the right of a partner to approve a merger, interest exchange, conversion, or domestication” the result of which is to impose vicarious liability on the person for the obligations of the resulting entity).

**SECTION 3-902. NAME LIMITATIONS.** The name of a partnership that is not a limited liability partnership may not contain the phrase “Registered Limited Liability Partnership” or “Limited Liability Partnership” or the abbreviation “R.L.L.P.”, “L.L.P.”, “RLLP”, or “LLP”.

### **Comment**

This section supplements this Code’s primary provisions on the names of entities, which are found in Sections 1-301 and 1-302.

**SECTION 3-903. ADMINISTRATIVE REVOCATION OF STATEMENT OF QUALIFICATION.**

(a) The [Secretary of State] may commence a proceeding under subsection (b) to

revoke the statement of qualification of a limited liability partnership administratively if the partnership does not:

(1) pay any fee, tax, interest, or penalty required to be paid to the [Secretary of State] not later than [six months] after it is due;

(2) deliver [an annual] [a biennial] report to the [Secretary of State] not later than [six months] after it is due; or

(3) have a registered agent in this state for [60] consecutive days.

(b) If the [Secretary of State] determines that one or more grounds exist for administratively revoking a statement of qualification, the [Secretary of State] shall serve the partnership with notice in a record of the [Secretary of State's] determination.

(c) If a limited liability partnership, not later than [60] days after service of the notice under subsection (b), does not cure or demonstrate to the satisfaction of the [Secretary of State] the nonexistence of each ground determined by the [Secretary of State], the [Secretary of State] shall administratively revoke the statement of qualification by signing a statement of administrative revocation that recites the grounds for revocation and the effective date of the revocation. The [Secretary of State] shall file the statement and serve a copy on the partnership pursuant to Section 3-116.

(d) An administrative revocation under subsection (c) affects only a partnership's status as a limited liability partnership and is not an event causing dissolution of the partnership.

(e) The administrative revocation of a statement of qualification of a limited liability partnership does not terminate the authority of its registered agent.

### **Comment**

Many failures to comply with statutory requirements that may give rise to administrative revocation occur because of oversight or inadvertence and are usually

corrected promptly when brought to the LLP's attention. Subsections (b) and (c) therefore provide a mandatory notice by the filing office to each LLP whose statement of qualification is subject to administrative revocation and a sixty-day grace period following the notice before the statement of administrative revocation may be filed.

In most instances, the issue whether a statement of qualification is subject to administrative revocation will not be controverted. If an LLP's statement of qualification is administratively revoked, the statement is no longer in effect. However, the partnership may petition the filing office for reinstatement under Section 3-904 and, if reinstatement is denied, the company may appeal to the courts under Section 3-905.

As a practical matter, administrative revocation permits the filing office to clear the record of "dead wood" and free up names.

However, the consequences for the partners can be quite serious. The liability shield remains effective for debts, liabilities, and other obligations incurred before revocation but disappears as to those incurred subsequently. A reinstated statement of qualification has retroactive effect generally, but exceptions can exist with regard to partnership obligations incurred before reinstatement. *See* Section 3-904(d)(3). For a discussion of when a partnership obligation is incurred, see the comment to Section 3-304(c) (The Temporal Nexus – When Claim Incurred).

**Subsection (a)(2)**—A limited liability partnership is required to file an annual/biennial report under Section 1-213.

**Subsection (d)**—This rule follows from Section 3-201(b) ("A partnership is the same entity regardless of whether the partnership has a statement of qualification in effect under Section 3-901.").

#### **SECTION 3-904. REINSTATEMENT.**

(a) A partnership whose statement of qualification has been revoked administratively under Section 3-903 may apply to the [Secretary of State] for reinstatement of the statement of qualification [not later than [two] years after the effective date of the revocation]. The application must state:

(1) the name of the partnership at the time of the administrative revocation of its statement of qualification and, if needed, a different name that satisfies Section 3-902;

(2) the address of the principal office of the partnership and the name and street and mailing addresses of its registered agent;

(3) the effective date of administrative revocation of the partnership's statement of qualification; and

(4) that the grounds for revocation did not exist or have been cured.

(b) To have its statement of qualification reinstated, a partnership must pay all fees, taxes, interest, and penalties that were due to the [Secretary of State] at the time of the administrative revocation and all fees, taxes, interest, and penalties that would have been due to the [Secretary of State] while the partnership's statement of qualification was revoked administratively.

(c) If the [Secretary of State] determines that an application under subsection (a) contains the required information, is satisfied that the information is correct, and determines that all payments required to be made to the [Secretary of State] by subsection (b) have been made, the [Secretary of State] shall:

(1) cancel the statement of revocation and prepare a statement of reinstatement that states the [Secretary of State's] determination and the effective date of reinstatement; and

(2) file the statement of reinstatement and serve a copy on the partnership.

(d) When reinstatement under this section has become effective, the following rules apply:

(1) The reinstatement relates back to and takes effect as of the effective date of the administrative revocation.

(2) The partnership's status as a limited liability partnership continues as if the revocation had not occurred.

(3) The rights of a person arising out of an act or omission in reliance on the revocation before the person knew or had notice of the reinstatement are not affected.

### Comment

**Subsection (a)(1)**—This provision will apply if, before the statement of qualification is reinstated, another entity has taken the company's name. *See* Section 3-902(c)(2).

**Subsection (d)(3)**—This paragraph provides an exception to the retroactive effect provided by Paragraphs (1) and (2). The greatest risk resulting from the exception is a creditor's claim of having entered into a contract with the partnership, knowing of the revocation and relying on the vicarious liability of each partner. The exception could also preclude a reinstated LLP's use of its own name. *See* Section 3-902(c)(2) (indirectly permitting an LLP to use the name of another partnership whose statement of qualification has been administratively revoked). Comparable provisions exist in other uniform acts pertaining to entities. *E.g.*, Section 5-112(b)(1).

### **SECTION 3-905. JUDICIAL REVIEW OF DENIAL OF REINSTATEMENT.**

(a) If the [Secretary of State] denies a partnership's application for reinstatement following administrative revocation of the partnership's statement of qualification, the [Secretary of State] shall serve the partnership with a notice in a record that explains the reasons for the denial.

(b) A partnership may seek judicial review of denial of reinstatement in [the appropriate court] not later than [30] days after service of the notice of denial.

### Comment

Because the grounds for administrative revocation under Section 3-904 are limited and straight forward, it is unlikely there will be a dispute about whether a partnership has corrected the reasons for the administrative revocation of the partnership's statement of qualification. But in the event a partnership disagrees with a determination by the filing office to deny the partnership's application for reinstatement, this section gives the partnership a limited right to seek judicial review of the denial of reinstatement.

**ARTICLE 4**  
**LIMITED PARTNERSHIPS**

**[PART] 1**

**GENERAL PROVISIONS**

**SECTION 4-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Limited Partnerships.

**Comment**

This article replaces a state’s current limited partnership statute, whether or not that statute is based on the Uniform Limited Partnership Act (1916), Revised Uniform Limited Partnership Act (1976/1985) or the Uniform Limited Partnership Act (2001). Section 4-112 contains transition provisions for the applicability of this article to limited partnerships formed before the effective date of the Code. *See* Section 1-708.

**SECTION 4-102. DEFINITIONS.**

(a) In this [article]:

(1) “Certificate of limited partnership” means the certificate required by Section 4-201. The term includes the certificate as amended or restated.

(2) “Contribution”, except in the phrase “right of contribution”, means property or a benefit described in Section 4-401 which is provided by a person to a limited partnership to become a partner or in the person’s capacity as a partner.

(3) “Distribution” means a transfer of money or other property from a limited partnership to a person on account of a transferable interest or in the person’s capacity as a partner. The term:

(A) includes:

(i) a redemption or other purchase by a limited partnership of a transferable interest; and



(ii) a transfer to a partner in return for the partner's relinquishment of any right to participate as a partner in the management or conduct of the partnership's activities and affairs or to have access to records or other information concerning the partnership's activities and affairs; and

(B) does not include amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.

(4) "General partner" means a person that:

(A) has become a general partner under Section 4-401 or was a general partner in a partnership when the partnership became subject to this [article] under Section 4-112; and

(B) has not dissociated as a general partner under Section 4-603.

(5) "Limited liability limited partnership" means a limited partnership whose certificate of limited partnership states that the partnership is a limited liability limited partnership.

(6) "Limited partner" means a person that:

(A) has become a limited partner under Section 4-301 or was a limited partner in a limited partnership when the partnership became subject to this [article] under Section 4-112; and

(B) has not dissociated under Section 4-601.

(7) "Limited partnership" means an entity formed under this [article] or which becomes subject to this [article] under [Article] 2 or Section 4-112. The term includes a limited liability limited partnership.

(8) “Partner” means a limited partner or general partner.

(9) “Partnership agreement” means the agreement, whether or not referred to as a partnership agreement and whether oral, implied, in a record, or in any combination thereof, of all the partners of a limited partnership concerning the matters described in Section 4-105(a). The term includes the agreement as amended or restated.

(10) “Required information” means the information that a limited partnership is required to maintain under Section 4-108.

(11) “Transferable interest” means the right, as initially owned by a person in the person’s capacity as a partner, to receive distributions from a limited partnership, whether or not the person remains a partner or continues to own any part of the right. The term applies to any fraction of the interest, by whomever owned.

(12) “Transferee” means a person to which all or part of a transferable interest has been transferred, whether or not the transferor is a partner. The term includes a person that owns a transferable interest under Section 4-602(a)(3) or 4-605(a)(4).

(b) The following definitions outside this [article] apply to this [article]:

(1) “Debtor in bankruptcy” – Section 1-102(6).

(2) “Foreign” – Section 1-102(14).

(3) “Jurisdiction” – Section 1-102(21).

(4) “Jurisdiction of formation” – Section 1-102(22).

(5) “Person” – Section 1-102(34).

(6) “Principal office” – Section 1-102(35).

(7) “Property” – Section 1-102(38).

(8) “Receipt” – Section 1-102(4)).

(9) “Record” – Section 1-102(41).

(10) “Registered agent” – Section 1-102(43).

(11) “Sign” – Section 1-102(44).

(12) “State” – Section 1-102(45).

(13) “Transfer” – Section 1-102(47).

### Comment

**Subsection (a)** – Subsection (a) contains definitions for terms used throughout this article.

**Subsection (b)** – Subsection (b) contains a list of definitions in Article 1 that are applicable to limited partnerships.

**“Certificate of limited partnership” [(a)(1)]** – Until the 1985 amendments to the Revised Uniform Limited Partnership Act (1976), the certificate of limited partnership contained significant information about the limited partnership and the relationship among the partners. Consistent with the 1985 amendments and ULPA (2001), under this article the certificate: (i) merely reflects the existence of a limited partnership (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. For the relationship between the certificate of limited partnership and the partnership agreement, see Section 4-107(d).

**“Contribution” [(a)(2)]** – This definition serves to distinguish capital contributions from other circumstances under which a partner or would-be partner might provide benefits to a limited partnership (*e.g.*, providing services to the partnership as an employee or independent contractor, leasing property to the partnership).

This definition also distinguishes “contributions” from capital raised from transferees who invest; to be a contribution, the property or benefit must be “provided by a person ... to become a partner or in the person’s capacity as a partner.” This distinction is ubiquitous in the law of unincorporated business organizations. *See, e.g.*, N.Y.LTD.LIAB.CO.LAW § 102(f) (McKinney 2013) (“‘Contribution’ means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to render services that a member contributes to a limited liability company in his or her capacity as a member.”).

In contrast, partnership agreements sometimes provide for contributions from transferees. In such circumstances, the default rules for liquidating distributions should be altered accordingly. *See* Section 4-810(b)(1) (referring to distributions to be made “to each person owning a transferable interest that reflects *contributions* made and not previously returned”) (emphasis added).

**“Distribution” [(a)(3)(A) – redemptions included]** – This provision specifically refers to transactions between a limited partnership and one of its partners, which in the corporate context would be labeled a “redemption.” This paragraph has subparts because ownership interests in a partnership are conceptually bifurcated into economic rights (“transferable interests”) and governance and information rights.

Under Section 4-503(a), “[a]ny distribution made by a limited partnership before its dissolution and winding up must be shared among the partners on the basis of the value, as stated in the required information when the limited partnership decides to make the distribution, of the contributions the limited partnership has received from each partner....” Since a redemption is a distribution, absent authorization in the partnership agreement a limited partnership may not redeem the interest of one partner or transferee without redeeming (or at least offering to redeem) the interests of all other partners and transferees to a comparable extent.

The law of close corporations has flirted with a similar notion. *See, e.g., Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 598, 328 N.E.2d 505, 518 (1975) (stating, with regard to closely held corporations, “if the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price”); *Toner v. Baltimore Envelope Co.*, 304 Md. 256, 273, 498 A.2d 642, 650 (1985) (rejecting the “per se breach of duty” approach); *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 850, 353 N.E.2d 657, 663 (1976) (stating that “untempered application of the strict good faith standard enunciated in *Donahue* to ... will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned”).

A partnership agreement can override Section 4-503(a)’s proportional treatment requirement without specifically mentioning redemptions.

EXAMPLE: A limited partnership agreement: (i) includes a list (the “protected list”) of decisions or actions that may be taken only with the consent of all the general partners and 2/3 of the interests owned by the limited partners; and (ii) provides that all other decisions and acts may be taken as the general partners determine. The protected list does not include redemptions. The partnership agreement overrides Section 4-503(a)’s proportional treatment requirement.

**Subsection (a)(3)(B) [exclusion]** – This exclusion affects the reach of: (i) Section 4-505’s clawback provisions; and (ii) the charging order remedy under Section 4-703. The effect on the clawback provision reflects the law in several states, *see, e.g.,* DEL. CODE ANN. tit. 6 § 17-607(a) (2012) and V.A. CODE § 153.210(b) (2012), and makes sense conceptually and as a matter of policy. *See In re Tri-River Trading, LLC*, 329 B.R. 252, 266 (B.A.P. 8th Cir. 2005), *aff’d*, 452 F.3d 756 (8th Cir. 2006) (“We know of no principle of law which suggests that a manager of a company is required to give up agreed upon salary to pay creditors when business turns bad.”).

Affecting the charging order remedy is novel. For further explanation, see Section 4-703(a), comment.

**“General partner” [(a)(4)]** – A partnership agreement may vary Section 4-401 and provide a process or mechanism for becoming a general partner that is different from or additional to the rules stated in that section. *See* Section 4-401(b)(1). For the purposes of this definition, a person who becomes a general partner pursuant to a provision of the partnership agreement “become[s] a general partner under Section 4-401.” After a person has been dissociated as a general partner, Section 4-603, the term “general partner” continues to apply to the person’s conduct while a general partner. *See* Section 4-605(b).

**“Limited liability limited partnership” [(a)(5)]** – Typically, a general partnership becomes a limited liability partnership when the filing office files a statement of qualification submitted by the partnership. In contrast, LLLP status results from a statement in a limited partnership’s certificate of limited partnership. Section 4-201(b)(5) requires a limited partnership’s certificate of limited partnership to state “whether the limited partnership is a limited liability limited partnership.”

**“Limited partner” [(a)(6)]** – This definition parallels the definition of “general partner” and the comment to Paragraph 7 applies here as well.

**“Limited partnership” [(a)(7)]** – This definition makes no reference to a limited partnership having partners upon formation, but Section 4-201(d) does.

**“Partnership agreement” [(a)(9)]** – This definition must be read in conjunction with Sections 4-105 through 4-107, which further describe the partnership agreement. In particular, although this definition refers to “the agreement ... of all the partners,” the limited partnership itself is bound by and may enforce the agreement. Section 4-106(a).

A partnership agreement is a contract, and therefore all statutory language pertaining to the partnership agreement must be understood in the context of the law of contracts.

The definition in Paragraph 14 is very broad and recognizes a wide scope of authority for the partnership agreement: “the matters described in Section 4-105(a).” Those matters include not only all relations *inter se* the partners and the partnership but also “the activities and affairs of the partnership and the conduct of those activities and affairs.” Section 4-105(a)(2). Moreover, the definition puts no limits on the form of the partnership agreement. To the contrary, the definition contains the phrase “whether oral, implied, in a record, or in any combination thereof.”

Unless the partnership agreement itself provides otherwise:

- a partnership agreement may comprise a number of separate documents (or records), however denominated; and
- subject to Section 4-106(b) (deeming new partners to assent to the then-existing partnership agreement), a document, record, understanding, etc. can be part of the partnership agreement only with the assent of all persons then partners.

An agreement among less than all partners might well be enforceable among those partners as parties, but would not be part of the partnership agreement. However, under Section

4-105(a)(3), an amendment to a partnership agreement can be made with less than unanimous consent if the partnership agreement itself so provides.

An agreement to form a limited partnership is not itself a partnership agreement. The term “partnership agreement” presupposes “partners,” and a person cannot be a partner in a partnership before the partnership exists. However, as soon as a limited partnership comes into existence, it perforce has a partnership agreement. For example, suppose: (i) two persons, Gamma and Lambda, orally and informally agree to join their activities through a limited partnership, in which Gamma will be the general partner and Lambda the limited partner; (ii) an appropriate certification of limited partnership is delivered to the filing office, which files the certificate; (iii) Gamma and Lambda become respectively the general and limited partner; and (iv) the limited partnership is thus formed under Section 4-201(d). A partnership agreement exists. In the words of Paragraph 14 “all the partners” have agreed who the partners are, that, as “all the partners” they will conduct a business, and that Gamma will be the managing partner and Lambda will be more or less passive. That agreement – no matter how informal or rudimentary – is an agreement “concerning the matters described in Section 4-105(a).” To the extent the agreement does not provide the *inter se* “rules of the game,” the “default rules” of this article “fill in the gaps.” Section 4-105(b).

This article states no rule as to whether the statute of frauds applies to partnership agreements. Case law suggests that the answer is yes:

Partnership agreements, like other contracts, are subject to the Statute of Frauds. A contract of partnership for a term exceeding one year is within the Statute of Frauds and is void unless it is in writing [and signed by the party to be bound]; however, a contract establishing a partnership terminable at the will of any partner is generally held to be capable of performance by its terms within one year of its making and, therefore, to be outside the Statute of Frauds.

*Abbott v. Hurst*, 643 So.2d 589, 592 (Ala. 1994) (citations omitted). *See also Chase Pratt, LLC v. Aetna Life Ins. Co.*, CV 960560740S, 1999 WL 229214 at \*4 (Conn. Super. Ct. Mar. 26, 1999) (recognizing that the one-year provision applies to limited partnership agreements but holding the provision inapplicable to a stated “99-year term,” because the agreement permitted dissolution at any time “earlier by mutual consent of the Partners”) (quoting the partnership agreement).

Likewise, the land provision of the statute of frauds:

applies to an oral contract to transfer or convey partnership real property, and the interest of the other partners therein, to one partner as an individual, as well as to a parol contract by one of the parties to convey certain land owned by him individually to the partnership, or to another partner, or to put it into the partnership stock.

*Froiseth v. Nowlin*, 156 Wash. 314, 316, 287 P. 55, 56 (Wash. 1930) (quoting 27 C.J.S. § 220). *See also E. Piedmont 120 Associates, L.P. v. Sheppard*, 209 Ga. App. 664, 665, 434 S.E.2d 101, 102 (Ga. Ct. App. 1993) (same, stating that “the fact that promises covered by the Statute of Frauds are made in the context of a partnership or joint venture agreement does not render the

statute inapplicable”); *Filippi v. Filippi*, 818 A.2d 608, 618 (R.I. 2003) (applying the statute of frauds to an alleged oral agreement to transfer land owned by a limited partnership to one of its partners).

In contrast, the land provision does not apply to a partner’s interest in a partnership, no matter how much the partnership owns or deals in real property. Interests in a partnership are personal property and reflect no direct interest in the entity’s assets. See Sections 4-102(24) and 4-701. Thus, the real property issues pertaining to a partnership ownership of land do not “flow through” to the partners and partnership interests. See, e.g., *Wooten v. Marshall*, 153 F. Supp. 759, 763-764 (S.D.N.Y. 1957) (involving an “oral agreement for a joint venture concerning the purchase, exploitation and eventual disposition of this 160 acre tract” and stating “[t]he real property acquired and dealt with by the venturers takes on the character of personal property as between the partners in the enterprise, and hence is not covered by [the Statute of Frauds]”). See also *Wade v. DeHart*, 26 Ohio N.P. 560 (Ohio Com. Pl. 1926), *aff’d sub nom.*, *Wade v. De Hart*, 26 Ohio App. 177, 159 N.E. 838 (Ohio Ct. App. 1927) (same).

On the question of how far a written (or “in a record”) partnership agreement can go to prevent oral or implied-in-fact terms, see Section 4-105(a)(3), comment. For the effect of a pre-formation agreement, see Section 4-106(c).

**“Transferable interest” [(a)(11)]** – Absent a contrary provision in the partnership agreement or the consent of the partners, a “transferable interest” is the only interest in a limited partnership which can be transferred. See Section 4-702.

This article defines “[t]ransferable interest” as an interest “initially owned by a person in the person’s capacity as a partner,” because this article does not contemplate a limited partnership directly creating interests that comprise only economic rights. See Sections 4-301 and 4-401 (addressing how a person becomes a limited and general partner) and 4-702 (addressing how a person becomes a transferee).

**“Transferee” [(a)(12)]** – This definition should be read in light of Sections 4-602(a)(3) and 4-605(a)(4), which subject to limited exceptions provide that “any transferable interest owned by [a general or limited partner] in the person’s capacity as a [general or limited] partner immediately before dissociation is owned by the person solely as a transferee.”

### **SECTION 4-103. KNOWLEDGE; NOTICE.**

(a) A person knows a fact if the person:

- (1) has actual knowledge of it; or
- (2) is deemed to know it under law other than this [Code].

(b) A person has notice of a fact if the person:

- (1) has reason to know the fact from all the facts known to the person at the time

in question; or

(2) is deemed to have notice of the fact under subsection (c) or (d).

(c) A certificate of limited partnership on file in the office of the [Secretary of State] is notice that the partnership is a limited partnership and the persons designated in the certificate as general partners are general partners. Except as otherwise provided in subsection (d), the certificate is not notice of any other fact.

(d) A person not a partner is deemed to have notice of:

(1) a person's dissociation as a general partner 90 days after an amendment to the certificate of limited partnership which states that the other person has dissociated becomes effective or 90 days after a statement of dissociation pertaining to the other person becomes effective, whichever occurs first;

(2) a limited partnership's:

(A) dissolution 90 days after an amendment to the certificate of limited partnership stating that the limited partnership is dissolved becomes effective;

(B) termination 90 days after a statement of termination under Section 4-802(b)(2)(F) becomes effective; and

(C) participation in a merger, interest exchange, conversion, or domestication, 90 days after articles of merger, interest exchange, conversion, or domestication under [Article] 2 become effective.

(e) Subject to Section 1-212, a person notifies another person of a fact by taking steps reasonably required to inform the other person in ordinary course, whether or not those steps cause the other person to know the fact.

(f) A general partner's knowledge or notice of a fact relating to the limited partnership is



effective immediately as knowledge of or notice to the partnership, except in the case of a fraud on the partnership committed by or with the consent of the general partner. A limited partner's knowledge or notice of a fact relating to the partnership is not effective as knowledge of or notice to the partnership.

### Comment

Three aspects of this section warrant particular note. First, this section is substantially slimmer than the corresponding provisions of previous uniform acts pertaining to business organizations: UPA (1997), ULLCA (1996), and ULPA (2001). Each of those acts borrowed heavily from the comparable provision of the Uniform Commercial Code. This article relies instead on generally applicable principles of agency law, *see* Section 1-702 (Supplemental Principles of Law), although Subsection (f) does provide a rule for attributing to a partnership knowledge or notice possessed by a general partner.

Second, the section contains no generally applicable provisions determining when an organization is charged with knowledge or notice, because those imputation rules: (i) comprise core topics within the law of agency; (ii) are very complicated; (iii) should not have any different content under this article than in other circumstances; and (iv) are the subject of considerable attention in the RESTATEMENT (THIRD) OF AGENCY (2006).

Third, this article does not define “notice” to include “knowledge.” Although conceptualizing the latter as giving the former makes logical sense and has a long pedigree, that conceptualization is counter-intuitive for the uninitiated. In ordinary usage, notice has a meaning separate from knowledge. This article follows ordinary usage and therefore contains some references to “knowledge or notice.”

**Subsection (a)(2)** – In this context, the most important source of “law other than this [Code]” is the common law of agency.

**Subsection (b)(1)** – The “facts known to the person at the time in question” include facts the person is deemed to know under Subsection (a)(2).

**Subsection (c)** – As for the significance of constructive notice “that the partnership is a limited partnership,” *see Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 1003 (Colo. 1998) (interpreting a comparable provision of the Colorado LLC statute and holding the provision ineffective to change common law agency principles, including the rules relating to the liability of an agent that transacts business for an undisclosed principal).

As for constructive notice that “the persons designated in the certificate as general partners are general partners,” Section 4-201(b)(4) requires the initial certificate of limited partnership to name each general partner, and Section 4-202(d) requires a limited partnership to promptly amend its certificate of limited partnership to reflect any change in the identity of its general partners. Nonetheless, it will be possible, albeit improper, for a person to be designated

in the certificate of limited partnership as a general partner without having become a general partner as contemplated by Section 4-401. Likewise, it will be possible for a person to have become a general partner under Section 4-401 without being designated as a general partner in the certificate of limited partnership. According to the last clause of this subsection, the fact that a person is not listed in the certificate as a general partner is not notice that the person is not a general partner. For further discussion of this point, see the comment to Section 4-401.

If the partnership agreement and the public record are inconsistent, the partnership agreement prevails as to *inter se* matters and the record prevails as to third parties who have reasonably relied on it. Section 4-107(d). *See also* Sections 4-202(d) (requiring the limited partnership to amend its certificate of limited partnership to keep accurate the listing of general partners), 4-202(e) (requiring a general partner to take corrective action when the general partner knows that the certificate of limited partnership contains false information), and 4-205 (imposing liability for false information in, *inter alia*, the certificate of limited partnership).

**Subsection (d)** – This subsection provides constructive notice of facts stated in specified filed public records. The subsection works in conjunction with other sections of this article to curtail the power to bind and personal liability of general partners and persons dissociated as general partners. *See* Sections 4-402, 4-606, 4-607, 4-804, and 4-805. The constructive notice begins ninety days after the effective date of the filed record. For the rules on delayed effective dates, see Section 1-203.

The 90-day delay applies only to the constructive notice and not to the event described in the filed record.

**EXAMPLE:** On March 15, X dissociates as a general partner from XYZ Limited Partnership by giving notice to XYZ. *See* Section 4-603(1). On March 20, XYZ amends its certificate of limited partnership to remove X’s name from the list of general partners. *See* Section 4-202(d)(2).

X’s dissociation is effective March 15. If on March 16 X purports to be a general partner of XYZ and under Section 4-606(a) binds XYZ to some obligation, X will be liable under Section 4-606(b) as a “person dissociated as a general partner.”

On June 19 (90 days after March 20), the world has constructive notice of X’s dissociation as a general partner. Beginning on that date, X will lack the power to bind XYZ. *See* Section 4-606(a)(2)(B) (providing that a person dissociated as a general partner can bind the limited partnership only if, *inter alia*, “at the time the other party enters into the transaction . . . the other party does not know or have notice of the dissociation”).

Constructive notice under this subsection applies to partners and transferees as well as other persons.

**Subsection (e)** – If a person “notifies” another person of a fact, the other person has “reason to know” the fact and therefore has notice under Subsection (b)(1). However, a person

can have “notice” of a fact without having been “notifie[d]” of the fact.

Section 1-212 pertains to delivery of records *by* the filing office.

**Subsection (f)** – This subsection states the rule for imputing a partner’s knowledge or notice to the partnership. Under this subsection and Section 4-302, information possessed by a person that is only a limited partner is not attributable to the limited partnership. However, information possessed by a person that is both a general partner and a limited partner is attributable to the limited partnership. *See* Section 4-109 (Dual Capacity). For a discussion of agency law principles analogous to “fraud on the partnership,” see RESTATEMENT (THIRD) OF AGENCY § 5.04 cmt. b (2006).

**SECTION 4-104. GOVERNING LAW.** The law of this state governs:

- (1) the internal affairs of a limited partnership; and
- (2) the liability of a partner as partner for a debt, obligation, or other liability of a limited partnership.

### Comment

**Paragraph (1)** – Like any other legal concept, “internal affairs” may be indeterminate at its edges. However, the concept certainly includes interpretation and enforcement of the partnership agreement, relations among the partners as partners, and relations between the limited partnership and its partners. *Compare* Section 4-104, *with* 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”).

“Internal affairs” do not encompass the power *vel non* of a person to bind a limited partnership. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 292(2) (1971) (“The principal will be held bound by the agent’s action if he would so be bound under the local law of the state where the agent dealt with the third person, provided at least that the principal had authorized the agent to act on his behalf in that state or had led the third person reasonably to believe that the agent had such authority.”); *Id.* § 295(1) (“Whether a partnership is bound by action taken on its behalf by an agent in dealing with a third person is determined by the local law of the state selected by application of the rule of § 292.”); RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 345 cmt. c (1934) (Law Governing Effect of Act of Agent or Partner) (“If ... the principal or partner sends the agent or other partner into a state to act on his behalf, he assumes the risk of liability not only for authorized but for unauthorized conduct of the agent or partner in accordance with the law of that state.”). *See also Farm & Ranch Services, Ltd. v. LT Farm & Ranch, LLC*, 779 F. Supp.2d 949, 960 (S.D. Iowa 2011).

The partnership agreement cannot alter this section. *See* Section 4-105(c)(1). However, partnership agreement may lawfully incorporate by reference the provisions of another state’s

limited partnership statute. If done correctly, this incorporation makes the foreign statutory language part of the partnership agreement, and the incorporated terms (together with the rest of the partnership agreement) then govern the partners (and those claiming through the partners) to the extent not prohibited by this article. *See* Section 4-105. This approach: (i) does *not* switch the limited partnership's governing law to that of another state; (ii) instead takes the provisions of another state's law and incorporates them by reference into the contract among the partners; (iii) raises complex drafting issues – *e.g.*, how to address subsequent changes to the incorporated law (whether occurring by statutory amendment or court decision); and (iv) thus is rarely, if ever, a good idea.

**Paragraph (2)** – This paragraph obviously encompasses Sections 4-303 (the liability shield for limited partners) and 4-404(c) (the shield for general partners in a limited liability limited partnership), but does not encompass a claim that a partner is liable to a third party for: (i) having purported to bind a limited partnership to the third party; or (ii) having committed a tort against the third party while acting on a limited partnership's behalf or in the course of the partnership's business. That liability is not by status (*i.e.*, not partner as a partner) but rather results from function or conduct. *Cf.* Section 4-302(b) (stating that, although this article does not make a limited partner as limited partner the agent of a limited partnership, other law may make a limited partnership liable for the conduct of a limited partner).

“Internal affairs” and the “liability of a partner as a partner” are mentioned separately because it can be argued that the liability of partners to third parties is not an internal affair. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 307 (1971) (treating shareholders' liability separately from the internal affairs doctrine). A few cases subsume owner/manager liability into internal affairs, but many do not. *See, e.g., Kalb, Voorhis & Co. v. American Fin. Corp.*, 8 F.3d 130, 132 (2d Cir. 1993) (holding that the corporation's “primary purpose is to insulate shareholders from legal liability” and therefore “the state of incorporation has the greater interest in determining when and if that insulation is to be stripped away”) (quoting *Soviet Pan Am Travel Effort v. Travel Comm., Inc.*, 756 F.Supp. 126, 131 (S.D.N.Y. 1991) (internal quotation marks omitted)).

In any event, most (if not all) limited partnership statutes follow the rule stated in this paragraph. *See* ULPA (1975/1986) § 901 (stating that “the laws of the state under which a foreign limited partnership is organized govern its organization and internal affairs and the liability of its limited partners”); and ULPA (2001) § 901 (same but as to all partners).

Moreover, “[t]he general rule [from the case law] is that a plaintiff's alter ego theory is governed by the law of the state in which the business at issue is organized.” *Rual Trade Ltd. v. Viva Trade LLC*, 549 F. Supp. 2d 1067, 1077 (E.D. Wis. 2008). *See also, e.g., In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747, 787 (Bankr. W.D. La. 2013) (stating both conceptual and policy rationales for choosing the law of the state of formation); *In re Saba Enters.*, 421 B.R. 626, 648-51 (Bankr. S.D.N.Y. 2009) (examining the issue in detail and applying the state of formation rule).

**SECTION 4-105. PARTNERSHIP AGREEMENT; SCOPE, FUNCTION, AND LIMITATIONS.**

(a) Except as otherwise provided in subsections (c) and (d), the partnership agreement governs:

(1) relations among the partners as partners and between the partners and the limited partnership;

(2) the activities and affairs of the partnership and the conduct of those activities and affairs; and

(3) the means and conditions for amending the partnership agreement.

(b) To the extent the partnership agreement does not provide for a matter described in subsection (a), this [article] governs the matter.

(c) A partnership agreement may not:

(1) vary the law applicable under Section 4-104;

(2) vary a limited partnership's capacity under Section 4-111 to sue and be sued in its own name;

(3) vary any requirement, procedure, or other provision of this [Code] pertaining to:

(A) registered agents; or

(B) the [Secretary of State], including provisions pertaining to records authorized or required to be delivered to the [Secretary of State] for filing under this [Code];

(4) vary the provisions of Section 1-210;

(5) vary the right of a general partner under Section 4-406(b)(2) to vote on or consent to an amendment to the certificate of limited partnership which deletes a statement that

the limited partnership is a limited liability limited partnership;

(6) alter or eliminate the duty of loyalty or the duty of care except as otherwise provided in subsection (d);

(7) eliminate the contractual obligation of good faith and fair dealing under Sections 4-305(a) and 4-409(d), but the partnership agreement may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured;

(8) relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law;

(9) vary the information required under Section 4-108 or unreasonably restrict the duties and rights under Section 4-304 or 4-407, but the partnership agreement may impose reasonable restrictions on the availability and use of information obtained under those sections and may define appropriate remedies, including liquidated damages, for a breach of any reasonable restriction on use;

(10) vary the grounds for expulsion specified in Section 4-603(5)(B);

(11) vary the power of a person to dissociate as a general partner under Section 4-604(a), except to require that the notice under Section 4-603(1) be in a record;

(12) vary the causes of dissolution specified in Section 4-801(a)(6);

(13) vary the requirement to wind up the partnership's activities and affairs as specified in Section 4-802(a), (b)(1), and (d);

(14) unreasonably restrict the right of a partner to maintain an action under [Part] 9;

(15) vary the provisions of Section 4-905, but the partnership agreement may provide that the partnership may not have a special litigation committee;

(16) vary the right of a partner to approve a merger, interest exchange, conversion, or domestication under Section 2-203(a)(2), 2-303(a)(2), 2-403(a)(2), or 2-503(a)(2);

(17) vary the required contents of a plan of merger under Section 2-202(a), plan of interest exchange under Section 2-302(a), plan of conversion under Section 2-402(a), or plan of domestication under Section 2-502(a); or

(18) except as otherwise provided in Sections 4-106 and 4-107(b), restrict the rights under this [Code] of a person other than a partner.

(d) Subject to subsection (c)(8), without limiting other terms that may be included in a partnership agreement, the following rules apply:

(1) The partnership agreement may:

(A) specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts; and

(B) alter the prohibition in Section 4-504(a)(2) so that the prohibition requires only that the partnership's total assets not be less than the sum of its total liabilities.

(2) If not manifestly unreasonable, the partnership agreement may:

(A) alter or eliminate the aspects of the duty of loyalty stated in Section 4-409(b);

(B) identify specific types or categories of activities that do not violate the duty of loyalty;

(C) alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law; and

(D) alter or eliminate any other fiduciary duty.

(e) The court shall decide as a matter of law whether a term of a partnership agreement is manifestly unreasonable under subsection (c)(7) or (d)(2). The court:

(1) shall make its determination as of the time the challenged term became part of the partnership agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes, activities, and affairs of the limited partnership, it is readily apparent that:

(A) the objective of the term is unreasonable; or

(B) the term is an unreasonable means to achieve its objective.

### **Comment**

The Harmonization Project rewrote this section to conform, for the most part, to the corresponding section of ULLCA (2006) (Last Amended 2013).

#### *Principal Provisions of the Article Concerning the Partnership Agreement*

The partnership agreement is pivotal to a limited partnership, and Sections 4-105 through 4-107 are pivotal to this article. They must be read together, along with Section 4-102(a)(9) (defining the partnership agreement).

This Section performs five essential functions. Subsection (a) establishes the primacy of the partnership agreement in establishing relations *inter se* the limited partnership and its partners. Subsection (b) recognizes this article as comprising mostly default rules – *i.e.*, gap fillers for issues at to which the partnership agreement provides no rule. Subsection (c) lists the few mandatory provisions of the article. Subsection (d) lists some provisions frequently found in partnership agreements, authorizing some provisions unconditionally and other provisions so long as “not manifestly unreasonable.” Subsection (e) delineates in detail both the meaning of “not manifestly unreasonable” and the information relevant to a determining a claim that a provision of a partnership agreement is manifestly unreasonable.

Section 4-106 details the effect of a partnership agreement on the limited partnership and on persons becoming partners. Section 4-107 concerns the effect of a partnership agreement on third parties.

#### *Role and Inevitability of Partnership Agreement*

“A limited partnership is a creature of both statute and contract.” *Cantor Fitzgerald, L.P. v. Cantor*, CIV.A. 18101, 2001 WL 1456494 at \*5 (Del. Ch. Nov. 5, 2001); *Gottsacker v. Monnier*, 281 Wis. 2d 361, 370, 697 N.W.2d 436, 440 (2005) (stating that “from the partnership form, the LLC borrows ... internal governance by contract”), and Section 4-102(a)(9) delineates



a very broad scope for “partnership agreement.” As a result, once a limited partnership comes into existence and has at least one general partner and one limited partner, a partnership agreement necessarily exists. *See* the comment to Section 4-102(a)(9). Accordingly, this article refers to “the partnership agreement” rather than “a partnership agreement.” This phrasing should not, however, be read to require a limited partnership or its partners to take any formal action to adopt a partnership agreement.

Subject only to Subsections (c) and (d), the partnership agreement has plenary power to structure and regulate the relations of the partners *inter se*. Although the certificate of limited partnership is a limited partnership’s foundational document, among the partners the partnership agreement controls.

The partnership agreement is the exclusive consensual process for modifying this article’s various default rules pertaining to relationships *inter se* the partners and between the partners and the limited partnership. Section 4-105(b). The partnership agreement also has power over “[t]he obligations of a limited partnership and its partners to a person in the person’s capacity as a transferee or a person dissociated as a partner.” Section 4-107(b). For the relationship between the partnership agreement and certificate of limited partnership, see Section 4-107(d).

#### *The Partnership Agreement and the Fiduciary and Other Duties of the General Partner*

One of the most complex questions in the law of unincorporated business organizations is the extent to which an agreement among the organization’s owners can affect the fiduciary and other duties of those who manage the organization – in the case of a limited partnership, the general partner (or partners). As explained in detail in the comment to Subsection (d)(3), this article rejects the notion that a contract can completely transform an inherently fiduciary relationship into a merely arm’s length association. Within that limitation, however, this section provides substantial power to the partnership agreement to reshape, limit, and eliminate fiduciary and other managerial duties.

Subsection (a) recognizes that the partnership agreement is the map to the parties’ deal and that any claim by a partner of managerial misconduct must be assessed first under the relevant terms of the partnership agreement. Subsection (d) specifically validates arrangements commonly used to reshape managerial duties and limit the consequences of breaching those duties. Subsection (c) contains relevant limitations, but those limitations: (i) must be read together with Subsection (d); and (ii) do not preclude the partnership agreement fundamentally redesigning the duties applicable to the general partners. For this article’s design of those duties, see Sections 4-304, 4-407, and 4-409.

**Subsection (a)** – This subsection describes the very broad scope of a limited partnership’s partnership agreement, which includes all matters constituting “internal affairs.” *Compare* Section 4-105(a), *with* Section 4-104(1) (using the phrase “internal affairs” in stating a choice of law rule). This broad grant of authority is subject to the restrictions stated in Subsection (c), including the broad restriction stated in Paragraph (c)(18) (concerning the rights of third parties under this article).

**Subsection (a)(1)** – This paragraph encompasses all the rights and duties of each partner, including rights and duties pertaining to transactions under Article 2.

**Subsection (a)(3)** – Under this provision, the partnership agreement can control both the quantum of consent required (*e.g.*, majority of partners) and the means by which the consent is manifested (*e.g.*, prohibiting modifications except when consented to in writing). *See also* the comment to Section 4-107(a).

Under Subsection (b), if the partnership agreement does not address the issue, this article provides the rule. Section 4-407(b)(4)(C) (requiring the affirmative vote or consent of all the partners) and 4-407(c)(3)(C) (same). Under Section 1-702 (Supplemental Principles of Law) the parol evidence rule will apply to a written partnership agreement when appropriate under contract law.

**Subsection (b)** – To the extent the partnership agreement does not determine an *inter se* matter, this article determines the matter. The partnership agreement may vary any provision of this article pertaining to *inter se* matters, except as provided in Subsections (c) and (d).

Sometimes – but not always – the comments to this article refer to a variable provision as a “default rule” and a non-waivable provision as “mandatory.” These references are merely to draw attention to the default/mandatory distinction in particular contexts and have neither the intent nor the power to affect the default/mandatory status of provisions of this article whose comments lack a comparable reference.

**Subsection (c)** – This subsection lists provisions of this article whose respective effects cannot be varied or may be varied subject to a stated limitation. For historical reasons, this subsection uses the words “vary” and “alter” interchangeably. No difference in meaning is intended.

If a person claims that a term of the partnership agreement violates this subsection, as a matter of ordinary procedural law the burden of proof is on the person making the claim.

**Subsection (c)(1)** – Section 4-104 states that this article provides the law applicable to: (i) the internal affairs of a limited partnership formed under this article; and (ii) the liability of partners for obligations of the limited partnership. The organizers of a limited partnership make this choice of law by choosing to form a limited partnership under this article. Domestication to another jurisdiction will re-set the choice of law, *see* Sections 2-501 through 2-506, but the partnership agreement cannot. The partnership agreement may incorporate wholesale and by reference the provisions of another jurisdiction’s limited partnership statute, but that approach raises complex drafting issues – *e.g.*, how to address future revisions to that statute – and in any event is subject to the strictures of Section 4-105(c) and (d). *See also* the comment to Section 4-104(1).

**Subsection (c)(2)** – Under this article, a limited partnership is emphatically an entity, and the partners lack the power to alter that characteristic.

**Subsection (c)(3)** – This prohibition is arguably implicit in Subsection (c)(18) (affecting

rights of third parties under this article) but is stated expressly to avoid any doubt.

**Subsection (c)(4)** – This provision means that the partnership agreement cannot affect the right of an “aggrieved” person to seek the court’s help when “a person required by this [Code] to sign a record or deliver a record to the filing office for filing under this [Code] does not do so.” Section 1-210.

**Subsection (c)(5)** – Because deleting the specified statement exposes each general partner to unlimited liability for each debt, liability, or other obligation of the limited partnership accrued after the deletion: (i) Section 4-406(b)(2) gives each general partner veto power; and (ii) this subsection makes that power non-waivable.

**Subsection (c)(6)** – This limitation is less powerful than might first appear, because Subsection (d) specifically authorizes substantial alterations to the duties of loyalty and care, including restricting and substantially eliminating those duties.

**Subsection (c)(7)** – Sections 4-305(a) and 4-409(d) refer to the “contractual obligation of good faith and fair dealing,” which contract law implies in every contract. The partnership agreement cannot eliminate this obligation, neither in whole (*i.e.*, generally) nor in part (*i.e.*, as applicable to specified situations).

However, a partnership agreement may “prescribe the standards ... by which the performance of the obligation is to be measured.”

EXAMPLE: The partnership agreement of a limited partnership gives the general partner the discretion to cause the limited partnership to enter into contracts with affiliates of the general partner (so-called “Conflict Transactions”). The agreement further provides: “When causing the Limited Partnership to enter into a Conflict Transaction, the general partner complies with Section 4-409(d) of [this article] if a disinterested person, knowledgeable in the subject matter, states in writing that the terms and conditions of the Transaction are equivalent to the terms and conditions that would be agreed to by persons at arm’s length in comparable circumstances.” This provision “prescribe[s] the standards by which the performance of the [Section 4-409(d)] obligation is to be measured.”

EXAMPLE: Same facts as the previous example, except that, during the performance of a Conflict Transaction, the general partner causes the limited partnership to waive material protections under the applicable contract. The standard stated in the previous example is inapposite to this conduct. Section 4-409(d) therefore applies to the conduct without any direct contractual delineation. (However, other terms of the agreement may be relevant to determining whether the conduct violates Section 4-409(d). *See* the comment to Section 4-409(d).)

EXAMPLE: The partnership agreement of a limited partnership gives the general partner “sole discretion” to make various decisions. The agreement further provides: “Whenever this agreement requires or permits a general partner to make a decision that has the potential to benefit one class of partners to the detriment of another class, the general partner complies with Section 4-409(d) of [this article] if the general partner makes the

decision with:

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

This provision "prescribe[s] the standards by which the performance of the [Section 4-409(d)] obligation is to be measured." *Compare* Section 4-105(c)(7), with *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010) (considering such a situation in the context of the right to call preferred stock and deciding by a 3-2 vote that exercising the call did not breach the implied covenant of good faith and fair dealing).

A partnership agreement that seeks to prescribe standards for measuring the contractual obligation of good faith and fair dealing under Section 4-409(d) should expressly refer to the obligation. *See Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 418 (Del. 2013) (distinguishing between the implied contractual covenant and an express contractual obligation of "good faith" as stated in a limited partnership agreement).

For an explanation of the function and role of the covenant of good faith and fair dealing, see the comment to Section 4-409(d). For the rules delimiting the "not manifestly unreasonable" requirement, see Subsection (e).

**Subsection (c)(8)** – These restrictions are ubiquitous in the law of business entities and, in conjunction with other provisions of this section, control the otherwise very broad power of a partnership agreement to affect fiduciary and other duties. The restrictions are central to the raft of exculpatory provisions that sprung up in corporate statutes in response to *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985). Delaware led the response with DEL. CODE ANN. tit. 8, § 102(b)(7), and a number of LLC statutes have similar provisions. *E.g.* GA. CODE ANN. § 14-11-305(4)(A) (2011). For an extreme example, see VA. CODE ANN. § 13.1-1025 (B) (2012). In this context, "conduct" includes both acts and omissions. BLACK'S LAW DICTIONARY (9th ed. 2009) (defining conduct as "[p]ersonal behavior, whether by action or inaction").

The term "bad faith" has multiple meanings, and the context determines which meaning applies. In the context of the duty of loyalty, "bad faith" includes conduct motivated by ill will or other intent purposely to harm another person. The concept also includes conduct from which a person derives an improper personal benefit. *See, e.g., Mroz v. Hoaloha Na Eha, Inc.*, 410 F. Supp. 2d 919, 936-37 (D. Haw. 2005) (denying a motion to dismiss a claim that "the Majority Partners" were personally liable for the partnership's wrongful termination of the plaintiff; quoting the complaint as alleging that "the Majority Partners, individually and as a group, acted with malice and/or ill will, and or with an intent to serve their own personal interests and/or without an intent to serve company interests, and/or outside of the scope of their authority and/or without justification"); *BOGNC, LLC v. Cornelius NC Self-Storage LLC*, 10 CVS 19072, 2013 WL 1867065 at \*9 (N.C. Super. [Business Court] May 1, 2013) (noting that "no ... [exculpatory] provision may limit a manager's liability for acts known to be in conflict with the interests of the limited liability company, or for acts from which the manager derived an improper personal benefit") (citing N.C. GEN. STAT. § 57C-3-32(b)); *Lasica v. Savers Grp. of Minnesota, LLC*, A12-0092, 2012 WL 3553246 at \*2 (Minn. Ct. App. Aug. 20, 2012) (noting that an "individual

seeking indemnification [under statute providing for indemnification]) must have acted in good faith and must not have received an improper personal benefit”) (citing MINN. STAT. § 322B.69, subds. 2(a)(2), (3) (2010)).

In the context of the duty of care, the concept of bad faith comes primarily from corporate law and means an extreme breach of the duty—*i.e.*, “the failure to exercise “*honest judgment* in the lawful and legitimate furtherance of corporate purposes.” *Deblinger v. Sani-Pine Products Co., Inc.*, 107 A.D.3d 659, 661, 967 N.Y.S.2d 394 (2013) (quoting *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994 (1979) (emphasis added) (internal quotation marks omitted)).

Thus, when a plaintiff alleges bad faith as pertaining to the duty of care, “[t]he burden ... is to show irrationality: a plaintiff must demonstrate that no reasonable business person could possibly authorize the action in good faith. Put positively, the decision must go so far beyond the bounds of reasonable business judgment that its only explanation is bad faith.” *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005) (discussing then prevailing Delaware law) (citation omitted). *See also KDW Restructuring & Liquidation Servs. LLC v. Greenfield*, 874 F. Supp. 2d 213, 226 (S.D.N.Y. 2012) (referring to a lack of “a rationale corporate purpose” and “a disregard for the duty to examine all available information—*information that was readily at hand*”) (emphasis added).

With regard to both the duty of loyalty and the duty of care, “bad faith” is entirely distinct from the meaning of “good faith” in the contractual covenant of good faith and fair dealing. *See* the comment to Section 4-409(d).

Subsection (c)(8) pertains to indirect as well as direct efforts to “relieve or exonerate” and thus limits how far a partnership agreement can go in providing for indemnification. *See* Section 4-408(b) (stating a default rule for indemnification).

Although this paragraph does not expressly address contracts between a limited partnership and a general partner, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

EXAMPLE: A limited partnership enters into a management contract with its general partner, and the contract provides the general partner exoneration for liability to the limited partnership even for willful and intentional misconduct. Most likely, contract law will treat the provision as against public policy and therefore unenforceable.

RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981) (“A term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy.”). If not, a court should hold the provision unenforceable to avoid evisceration of Subsection (c)(8). (Or, the court could invoke the policy expressed in Subsection (c)(8) as grounds for holding the provision unenforceable under contract law.)

**Subsection (c)(9)** – Although phrased as a restriction, this provision grants substantial power to the partnership agreement.

EXAMPLE: The partnership agreement of a limited partnership states “No limited

partner may have access to information constituting a trade secret of the Partnership.” This restriction is reasonable.

The information required under Section 4-108 is skeletal, and the partnership agreement can impose reasonable limitations on access to and use of other information.

This article also empowers the limited partnership “as a matter within the ordinary course of its activities and affairs [to] impose reasonable restrictions and conditions on access to and use of information” obtained under Section 4-304 or 4-407. *See* Sections 4-304(j) and 4-407(j), cmts.

In determining whether a restriction is reasonable, a court might consider: (i) the danger or other problem the restriction seeks to avoid; (ii) the purpose for which the information is sought; and (iii) whether, in light of both the problem and the purpose, the restriction is reasonably tailored. Under this article, general and limited partners have sharply different roles. A restriction that is reasonable as to a limited partner is not necessarily reasonable as to a general partner. Restricting a limited partner’s access to or use of the names and addresses of other limited partners is not per se unreasonable.

**Subsection (c)(11)** – A partnership agreement certainly may make a person’s dissociation as a general partner a breach of contract, but eliminating even the *power* to dissociate would contradict the essence of the limited partnership. General partners in a limited partnership are analogous to partners in a general partnership, and the relationship among general partners is at its core a *voluntary* association.

Moreover, general partners in a limited partnership provide services not only as fiduciaries but also pursuant to a contract. *See* Section 4-105, cmt. (Role and Inevitability of Partnership Agreement). Only in exceptional circumstances does a party to a contract lack the power to breach, and such circumstances do not exist as to general partners of a limited partnership. Indeed, courts will not enjoin a person to remain in an ongoing contractual relationship that involves trust and confidence. E. ALLAN FARNSWORTH, *CONTRACTS* § 12.7 at 781 (3rd ed. 1999) (“A court will not grant specific performance of a contract to provide a service that is personal in nature. This refusal ... is based [in part] of the undesirability of compelling the continuance of personal relations after disputes have arisen and confidence and loyalty have been shaken and the undesirability, in some instances, of imposing what might seem like involuntary servitude.”) (footnote omitted).

For two reasons this article treats limited partners quite differently. First, to make possible this article as a suitable vehicle for family limited partnerships, “[a] person does not have a right to dissociate as a limited partner before the completion of the winding up of the limited partnership.” Section 4-601(a).

Second, the partnership agreement may eliminate a limited partner’s power to dissociate, because limited partners do not resemble contract obligors. Limited partners *qua* limited partners provide no services to the limited partnership, and therefore the analysis stated in the second paragraph of this comment does not apply. Moreover, limited partners have no fiduciary duties, Section 4-305(b), and therefore the analysis stated in the first paragraph of this comment

is inapposite as well.

**Subsection (c)(12)** – The partnership agreement may not change the stated grounds for judicial dissolution but may determine the forum in which a claim for dissolution under Section 4-801(a)(6) is determined. For example, arbitration and forum selection clauses are commonplace in business relationships in general and in partnership agreements in particular.

The approach of this paragraph differs from the law of Delaware. *See Huatuco v. Satellite Healthcare*, CV 8465-VCG, 2013 WL 6460898 at \*1 and n.2 (Del. Ch. Dec. 9, 2013) (stating that “the right to judicial dissolution is a default right which the parties may eschew by contract” but reserving the question of “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires—leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre’s *Huis Clos*”).

**Subsection (c)(13)** – The cited provisions comprise the non-waivable aspects of winding up a dissolved limited partnership. The other provisions of Section 4-802 are default rules.

**Subsection (c)(14)** – Part 9 delineates a partner’s rights to bring direct and derivative actions. It would be unreasonable to frustrate these rights but not unreasonable to channel their exercise. For example, the partnership agreement might select a forum, require pre-suit mediation, provide for arbitration of both direct and derivative claims, or override Section 4-902 and require “universal demand” in all derivative cases. Similarly, it is not unreasonable to provide for liquidated damages consonant with the law of contracts. In contrast, it would be unreasonable for a partnership agreement to both: (i) require a would-be derivative plaintiff to make demand regardless of futility; and (ii) bar taking the claim to court no matter how long the general partners ponder the demand.

**Subsection (c)(15)** – A partnership agreement may not alter this article’s rules for a special litigation committee but may preclude entirely the use of such a committee.

**Subsection (c)(16)** – Section 2-203(a)(1), 2-303(a)(1), 2-403(a)(1), and 2-503(a)(1) each requires the consent or the affirmative vote of all partners. The partnership agreement may modify these requirements. In contrast, under the sections stated in this subsection:

- each partner is protected from being merged, exchanged, converted, or domesticated “into” the status of a partner in a general partnership that is not a limited liability partnership (or a comparable “unshielded” position in some other organization) without the member having *directly* consented to either:
  - the merger, interest exchange, conversion, or domestication; or
  - a partnership agreement provision that permits such transactions to occur with less than unanimous consent of the partners; and
- merely consenting to a partnership agreement provision that permits amendment of the agreement with less than unanimous consent of the partners does not qualify as the requisite direct consent.

**Subsection (c)(17)** – Because these plans are the basic “deal documents” for each of the

organic transactions contemplated in Article 2, the partnership agreement may not vary the contents of these plans.

**Subsection (c)(18)** – This limitation pertains only to “the rights under this [Code] of” third parties other than partners. Moreover, the limitation is subject to two substantial exceptions: Section 4-106 (pertaining to the partnership agreement’s relationship to the limited partnership itself and to persons becoming partners) and Section 4-107(b) (pertaining to the partnership agreement’s power over the rights of transferees).

**Subsection (d)** – The partnership agreement has plenipotentiary power over the matters described in Subsection (a), except as specifically limited by Subsections (c). However, for the convenience of practitioners and the courts, Paragraphs 1 and 2 list various terms often found in partnership agreements. No negative inference should be drawn about terms not listed; the listing is provided “without limiting other terms that may be included in a partnership agreement.”

Paragraph 2 lists arrangements subject to the “not manifestly unreasonable standard.” Subsection (e) delineates that standard. The same standard applies to terms of a partnership agreement which seek to “prescribe the standards ... by which the performance of the [contractual] obligation [of good faith and fair dealing] is to be measured.” Subsection (c)(7).

**Subsection (d)(1)(A)** – An arrangement *not* involving “one or more disinterested and independent persons” acting “after full disclosure of all material facts” would “alter ... the aspects of the duty of loyalty stated in Section 4-409(b)” and would therefore be subject to the “not manifestly unreasonable standard” of Subsection (d)(2)(A).

For the meaning of “material” as applied to information, see the comment to Section 4-409(f).

**Subsection (d)(1)(B)** – Section 4-504(a)(2) prohibits distributions:

- *not merely* when, after the distribution, “the partnership’s total assets would be less than the sum of its total liabilities,”
- *but also* when, after the distribution, the assets would be less than the total liabilities “plus the amount that would be needed, if the partnership were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of partners and transferees whose preferential rights are superior to those of persons receiving the distribution.”

The second part of the solvency test pertains to preferential rights to distributions, is thus a matter *inter se* the partners and any transferees, and is therefore subject to change in the partnership agreement.

In contrast, the first part of the solvency test protects third parties – creditors of the limited partnership – and therefore cannot be changed by the partnership agreement. Section 4-105(c)(18). Likewise, the partnership agreement cannot change solvency test stated in Section 4-504(a)(1) (that “the partnership would not be able to pay its debts as they become due in the



ordinary course of the partnership's activities and affairs").

**Section (d)(2)** – This article rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of “freedom of contract” against the dangers that inescapably exist when some have power over the interests of others.

Nonetheless, a properly drafted partnership agreement may substantially alter and even eliminate fiduciary duties. Two important limitations exist. First, arrangements subject to this subsection may not be “manifestly unreasonable.” *See* Subsection (e) (delineating this standard).

Second, the partnership agreement may not transform the relationship *inter se* the general partners to the limited partnership and limited partners into an entirely arm's length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. This rule is fundamental in the jurisprudence of fiduciary duty. *See, e.g., Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, Civ. A. No. 5502-CS, 2011 WL 3505355 at \*31 (Del. Ch. Aug. 8 2011) (stating that, even under a statute that “permits the waiver of fiduciary duties ... such waivers must be set forth clearly”); *Kelly v. Blum*, Civ. A. No. 4516-VCP, 2010 WL 629850, at \*10 n.70 (Del. Ch. Feb. 24, 2010) (“Having been granted great contractual freedom by the LLC Act, drafters of or parties to an LLC agreement should be expected to provide ... clear and unambiguous provisions when they desire to expand, restrict or eliminate the operation of traditional fiduciary duties”). It would therefore be manifestly unreasonable for a partnership agreement to negate this rule.

Although Subsection (d)(2) does not expressly address contracts between a limited partnership and general partner, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

**EXAMPLE:** A limited partnership enters into a management contract with its sole general partner, and the contract provides that the duties of loyalty stated in Section 4-409(b) are entirely eliminated. If the partnership agreement were to so provide, the provision would be subject to the “manifestly unreasonable standard.” Section 4-105(d)(2)(A). Absent the authorization provided by Section 4-105(d)(2)(A), the management contract's attempt to waive fiduciary duties may be unenforceable as a matter of public policy and contract law. *See Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57, 133 Cal. Rptr. 2d 218 (2003) (stating that “waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void”). If not, a court should hold the provision unenforceable nonetheless so as to avoid eviscerating Subsection (d)(2).

**Subsection (d)(2)(A)** – Subject to the “not manifestly unreasonable” standard, this paragraph empowers the partnership agreement to eliminate *all* aspects of the duty of loyalty listed in Section 4-409(b). The obligation of good faith and fair dealing, Section 4-409(d), would remain. *See* Subsection (c)(6). As to any other, uncoded aspects of the duty of loyalty, see Subsection (d)(2)(D) (empowering the partnership agreement to “alter or eliminate any other fiduciary duty”).

EXAMPLE: Joint Venture Limited Partnership (“JV”) is a limited partnership, with two general partners, Kappa, Inc. (“Kappa”) and Lambda, LLC (“Lambda”). The partnership agreement provides that:

- JV is managed by a “board” consisting of one person appointed by Kappa and one person appointed by Lambda;
- each appointee:
  - owes fiduciary and any other duties exclusively to the general partner that made the appointment; and
  - owes no duties to:
    - the other general partner;
    - the limited partners; and
    - the limited partnership itself.

The “not manifestly unreasonable” standard applies to these provisions under Subsection (d)(2)(A) and (D), and the provisions are not manifestly unreasonable. Note that the provisions do not affect the duties of Kappa and Lambda as general partners.

EXAMPLE: ABC Limited Partnership (“ABC”) is a limited partnership with three general partners. ABC has two entirely separate lines of business, the Alpha business and the Beta business. Under ABC’s partnership agreement:

- General Partner 1’s responsibilities pertain exclusively to the Alpha business, while responsibility for:
  - the Beta business is allocated exclusively to General Partner 2; and
  - ABC’s overall operations is allocated exclusively to General Partner 3.
- General Partner 2’s responsibilities pertain exclusively to the Beta business, while responsibility for:
  - the Alpha business is allocated exclusively to General Partner 1; and
  - ABC’s overall operations is allocated exclusively to General Partner 3.
- General Partner 1 has no fiduciary duties pertaining to the Beta business.
- General Partner 2 has no fiduciary duties pertaining to the Alpha business.

The “not manifestly unreasonable” standard applies to these provisions under Subsection (d)(2)(A) and (D), and the provisions are not manifestly unreasonable.

**Subsection (d)(2)(B)** – Under this paragraph, a partnership agreement might provide that an affiliate of a general partner will provide compensated services to the limited partnership at a price not exceeding market price, or that a general partner may pursue opportunities that otherwise would be partnership opportunities. Such arrangements are commonplace and permissible.

**Subsection (d)(2)(C)** – In this context, “conduct” includes both acts and omissions. Black’s Law Dictionary (9th ed. 2009), conduct (defining conduct as “[p]ersonal behavior, whether by action or inaction”). Subject to the “not manifestly unreasonable” standard and the bedrock requirements stated here and in Subsection (c)(8), the partnership agreement can reduce the duty of care substantially. In particular, the partnership agreement can eliminate the aspects of the duty of care pertaining to gross negligence and recklessness.

This provision replicates in a particular context the general rule stated in Subsection (c)(8). For the meaning of “bad faith” in the context of the duty of care, see the comment to Subsection (c)(8).

**Subsection (e)** – The “not manifestly unreasonable” concept became part of uniform business entity statutes when UPA (1997) imported the concept from the Uniform Commercial Code. (In the current version of the Uniform Commercial Code, the concept appears in Section 1-302(b).)

This subsection provides rules for applying the concept, specifying:

- who decides the issue of “manifestly unreasonable”
  - “the court ... as a matter of law,” Subsection (e);
- the framework for determining the issue
  - determination to be made “in light of the purposes, activities, and affairs of the limited partnership,” Subsection (e)(2);
- the temporal setting for determining the issue
  - “determination [to be made] as of the time the challenged term became part of the partnership agreement,” Subsection (e)(1); and
- what information is admissible for determining the issue
  - “only circumstances existing” when “the challenged term became part of the partnership agreement,” Subsection (e)(1).

The subsection also provides a very demanding standard for persons claiming that a term of a partnership agreement is “manifestly unreasonable.” “The court ... may invalidate the term only if, in light of the purposes, activities, and affairs of the limited partnership it is *readily apparent* that: (A) the objective of the term is unreasonable; or (B) the term is an unreasonable means to achieve the term’s objective.” Subsection (e)(2) (emphasis added).

Subsection (e) is fundamental to this article, because: (i) this article generally defers to the agreement among the partners; and (ii) Subsection (e) safeguards the partnership agreement in at least four ways:

- Determining manifest unreasonableness *inter se* partners of an organization is a different task than doing so in a commercial context, where concepts like “usages of trade” are available to inform the analysis. Each business organization must be understood in its own terms and context.
- If loosely applied, the concept of “manifestly unreasonable” would permit a court to rewrite the partners’ agreement, which would destroy the balance this article seeks to establish between freedom of contract and fiduciary duty.
- Case law has not adequately delineated the concept. *See, e.g., In re Brobeck, Phleger & Harrison LLP*, 408 B.R. 318, 335 (Bankr. N.D. Cal. 2009) (“RUPA [UPA (1997)] does not define what is ‘manifestly unreasonable’ and the parties have not cited, nor can the court locate, a decision that defines the term. Absent case law or even a dictionary definition, the court must rely on its common sense to recognize something as manifestly unreasonable.”).
- In the context of statutes permitting stock transfer restrictions unless “manifestly

unreasonable,” courts have often ignored the word “manifestly.” *See, e.g., Brandt v. Somerville*, 692 N.W.2d 144, 152 (N.D. 2005) (stating that “in close corporations, a majority of courts have sustained restrictions that are determined to be reasonable in light of the relevant circumstances”); *Roof Depot, Inc. v. Ohman*, 638 N.W.2d 782, 786 (Minn. Ct. App. 2002) (stating that “the restrictions [on share transfer] are not ‘manifestly unreasonable’ because they are reasonable means to ensure that the management and control of the business remains in the group of investors or with people well known to them”); *Castriota v. Castriota*, 268 N.J. Super. 417, 423-24, 633 A.2d 1024, 1027-28 (App. Div. 1993) (“We are obliged to apply the statute in a manner consonant with its essential purpose to permit reasonable restrictions upon alienation.”).

**Subsection (e)(1)** – The significance of the phrase “as of the time the term as challenged became part of the partnership agreement” is best shown by example.

**EXAMPLE:** When a particular limited partnership comes into existence, its business plan is quite unusual and its success depends on the willingness of a particular individual to serve as the limited partnership’s sole general partner. This individual has a rare combination of skills, experiences, and contacts, which are particularly appropriate for the partnership’s start-up. In order to induce the individual to accept the position of sole general partner, the other partners are willing to have the partnership agreement significantly limit the general partner’s fiduciary duties. Several years later, when the limited partnership’s operations have turned prosaic and the general partner’s talents and background are not nearly so crucial, a limited partner challenges the fiduciary duty limitations as manifestly unreasonable. The relevant time under Subsection (e)(1) is when the limited partnership began. Subsequent developments are not relevant, except as they might inferentially bear on the circumstances in existence at the relevant time.

**EXAMPLE:** As initially adopted, a partnership agreement identifies a category of decisions ordinarily subject to the duty of loyalty and provides that “the general partner’s sole, reasonable discretion” satisfies the duty. A year later, the agreement is amended to delete the word “reasonable.” Later, a partner claims that, without the word “reasonable,” the provision is manifestly unreasonable. The relevant time under Subsection (e)(1) is when the agreement was amended, not when the agreement was initially adopted.

**Subsection (e)(2)** – If a person claims that a term of the partnership agreement is manifestly unreasonable under Subsections (c)(7) or (d)(2), as a matter of ordinary procedural law the person making the claim has the burden of proof.

## **SECTION 4-106. PARTNERSHIP AGREEMENT; EFFECT ON LIMITED PARTNERSHIP AND PERSON BECOMING PARTNER; PREFORMATION AGREEMENT.**

(a) A limited partnership is bound by and may enforce the partnership agreement,

whether or not the partnership has itself manifested assent to the agreement.

(b) A person that becomes a partner is deemed to assent to the partnership agreement.

(c) Two or more persons intending to become the initial partners of a limited partnership may make an agreement providing that upon the formation of the partnership the agreement will become the partnership agreement.

### Comment

**Subsection (a)** – This subsection resolves twin questions that have troubled some courts – namely, whether an unincorporated entity that has not signed its foundational agreement nonetheless is bound by and may enforce the agreement. The questions have been particularly troubling in the context of agreements to arbitrate. *See, e.g., Elkjer v. Scheef & Stone, L.L.P.*, 3:13-CV-1655-K, --- F. Supp.2d ---, 2014 WL 1255844 at \*5-6 (N.D. Tex. Mar. 27, 2014) (concluding that a limited liability partnership “is a party to the Partnership Agreement,” even though the partnership itself never signed or otherwise assented to the agreement; enforcing arbitration provision to the benefit of the LLP). *Contra Trover v. 419 OCR, Inc.*, 397 Ill. App. 3d 403, 409, 921 N.E.2d 1249, 1255 (2010) (finding that “neither FODG [an LLC] nor the Golf Club [a related LLC] was a party to the operating agreements and that they are therefore not bound by the arbitration clauses therein”).

Developments pertaining to the Virginia LLC Act further illustrate the difficulties. In *Mission Residential, LLC v. Triple Net Properties, LLC*, 275 Va. 157, 161-62, 654 S.E.2d 888, 891 (2008), the Virginia Supreme Court held that an LLC member’s derivative claim was not subject to the arbitration provision in the operating agreement, because: (i) the LLC was “the real party in interest;” (ii) the LLC had not signed the operating agreement; and (iii) requiring the claim to be arbitrated would “ignore[] the separate existence of Holdings [the LLC].” The Virginia legislature promptly disagreed and amended the LLC act to state: “A limited liability company is bound by its operating agreement whether or not the limited liability company executes the operating agreement.” VA. CODE ANN. § 13.1–1023.A.1 (2012). The legislature left open the question of a limited liability company’s power to enforce an operating agreement that the company has not executed.

This subsection answers the twin questions, categorically and in the affirmative.

This subsection does not consider whether a limited partnership is an indispensable party to a suit concerning the partnership agreement. That is a question of procedural law, and the answer can determine whether federal diversity jurisdiction exists.

**Subsection (b)** – Given the possibility of oral and implied-in-fact terms in the partnership agreement, a person becoming a partner of an existing limited partnership should take precautions to ascertain fully the contents of the partnership agreement. *See* the comment to Section 4-105(a)(3).

**Subsection (c)** – A preformation agreement is not a partnership agreement. A partnership agreement is among “partners,” and, under this article, the earliest a person can become a partner is upon the formation of the limited partnership. Section 4-401.

**SECTION 4-107. PARTNERSHIP AGREEMENT; EFFECT ON THIRD PARTIES AND RELATIONSHIP TO RECORDS EFFECTIVE ON BEHALF OF LIMITED PARTNERSHIP.**

(a) A partnership agreement may specify that its amendment requires the approval of a person that is not a party to the agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.

(b) The obligations of a limited partnership and its partners to a person in the person’s capacity as a transferee or person dissociated as a partner are governed by the partnership agreement. Subject only to a court order issued under Section 4-703(b)(2) to effectuate a charging order, an amendment to the partnership agreement made after a person becomes a transferee or is dissociated as a partner:

(1) is effective with regard to any debt, obligation, or other liability of the partnership or its partners to the person in the person’s capacity as a transferee or person dissociated as a partner; 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 partner.

(c) If a record delivered by a limited partnership to the [Secretary of State] for filing becomes effective and contains a provision that would be ineffective under Section 4-105(c) or (d)(2) if contained in the partnership agreement, the provision is ineffective in the record.

(d) Subject to subsection (c), if a record delivered by a limited partnership to the

[Secretary of State] for filing becomes effective and conflicts with a provision of the partnership agreement:

- (1) the agreement prevails as to partners, persons dissociated as partners, and transferees; and
- (2) the record prevails as to other persons to the extent they reasonably rely on the record.

### Comment

**Subsection (a)** – This subsection, derived from DEL. CODE ANN. tit. 6, § 18-302(e), permits the partnership agreement to: (i) accord a non-partner veto rights over amendments to the agreement; and (ii) establish other preconditions for amendments. An amendment made in derogation of a veto right or precondition is ineffective.

Veto rights are likely to be sought by lenders but may also be attractive to non-partner managers.

**EXAMPLE:** A non-partner manager enters into a management contract with a limited partnership, and that agreement provides in part that the limited partnership may remove the manager without cause only with the consent of partners holding 2/3 of the profits interests. The partnership agreement contains a parallel provision (the “partnership agreement’s quantum provision”), but the non-partner manager is not a party to the partnership agreement. Later, the partners amend the partnership agreement’s quantum provision to reduce the quantum to a simple majority of profits interests and thereafter purport to remove the manager without cause. Although the limited partnership has undoubtedly breached its contract with the manager and subjected itself to a damage claim, the limited partnership has the *power* under Section 4-105(a)(2) to effect the removal – unless the partnership agreement provides the manager a veto right over changes in the partnership agreement’s quantum provision.

This subsection does not refer to partner veto rights because, unless otherwise provided in the partnership agreement, the consent of each partner is necessary to effect an amendment. *See* Section 4-406(b)(1).

Because “[a] partnership agreement may specify that its amendment requires ... the satisfaction of a condition,” a partnership agreement can require that any amendment be made through a writing or a record signed by each partner. *See also* Section 4-105(a)(3) (empowering the partnership agreement to determine “the means and conditions for amending the partnership agreement”).

**Subsection (b)** – The law of unincorporated business organizations is only beginning to grapple in a modern way with the tension between the rights of an organization’s owners to carry on their activities as they see fit (or have agreed) and the rights of transferees of the

organization's economic interests. Such transferees can include the heirs of business founders as well as former owners who are "locked in" as transferees of their own interests. *See* Sections 4-602(a)(3) and 4-605(a)(4).

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.

The scant case law in this area clearly favors the remaining partners over former partners and other transferees. *See, e.g., Bauer v. Blomfield Co./Holden Joint Venture*, 849 P.2d 1365, 1367 n.2 (Alaska 1993) (holding that a mere assignee "was not entitled to complain about a decision made with the consent of all the partners" and stating "[w]e are unwilling to hold that partners owe a duty of good faith and fair dealing to assignees of a partner's interest"); *Bynum v. Frisby*, 73 Nev. 145, 149-50, 311 P.2d 972, 975 (1957) ("[A]n assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners nor require them to resort to dissolution in order to prevent such a relationship from arising. The stranger remains a stranger entitled only to share in the partnership's worth and to demand an accounting upon dissolution.") (applying UPA (1914) § 27, pertaining to rights of an assignee). *See generally* Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 SUFFOLK L. REV. 587 (2009).

This subsection follows *Bauer* and other cases by expressly subjecting transferees (including a person dissociated as a partner) to partnership agreement amendments made after the transfer or dissociation, except amendments that increase obligations on transferees. For example, an amendment might extend the duration of a limited partnership but may not institute a new capital call obligation on transferees.

The question 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. An unreported LLC case suggests the answer might be yes, but the decision rests primarily on the wording of the LLC's operating agreement. In *Kohannim v. Katoli*, 08-11-00155-CV, 2013 WL 3943078 at \*10-11 (Tex. App. July 24, 2013), the court: (i) noted an 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"; (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." *Id.* at \*11.



For the very limited rights of transferees, see Section 4-702.

**Subsection (b)(1)** – This provision is inapposite when “a partner or transferee becomes entitled to receive a distribution.” Section 4-503(d). In that circumstance:

- “the partner or transferee has the status of ... a creditor of the limited partnership with respect to the distribution,” *Id.*; and
- the relevant obligation is not owed to “a person in the person’s capacity as a transferee or person dissociated as a partner,” Subsection (b), but rather to the person in the person’s capacity as a creditor.

**Subsection (c)** – This provision precludes using the certificate of limited partnership to make an end run around the strictures of Section 4-105(c) and (d)(2).

**Subsection (d)** – It will be possible, albeit improvident, for a limited partnership agreement to be inconsistent with the certificate of limited partnership or other public filings pertaining to the partnership. For those circumstances, this subsection provides rules for determining which source of information prevails:

- For partners, persons dissociated as partners, and transferees, the partnership agreement is paramount.
- Third parties may invoke the public record upon a showing of reasonable reliance, which presupposes actual knowledge – *i.e.*, deemed knowledge under Section 4-103(d) does not suffice.

The mere fact that a term is present in a publicly-filed record and not in the partnership agreement, or *vice versa*, does not automatically establish a conflict. This subsection does not expressly cover a situation in which: (i) one of the specified filed records contains information in addition to, but not inconsistent with, the partnership agreement; and (ii) a person, other than a partner or transferee, reasonably relies on the additional information. However, the policy reflected in this subsection seems equally applicable to that situation. Moreover, to argue that the partnership agreement prevails over the filed record is to argue that the additional term does conflict with the partnership agreement, at least in effect.

Section 4-105(a)(3) might also be relevant to the subject matter of this subsection. Absent a contrary provision in the partnership agreement, language in a certificate of limited partnership or other record delivered to the filing office for filing on behalf of the limited partnership might be evidence of the partners’ agreement and thereby constitute or at least imply a term of the partnership agreement.

This subsection does not apply to records delivered to the filing office for filing on behalf of a person other than a limited partnership.

**SECTION 4-108. REQUIRED INFORMATION.** A limited partnership shall maintain at its principal office the following information:

- (1) a current list showing the full name and last known street and mailing address of each

partner, separately identifying the general partners, in alphabetical order, and the limited partners, in alphabetical order;

(2) a copy of the initial certificate of limited partnership and all amendments to and restatements of the certificate, together with signed copies of any powers of attorney under which any certificate, amendment, or restatement has been signed;

(3) a copy of any filed articles of merger, interest exchange, conversion, or domestication;

(4) a copy of the partnership's federal, state, and local income tax returns and reports, if any, for the three most recent years;

(5) a copy of any partnership agreement made in a record and any amendment made in a record to any partnership agreement;

(6) a copy of any financial statement of the partnership for the three most recent years;

(7) a copy of the three most recent [annual] [biennial] reports delivered by the partnership to the [Secretary of State] pursuant to Section 1-213;

(8) a copy of any record made by the partnership during the past three years of any consent given by or vote taken of any partner pursuant to this [Code] or the partnership agreement; and

(9) unless contained in a partnership agreement made in a record, a record stating:

(A) a description and statement of the agreed value of contributions other than money made and agreed to be made by each partner;

(B) the times at which, or events on the happening of which, any additional contributions agreed to be made by each partner are to be made;

(C) for any person that is both a general partner and a limited partner, a

specification of what transferable interest the person owns in each capacity; and

(D) any events upon the happening of which the partnership is to be dissolved and its activities and affairs wound up.

### **Comment**

A required information section first appeared in ULPA (1976) § 105, although the notion of information rights traces back to the original uniform limited partnership act, ULPA (1916) § 10.

The partnership agreement cannot vary this section. However, subject to Section 4-105(c)(9), the agreement can vary Sections 4-304 and 4-407, which govern access to and use of the information required by this section.

**Paragraph (5)** – This requirement applies to both superseded and current agreements and amendments. An agreement or amendment is “made in a record” to the extent the agreement is integrated into a record and consented to in that memorialized form. It is possible for a partnership agreement to be made in part in a record and in part otherwise. *See* the comment to Section 4-102(a)(9). An oral agreement that is subsequently inscribed in a record (but not consented to as such) was not “made in a record” and is not covered by this paragraph. However, if the limited partnership happens to have such a record, Section 4-304(b) might and Section 4-407(a)(2) will provide a right of access.

**Paragraph (8)** – This paragraph does not require a limited partnership to make a record of consents given and votes taken. However, if the limited partnership has made such a record, this paragraph requires that the limited partnership maintain the record for three years. The requirement applies to any record made by the limited partnership, not just to records made contemporaneously with the giving of consent or voting. The three-year period runs from when the record was made and not from when the consent was given or vote taken.

**Paragraph (9)** – Information is “contained in a partnership agreement made in a record” only to the extent that the information is integrated into a record and, in that memorialized form, has been consented to as part of the partnership agreement.

This paragraph is not a statute of frauds provision. For example, failure to comply with Paragraph (9)(A) or (B) does not render unenforceable an oral promise to make a contribution. Likewise, failure to comply with Paragraph (9)(D) does not invalidate an oral term of the partnership specifying “events upon the happening of which the limited partnership is to be dissolved and its activities wound up.” *See also* Section 4-801(a).

Conversely, the mere fact that a limited partnership maintains a record in purported compliance with Paragraph (9)(A) or (B) does not prove that a person has actually promised to make a contribution. Likewise, the mere fact that a limited partnership maintains a record in purported compliance with Paragraph (9)(D) does not prove that the partnership agreement

actually includes the specified events as causes of dissolution.

Consistent with the partnership agreement's plenary power to structure and regulate the relations of the partners *inter se*, a partnership agreement can impose "made in a record" requirements which render unenforceable oral promises to make contributions or oral understandings as to "events upon the happening of which the limited partnership is to be dissolved."

**Paragraph (9)(A) and (B)** – Often a partnership agreement will state in record form the value of contributions made and promised to be made. If not, these provisions require that the value be stated in a record maintained as part of the limited partnership's required information. This article does not authorize the limited partnership or the general partners to set the value of a contribution without the concurrence of the person who has made or promised the contribution, although the partnership agreement itself can grant that authority.

**Paragraph (9)(C)** – The information required by this provision is essential for determining what happens to the transferable interests of a person that is both a general partner and a limited partner and that dissociates in one of those capacities but not the other. *See* Sections 4-602(a)(3) and 4-605(a)(5).

**SECTION 4-109. DUAL CAPACITY.** A person may be both a general partner and a limited partner. A person that is both a general and limited partner has the rights, powers, duties, and obligations provided by this [Code] and the partnership agreement in each of those capacities. When the person acts as a general partner, the person is subject to the obligations, duties, and restrictions under this [Code] and the partnership agreement for general partners. When the person acts as a limited partner, the person is subject to the obligations, duties, and restrictions under this [Code] and the partnership agreement for limited partners.

### **Comment**

It may be to the advantage of a general partner to own some of its interests as a limited partner, especially interests connected to voting rights. *See* Section 4-305(b) (providing that, except for the implied contractual covenant of good faith and fair dealing, "a limited partner does not have any duty to the limited partnership or to any other partner solely by reason of acting as a limited partner").

## SECTION 4-110. NATURE, PURPOSE, AND DURATION OF LIMITED PARTNERSHIP.

(a) A limited partnership is an entity distinct from its partners. A limited partnership is the same entity regardless of whether its certificate states that the limited partnership is a limited liability limited partnership.

(b) A limited partnership may have any lawful purpose, regardless of whether for profit.

(c) A limited partnership has perpetual duration.

### Comment

**Subsection (a)** – The “separate entity” characteristic is fundamental to a limited partnership and is inextricably connected to both the liability shield, Sections 4-303 and 4-404(b), and the inability of creditors of a partner or transferee to reach the assets of the limited partnership, absent a “reverse pierce” or a claim of fraudulent transfer. *See, e.g., C.F. Trust, Inc. v. First Flight, L.P.*, 580 S.E.2d 806, 810 (Va. 2003) (“hold[ing] that Virginia does recognize the concept of outsider reverse piercing and that this concept can be applied to a Virginia limited partnership”); *In re Flanagan*, 373 B.R. 216, 223, n.6 (Bankr. D. Conn. 2007) (stating that “[r]everse piercing claims have been recognized as viable causes of action in Connecticut” and “[t]he fact that [an entity] is a limited partnership does not alter the analysis”); *Egle v. Egle*, 817 So. 2d 136, 140 (La. Ct. App. 2002) (allowing plaintiff to proceed with claims that transfers made by her ex-spouse inter alia to an LLC were sham transactions).

Acquiring or relinquishing an LLLP shield changes only the rules governing a general partner’s liability for subsequently incurred obligations of the limited partnership. The underlying entity is unaffected.

**Subsection (b)** – Although some limited partnership statutes continue to require a business purpose, this article follows the current trend and takes a more expansive approach. The phrase “any lawful purpose, regardless of whether for profit” encompasses even charitable activities, but this article does not include any comprehensive protections pertaining to charitable assets and purposes. Section 2-104(b) does contain a “nondiversion” provision, but the provision applies only to the organic transactions contemplated by Article 2. Comprehensive protections must be (and typically are) found in other law, although sometimes that “other law” appears within a state’s non-profit corporation statute. *See, e.g., MINN. STAT. § 317A.811* (2012) (providing restrictions on charitable organizations that seek to “dissolve, merge, or consolidate, or to transfer all or substantially all of their assets” but imposing those restrictions only on “corporations,” which are elsewhere defined as corporations incorporated under the non-profit corporation act).

**Subsection (c)** – The word “perpetual” is a misnomer, albeit one commonplace in limited

partnership and limited liability company statutes. In this context, “perpetual” means merely that this article: (i) does not require a definite term; and (ii) creates no immediate nexus between the dissociation of a partner and the dissolution of the entity.

Moreover, the public record pertaining to a limited partnership will not necessarily reveal whether the limited partnership actually has a perpetual duration or has in fact dissolved, because: (i) this article, like all limited partnership statutes, provides several consent-based methods to dissolve a limited partnership; and (ii) none of those methods involve a public filing. For example, dissolution and winding up of a limited partnership may result from a term specified in the partnership agreement, an event specified in the partnership agreement, or the affirmative vote or consent of all partners. *See* Sections 4-801 (events causing dissolution) and 4-802 (winding up required upon dissolution). A partnership agreement is not a publicly-filed document, and a partner vote to dissolve a limited partnership is not a public event. A dissolved limited partnership may deliver to the filing office for filing an amendment to the certificate of limited partnership stating that the partnership is dissolved, Section 4-802(b)(2)(A), and later a statement of termination, Section 4-802(b)(2)(F), or both, but the filing of such statements is permissive rather than mandatory. *Id.*

Likewise, the public record will not reveal when (or even whether) a limited partnership has come into existence. *See* Section 4-201(d) (providing that the formation of a limited partnership requires both that the certificate of limited partnership become effective and that at least two separate persons become partners, with at least one being a general partner and one being a limited partner).

**SECTION 4-111. POWERS.** A limited partnership has the capacity to sue and be sued in the name of the partnership and the power to do all things necessary or convenient to carry on the partnership’s activities and affairs.

### **Comment**

Continuing the approach initiated in ULPA (2001) § 105, this article omits as unnecessary any detailed list of specific powers.

The partnership agreement cannot vary a limited partnership’s capacity to sue and be sued. Section 4-105(c)(2). A limited partnership’s standing to enforce the partnership agreement is a separate matter, which is covered by Section 4-106(a) (stating, as a default rule, that the limited partnership “may enforce the partnership agreement”).

### **SECTION 4-112. APPLICATION TO EXISTING RELATIONSHIPS.**

(a) Before [all-inclusive date], this [article] governs only:

(1) a limited partnership formed on or after [the effective date of this [article]];

and

(2) except as otherwise provided in subsections (c) and (d), a limited partnership formed before [the effective date of this [article]] which elects, in the manner provided in its partnership agreement or by law for amending the partnership agreement, to be subject to this [article].

(b) Except as otherwise provided in subsections (c) and (d), on and after [all-inclusive date] this [article] governs all limited partnerships.

(c) With respect to a limited partnership formed before [the effective date of this [article]], the following rules apply except as the partners otherwise elect in the manner provided in the partnership agreement or by law for amending the partnership agreement:

(1) Section 4-110(c) does not apply and the limited partnership has whatever duration it had under the law applicable immediately before [the effective date of this [article]].

(2) the limited partnership is not required to amend its certificate of limited partnership to comply with Section 4-201(b)(5).

(3) Sections 4-601 and 4-602 do not apply and a limited partner has the same right and power to dissociate from the limited partnership, with the same consequences, as existed immediately before [the effective date of this [article]].

(4) Section 4-603(4) does not apply.

(5) Section 4-603(5) does not apply and a court has the same power to expel a general partner as the court had immediately before [the effective date of this [article]].

(6) Section 4-801(a)(3) does not apply and the connection between a person's dissociation as a general partner and the dissolution of the limited partnership is the same as existed immediately before [the effective date of this [article]].

(d) With respect to a limited partnership that elects pursuant to subsection (a)(2) to be

subject to this [article], after the election takes effect the provisions of this [article] relating to the liability of the limited partnership's general partners to third parties apply:

(1) before [all-inclusive date], to:

(A) a third party that had not done business with the limited partnership in the year before the election took effect; and

(B) a third party that had done business with the limited partnership in the year before the election took effect only if the third party knows or has been notified of the election; and

(2) on and after [all-inclusive date], to all third parties, but those provisions remain inapplicable to any obligation incurred while those provisions were inapplicable under paragraph (1)(B).

**Legislative Note:** *The effective date is the date stated in Section 1-708. Subsection 4-112(c) presupposes that this article is replacing ULPA (1976) (Last Amended 1985). If this article is replacing a substantially different limited partnership act, the enacting jurisdiction should consider whether: (i) this article makes material changes to the “default” (or “gap filler”) rules of the predecessor statute; and (ii) if so, whether Subsection (c) should carry forward any of those rules for pre-existing limited partnerships. In this assessment, the focus is on pre-existing limited partnerships that have left default rules in place, whether advisedly or not. The central question is whether, for such limited partnerships, expanding Subsection (c) is necessary to prevent material changes to the partners’ “deal.”*

*In an enacting jurisdiction that has previously amended its existing limited partnership statute to provide for limited liability limited partnerships (LLLPs), this article should include transition provisions specifically applicable to pre-existing limited liability limited partnerships. The precise wording of those provisions must depend on the wording of the State’s previously enacted LLLP provisions. However, the following principles apply generally:*

*1. In Sections 4-806(b)(5) and 4-807(b)(4) (notice by dissolved limited partnership to claimants), the phrase “the limited partnership has been throughout its existence a limited liability limited partnership” should be revised to encompass a limited partnership that was a limited liability limited partnership under the State’s previously enacted LLLP provisions.*

*2. Section 4-112(d) should provide that, if a pre-existing limited liability limited partnership elects to be subject to this article, this article’s provisions relating to the liability of general partners to third parties apply immediately to all third parties, regardless of whether a*



*third party has previously done business with the limited liability limited partnership.*

*3. A pre-existing limited liability limited partnership that elects to be subject to this article should have to comply with Sections 4-201(b)(5) (requiring the certificate of limited partnership to state whether the limited partnership is a limited liability limited partnership) and Section 1-302(b) (establishing name requirements for a limited liability limited partnership).*

*4. As for Section 4-112(b) (providing that, after a transition period, this article applies to all preexisting limited partnerships):*

*a. if a State's previously enacted LLLP provisions have requirements essentially the same as Sections 4-201(b)(5) and 1-302(b), pre-existing limited liability limited partnerships should automatically retain LLLP status under this article.*

*b. if a State's previously enacted LLLP provisions have name requirements essentially the same as Section 1-302(b) and provide that a public filing other than the certificate of limited partnership establishes a limited partnership's status as a limited liability limited partnership:*

*i. that filing can be deemed to an amendment to the certificate of limited partnership to comply with Section 4-201(b)(5), and*

*ii. pre-existing limited liability limited partnerships should automatically retain LLLP status under this article.*

*c. if a State's previously enacted LLLP provisions do not have name requirements essentially the same as Section 1-302(b), it will be impossible both to enforce Section 1-302(b) and provide for automatic transition to LLLP status under this article.*

*It is recommended that the "all-inclusive" date should be at least one year after the effective date of the Code, but no more than two years.*

**SECTION 4-113. SUBJECTS COVERED OUTSIDE [ARTICLE] 4.** The following subjects are covered in whole or in part outside this [article]:

- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Name of entity – Part 3 of Article 1.
- (4) Registered agent of entity – Part 4 of Article 1.
- (5) Foreign entities – Part 5 of Article 1.

(6) Administrative dissolution – Part 6 of Article 1.

(7) Miscellaneous provisions, including supplemental principles of law and reservation of right to amend or repeal – Part 7 of Article 1.

(8) Entity transactions generally – Part 1 of Article 2.

(9) Merger – Part 2 of Article 2.

(10) Interest exchange – Part 3 of Article 2.

(11) Conversion – Part 4 of Article 2.

(12) Domestication – Part 5 of Article 2.

### **Comment**

This section lists the principal parts of the Code outside of this article that are applicable to limited partnerships.

## **[PART] 2**

### **FORMATION; CERTIFICATE OF LIMITED PARTNERSHIP AND OTHER FILINGS**

#### **SECTION 4-201. FORMATION OF LIMITED PARTNERSHIP; CERTIFICATE OF LIMITED PARTNERSHIP.**

(a) To form a limited partnership, a person must deliver a certificate of limited partnership to the [Secretary of State] for filing.

(b) A certificate of limited partnership must state:

(1) the name of the limited partnership, which must comply with Sections 1-301 and 1-302(b);

(2) the street and mailing addresses of the partnership's principal office;

(3) the name and street and mailing addresses in this state of the partnership's registered agent;

(4) the name and street and mailing addresses of each general partner; and

(5) whether the limited partnership is a limited liability limited partnership.

(c) A certificate of limited partnership may contain statements as to matters other than those required by subsection (b), but may not vary or otherwise affect the provisions specified in Section 4-105(c) and (d) in a manner inconsistent with that section.

(d) A limited partnership is formed when:

(1) the certificate of limited partnership becomes effective;

(2) at least two persons have become partners;

(3) at least one person has become a general partner; and

(4) at least one person has become a limited partner.

### **Comment**

For a limited partnership to be formed (*i.e.*, to come into existence), four conditions must be met: (i) a certificate of limited partnership must become effective; (ii) at least two persons must become a partners; (iii) at least one person must become a general partner; and (iv) at least one person must become a limited partner.

By definition, the earliest a person can become a limited partner is when the certificate of limited partnership takes effect. *See* Section 4-102(a)(6) (defining “limited partner” as a person that “has become a limited partner under Section 4-301”). However, a certificate of limited partnership can take effect long before any person becomes a limited partner, and this article does not require any public filing to indicate that a person has become a limited partner. Therefore, the public record will not reflect when (and even whether) a limited partnership has come into existence.

**Subsection (a)** – The requirements for filing documents with the filing office are in Part 2 of Article 1.

**Subsection (b)** – Consistent with the modern trend, this Code requires only the most “bare bones” of disclosure.

**Subsection (b)(3)** – The rules regarding registered agents are found in Part 4 of Article 1. *See* also Section 1-104 (Delivery of Record).

**Subsection (b)(4)** – The requirement to identify all general partners dates back to 1916. ULPA (1916) § 2. When a person dissociates as a general partner or a person becomes a new general partner, the certificate must be amended. *See* Section 4-202(d). However, a person can become a general partner for many purposes without being listed as such on the certificate. *See* the comment to Section 4-401.

**Section (b)(5)** – This article permits a limited partnership to be a limited liability limited partnership (“LLLP”), and this provision requires the certificate of limited partnership to state whether the limited partnership is an LLLP. The requirement is intended to force the organizers of a limited partnership to decide whether the limited partnership is to be an LLLP.

Subject to Sections 4-406(b)(2) and 4-105(c)(5), a limited partnership may amend its certificate of limited partnership to add or delete a statement that the limited partnership is a limited liability limited partnership. An amendment deleting such a statement must be accompanied by an amendment stating that the limited partnership is *not* a limited liability limited partnership. Section 4-201(b)(5) does not permit a certificate of limited partnership to be silent on this point, except for pre-existing partnerships that become subject to this article under Section 4-112. *See* Section 4-112(c)(2).

**Subsection (c)** – This provision permits the certificate of limited partnership to contain information beyond that required in Subsection (b). A limited partnership should have good reason, however, before choosing to include additional information. Such information: (i) is available to the public (including competitors); (ii) increases the chances of a conflict between the certificate of limited partnership and the partnership agreement, *see* Section 4-107(d); (iii) permits the argument that the additional information is part of the partnership agreement, *see* the comment to Section 4-102(a)(6) (stating that “[t]he partnership agreement may comprise a number of separate documents (or records), however denominated, unless the partnership agreement itself provides otherwise”); and (iv) can be confusing to the extent the information appears to delineate the power of persons to act for the limited partnership. In any event, placing additional information in the certificate of limited partnership does not enable a limited partnership to “end run” the provisions of Section 4-105(c) and (d) (limiting the power of the partnership agreement to vary specified provisions of this Code).

## **SECTION 4-202. AMENDMENT OR RESTATEMENT OF CERTIFICATE OF LIMITED PARTNERSHIP.**

(a) A certificate of limited partnership may be amended or restated at any time.

(b) To amend its certificate of limited partnership, a limited partnership must deliver to the [Secretary of State] for filing an amendment stating:

- (1) the name of the partnership;
- (2) the date of filing of its initial certificate; and
- (3) the text of the amendment.

(c) To restate its certificate of limited partnership, a limited partnership must deliver to the [Secretary of State] for filing a restatement, designated as such in its heading.

(d) A limited partnership shall promptly deliver to the [Secretary of State] for filing an amendment to a certificate of limited partnership to reflect:

- (1) the admission of a new general partner;
- (2) the dissociation of a person as a general partner; or
- (3) the appointment of a person to wind up the limited partnership's activities and affairs under Section 4-802(c) or (d).

(e) If a general partner knows that any information in a filed certificate of limited partnership was inaccurate when the certificate was filed or has become inaccurate due to changed circumstances, the general partner shall promptly:

- (1) cause the certificate to be amended; or
- (2) if appropriate, deliver to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

### **Comment**

Like other provisions of the Code requiring records to be delivered to the filing officer for filing, this section is not subject to change by the partnership agreement. *See* Section 4-105(c)(3). Except for Subsection (d), this section is essentially mechanical.

**Subsection (d)** – This subsection lists changes in circumstances which require an amendment to the certificate. Neither a statement of change, Section 1-407, nor the annual/biennial report, Section 1-212, suffice to report the addition or deletion of a general partner or the appointment of a person to wind up a limited partnership that has no general partner.

Acquiring or relinquishing LLLP status also requires an amendment to the certificate. *See* Sections 4-105(c)(5), 4-201(b)(5), and 4-406(b)(2).

This subsection states an obligation of the limited partnership. However, so long as the limited partnership has at least one general partner, the general partner or partners are responsible for managing the limited partnership's activities. Section 4-406(a). That management responsibility includes maintaining accuracy in the limited partnership's public record. Moreover, Subsection (e) imposes direct responsibility on any general partner that knows that the filed certificate of limited partnership contains false information.

**Subsection (e)** – This subsection imposes an obligation directly on the general partners rather than on the limited partnership. A general partner’s failure to meet the obligation can expose the general partner to liability to third parties under Section 4-204 and might constitute a breach of the general partner’s duties under Section 4-409. In addition, an aggrieved person may seek a remedy under Sections 1-210 (Signing and Filing Pursuant to Judicial Order) and 1-211 (Liability for Inaccurate Information in Filed Record).

**SECTION 4-203. SIGNING OF RECORDS TO BE DELIVERED FOR FILING TO [SECRETARY OF STATE].** A record delivered to the [Secretary of State] for filing

pursuant to this [Code] must be signed as follows:

(1) An initial certificate of limited partnership must be signed by all general partners listed in the certificate.

(2) An amendment to the certificate of limited partnership adding or deleting a statement that the limited partnership is a limited liability limited partnership must be signed by all general partners listed in the certificate.

(3) An amendment to the certificate of limited partnership designating as general partner a person admitted under Section 4-801(a)(3)(B) following the dissociation of a limited partnership’s last general partner must be signed by that person.

(4) An amendment to the certificate of limited partnership required by Section 4-802(c) following the appointment of a person to wind up the dissolved limited partnership’s activities and affairs must be signed by that person.

(5) Any other amendment to the certificate of limited partnership must be signed by:

(A) at least one general partner listed in the certificate;

(B) each person designated in the amendment as a new general partner; and

(C) each person that the amendment indicates has dissociated as a general partner,

unless:

(i) the person is deceased or a guardian or general conservator has been

appointed for the person and the amendment so states; or

(ii) the person has previously delivered to the [Secretary of State] for filing a statement of dissociation.

(6) A restated certificate of limited partnership must be signed by at least one general partner listed in the certificate, and, to the extent the restated certificate effects a change under any other paragraph of this subsection, the certificate must be signed in a manner that satisfies that paragraph.

(7) A statement of termination must be signed by all general partners listed in the certificate of limited partnership or, if the certificate of a dissolved limited partnership lists no general partners, by the person appointed pursuant to Section 4-802(c) or (d) to wind up the dissolved limited partnership's activities and affairs.

(8) Any other record delivered by a limited partnership to the [Secretary of State] for filing must be signed by at least one general partner listed in the certificate of limited partnership.

(9) A statement by a person pursuant to Section 4-605(a)(3) stating that the person has dissociated as a general partner must be signed by that person.

(10) A statement of negation by a person pursuant to Section 4-306 must be signed by that person.

(11) Any other record delivered on behalf of a person to the [Secretary of State] for filing must be signed by that person.

### **Comment**

Section 1-102(44) defines "sign" broadly, including "an electronic symbol, sound, or process."

**SECTION 4-204. LIABILITY OF GENERAL PARTNER FOR INACCURATE INFORMATION IN FILED RECORD.** If a record delivered to the [Secretary of State] for filing under this [Code] and filed by the [Secretary of State] contains inaccurate information, a person that suffers loss by reliance on the information may recover damages for the loss from a general partner if:

(1) the record was delivered for filing on behalf of the partnership; and

(2) the general partner knew or had notice of the inaccuracy for a reasonably sufficient time before the information was relied upon so that, before the reliance, the general partner reasonably could have:

(A) effected an amendment under Section 4-202;

(B) filed a petition under Section 1-210; or

(C) delivered to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

### **Comment**

This section works in concert with Section 1-211, which addresses another aspect of liability for inaccurate information in a filed record.

Although this article establishes the avoidance of gross negligence as the standard of care for general partners viz-a-viz the limited partnership, this provision encompasses liability to third parties. Accordingly, the standard here is more demanding. The phrases “reasonably sufficient time” and “reasonably could have” indicate a standard of ordinary care. “[N]otice of the inaccuracy” involves “reason to know.” Section 4-103(b)(1)

## **[PART] 3**

### **LIMITED PARTNERS**

#### **SECTION 4-301. BECOMING LIMITED PARTNER.**

(a) Upon formation of a limited partnership, a person becomes a limited partner as agreed



among the persons that are to be the initial partners.

(b) After formation, a person becomes a limited partner:

- (1) as provided in the partnership agreement;
- (2) as the result of a transaction effective under [Article] 2;
- (3) with the affirmative vote or consent of all the partners; or
- (4) as provided in Section 4-801(a)(4) or (a)(5).

(c) A person may become a limited partner without:

- (1) acquiring a transferable interest; or
- (2) making or being obligated to make a contribution to the limited partnership.

### **Comment**

**Subsection (b)(3)** – A limited partnership being in part a creature of contract, consent is determined on an objective basis (*i.e.*, contract law’s “reasonable person” standard). Depending on the terms of a limited partnership agreement, the partners’ manifestation of consent might involve detailed formalities, entirely informal activities, or anything in between. Moreover, the partnership agreement might reduce the quantum of consent necessary or shift the consent exclusively to the general partners.

Given that a limited partnership is a voluntary association, a person cannot become a partner of a limited partnership without manifesting consent to do so. That consent also is judged objectively.

Under Section 4-106(b), “[a] person that becomes a partner is deemed to assent to the partnership agreement,” and the agreement binds the partner regardless of whether the partner has actually indicated assent in any way.

**Subsection (d)** – To accommodate business practices and also because a limited partnership need not have a business purpose, this subsection permits so-called “non-economic partners.”

### **SECTION 4-302. NO AGENCY POWER OF LIMITED PARTNER AS LIMITED PARTNER.**

(a) A limited partner is not an agent of a limited partnership solely by reason of being a limited partner.

(b) A person’s status as a limited partner does not prevent or restrict law other than this

[Code] from imposing liability on a limited partnership because of the person's conduct.

### Comment

**Subsection (a)** – In this respect a limited partner is analogous to a shareholder in a corporation; in each case, status as owner provides neither the right to manage nor a reasonable appearance of that right. The phrase “solely by reason of being a limited partner” conforms to Subsection (b).

**Subsection (b)** – The phrase “as a limited partner” indicates that: (i) this section does not disable a general partner that also owns a limited partner interest; (ii) the partnership agreement may as a matter of contract allocate managerial rights to one or more limited partners; and (iii) a separate agreement can empower and entitle a person that is a limited partner to act for the limited partnership in another capacity, *e.g.*, as an agent. *See* the comment to Section 4-305(a).

The fact that a limited partner *qua* limited partner has no power to bind the limited partnership means that, subject to Section 4-109 (Dual Capacity), information possessed by a limited partner is not attributed to the limited partnership. *See* Section 4-103(f).

This Code specifies various circumstances in which limited partners have consent rights, including:

- admission of a limited partner, Section 4-301(b)(3)
- admission of a general partner, Section 4-401(b)(3)
- amendment of the partnership agreement, Section 4-406(b)(1)
- the decision to amend the certificate of limited partnership so as to obtain or relinquish LLLP status, Section 4-406(b)(2)
- the disposition of all or substantially all of the limited partnership's property, outside the usual and regular course of its activities and affairs, Section 4-406(b)(3)
- the compromise of a partner's obligation to make a contribution or return an improper distribution, Section 4-502(c)
- expulsion of a limited partner by consent of the other partners, Section 4-601(b)(4)
- expulsion of a general partner by consent of the other partners, Section 4-603(4)
- causing dissolution by consent, Section 4-801(a)(2)
- causing dissolution by consent following the dissociation of a general partner, when at least one general partner remains, Section 4-801(a)(3)(A)
- avoiding dissolution and appointing a successor general partner, following the dissociation of the sole general partner, Section 4-801(a)(3)(B)(i)
- appointing a person to wind up the limited partnership when there is no general partner, Section 4-802(c)
- rescinding dissolution, Section 4-803(b)(1)
- approving, amending or abandoning a plan of:
  - merger, Sections 2-203 and 2-204;
  - interest exchange, Sections 2-303 and 2-304;
  - conversion, Sections 2-403 and 2-404; and
  - domestication, Sections 2-503 and 2-504.

**SECTION 4-303. NO LIABILITY AS LIMITED PARTNER FOR LIMITED PARTNERSHIP OBLIGATIONS.**

(a) A debt, obligation, or other liability of a limited partnership is not the debt, obligation, or other liability of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the partnership solely by reason of being or acting as a limited partner, even if the limited partner participates in the management and control of the limited partnership. This subsection applies regardless of the dissolution of the partnership.

(b) The failure of a limited partnership to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a limited partner for a debt, obligation, or other liability of the partnership.

**Comment**

*Elimination of the “Control Rule”*

ULPA (2001) eliminated the so-called “control rule,” which had impaired the liability protection accorded limited partners and had become an anachronism in a world with LLPs, LLCs and, most importantly, LLLPs.

The “control rule” first appeared in a uniform act in 1916, although the concept is much older. Section 7 of the original Uniform Limited Partnership Act provided that “a limited partner shall not become liable as a general partner [*i.e.*, for the obligations of the limited partnership] unless ... he takes part in the control of the business.”

ULPA (1976) “carrie[d] over the basic test from former Section 7,” but recognized “the difficulty of determining when the control line has been overstepped.” ULPA (1976) § 303, comment. Accordingly, ULPA (1976) tried to buttress the limited partner’s shield by: (i) providing a safe harbor for a lengthy list of activities deemed not to constitute participating in control, Section 303(b); and (ii) limiting a limited partner’s “control rule” liability “only to persons who transact business with the limited partnership with actual knowledge of [the limited partner’s] participation in control,” Section 303(a). However, these protections were complicated by a countervailing rule which made a limited partner generally liable for the limited partnership’s obligations “if the limited partner’s participation in the control of the business is . . . substantially the same as the exercise of the powers of a general partner.” Section 303(a).

The 1985 amendments to ULPA (1976) further buttressed the limited partner's shield, removing the "substantially the same" rule, expanding the list of safe harbor activities and limiting "control rule" liability "only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." ULPA (1976/1985) § 303(a).

ULPA (2001) took the logical next step, bringing limited partners into parity with corporate shareholders, LLC members, and LLP partners.

**Subsection (a)** – This subsection provides a corporate-like liability shield for limited partners, protecting them against the debts, obligations and other liabilities of the limited partnership – *i.e.*, against vicarious liability for the obligations of the entity. Because a dissolved limited partnership is nonetheless an entity formed under this article, dissolution has no effect on the liability shield.

For further comments on the nature of the shield, see Section 4-404(c), comment.

**Subsection (b)** – For an explanation of this subsection, see Section 4-404(d), comment.

#### **SECTION 4-304. RIGHTS TO INFORMATION OF LIMITED PARTNER AND PERSON DISSOCIATED AS LIMITED PARTNER.**

(a) On 10 days' demand, made in a record received by the limited partnership, a limited partner may inspect and copy required information during regular business hours in the limited partnership's principal office. The limited partner need not have any particular purpose for seeking the information.

(b) During regular business hours and at a reasonable location specified by the limited partnership, a limited partner may inspect and copy information regarding the activities, affairs, financial condition, and other circumstances of the limited partnership as is just and reasonable if:

(1) the limited partner seeks the information for a purpose reasonably related to the partner's interest as a limited partner;

(2) the limited partner makes a demand in a record received by the limited partnership, describing with reasonable particularity the information sought and the purpose for

seeking the information; and

(3) the information sought is directly connected to the limited partner's purpose.

(c) Not later than 10 days after receiving a demand pursuant to subsection (b), the limited partnership shall inform in a record the limited partner that made the demand of:

(1) what information the partnership will provide in response to the demand and when and where the partnership will provide the information; and

(2) the partnership's reasons for declining, if the partnership declines to provide any demanded information.

(d) Whenever this [Code] or a partnership agreement provides for a limited partner to vote on or give or withhold consent to a matter, before the vote is cast or consent is given or withheld, the limited partnership shall, without demand, provide the limited partner with all information that is known to the partnership and is material to the limited partner's decision.

(e) Subject to subsection (j), on 10 days' demand made in a record received by a limited partnership, a person dissociated as a limited partner may have access to information to which the person was entitled while a limited partner if:

(1) the information pertains to the period during which the person was a limited partner;

(2) the person seeks the information in good faith; and

(3) the person satisfies the requirements imposed on a limited partner by subsection (b).

(f) A limited partnership shall respond to a demand made pursuant to subsection (e) in the manner provided in subsection (c).

(g) A limited partnership may charge a person that makes a demand under this section

reasonable costs of copying, limited to the costs of labor and material.

(h) A limited partner or person dissociated as a limited partner may exercise the rights under this section through an agent or, in the case of an individual under legal disability, a legal representative. Any restriction or condition imposed by the partnership agreement or under subsection (j) applies both to the agent or legal representative and to the limited partner or person dissociated as a limited partner.

(i) Subject to Section 4-704, the rights under this section do not extend to a person as transferee.

(j) In addition to any restriction or condition stated in its partnership agreement, a limited partnership, as a matter within the ordinary course of its activities and affairs, may impose reasonable restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient. In a dispute concerning the reasonableness of a restriction under this subsection, the partnership has the burden of proving reasonableness.

### **Comment**

This section balances two countervailing concerns relating to information: the need of limited partners and former limited partners for access versus the limited partnership's need to protect confidential business data and other intellectual property. The balance must be understood in the context of fiduciary duties. The general partners are obliged through their duties of care and loyalty to protect information whose confidentiality is important to the limited partnership or otherwise inappropriate for dissemination. *See* Section 4-409 (general standards of general partner conduct). A limited partner, in contrast, "does not have any [fiduciary] duty to the limited partnership or to any other partner solely by reason of acting as a limited partner." Section 4-305(b).

Like predecessor law, this article divides limited partner access rights into two categories: required information and other information. However, this article builds on predecessor law by:

- expanding slightly the category of required information and stating explicitly that a limited partner may have access to that information without having to show cause;

- specifying a procedure for limited partners to follow when demanding access to other information;
- specifying how a limited partnership must respond to such a demand and setting a time limit for the response;
- retaining predecessor law's "just and reasonable" standard for determining a limited partner's right to other information, while recognizing that, to be "just and reasonable," a limited partner's demand for other information must meet minimum standards of relatedness and particularity;
- expressly requiring the limited partnership to volunteer known, material information when seeking or obtaining consent from limited partners;
- codifying (while limiting) the power of the partnership agreement to vary limited partner access rights;
- permitting the limited partnership to establish other reasonable limits on access; and
- providing access rights for former limited partners.

Although the rights and duties stated in this section are extensive, they are not necessarily all-inclusive. This article's statement of fiduciary duties is not exhaustive. *See* the comment to Section 4-409(a). Some cases characterize owners' information rights as reflecting a fiduciary duty of those with management power. *E.g.*, *Fate v. Owens*, 130 N.M. 503, 511, 27 P.3d 990, 998 (2001) (stating that "[a] partner, as a fiduciary, is required to fully disclose material facts and information relating to partnership affairs to the other partners," including limited partners); *Konover Dev. Corp. v. Zeller*, 228 Conn. 206, 218-19, 635 A.2d 798, 804-05 (1994) (stating that "the general partner of a limited partnership has the fiduciary duty of rendering true accounts and full information about anything which affects the partnership") (quoting *Williams v. Bartlett*, 189 Conn. 471, 482 n. 8, 457 A.2d 290 (1983) (internal quotations omitted)). Also, the rights stated in this section are in addition to whatever discovery rights a party has in a civil suit.

In contrast, the rights of transferees are limited to those stated in this section and Section 4-702(c); general partners do not owe fiduciary duties to transferees.

The rights stated in this section are personal to limited partners and transferees, and are enforceable through a direct action. *See* the comment to Section 4-901(b).

**Subsection (a)** – The phrase "required information" is a defined term. *See* Sections 4-102(a)(10) and 4-108. This subsection's broad right of access is subject not only to reasonable limitations in the partnership agreement, Section 4-105(c)(9), but also to the power of the limited partnership to impose reasonable limitations on use, Subsection (j). Unless the partnership agreement provides otherwise, general partners have the authority to use that power. *See* Section 4-406(a).

**Subsection (b)** – The language describing the information to be provided comes essentially verbatim from ULPA (1976/1985) § 305 (2)(i) and (iii). The procedural requirements derive from the Model Business Corporation Act § 16.02(c). This subsection does not itself impose a requirement of good faith because Section 4-305(a) contains a generally applicable obligation of good faith and fair dealing for limited partners. *But see* Subsection (e)(2) (establishing a duty of good faith applicable to a former limited partner).

**Subsection (d)** – The duty stated in this subsection is at the core of the duties owed by a limited partnership and its general partners to the limited partners, and imposes an affirmative duty to volunteer information. The obligation is limited to information which is both material and known by the limited partnership.

“Knowledge” is viewed subjectively – *i.e.*, actual knowledge. Section 4-103(a)(1). A limited partnership will “know” what its general partners know. Under Section 4-103(f), “[a] general partner’s knowledge ... of a fact relating to the limited partnership is effective immediately as knowledge of or notice to the partnership.” As to others acting or reasonably appearing to act on behalf of the limited partnership, common law agency rules will apply. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (Imputation of Notice of Fact to Principal).

In contrast, materiality is viewed objectively. Thus, this subsection applies to known, material information, even if the limited partnership does not know that the information is material.

If a violation of this subsection causes harm to a limited partner, the limited partnership is answerable in damages. In appropriate circumstances, a violation might cause a court to enjoin or even rescind an action of a limited partnership, especially when the violation has interfered with an approval or veto mechanism involving limited partner consent. *E.g.*, *Blue Chip Emerald LLC v. Allied Partners Inc.*, 299 A.D.2d 278, 279-280 (N.Y. App. Div. 2002) (invoking partnership law precedent as reflecting a duty of full disclosure and holding that “[a]bsent such full disclosure, the transaction is voidable”), abrogated on other grounds by *Centro Empresarial Cempresa S.A. v. Am. Movil, S.A.B. de C.V.*, 17 N.Y.3d 269, 952 N.E.2d 995 (N.Y. 2011). In addition, a limited partnership’s violation of this paragraph could give rise to a claim for damages against a general partner who, through the breach of a duty stated in Section 4-409, causes or suffers the limited partnership to violate this paragraph. *See Anthony v. Padmar, Inc.*, 465 S.E.2d 745, 755 (S.C. Ct. App. 1995) (finding general partners made a defective disclosure prior to a vote and were therefore liable for resulting pecuniary damages to limited partners).

**Subsection (e)** – Codifying the information rights of former partners began with UPA (1997) § 403(b). Access is limited and subject to conditions.

EXAMPLE: A person dissociated as a limited partner seeks access to information pertaining to the period during which the person was a limited partner and to which the person would have access while a limited partner. The person makes a bald demand, merely stating a desire to review the information at the limited partnership’s principal office. In particular, the demand does not describe “with reasonable particularity the information sought and the purpose for seeking the information.” *See* Subsection (b)(2). The limited partnership is not obliged to allow access. The person must first comply with Subsection (e), which incorporates by reference the requirements of Subsection (b).

*See also* Subsection (i) (pertaining to information rights of the legal representative of a deceased limited partner).

**Subsection (e)(2)** – A duty of good faith is needed here because a person claiming access



under this subsection is no longer a limited partner and is no longer subject to Section 4-305(a). *See* Section 4-602(a)(2) (dissociation as a limited partner terminates duty of good faith as to subsequent events). *But see id.*, comment (noting that the common law implied covenant will continue to be relevant if the partnership agreement provides continuing rights and obligations for a person dissociated as a limited partner).

As for the meaning of “good faith” in this context, see the comment to Section 4-407(e)(2).

**Subsection (h)** – Some old cases involved conflicts over whether a shareholder could exercise inspection rights through another person. *White v. Coeur D’Alene Big Creek Mining Co.*, 55 P.2d 720, 723 (Idaho 1936) (stating that “[t]he refusal to permit respondent [shareholder] to appoint his own attorney or agent to make the examination [of the corporation’s books] was in effect a denial of his right” of inspection); *State v. Monida & Yellowstone Stage Co.*, 124 N.W. 971, 972 (Minn. 1910) (upholding a trial court’s mandamus order, “which shall provide that [the shareholder complainant], or such attorney or agent as he may select, . . . shall be allowed to inspect the books, records, and papers of the defendant [corporation]”). In light of that history, for the avoidance of doubt, this subsection expressly authorizes taking action through an agent. No negative inference should be drawn about using agents to take other action under this article.

**Subsection (i)** – This section provides no information rights to a person as transferee. Transferee status brings only the very limited information rights stated in Section 4-702(c). However, a transferee that is a person dissociated as a limited partner has rights in the latter capacity under Subsection (e).

**Subsection (j)** – This subsection permits the limited partnership – as distinguished from the partnership agreement – to impose access and use limitations. *See* Section 4-105(c)(9) (providing that the partnership agreement may impose reasonable restrictions). Under Section 4-406(a), it will be the general partners that decide whether the limited partnership will impose access and use restrictions.

The limited partnership bears the burden of proving the reasonableness of any restriction imposed under this subsection. In determining whether a restriction is reasonable, a court might consider: (i) the danger or other problem the restriction seeks to avoid; (ii) the purpose for which the information is sought; and (iii) whether, in light of both the problem the restriction seeks to avoid and the purpose for which information is sought, the restriction is reasonably tailored. Restricting use of the names and addresses of limited partners is not *per se* unreasonable.

## **SECTION 4-305. LIMITED DUTIES OF LIMITED PARTNERS.**

(a) A limited partner shall discharge any duties to the partnership and the other partners under the partnership agreement and exercise any rights under this [Code] or the partnership agreement consistently with the contractual obligation of good faith and fair dealing.

(b) Except as otherwise provided in subsection (a), a limited partner does not have any duty to the limited partnership or to any other partner solely by reason of acting as a limited partner.

(c) If a limited partner enters into a transaction with a limited partnership, the limited partner's rights and obligations arising from the transaction are the same as those of a person that is not a partner.

### Comment

**Subsection (a)** – Fiduciary duty typically attaches to a person whose status or role creates significant power for that person over the interests of another person. Under this article, limited partners have very limited power of any sort in the regular activities of the limited partnership and no power whatsoever justifying the imposition of fiduciary duties either to the limited partnership or fellow partners. *See, e.g., Lichtyger v. Franchard Corp.*, 223 N.E.2d 869, 873 (N.Y. 1966) (“the limited partner is in a position analogous to that of a corporate shareholder, an investor who likewise has limited liability and no voice in the operation of an enterprise”) (internal quotation omitted).

It is possible for a partnership agreement to allocate significant managerial authority and power to a limited partner, but in that case the power exists not as a matter of status or role but rather as a matter of contract. *E.g., DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago*, 75 A.3d 101, 111 (Del. 2013) (pertaining to a limited partnership agreement that allowed the limited partners to remove the general partner). The proper limit on such contract-based power is the contract itself (including the implied obligation of good faith and fair dealing), not fiduciary duty, unless the partnership agreement itself: (i) expressly imposes a fiduciary duty; or (ii) creates a role for a limited partner which, as a matter of other law, gives rise to a fiduciary duty. For example, if the partnership agreement makes a limited partner an agent for the limited partnership as to particular matters, the law of agency will impose fiduciary duties on the limited partner with respect to the limited partner's role as agent.

This subsection refers to the “contractual obligation of good faith and fair dealing” to emphasize that the obligation is not an invitation to re-write agreements among the partners. At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights – *i.e.*, duties and rights “under this [Code].” However, for the most part those duties and rights apply to relationships *inter se* the partners and the limited partnership and function only to the extent not displaced by the partnership agreement. Those statutory default rules are thus intended to function like a contract; applying the contractual notion of good faith and fair dealing therefore makes sense.

For a detailed discussion of the implied contractual obligation of good faith and fair dealing, see the comment to Section 4-409(d). As to the power of the partnership agreement to

affect the obligation, see Section 4-105(c)(7) (prohibiting elimination but allowing the agreement to “prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured”).

**SECTION 4-306. PERSON ERRONEOUSLY BELIEVING SELF TO BE LIMITED PARTNER.**

(a) Except as otherwise provided in subsection (b), a person that makes an investment in a business enterprise and erroneously but in good faith believes that the person has become a limited partner in the enterprise is not liable for the enterprise’s obligations by reason of making the investment, receiving distributions from the enterprise, or exercising any rights of or appropriate to a limited partner, if, on ascertaining the mistake, the person:

(1) causes an appropriate certificate of limited partnership, amendment, or statement of correction to be signed and delivered to the [Secretary of State] for filing; or

(2) withdraws from future participation as an owner in the enterprise by signing and delivering to the [Secretary of State] for filing a statement of negation under this section.

(b) A person that makes an investment described in subsection (a) is liable to the same extent as a general partner to any third party that enters into a transaction with the enterprise, believing in good faith that the person is a general partner, before the [Secretary of State] files a statement of negation, certificate of limited partnership, amendment, or statement of correction to show that the person is not a general partner.

(c) If a person makes a diligent effort in good faith to comply with subsection (a)(1) and is unable to cause the appropriate certificate of limited partnership, amendment, or statement of correction to be signed and delivered to the [Secretary of State] for filing, the person has the right to withdraw from the enterprise pursuant to subsection (a)(2) even if the withdrawal would otherwise breach an agreement with others that are or have agreed to become co-owners of the

enterprise.

### **Comment**

This section deals with the somewhat rare situation in which a person intending in good faith to be a limited partner invests in an enterprise, but:

- the enterprise is not a limited partnership (*i.e.*, no certificate of limited partnership has become effective); or
- the certificate of limited partnership has become effective but lists the person as a general partner.

**Subsection (a)** – In this subsection, “good faith” does not refer to the implied contractual covenant under Section 4-409(d). By hypothesis, a person invoking this section is not a partner under this article. In this context, “good faith” is properly understood as referring to the notion of “clean heart, [even if] empty head.” Thus, the good faith standard here is entirely subjective, pertaining to the person’s actual state of mind regardless of whether that statement of mind is objectively reasonable.

**Subsection (a)(2)** – The requirement that a person “withdraw[] from future participation as an owner in the enterprise” means, in part, that the person refrain from taking any further profit from the enterprise. However, the person is not required to return previously obtained profits or forfeit the investment.

## **[PART] 4**

### **GENERAL PARTNERS**

#### **SECTION 4-401. BECOMING GENERAL PARTNER.**

(a) Upon formation of a limited partnership, a person becomes a general partner as agreed among the persons that are to be the initial partners.

(b) After formation of a limited partnership, a person becomes a general partner:

- (1) as provided in the partnership agreement;
- (2) as the result of a transaction effective under [Article] 2;
- (3) with the affirmative vote or consent of all the partners; or
- (4) as provided in Section 4-801(a)(3)(B).

(c) A person may become a general partner without:

(1) acquiring a transferable interest; or

(2) making or being obligated to make a contribution to the partnership.

### Comment

A person's status as a general partner is not dependent on the person being so designated in the certificate of limited partnership. If a person does become a general partner under this section without being so designated:

- the limited partnership is obligated to promptly and appropriately amend the certificate of limited partnership, Section 4-202(d)(1);
- each general partner that knows of the discrepancy is personally obligated to cause the certificate to be promptly and appropriately amended, Section 4-202(e)(1), and is subject to liability for failing to do so, Section 4-204;
- the “non-designated” general partner has no right to sign records which are to be filed on behalf of the limited partnership under this article, Section 4-203(a), except the right to sign an amendment to the certificate of limited partnership in the capacity of a person newly designated as a general partner, *see* Section 4-203(a)(5)(B);
- the “non-designated” general partner has nonetheless:
  - the powers of a general partner to bind the limited partnership under Sections 4-402 and 4-403; and
  - the rights and duties of a general partner viz-a-viz the limited partnership and the other partners.

A limited partnership's liability under Section 4-402 does not depend on the “act of a general partner” being the act of a general partner designated in the certificate of limited partnership. Moreover, the notice provided by Section 4-103(c) does not undercut any appearance of authority. Section 4-402 refers only to notice under Section 4-103(d) and, in any event, according to the second sentence of Section 4-103(c), the fact that a person is not listed as in the certificate as a general partner is not notice that the person is not a general partner.

EXAMPLE: By consent of the partners of XYZ Limited Partnership, Partner G is admitted as a general partner. However, XYZ's certificate of limited partnership is not amended accordingly. Later, Partner G – acting without actual authority – purports to bind XYZ to a transaction with Third Party. Third Party does not review the filed certificate of limited partnership before entering into the transaction. XYZ will be bound under Section 4-402, assuming that Partner G's action is “for apparently carrying on in the ordinary course the partnership's activities and affairs or activities and affairs of the kind carried on by the partnership.”

EXAMPLE: Same facts, except that Third Party does review the certificate of limited partnership before entering into the transaction. The result might still be the same. The omission of a person's name from the certificate's list of general partners is not notice that the person is not a general partner. Therefore, Third Party's review of the certificate does not mean that Third Party knew, had received a notification or had notice that

Partner G lacked authority. At most, XYZ could argue that, because Third Party knew that Partner G was not listed in the certificate, a transaction entered into by Partner G could not reasonably appear to Third Party to be for apparently carrying on the limited partnership's activities in the ordinary course. For a discussion of the reasonableness requirement, see the comment to Section 4-402(a).

**Subsection (b)(3)** – A limited partnership being in part a creature of contract, consent is determined on an objective basis (*i.e.*, contract law's "reasonable person" standard). Depending on the terms of the partnership agreement, the partners' manifestation of consent might involve detailed formalities, entirely informal activities, or anything in between. Moreover, the partnership agreement might reduce the quantum of consent necessary or shift the consent right to the general partners.

A limited partnership being a voluntary association, a person cannot become a partner without manifesting consent to do so. That consent also is judged objectively.

Under Section 4-106(b), "[a] person that becomes a partner is deemed to assent to the partnership agreement," and the agreement binds the partner regardless of whether the partner has actually indicated assent in any way.

**Subsection (c)(1)** – To accommodate business practices and also because a limited partnership need not have a business purpose, this provision permits so-called "non-economic partners."

## **SECTION 4-402. GENERAL PARTNER AGENT OF LIMITED PARTNERSHIP.**

(a) Each general partner is an agent of the limited partnership for the purposes of its activities and affairs. An act of a general partner, including the signing of a record in the partnership's name, for apparently carrying on in the ordinary course the partnership's activities and affairs or activities and affairs of the kind carried on by the partnership binds the partnership, unless the general partner did not have authority to act for the partnership in the particular matter and the person with which the general partner was dealing knew or had notice that the general partner lacked authority.

(b) An act of a general partner which is not apparently for carrying on in the ordinary course the limited partnership's activities and affairs or activities and affairs of the kind carried on by the partnership binds the partnership only if the act was actually authorized by all the other partners.

## Comment

**Derivation** – ULPa (2001) derived this section from UPA (1997) § 301(1), which was derived from UPA (1914) § 9. For further information on the derivation, see the comment to Section 3-301.

At common law, a general partner was considered a general agent of the partnership. JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 101 at 153 (2nd ed. 1850); RESTATEMENT (SECOND) OF AGENCY § 14A cmt. a (1958), and the mere status of a general partner “clothes” a person with apparent authority to carry on the partnership business. *Stockwell v. U.S.*, 80 U.S. 531, 567 (1871); *Lincoln Nat. Bank v. Schoen*, 56 Mo. App. 160, 1894 WL 1879 (1894); *Kansallis Finance Ltd. v. Fern*, 659 N.E.2d 731, 733, 740 (Mass. 1996). In 1914, the Uniform Partnership Act codified this principle, UPA (1914) § 9 (Partner Agent of Partnership as to Partnership Business), and “statutory apparent authority” has been part of uniform partnerships acts ever since. See UPA (1997) § 301 (Partner Agent of Partnership; ULPa (2001) § 402 (General Partner Agent of Limited Partnership).

This section’s principal purpose is to delineate a general partner’s statutory apparent authority. The partnership agreement and Section 4-406 govern the rights of the partners among themselves, including the right to restrict a general partner’s actual authority.

**Subsection (a)** – This subsection reflects the basic common law principles, as first codified in UPA (1914) § 9(1) and later in UPA (1997) § 301(1). In effect, the subsection characterizes a general partner as a general managerial agent of the limited partnership. Such agents have both actual and apparent authority, and this section delineates the apparent authority. For a discussion of the scope of actual authority, see the comment to Section 4-406(a) and (b).

The agency law origins of statutory apparent authority have informed courts’ application of UPA (1914) § 9(1), and that case law is equally applicable under this article. For example, although the statutory language does not appear to require that the appearance of authority be reasonable, the case law does so routinely. See, e.g., *In re Fox Hill Office Invs., Ltd.*, 101 B.R. 1007, 1019 (Bankr. W.D. Mo. 1989) (stating a third-party lender in possession of a copy of a limited partnership’s partnership agreement was on notice of the general partner’s lack of authority and therefore should have inquired as to the partner’s authority), *aff’d*, 926 F.2d 752 (8th Cir. 1991); *Investors Title Ins. Co. v. Herzig*, 360 S.E.2d 786, 789 (N.C. 1987) (stating that “in order to hold the [partnership] liable, [a third party] must show that in the exercise of reasonable care under the circumstances, it was justified in believing that the principal had conferred . . . authority to [act] on behalf of the partnership”); *First Interstate Bank of Oregon, N.A. v. Bergendahl*, 723 P.2d 1005, 1010 (Or. Ct. App. 1986) (stating that bank in possession of management agreement was on notice of general partner’s restricted authority and could not rely on a theory of apparent authority).

Likewise, per the law of apparent authority, a general partner can bind a partnership under this section even if the partner intends to take and does take the resulting benefits for the partner’s own benefit. See *Wolfe v. Harms*, 413 S.W.2d 204, 216 (Mo. 1967) (stating that partnership is liable for partner’s acts “even if the predominant motive of the partner was to benefit himself or third persons”); *Rouse v. Pollard*, 18 A.2d 5, 7 (N.J. Eq. 1941) (“All the

partners are responsible for the act of one of their number as agent, even though he acts for some secret purpose of his own, and not really for the benefit of the [partnership].”), *aff’d*, 21 A.2d 801 (N.J. Eq. 1941); *Investors Title Ins. Co. v. Herzig*, 360 S.E.2d 786, 788 (N.C. 1987) (stating that the mere fact that the partner’s act was for personal gain was not enough to justify summary judgment for the partnership on the subject of the partnership’s liability for the act).

The fact that a person is not listed in the certificate of limited partnership as a general partner is not notice that the person is not a partner and is not notice that the person lacks authority to act for the limited partnership. *See* Section 4-103(c) and the comment to Section 4-401. In contrast, several filings under Section 4-103(d) may provide notice “to the world” that a person lacks authority to bind a limited partnership.

EXAMPLE: For the past ten years, Partner X has been a general partner of XYZ Limited Partnership and has regularly conducted the limited partnership’s business with Third Party. However, 100 days ago the limited partnership expelled Partner X as a general partner and the next day delivered for filing an amendment to XYZ’s certificate of limited partnership which stated that Partner X was no longer a general partner. On that same day, the filing officer filed the amendment.

Today Partner X approaches Third Party, purports still be to a general partner of XYZ and purports to enter into a transaction with Third Party on XYZ’s behalf. Third Party is unaware that Partner X has been expelled and has no reason to doubt Partner X’s bona fides. Nonetheless, XYZ is not liable on the transaction. Under Section 4-103(d)(1), Third Party has notice that Partner X is dissociated and perforce has notice that Partner X is not a general partner authorized to bind XYZ because Third Party is deemed to have notice ninety days after the amendment became effective.

The reference to “signing of a record in the partnership’s name” encompasses records that purport to convey title to realty.

**Subsection (b)** – Under this provision, a general partner that lacks both actual and statutory apparent authority entirely lacks the power to bind the entity. *Accord* RESTATEMENT (THIRD) OF AGENCY, ch. 2, Introductory Note (2006) (stating that “this Restatement... does not use the concept of inherent agency power”). *But see* the comment to Section 4-403. (explaining that, under that section, a general partner may bind a limited partnership by unauthorized and wrongful conduct as to which the apparent authority *vel non* is irrelevant).

Agency law determines whether a general partner has actual authority in any particular situation. *See* RESTATEMENT (THIRD) OF AGENCY § 3.01 (2006) (Creation of Actual Authority). For delineation of a general partner’s actual authority when this article’s default management rules remain in effect, see the comment to Section 4-406(a) and (b). However, the partnership agreement will typically be the primary source of a general partner’s actual authority.

This subsection does not affect a limited partnership’s power to ratify a general partner’s unauthorized act. *See* RESTATEMENT (THIRD) OF AGENCY, Chapter 4 (2006) (Ratification) and Section 1-702 (Supplemental Principles of Law).



**SECTION 4-403. LIMITED PARTNERSHIP LIABLE FOR GENERAL  
PARTNER'S ACTIONABLE CONDUCT.**

(a) A limited partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a general partner acting in the ordinary course of activities and affairs of the partnership or with the actual or apparent authority of the partnership.

(b) If, in the course of a limited partnership's activities and affairs or while acting with actual or apparent authority of the partnership, a general partner receives or causes the partnership to receive money or property of a person not a partner, and the money or property is misapplied by a general partner, the partnership is liable for the loss.

**Comment**

**Subsection (a)** – This provision is derived from UPA (1914) § 13 (Partnership Bound by Partner's Wrongful Act) as modernized by UPA (1997) § 305(a) (Partnership Liable for Partner's Actionable Conduct) and for the most part parallels the agency law doctrine of *respondeat superior*. See RESTATEMENT (SECOND) OF AGENCY § 14A cmt. a (1958) (“When one of the partners is in active management of the business or is otherwise regularly employed in the business, he is a servant of the partnership.”). The liability is vicarious and without regard to the fault of those managing the partnership. For more information on the historical development of this section, see Section 3-305(a), comment.

To successfully invoke this provision, a plaintiff must show: (i) “a wrongful act or omission, or other actionable conduct” by a general partner; (ii) that caused “loss or injury”; and (iii) that at the relevant moment, the general partner was acting with actual authority, apparent authority (if relevant), or within “the ordinary course of activities and affairs of the partnership.” Extrapolating from agency law, apparent authority is relevant only when the appearance of authority augments the impact of the wrongful act. See RESTATEMENT (THIRD) OF AGENCY, § 7.08 (2006) (“A principal is subject to vicarious liability for a tort committed by an agent in dealing or communicating with a third party on or purportedly on behalf of the principal when actions taken by the agent with apparent authority constitute the tort or enable the agent to conceal its commission.”).

An act or omission may be “in the ordinary course of activities and affairs of the partnership” even though the act is wrongful. Any other interpretation would vitiate the “ordinary course” element. “The proper question ... is not whether the specific wrongful act is ‘ordinary course’ ..., but rather whether that type of act, if done rightfully, would be.” DANIEL S.

KLEINBERGER, AGENCY, PARTNERSHIP AND LLCs: EXAMPLES AND EXPLANATIONS § 10.5.1 at 350 (4th ed., Wolters Kluwer, 2012) (emphasis omitted). However, in *Jackson v. Jackson*, 20 N.C.App. 406, 408, 201 S.E.2d 722, 724 (N.C.App. 1974), the North Carolina Court of Appeals stated that, while “[a]dvising the initiation of a criminal prosecution is clearly within the normal range of activities for a typical law partnership, ... taking such action maliciously and without probable cause is quite a different matter.” The court held that “[i]n view of [ethics] rules, which clearly forbid any attempt by a lawyer to prosecute a person without cause, it cannot be held that malicious prosecution is within the ordinary course of business of a law partnership.” *Id.* It is difficult to identify a reasonable limit to this approach. Presumably, at least, a partner’s “plain vanilla” malpractice is within a law firm’s ordinary course of business despite the ethical rules requiring lawyers to act zealously and competently.

In any event, Subsection (a) refers to “the ordinary course of activities and affairs of the *partnership*” (emphasis added); thus the proper question is whether the conduct is in the ordinary course for the partnership and not whether the particular general partner ordinarily plays a role in that part of the partnership’s business. See *In Moren ex. rel. Moren v. JAX Rest.*, 679 N.W.2d 165, 167-168 (Minn. Ct. App. 2004) (stating, as part of its analysis under UPA (1997) § 305, that “[i]t is undisputed that one of the cooks scheduled to work that evening [at the partnership’s restaurant] did not come in, and that [one] partner asked [another partner] to help in the kitchen ... [and] that [the other partner] was making pizzas for the partnership when” her negligence injured the plaintiff); *Vanacore v. Kennedy*, 86 F. Supp. 2d 42, 51 (D. Conn. 1998), *aff’d sub nom.*, *Vanacore v. Space Realty, Inc.*, 208 F.3d 204 (2d Cir. 2000) (stating that “Kennedy [a partner] committed his misdeeds, which led directly to plaintiff’s injuries, within the ordinary course of the business of E & K [the partnership]”); *Sheridan v. Desmond*, 697 A.2d 1162, 1166 (Conn. App. Ct. 1997) (stating that to be considered “in ordinary course of the business,” a partner’s action must be “the kind of thing a . . . partner would do”) (emphasis added).

**Subsection (b)** – This provision is derived from UPA (1914) § 14 (Partnership Bound by Partner’s Breach of Trust) and UPA (1997) § 305(b) (Partnership Liable for Partner’s Actionable Conduct). It is not necessary that the general partner “receiv[ing] or caus[ing] the partnership to receive money or property” do so wrongfully. Culpability is necessary at the second phase – *i.e.*, when “the money or property is misapplied by a general partner.”

#### **SECTION 4-404. GENERAL PARTNER’S LIABILITY.**

(a) Except as otherwise provided in subsections (b) and (c), all general partners are liable jointly and severally for all debts, obligations, and other liabilities of the limited partnership unless otherwise agreed by the claimant or provided by law.

(b) A person that becomes a general partner is not personally liable for a debt, obligation, or other liability of the limited partnership incurred before the person became a general partner.

(c) A debt, obligation, or other liability of a limited partnership incurred while the

partnership is a limited liability limited partnership is solely the debt, obligation, or other liability of the limited liability limited partnership. A general partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the limited liability limited partnership solely by reason of being or acting as a general partner. This subsection applies:

(1) despite anything inconsistent in the partnership agreement that existed immediately before the vote or consent required to become a limited liability limited partnership under Section 4-406(b)(2); and

(2) regardless of the dissolution of the partnership.

(d) The failure of a limited liability limited partnership to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a general partner for a debt, obligation, or other liability of the partnership.

(e) An amendment of a certificate of limited partnership which deletes a statement that the limited partnership is a limited liability limited partnership does not affect the limitation in this section on the liability of a general partner for a debt, obligation, or other liability of the limited partnership incurred before the amendment became effective.

### **Comment**

**Derivation** – ULPA (2001) derived this section from UPA (1997) § 306, which was also the source for ULLCA (2006) § 304. The Harmonization Project brought the two partnership acts and the limited liability company act into accord to the extent the three acts overlap.

**Subsection (a)** – Until the advent of limited liability partnerships and limited liability limited partnerships, one hallmark of general partner status was strict, vicarious liability for the debts, obligations, and other liabilities of the partnership. This subsection states a modern version of that venerable rule. The Harmonization Project made no substantive changes to this subsection.

**Subsection (b)** – UPA (1997) continued the approach of UPA (1914) §§ 17 and 41(7) to the vicarious liability of an incoming partner, but used a simpler and clearer formulation. ULPA (2001) followed UPA (1997), and the Harmonization Project made no substantive changes to this

subsection.

With regard to when a limited partnership incurs a debt, obligation, or other liability, the case law is scant and concerns contractual and similar obligations. The leading case is *Conklin Farm v. Leibowitz*, 140 N.J. 417, 658 A.2d 1257 (1995), which 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.

*Conklin* concerned a partnership loan obligation that was: (i) entered into before a particular partner joined the partnership; but (ii) for the most part, was payable afterwards. The court held that “interest is part of the contractual debt, and the obligation to pay interest on a loan arises, if at all, at the time that the parties execute the note or other debt instrument.” *Conklin*, 140 N.J. at 423,425, 658 A.2d at 1261 (emphasis in original). The court indicated that the same analysis applies to the obligation to repay principal. 140 N.J. at 429, 658 A.2d at 1263 (stating that “the decisive issue before this court ... [is that] [p]ayment of interest, like repayment of advances, is an obligation that arises at the time the debt instrument is executed”).

*Conklin* discussed the lease issue in response to the creditor's argument that “just as a rent obligation arises for current use of property, an interest obligation arises for current use of principal.” *Conklin*, 140 N.J. at 425, 658 A.2d at 1261. Rejecting that argument, the court: (i) noted “the *common-law* obligation to pay rent based on current tenancy [which]... arises with each period of tenancy, and ... arises even in the absence of a lease”; (ii) described “the common-law obligation to pay rent [as] entirely independent of the contractual obligation under the lease”; and (iii) held that, for purposes of partnership law, the rule for “incurring” a lease obligation rests on the common law duty in tenancy and not on the lease as a contract. *Conklin*, 140 N.J. at 426, 658 A.2d at 1262 (citing *Ellingson v. Walsh, O'Connor & Barneson*, 15 Cal. 2d 673, 104 P.2d 507, 508 (1940)). *Conklin* involved a general partnership but, in this context, that difference is immaterial.

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. “Although the courts have not been consistent ... the interpretation of [when] a ... statute [of limitations begins to run] as applied to torts has been such that the statute does not usually begin to run until the tort is complete.... A tort is ordinarily not complete until there has been an invasion of a legally protected interest of the plaintiff.” RESTATEMENT (SECOND) OF TORTS § 899 cmt c. (1979); *Loehr v. Ventura Cnty. Cmty. Coll. Dist.*, 147 Cal. App. 3d 1071, 1078, 195 Cal. Rptr. 576 (Ct. App. 1983). By analogy, a limited partnership would incur liability for a tort when the harm occurs. See, e.g., *Jones v. Cox*, 828 P.2d 218, 224 (Colo. 1992) (“A cause of action has commonly been understood to ‘accrue’ when a suit may be maintained thereon.”) (quoting BLACK'S LAW DICTIONARY 19 (5th ed. 1979)); *Loehr v. Ventura Cnty. Cmty. Coll. Dist.*, 147 Cal. App. 3d 1071, 1078, 195 Cal. Rptr. 576 (Ct. App. 1983).

However, a policy argument exists to the contrary. Vicarious liability for a limited partnership's torts should be confined to persons who are general partners when the wrongful conduct occurs. It is the conduct, not the consequences, that is wrongful; therefore, the occurrence of the wrongful conduct should determine which set of general partners are liable for the conduct's consequences.

For further discussion of the “incurred” issue, see Subsection (c), comment (The Temporal Nexus –When Claim Incurred).

**Subsection (c)** – This subsection provides a corporate/LLC-like liability shield for general partners, protecting them from (and only from) the debts, obligations and liabilities of the limited partnership – *i.e.*, against a partner’s alleged vicarious liability for the obligations of the entity.

*Shield Applicable Regardless of the Identity of the Plaintiff*

What makes the shield relevant is the nature of the claim. If the complaint seeks to hold a partner vicariously liability for the LLLP’s obligations, the shield applies. If not, not. Thus, there is no distinction among a claim arising from an LLLP’s debt to a commercial creditor, a partner’s claim that the LLLP has failed to return a contribution as required by the partnership agreement, and a claim by a former partner that the LLLP has failed to follow through on a buy-out agreement. *See Rappaport v. Gelfand*, 197 Cal. App. 4th 1213, 1230-1232, 129 Cal. Rptr. 3d 670, 682-84 (Cal.App. 2 Dist. 2011) (involving a claim by a former partner). *Accord Ederer v. Gursky*, 9 N.Y.3d 514, 526, 881 N.E.2d 204, 212-213 (N.Y. 2007) (Smith, J., dissenting).

*Shield Inapposite for Claims Arising from a Partner’s Own Conduct*

Because the partner liability at issue is solely vicarious, the LLLP shield is irrelevant to claims seeking to hold a partner directly liable on account of the partner’s own conduct. Case law on this issue comes from the analogous context of limited liability companies, and in that context a few judges have failed to understand this point. *See* the comment to Section 5-304(a) (Shield Inapposite for Claims Arising from a Member’s or Manager’s Own Conduct). However, the overwhelming weight of case law is contrary, as are the actual words of shield provisions (immunizing only for obligations of the entity and making no reference to direct obligations of an owner or manager) and public policy (which recoils from the idea of immunizing a person’s misconduct solely because the person acts on behalf of an organization).

EXAMPLE: A general partner personally guarantees a debt of a limited liability limited partnership. Subsection (c) is irrelevant to the general partner’s liability as guarantor.

EXAMPLE: A general partner purports to bind a limited liability limited partnership while lacking any agency law power to do so. The LLLP is not bound, but the partner is liable for having breached the “warranty of authority” (an agency law doctrine). Subsection (c) does not apply. The liability is not *for* a debt, obligation, or other liability of the LLLP, but is rather the partner’s own, direct liability. Indeed, the liability exists because the LLLP is *not* indebted, obligated or liable. RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006).

EXAMPLE: A general partner of a limited liability limited partnership defames a third party in circumstances that render the LLLP vicariously liable under Section 4-403(a). Under Subsection (c), the third party cannot hold the partner accountable for the *partnership’s* liability, but that protection is immaterial. The partner is the tortfeasor and in that role is directly liable to the third party.

EXAMPLE: An LLLP provides professional services, and one of its general partners

commits malpractice. The liability shield is irrelevant to the partner's direct liability in tort. However, if the partner's malpractice liability is attributed to the partnership under Section 4-403(a), the liability shield will protect the other general partners against a claim that they must make good on the LLLP's liability. The same analysis applies if the plaintiff also successfully claims that another general partner was negligent in supervising the first partner.

Subsection (c) pertains only to claims based on the LLLP's liability and is irrelevant to claims by a limited liability limited partnership or a partner against a general partner and *vice versa*. See Sections 4-409 (pertaining to management duties) and 4-901 (pertaining to direct claims by a partner).

### *Shield Inapposite to Role Liability Claims*

Provisions of regulatory law may impose liability on a general partner of an LLLP due to a role the general partner plays in the limited partnership. See, e.g., *Food Team Intern., Ltd. v. Unilink, LLC*, 872 F. Supp. 2d 405, 424 (E.D. Pa. 2012) (holding several individuals "subject to secondary individual liability under PACA [Perishable Agricultural Commodities Act]" because their roles within a limited liability company enabled them to control the relevant assets) (citing *Bear Mountain Orchards, Inc. v. Mich-Kim, Inc.*, 623 F.3d 163, 172 (3d Cir. 2010)). Subsection (c) does not affect this "role liability."

### *The Temporal Nexus – When Claim Incurred*

The LLLP shield functions only with respect to obligations incurred while the partnership is a limited liability limited partnership. The shield does not protect general partners from vicarious liability for partnership obligations incurred before a partnership becomes an LLLP or after the partnership ends its LLLP status. Sections 4-201(b)(5) and 4-406(b)(2).

For a preliminary discussion of when a partnership obligation is incurred, see Subsection (b), comment. It could well be argued that "incurred" under Subsection (c) has the same meaning as "incurred" under Subsection (b). *IBP, Inc. v. Alvarez*, 546 U.S. 21, 34, 126 S.Ct. 514, 523 (2005) (referring to "the normal rule of statutory interpretation that identical words used in different parts of the same statute are generally presumed to have the same meaning"); *Timberline Air Serv., Inc. v. Bell Helicopter-Textron, Inc.*, 125 Wash. 2d 305, 313, 884 P.2d 920, 925 (1994) (stating that "[w]hen the same words are used in different parts of the same statute, it is presumed that the Legislature intended that the words have the same meaning").

However, the argument should yield if the subsections' different contexts raise different issues of policy. 1A SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 45:12 (7th ed.) (stating that "departure from the literal construction of a statute is justified when such a construction would produce an absurd and unjust result and would clearly be inconsistent with the purposes and policies of the act in question"). See, e.g., *S.V. v. R.V.*, 933 S.W.2d 1, 4 (Tex. 1996) ("[W]e have held that a cause of action accrues when a wrongful act causes some legal injury, even if the fact of injury is not discovered until later, and even if all resulting damages have not yet occurred. We have not applied this rule without exception, however, and have sometimes held that an action does not accrue until the plaintiff knew or in the exercise of reasonable diligence should have known of the wrongful act and resulting injury.") (citations

omitted).

The case law concerning contractual obligations (incurred when the contract is made) applies appropriately in the context of the LLLP 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 limited partnership enters into a lease with a commercial landlord. Knowing that each general partner is automatically liable for the partnership's debt, the landlord does not obtain personal guarantees. Subsequently, the partnership becomes an LLLP. 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.

A similar issue exists with regard to tort liability. Courts must look to when the conduct causing the injury takes place and not to when actual injury occurs. Otherwise, a limited partnership could: (i) engage in wrongful conduct that does not cause immediate injury; (ii) come to realize that the conduct has occurred; (iii) subsequently amend its certificate of limited partnership to become a limited liability limited partnership; and (iv) thereby eliminate the vicarious liability of its general partners for all harm subsequently arising from the misconduct. *Cf. Savini v. Univ. of Hawaii*, 113 Haw. 459, 465, 153 P.3d 1144, 1150 (2007) (addressing the question of when a statute of limitations begins to run for bodily injury, when another statute precludes bringing a claim until the amount of damages has reach a specified threshold).

In general, courts should determine the “incurred” question under Subsection (c) so that the LLLP shield protects the general partners of an LLLP to the same extent that the corporate and LLC shields protect corporate shareholders and LLC members. From that perspective, LLLP status obtained after a limited partnership commits a wrongful act should provide no greater protection for the general partners than the protection a sole proprietor obtains by forming an LLC after committing a wrongful act – *i.e.*, none. *See, e.g., Foxchase, LLP v. Cliatt*, 562 S.E. 2d 221, 224 (Ga. Ct. App. 2002) (holding that a partnership's liability shield did not protect partners from claims of property damage caused by the construction of a golf course, where the jury could have found that the “damage ... occurred when they, not the partnership, owned the course”).

**Subsection (c)(2) – *The Shield and Dissolution.*** The rule stated here is inherent in the nature of partnership dissolution. “[D]issolution does not end a limited partnership’s existence but rather changes the purpose of that existence.” Comment to Section 4-801. “A dissolved limited partnership shall wind up its business and... continues after dissolution ... for the purpose of winding up.” Section 4-802(a). Put another way: dissolution and winding up are part of the life cycle of a limited liability limited partnership – sometimes the most complicated part. There is no logical reason to remove the shield during the last part of a LLLP’s partnership’s life cycle.

This subsection makes this point expressly, because it is possible to misinterpret some outlying LLP cases as holding to the contrary. *See, e.g., Carolina Cas. Ins. Co. v. L.M. Ross*

*Law Grp., LLP*, 151 Cal. Rptr. 3d 628, 635 (2012) (affirming the trial court’s decision to hold an LLP’s named partner liable for a judgment against his limited liability partnership; noting that “[c]entral to the decision to amend the judgment to add Ross [the named partner] as a judgment debtor ... is the trial court’s finding that Ross Law Group dissolved”; recognizing, however, that, before the partnership incurred the liability, Ross had signed and filed with the California Secretary of State a form stating that the law firm had “cease[d] to be a registered limited liability partnership and is hereby filing this notice with the California Secretary of State that [it] is no longer a registered limited partnership”) (quotation marks omitted).

*The Shield and Termination.* This subsection does not expressly provide that, when a limited liability partnership’s existence terminates, the liability shield remains in place as to any debt, obligation, or other liability of the partnership incurred before the termination. However, the point follows ineluctably from this subsection, which adopts an “occurrence” rather than a “claims made” basis for determining whether the shield applies. *See* the comment to Subsection (c) (The Temporal Nexus –When Claim Incurred).

Moreover, any other result would: (i) create huge holes in the shield; (ii) put the law of unincorporated businesses at odds with the law of corporations; (iii) render surplus this article’s distribution recapture provision, Section 4-407; (iv) render meaningless the exception to the notice requirement as stated in Sections 4-806(b)(5) and 4-807(b)(4); and (v) render nonsensical the otherwise logical extension of the equitable trust fund theory to limited liability partnerships. *Cf. Velasquez v. Franz*, 589 A.2d 143, 146 (N.J. 1991) (explaining that “the trust-fund doctrine... renders shareholders who receive distributed assets of the corporation liable as ‘trustees’ for claims of the corporation’s creditors”).

**Subsection (d)** – This subsection was added during the Harmonization Project and pertains to the equitable doctrine of “piercing the veil” – *i.e.*, conflating an entity and its owners to hold one liable for the obligations of the other. The doctrine of “piercing the corporate veil” is well-established, and courts should apply the doctrine to limited liability partnership for the same reasons that courts have regularly (and sometimes almost reflexively) applied the doctrine to limited liability companies. *Cf. Axtmann v. Chillemi*, 2007 ND 179, 740 N.W.2d 838, 847 (stating that “the shield of a limited liability partnership may be pierced under ‘the case law that states the conditions and circumstances under which the corporate veil or limited liability shield of a corporation may be pierced under North Dakota law....’”) (quoting N.D.C.C. § 45-22-09(1)).

However, LLLP piercing involves one important distinction from the corporate realm. While under corporate law “disregard of corporate formalities” is a key piercing factor, that factor is inapposite in the law of unincorporated organizations. Corporate formalities reflect statutory mandates. LLLP formalities derive for the most part from the agreement among the partners. From a policy perspective, disregarding formalities adopted by agreement differs substantially from disregarding formalities imposed by law.

Moreover, because the terms of a partnership agreement may be “implied,” Section 4-102(a)(9), an LLLP’s ongoing disregard of formalities may well constitute an amendment to the partnership agreement. If so, disregard equals amendment, and the concept of “disregard of formalities” makes no sense.



In contrast, this subsection is inapposite to another key piercing factor – disregard of the separateness between entity and owner. *Cf. Vanderford Co. v. Knudson*, 165 P.3d 261, 271 (Idaho 2007) (noting that managing member and “his accountant testified that the LLC's checking account was so confusing that the accountant could not be sure whose money was in the account at what times”); *Utzler v. Braca*, 972 A.2d 743 (Conn. App. 2009) (holding that veil piercing was appropriate under alter-ego theory when owner deposited LLC funds into a commingled bank account from which he made withdrawals for personal needs and unrelated projects).

**EXAMPLE:** The sole general partner of a limited liability limited partnership uses a car titled in the partnership's name for personal purposes and writes checks on the partnership's account to pay for personal expenses. These facts are relevant to a piercing claim; they pertain to economic separateness, not Subsection (b) formalities.

This subsection addresses claims to “impos[e] liability on a general partner for a debt, obligation, or other liability of the partnership” – *i.e.*, for what is sometimes termed a “direct pierce.” Whether the same approach should apply to claims for a “reverse pierce” is a question for the courts. *See Comm'r of Envtl. Prot. v. State Five Indus. Park, Inc.*, 304 Conn. 128, 140, 37 A.3d 724, 732-33 (2012) (stating that “[a]lthough some courts have adopted reverse veil piercing with little distinction as a logical corollary of traditional veil piercing, because the two share the same equitable goals, others wisely have recognized important differences between them”).

This subsection has no relevance to a partner's claim that the disregard of agreed-upon formalities is a breach of the limited partnership agreement.

**Subsection (e)** – The rule stated here is implicit in Subsection (c) but is stated expressly for the avoidance of doubt.

## **SECTION 4-405. ACTIONS BY AND AGAINST PARTNERSHIP AND PARTNERS.**

(a) To the extent not inconsistent with Section 4-404, a general partner may be joined in an action against the limited partnership or named in a separate action.

(b) A judgment against a limited partnership is not by itself a judgment against a general partner. A judgment against a partnership may not be satisfied from a general partner's assets unless there is also a judgment against the general partner.

(c) A judgment creditor of a general partner may not levy execution against the assets of the general partner to satisfy a judgment based on a claim against the limited partnership, unless

the partner is personally liable for the claim under Section 4-404 and:

(1) a judgment based on the same claim has been obtained against the limited partnership and a writ of execution on the judgment has been returned unsatisfied in whole or in part;

(2) the partnership is a debtor in bankruptcy;

(3) the general partner has agreed that the creditor need not exhaust partnership assets;

(4) a court grants permission to the judgment creditor to levy execution against the assets of a general partner based on a finding that partnership assets subject to execution are clearly insufficient to satisfy the judgment, that exhaustion of assets is excessively burdensome, or that the grant of permission is an appropriate exercise of the court's equitable powers; or

(5) liability is imposed on the general partner by law or contract independent of the existence of the partnership.

### Comment

**Subsection (a)** – If a debt, obligation, or other liability is incurred against a limited liability limited partnership, joining a general partner would be improper. Likewise, if a debt, obligation, or other liability against an ordinary limited partnership is incurred before a person becomes a general partner, it would be improper to join that person. As for when a claim is incurred, see the comments to Section 4-404(b) and (c).

The reference to “not inconsistent with Section 4-404” is the procedural analog to the substantive protections of Section 4-404(b) (incoming general partner not liable for pre-existing limited partnership obligations) and (c) (general partner not liable for partnership obligations incurred by an LLLP). When a general partner has personally guaranteed a limited partnership obligation, naming that general partner in a suit against the limited partnership is “not inconsistent with Section 4-404.” See the comment to Section 4-404 (Shield Inapposite for Claims Arising from a Partner's Conduct). Cf. *Bank of Boston Connecticut v. Schlesinger*, 220 Conn. 152, 157-58, 595 A.2d 872, 875 (1991) (upholding pre-judgment attachment of a partner's assets, where the partner had personally guaranteed the partnership's obligations).

**Subsection (b)** – Reflecting the entity construct, Section 4-110(a), this subsection provides that a judgment against the limited partnership: (i) is not, standing alone, a judgment

against the general partners; and (ii) cannot be satisfied from a general partner's personal assets absent a judgment against the general partner.

This article leaves to the law of judgments to determine the collateral effects to be accorded a prior judgment for or against the limited partnership in a subsequent action against a general partner individually. See RESTATEMENT (SECOND) OF JUDGMENTS § 60 (1982) and cmts. E.g., *Detrio v. U.S.*, 264 F.2d 658 (5th Cir. 1959); *Brunson v. Seltz*, 414 N.W.2d 547 (Minn. App. 1987) (Lansing, J.). *Contra Evanston Ins. Co. v. Dillard Dep't Stores, Inc.*, 602 F.3d 610, 618 (5th Cir. 2010) (disregarding *sub silentio* the separateness of partner and partnership, overlooking therefore the issue of collateral estoppel, discussing with approval a bankruptcy case in which “the trustee sought to enforce the partnership judgment against [partners] simply by virtue of their status as partner”; and quoting with approval that case’s holding that “[o]nce the liability of the partnership became fixed, the only issue remaining was whether the Defendants are partners of [the partnership]”) (quoting *In re Jones*, 161 B.R. 180, 183-184 (Bankr. N.D. Tex. 1993)) (second brackets in original).

This subsection and Subsection (c) combine to create a trap for the unwary. For statute of limitations purposes, a creditor's claim against the general partners accrues simultaneously with the claim against the limited partnership. If a creditor chooses not to sue the general partners in its suit against the limited partnership, the statute of limitations may run before the creditor commences suit against the general partners. *Am. Star Energy & Minerals Corp. v. Stowers*, 405 S.W.3d 905, 907 (Tex. App. 2013) (holding that the partnership creditor “was obligated to sue the partners of S & J ... within the same limitations period it had to sue S & J, the partnership” and that “[b]ecause, [the creditor] did not, the trial court correctly held that limitations ran”); *Sunseri v. Proctor*, 487 F. Supp. 2d 905, 908 (E.D. Mich. 2007), *aff'd*, 286 F. App'x 930 (6th Cir. 2008) (“While the plaintiff may use collateral estoppel to prevent the partner from relitigating the issue of liability, the plaintiff must still bring suit within the applicable limitations period for the underlying wrong.”).

**Subsection (c)** – Subject to the five listed exceptions, this subsection prevents a general partner's assets from being the first recourse for a judgment creditor of the limited partnership, even if the partner is liable for the judgment debt under Section 4-404.

Although this subsection is silent with respect to pre-judgment remedies, as a matter of policy the subsection should guide courts as they apply the law of pre-judgment remedies. *Compare Sec. Pac. Nat. Bank v. Matek*, 175 Cal. App. 3d 1071, 1077, 223 Cal. Rptr. 288 (Ct. App. 1985) (granting a pre-judgment remedy against a partner because there is “no distinction between those sued individually as partners and those sued as sole proprietors”), *with Bank of Boston Connecticut v. Schlesinger*, 220 Conn. 152, 157-58, 595 A.2d 872, 875 (1991) (upholding pre-judgment attachment of a partner's assets, because the partner had personally guaranteed the partnership's obligations).

#### **SECTION 4-406. MANAGEMENT RIGHTS OF GENERAL PARTNER.**

(a) Each general partner has equal rights in the management and conduct of the limited partnership's activities and affairs. Except as otherwise provided in this [article], any matter

relating to the activities and affairs of the partnership is decided exclusively by the general partner or, if there is more than one general partner, by a majority of the general partners.

(b) The affirmative vote or consent of all the partners is required to:

(1) amend the partnership agreement;

(2) amend the certificate of limited partnership to add or delete a statement that the limited partnership is a limited liability limited partnership; and

(3) sell, lease, exchange, or otherwise dispose of all, or substantially all, of the limited partnership's property, with or without the good will, other than in the usual and regular course of the limited partnership's activities and affairs.

(c) A limited partnership shall reimburse a general partner for an advance to the partnership beyond the amount of capital the general partner agreed to contribute.

(d) A payment or advance made by a general partner which gives rise to a limited partnership obligation under subsection (c) or Section 4-408(a) constitutes a loan to the limited partnership which accrues interest from the date of the payment or advance.

(e) A general partner is not entitled to remuneration for services performed for the limited partnership.

### **Comment**

**Subsection (a)** – This article assumes that, more often than not, people utilizing the article will want: (i) strong centralized management, strongly entrenched; and (ii) passive investors with little control over the entity. Section 4-302 essentially excludes limited partners from the ordinary management of a limited partnership's activities and affairs, unless the partnership agreement provides otherwise.

This subsection states affirmatively the general partners' commanding role. Only the partnership agreement and the express provisions of this article can limit that role.

The authority granted by this subsection includes the authority to delegate. Delegation does not relieve the delegating general partner or partners of their duties under Section 4-409. However, the fact of delegation is a fact relevant to any breach of duty analysis.

EXAMPLE: A sole general partner personally handles all important paperwork for a limited partnership. The general partner neglects to renew the fire insurance coverage on a building owned by the limited partnership, despite having received and read a warning notice from the insurance company. The building subsequently burns to the ground and is a total loss. The general partner might be liable for breach of the duty of care under Section 4-409(c) (gross negligence).

EXAMPLE: A sole general partner delegates responsibility for insurance renewals to the limited partnership's office manager, and that manager neglects to renew the fire insurance coverage on the building. Even assuming that the office manager has been grossly negligent, the general partner is not necessarily liable under Section 4-409(c). The office manager's gross negligence is not automatically attributed to the general partner. Under Section 4-409(c), the question is whether the general partner was grossly negligent (or worse) in selecting the office manager, delegating insurance renewal matters to the office manager, and supervising the office manager after the delegation.

The partnership agreement may also provide for delegation and, subject to Section 4-105(c)(6)-(8) and (d)(2), may modify a general partner's duties under Section 4-409.

For limited partnerships that have more than one general partner, this article provides that in most circumstances a "matter relating to the activities and affairs of the partnership is decided ... by a majority of the general partners." However, unlike corporate statutes, this article does not provide a rule for the quantum of participation necessary to constitute "a majority." *Cf., e.g.,* MINN. STAT. § 302A.237 (2014) (providing rules for determining the votes need to constitute "an act of the board"). If a limited partnership has more than one general partner, the partnership agreement should consider what "a majority" means in the event a general partner position is vacant. Note also that for some decisions this article requires the affirmative vote or consent of all partners. *See* the comment to Section 4-406(b).

**Subsection (b)** – Other provisions of this article also contain default rules providing for unanimous consent. *E.g.,* Sections 4-301(b)(3) (for a person to become a limited partner after formation of the limited partnership), 4-401(b)(3) (same as to becoming a general partner), and 4-502(3) (for compromising a person's obligation to make a contribution). In addition, the transactions authorized under Article 2 each have a default unanimous consent requirement.

**Subsections (a) and (b)** – These subsections have important implications for a partner's actual authority to act on behalf of the partnership. The actual authority of a general partner is a question of agency law, *see* RESTATEMENT (THIRD) OF AGENCY § 3.01 (2006) (Creation of Actual Authority), and depends fundamentally on the contents of the partnership agreement. If, however, the partnership agreement is silent on the issue, this subsection helps delineate that actual authority. Acting individually, a general partner:

- has no actual authority to commit the limited partnership to any matter for which this article requires the affirmative vote or consent of all partners;
- has the actual authority to commit the limited partnership to usual and customary matters, unless the general partner has reason to know that: (i) other general partners

might disagree; or (ii) for some other reason consultation with fellow general partners is appropriate; and

- has no actual authority to take unusual or non-customary actions that will have a substantial effect on the limited partnership.

The first point follows self-evidently from the language of this article. Where this article requires unanimity of all partners, no general partner could reasonably believe to the contrary (unless the partnership agreement provided otherwise).

The second point follows because:

- Subsection (a) serves as the gap-filler manifestation from the limited partnership to its general partners and does *not* require partners to act *only* in concert or after consultation. To the contrary, subject to the partnership agreement, this subsection expressly provides that “[e]ach general partner has equal rights in the management and conduct of the limited partnership’s activities and affairs.”
- It would be impractical to require collective action on even the smallest of decisions.
- However, to the extent a general partner has reason to know of a possible difference of opinion among the general partners, this subsection requires a decision by “a majority of the general partners.”

A third point is a matter of common sense. The more serious the matter, the less likely it is that a general partner has actual authority to act unilaterally. *Cf.* RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. c (2006) (noting the unreasonableness 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”).

**Subsection (e)** – In a limited partnership, winding up is one of the tasks for which the limited partners depend on the general partner. There is no reason for this article to single out this particular task as giving rise to compensation.

#### **SECTION 4-407. RIGHTS TO INFORMATION OF GENERAL PARTNER AND PERSON DISSOCIATED AS GENERAL PARTNER.**

(a) A general partner may inspect and copy required information during regular business hours in the limited partnership’s principal office, without having any particular purpose for seeking the information.

(b) On reasonable notice, a general partner may inspect and copy during regular business hours, at a reasonable location specified by the limited partnership, any record maintained by the

partnership regarding the partnership's activities, affairs, financial condition, and other circumstances, to the extent the information is material to the general partner's rights and duties under the partnership agreement or this [Code].

(c) A limited partnership shall furnish to each general partner:

(1) without demand, any information concerning the partnership's activities, affairs, financial condition, and other circumstances which the partnership knows and is material to the proper exercise of the general partner's rights and duties under the partnership agreement or this [Code], except to the extent the partnership can establish that it reasonably believes the general partner already knows the information; and

(2) on demand, any other information concerning the partnership's activities, affairs, financial condition, and other circumstances, except to the extent the demand or the information demanded is unreasonable or otherwise improper under the circumstances.

(d) The duty to furnish information under subsection (c) also applies to each general partner to the extent the general partner knows any of the information described in subsection (b).

(e) Subject to subsection (j), on 10 days' demand made in a record received by a limited partnership, a person dissociated as a general partner may have access to the information and records described in subsections (a) and (b) at the locations specified in those subsections if:

(1) the information or record pertains to the period during which the person was a general partner;

(2) the person seeks the information or record in good faith; and

(3) the person satisfies the requirements imposed on a limited partner by Section 4-304(b).

(f) A limited partnership shall respond to a demand made pursuant to subsection (e) in the manner provided in Section 4-304(c).

(g) A limited partnership may charge a person that makes a demand under this section the reasonable costs of copying, limited to the costs of labor and material.

(h) A general partner or person dissociated as a general partner may exercise the rights under this section through an agent or, in the case of an individual under legal disability, a legal representative. Any restriction or condition imposed by the partnership agreement or under subsection (j) applies both to the agent or legal representative and to the general partner or person dissociated as a general partner.

(i) The rights under this section do not extend to a person as transferee, but if:

(1) a general partner dies, Section 4-704 applies; and

(2) an individual dissociates as a general partner under Section 4-603(6)(B) or (C), the legal representative of the individual may exercise the rights under subsection (c) of a person dissociated as a general partner.

(j) In addition to any restriction or condition stated in its partnership agreement, a limited partnership, as a matter within the ordinary course of its activities and affairs, may impose reasonable restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient. In a dispute concerning the reasonableness of a restriction under this subsection, the partnership has the burden of proving reasonableness.

### **Comment**

**Subsection (a)** – The phrase “required information” is a defined term. *See* Sections 4-102(a)(10) and 4-108. This subsection’s broad right of access is subject both to reasonable limitations in the partnership agreement, Section 4-105(c)(9), and also the power of the limited partnership to impose reasonable limitations on use, Subsection (j). However, limiting a general



partner's access to this information or any other information would be quite unusual.

**Subsection (b)** – This subsection states the rule pertaining to information memorialized in “any record maintained by the partnership.” Except in unusual circumstances (*e.g.*, a back-up general partner with no ongoing responsibilities), all of the information encompassed by this provision will be “material to the general partner’s rights and duties under the partnership agreement or this [Code].” For further discussion of the meaning of “material” as applied to information, see the comment to Section 4-409(f).

**Subsection (c)** – Because a limited partnership is an entity, this subsection imposes a duty on the partnership, not the partners. However, the general partners are typically responsible for seeing that the limited partnership fulfills this obligation. For the limited partnership, breaching this obligation is a matter of strict liability (analogous to breaching a contract). In contrast, Section 4-409 provides the standard for evaluating a general partner’s conduct in this context. Subsection (d) establishes a separate duty for the general partners.

A general partner’s right to information under this subsection is personal to the general partner and enforceable under Section 4-901(a). These rights are in addition to whatever discovery rights a party has in a civil suit.

**Subsection (c)(1)** – This provision imposes an affirmative duty to volunteer information. However, given the assumption that each general partner will be active in management, the obligation ceases “to the extent the partnership can establish that it reasonably believes the general partner already knows the information.”

In any event, the obligation is limited to information which is both material and known by the limited partnership. “Knowledge” is viewed subjectively – *i.e.*, actual knowledge. Section 4-103(a)(1). Materiality is viewed objectively. Thus, the duty applies to known, material information, even if the limited partnership does not know that the information is material.

A limited partnership will “know” what its general partners know. Under Section 4-103(f), “[a] general partner’s knowledge ... of a fact relating to the limited partnership is effective immediately as knowledge of or notice to the partnership.” As to others acting or reasonably appearing to act on behalf of the limited partnership, common law agency rules will apply. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006) (Imputation of Notice of Fact to Principal).

Typically a general partner’s duties are continuous, and therefore a general partner’s right to information is not just transaction-specific. Ongoing managerial responsibilities require ongoing information – both periodically and *ad hoc* when a situation warrants.

For the meaning of “material” as applied to information, see the comment to Section 4-409(f).

**Subsection (c)(2)** – Other law determines which party has the burden of proof as to the stated exception.

**Subsection (d)** – This subsection imposes a duty directly on each general partner. The duty is both narrower and more demanding than the duty placed on general partners as the typically responsible parties under Subsection (c). The duty is narrower because the relevant information is confined to “the information [pertaining to records] described in subsection (b),” rather than the wide scope of “any information” delineated by Subsection (c). The duty is more demanding because it applies directly to the general partners, is therefore in the nature of a contractual obligation, and its breach is a matter of strict liability. For example, it is no defense for a general partner under this section to assert that, although the partner failed to furnish required information, the failure did not amount to gross negligence under Section 4-409(c).

EXAMPLE: A limited partnership has two general partners: each of which is regularly engaged in conducting the limited partnership’s activities; both of which are aware of and have regular access to all significant limited partnership records; and neither of which has special responsibility for or knowledge of any particular aspect of those activities or the relevant partnership records. Most likely, neither general partner is obliged to draw the other general partner’s attention to information apparent in the limited partnership’s records.

EXAMPLE: Although a limited partnership has three general partners, one is the managing partner with day-to-day responsibility for running the limited partnership’s activities. The other two meet periodically with the managing general partner, and together with that partner function in a manner analogous to a corporate board of directors. Most likely, the managing general partner has a duty to draw the attention of the other general partners to important information, even if that information would be apparent from a review of the limited partnership’s records.

As with Subsection (c), a general partner’s right to information under this subsection is personal to the general partner and enforceable under Section 4-901(a). These rights are in addition to whatever discovery rights a party has in a civil suit.

**Subsection (e)** – Codifying the information rights of former owners began with RUPA (1997) § 403(b). Access is limited and subject to conditions, most of which are drawn from Section 4-304 (pertaining to the information rights of limited partners). *See also* Subsection (i) (providing information rights to the legal representative of a deceased general partner); Section 4-704 (providing additional information rights to the legal representative of the deceased partner).

**Subsection (e)(1)** – A person dissociated as a general partner has information rights in that capacity only as to the period during which the person was a general partner. To the extent that further information is accessible under Section 4-704(2) (providing access to the legal representative of a deceased partner’s estate), that access is limited both in purpose (“for purposes of settling the estate”) and in scope (“the rights of a current limited partner under Section 4-304”).

**Subsection (e)(2)** – A duty of good faith is needed here, because a person claiming access under this subsection is no longer a general partner and no longer subject to a general partner’s duties and obligations under Section 4-409. Section 4-605(a)(2) (dissociation as a partner

terminates duty of good faith as to subsequent events). *But see id.*, comment (noting that the common law implied covenant will continue to be relevant if the partnership agreement provides continuing rights and obligations for a person dissociated as a general partner).

In the context of Subsection (e)(2), “good faith” is properly understood to mean an honest belief that the request is made for a proper purpose. *Associated Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 285 (Tex. 1998) (holding that “‘good faith’ in the surety agreement before us refers to conduct which is honest in fact, free of improper motive or wilful ignorance of the facts at hand”); *Andrews v. Bible*, 812 S.W.2d 284, 288 (Tenn. 1991) (describing “subjective good faith” as “[a] pure heart but an empty head”) (quoting *Whittington v. Ohio River Co.*, 115 F.R.D. 201, 209 (E.D.Ky.1987)). Willful ignorance includes being an ostrich. “While ‘honesty’ may require no more than a pure heart, it is questionable that a pure heart can co-exist with closed eyes. It is not honest to close one’s eyes so as to maintain an empty head.” *J.R. Hale Contracting Co. v. United New Mexico Bank at Albuquerque*, 799 P.2d 581, 591 (NM 1990). *See also* UPA (1914) § (3)(1) (“A person has ‘knowledge’ of a fact within the meaning of this act not only when he has actual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances shows bad faith.”).

**Subsection (e)(3)** – Applying the limited partner standard Section 4-304(b) to a person dissociated as a general partner makes sense, because the person has no further management role. Theoretically, an even stricter standard might apply, because limited partners have at least some governance role. However, this article already has several different standards applicable to information rights. *See* Sections 4-304(b) (limited partner), Section 4-304(e) (person dissociated as a limited partner), 4-407(b), (c)(2) (general partner), 4-407(e) (person dissociated as a general partner). This article applies Section 4-304(b) to a person dissociated as a general partner to avoid having to create another standard.

**Subsection (h)** – Some old cases involved conflicts over whether a shareholder could exercise inspection rights through another person. *White v. Coeur D’Alene Big Creek Mining Co.*, 55 P.2d 720, 723 (Idaho 1936) (stating that “[t]he refusal to permit respondent [shareholder] to appoint his own attorney or agent to make the examination [of the corporation’s books] was in effect a denial of his right” of inspection); *State v. Monida & Yellowstone Stage Co.*, 124 N.W. 971, 972 (Minn. 1910) (upholding a trial court’s mandamus order, “which shall provide that [the shareholder complainant], or such attorney or agent as he may select, ... shall be allowed to inspect the books, records, and papers of the defendant [corporation]”). In light of that history, for the avoidance of doubt, this subsection expressly authorizes taking action through an agent. No negative inference should be drawn about using agents to take other action under this article.

**Subsection (i)** – This section provides no information rights to a person as transferee. Transferee status brings only the very limited information rights stated in Section 4-702(c). However, a transferee that is a person dissociated as a limited partner has rights in the latter capacity under Subsection (e).

**Subsection (j)** – This subsection provides fallback protection for gaps in the partnership agreement. For example, the general partners may protect trade secrets from disclosure and prohibit various misuses of confidential information even if the partnership agreement omits to

do so.

Strictly speaking, the reference to “ordinary course” is unnecessary. *See* Section 4-406(a) (providing generally that “any matter relating to the activities and affairs of the partnership is decided exclusively” by the general partners). The phrase is included merely for the avoidance of doubt.

The limited partnership bears the burden of proving the reasonableness of any restriction imposed under this subsection. In determining whether a restriction is reasonable, a court might consider: (i) the danger or other problem the restriction seeks to avoid; (ii) the purpose for which the information is sought; and (iii) whether, in light of both the problem and the purpose, the restriction is reasonably tailored.

The burden of persuasion under this subsection contrasts with the burden of persuasion under Section 4-105(c)(9) (prohibiting unreasonable limitations on the information rights provided by this section). Under that paragraph, as a matter of ordinary procedural law the burden is on the person making the claim.

#### **SECTION 4-408. REIMBURSEMENT; INDEMNIFICATION; ADVANCEMENT; AND INSURANCE.**

(a) A limited partnership shall reimburse a general partner for any payment made by the general partner in the course of the general partner’s activities on behalf of the partnership, if the general partner complied with Sections 4-406, 4-409, and 4-504 in making the payment.

(b) A limited partnership shall indemnify and hold harmless a person with respect to any claim or demand against the person and any debt, obligation, or other liability incurred by the person by reason of the person’s former or present capacity as a general partner, if the claim, demand, debt, obligation, or other liability does not arise from the person’s breach of Section 4-406, 4-409, or 4-504.

(c) In the ordinary course of its activities and affairs, a limited partnership may advance reasonable expenses, including attorney’s fees and costs, incurred by a person in connection with a claim or demand against the person by reason of the person’s former or present capacity as a general partner, if the person promises to repay the partnership if the person ultimately is

determined not to be entitled to be indemnified under subsection (b).

(d) A limited partnership may purchase and maintain insurance on behalf of a general partner against liability asserted against or incurred by the general partner in that capacity or arising from that status even if, under Section 4-105(c)(8), the partnership agreement could not eliminate or limit the person's liability to the partnership for the conduct giving rise to the liability.

### Comment

**Subsections (a) and (b)** – These subsections apply only to general partners. A limited partnership's obligation, if any, to reimburse or indemnify others (*e.g.*, employees, independent contractors, other agents) is a question for other law, including the law of agency, contract and restitution. The fact a person has dissociated as a partner does not affect any obligations incurred by the partnership under these subsections for conduct occurring before the dissociation.

To the extent a partnership agreement modifies or displaces the default rules stated in Sections 4-406 and 4-409, the agreement should also address these subsections. For example, if the partnership agreement establishes a duty of ordinary care (modifying Section 4-409(c)), the agreement should specify which level of care is necessary to satisfy Subsections (a) and (b). It is not necessary that the levels of care be the same, only that the partnership agreement make the situation clear and thereby avoid difficult issues of interpretation.

**Subsection (a)** – The reimbursement obligation stated here is a default rule and roughly parallels a rule of agency law. RESTATEMENT (THIRD) OF AGENCY § 8.14(2)(a) (2006) (stating that “[a] principal has a duty to indemnify an agent ... when the agent makes a payment (i) within the scope of the agent's actual authority, or (ii) that is beneficial to the principal, unless the agent acts officiously in making the payment”).

**Subsection (b)** – This subsection provides for indemnification but only as a default rule. Subject only to Section 4-105(c)(8), the partnership agreement can relax these preconditions substantially. The agreement can also impose stricter preconditions.

The rule's eligibility requirements correspond to the default rules on management duties, which is appropriate because otherwise the statutory default rule on indemnification could undercut or even vitiate the statutory default rules on duty.

Although referring broadly to any “person,” this subsection is actually limited to present and former general partners. The indemnification obligation applies to only to a “debt, obligation, or other liability incurred by the person by reason of the person's former or present capacity as a general partner.” Thus, by its terms this subsection does not apply to a person in the capacity of an officer, manager, CEO, etc.

Of course, the partnership agreement may mandate indemnification to officers, managers, employees, and other persons providing services to or acting for the limited partnership. Within the limitations stated in Section 4-105(c)(8), a limited partnership agreement may obligate a limited partnership to indemnify a person even when the person has breached a managerial duty or the partnership agreement itself.

**Subsection (c)** – This subsection authorizes but does not require a limited partnership to provide advances to cover expenses. *Cf. Majkowski v. American Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 589 (Del. Ch. 2006) (“Because rights to indemnification and advancement differ in important ways, our courts have refused to recognize claims for advancement not granted in specific language clearly suggesting such rights.”). The phrase “hold harmless” likewise does not encompass advances. *Id.* The authorization applies only to those persons eligible for indemnification under Subsection (b), but the partnership agreement certainly can authorize a broader scope and even make advances obligatory.

The reference to “ordinary course” pertains to Section 4-406(a) (stating that “any matter relating to the activities and affairs of the partnership is decided exclusively by the general partner or, if there is more than one general partner, by a majority of the general partners.”)

**Subsection (d)** – This subsection’s language is very broad and authorizes a limited partnership to purchase insurance to cover, *e.g.*, a general partner’s intentional misconduct. It is unlikely that such insurance would be available. This authorization comes from this article, not the partnership agreement, and therefore is not subject to restrictions stated in Section 4-105(c)(8) (precluding the partnership agreement from “reliev[ing] or exonerat[ing] a person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law”).

#### **SECTION 4-409. STANDARDS OF CONDUCT FOR GENERAL PARTNERS.**

(a) A general partner owes to the limited partnership and, subject to Section 4-901, the other partners the duties of loyalty and care stated in subsections (b) and (c).

(b) The fiduciary duty of loyalty of a general partner includes the duties:

(1) to account to the limited partnership and hold as trustee for it any property, profit, or benefit derived by the general partner:

(A) in the conduct or winding up of the partnership’s activities and affairs;

(B) from a use by the general partner of the partnership’s property; or

(C) from the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of

the partnership's activities and affairs as or on behalf of a person having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct or winding up of the partnership's activities and affairs.

(c) The duty of care of a general partner in the conduct or winding up of the limited partnership's activities and affairs is to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or knowing violation of law.

(d) A general partner shall discharge the duties and obligations under this [Code] or under the partnership agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.

(e) A general partner does not violate a duty or obligation under this [Code] or under the partnership agreement solely because the general partner's conduct furthers the general partner's own interest.

(f) All the partners of a limited partnership may authorize or ratify, after full disclosure of all material facts, a specific act or transaction by a general partner that otherwise would violate the duty of loyalty.

(g) It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the limited partnership.

(h) If, as permitted by subsection (f) or the partnership agreement, a general partner enters into a transaction with the limited partnership which otherwise would be prohibited by subsection (b)(2), the general partner's rights and obligations arising from the transaction are the same as those of a person that is not a general partner.

## Comment

ULPA (2001) derived this section from UPA (1997) § 404. The 2011 and 2013 Harmonization amendments made one major substantive change; they “un-cabined” fiduciary duty. UPA (1997) § 404 had deviated substantially from UPA (1914) by purporting to codify all fiduciary duties owed by partners. This approach had a number of problems. Most notably, the exhaustive list of fiduciary duties left no room for the fiduciary duty owed by partners to each other – *i.e.*, “the punctilio of an honor the most sensitive.” *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928). Although UPA (1997) § 404(b) purported to state “[a] partner’s duty of loyalty to the partnership *and the other partners*” (emphasis added), the three listed duties each protected the partnership and not the partners.

The 2011 and 2013 Harmonization amendments “un-cabined” fiduciary duty in both partnership acts, thereby harmonizing them to ULLCA (2006). As harmonized, this section states some of the core aspects of the fiduciary duty of loyalty, provides a duty of care, and incorporates the contractual obligation of good faith and fair dealing. The duties stated in this section are subject to the limited partnership agreement, but Section 4-105(c) and (d) contain important limitations on the power of the partnership agreement to affect fiduciary and other duties and the obligation of good faith and fair dealing.

For the effect of dissociation on a person’s duties under this section, see Sections 4-602(a)(2) (limited partners) and 4-605(a)(2) (general partners).

**Subsection (a)** – This subsection recognizes two core managerial duties but, unlike UPA (1997) and ULPA (2001), does not purport to be exhaustive. For example, many cases characterize a manager’s duty to disclose as a fiduciary duty. *E.g.*, *Lonergan v. EPE Holdings, LLC*, 5 A.3d 1008, 1023 (Del. Ch. 2010) (stating that “in the limited partnership context, absent contractual modification, a general partner owes fiduciary duties that include a duty of full disclosure”) (quotation marks and citation omitted); *Exxon Corp. v. Burghlin*, 4 F.3d 1294, 1298 (5th Cir. 1993) (“Under Alaska law, a general partner stands in a fiduciary relationship with the limited partnership and thereby owes ‘a fiduciary duty ... to disclose information concerning partnership affairs.’”) (quoting *Parker v. Northern Mixing Co.*, 756 P.2d 881, 894 (Alaska 1988)).

**Subsection (b)** – This subsection states three core aspects of the fiduciary duty of loyalty: (i) not “usurping” partnership opportunities or otherwise wrongly benefiting from the limited partnership’s operations or property; (ii) avoiding conflict of interests in dealing with the limited partnership (whether directly or on behalf of another); and (iii) refraining from competing with the limited partnership. Essentially the same duties exist in agency law and under the law of all types of business organizations.

The duties apply beginning with “the conduct of the partnership’s activities and affairs,” which by definition cannot exist before the partnership does; thus the stated duties do not apply to pre-formation activities.

The duties stated in this subsection comprise a default rule. Under Section 4-105(d)(3)(A): “If not manifestly unreasonable, the partnership agreement may ... alter or



eliminate the aspects of the duty of loyalty stated in Section 4-409(b).”

**Subsection (b)(1)** – The phrase “hold as trustee” dates back to UPA (1914) § 21 and reflects the availability of disgorgement remedies, such as a constructive trust. In contrast to an actual trustee, a person subject to this duty does not: (i) face the special obstacles to consent characteristic of trust law; or (ii) enjoy protection for decisions taken in reliance on the governing instrument and other sources of information. Cf. Section 8-506 (“A trustee [of a statutory trust] ... is not liable to the trust or to a beneficial owner for breach of any duty, *including a fiduciary duty*, to the extent the breach results from reasonable reliance on: (1) a term of the governing instrument; (2) a record of the statutory trust; or (3) an opinion, report, or statement of another person that the person to which the opinion, report, or statement is made or delivered reasonably believes is within the other person’s professional or expert competence and is made or delivered to the trustee. ...”) (emphasis added).

**Subsection (b)(1)(A)** – This provision is consistent with a basic principle of agency law – namely, that an agent may not benefit at all from the performance of the agency unless the principal consents. RESTATEMENT (THIRD) OF AGENCY § 8.06, cmt. c. (2006). Typically, however, the limited partnership agreement legitimizes particular benefits – *e.g.*, a management fee paid to a general partner in addition to that partner’s share of distributions. Also, an agreed allocation of distributions takes those benefits outside the reach of this provision.

**Subsection (b)(1)(B)** – For the expansive meaning of “property,” see Section 1-102(38). The term includes confidential information.

**Subsection (b)(1)(C)** – This article does not specify what constitutes “a partnership opportunity,” but ample case law exists. *See, e.g., In re Monetary Grp.*, 159 B.R. 964 (M.D. Fla. 1990) (discussing the usurpation of a limited partnership opportunity”), *aff’d in part, rev’d in part*, 2 F.3d 1098 (11th Cir. 1993); *Lichtyger v. Franchard Corp.*, 18 N.Y.2d 528, 223 N.E.2d 869, 873 (1966) (“There is no basis or warrant for distinguishing the fiduciary relationship of corporate director and shareholder from that of general partner and limited partner.”)

In the context of winding up, the scope of partnership opportunities inevitably narrows.

In most, if not all, situations, usurping a partnership opportunity also breaches the duty not to compete, Paragraph (b)(3), but not *vice versa*.

**Subsection (b)(2)** – In this context, the phrase “adverse interest” is a term of art, meaning “to be on the other side of the table” in some dealing with the limited partnership. Absent informed consent by the limited partnership, this duty is breached by the mere existence of the conflict of interest; the limited partnership need not prove that the outcome of the dealing was adverse to the partnership. *But see* Subsection (g) (permitting the defense of fairness).

**Subsection (b)(3)** – Although competition is often thought of in terms of potential customers, this duty applies equally to competition for resources, including employees.

**Subsection (c)** – This article no longer refers to the duty of care as a fiduciary duty, because: (i) the duty of care applies in many non-fiduciary situations; and (ii) breach of the duty

of care is remediable only in damages while breach of a fiduciary duty gives rise also to equitable remedies, including disgorgement, constructive trust, and rescission.

The change in label is consistent with the RESTATEMENT (THIRD) OF AGENCY § 8.02 (2006), which refers to the agent's "fiduciary duty" to act loyally, but eschews the word "fiduciary" when stating the agent's duties of "care, competence, and diligence." *Id.* § 8.08. However, the label change is merely semantics; no change in the law is intended.

The partnership agreement can raise the standard of care, or subject to Sections 4-105(c)(8) and (d)(2)(C), lower it. A person's practical exposure for breaching the duty of care involves not only the standard of care but also any partnership agreement provision that: (i) exonerates the person from liability for breach of the duty of care, Section 4-105(c)(8); or (ii) entitles the person to indemnification despite such breach, Section 4-408(b), comment.

**Subsection (d)** – This subsection refers to the "*contractual* obligation of good faith and fair dealing" (emphasis added) and thereby invokes the implied obligation that exists in every contract. *See* RESTATEMENT (SECOND) CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). The adjective ("*contractual*") should help avoid decisions like *Phelps v. Frampton*, 2007 MT 263, 339 Mont. 330, 342-43, 170 P.3d 474, 483 (2007) (holding that Montana's version of UPA (1997) creates a statutory obligation of good faith and fair dealing separate from the implied contractual covenant).

At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights – *i.e.*, duties and rights "under this [Code]." However, for the most part those duties and rights apply to relationships *inter se* the partners and the limited partnership and function only to the extent not displaced by the partnership agreement. Those statutory default rules are thus intended to function like a contract; applying the contractual notion of good faith and fair dealing therefore makes sense.

The contractual obligation of "good faith" has nothing to do with 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." DEL. CODE ANN. tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty. *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006).

Likewise, the contractual obligation of good faith and fair dealing has nothing to do with the "utmost good faith" sometimes used to describe the fiduciary duties that owners of closely held businesses owe each other. *See, e.g., Meinhard v. Salmon*, 249 N.Y. 458, 477, 164 N.E. 545, 551 (1928) ("[W]here parties engage in a joint enterprise each owes to the other the duty of the utmost good faith in all that relates to their common venture. Within its scope they stand in a fiduciary relationship."); *Donahue v. Rodd Electrottype Co. of New England, Inc.*, 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975) ("[S]tockholders 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 omitted) (citations omitted) (internal

quotations omitted).

To the contrary, the contractual obligation of good faith and fair dealing is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a general partner from acting in the general partner's own self-interest:

“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.

*Gerber v. Enter. Products Holdings, LLC*, 67 A.3d 400, 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). *See also* Subsection (e).

Courts should not use the contractual obligation to change *ex post facto* the parties' or this Code's allocation of risk and power. To the contrary, 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.

The partnership agreement or this article may grant discretion to a general partner, and the contractual obligation of good faith and fair dealing is especially salient when discretion is at issue. However, a general partner may properly exercise discretion even though another partner (whether general or limited) suffers as a consequence. Conduct does not violate the obligation of good faith and fair dealing merely because that conduct substantially prejudices a party. Indeed, parties allocate risk precisely because prejudice may occur.

The exercise of discretion constitutes a breach of the obligation of good faith and fair dealing only when the party claiming breach shows that the conduct has no honestly-held purpose that legitimately comports with the parties' agreed-upon arrangements:

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.*

*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 by *Gerber*).

In sum, the purpose of the contractual obligation of good faith and fair dealing is to

protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.

As to the power of the partnership agreement to affect the contractual obligation of good faith and fair dealing, see Section 4-105(c)(7) (prohibiting elimination but allowing the agreement to “prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured”). For examples, see the comment to Section 4-105(c)(7). As to whether the obligation stated in this subsection applies to the benefit of transferees, see the comment to Section 4-107(b).

**Subsection (e)** – A general partner in a limited partnership has at least two different roles: (i) as a party to the limited partnership agreement, with rights and obligations under that agreement; and (ii) as manager or co-manager of the enterprise. This provision pertains to the first role. A general partner’s exercise of rights under the partnership agreement is subject to the obligation of good faith and fair dealing, Subsection (d), but a general partner does not breach that contractual obligation “solely because the general partner’s conduct furthers the general partner’s own interest.” In contrast, this provision is ineffective with regard to a general partner’s duties as manager or co-manager. For example, a general partner’s liability under Section 4-409(b)(3) (prohibiting competition) is not “solely because the general partner’s conduct furthers the general partner’s own interest.” Rather, the liability results from the breach of a specific obligation – *i.e.*, the codified aspect of the duty of loyalty that prohibits competition.

**Subsection (f)** – Here and elsewhere in this Code, information “is material if there is a substantial likelihood that a reasonable [decision maker] would consider it important in deciding how to vote” or take other action under this Code or the partnership agreements. *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132 (1976).

The partnership agreement can provide additional or different methods of authorization or ratification, subject to the strictures of Section 4-105(c)(5), (d)(1), and (d)(3)(A)(B) and (D).

**Subsection (g)** – This subsection codifies judge-made law applicable to all business entities. *See, e.g., Lonergan v. EPE Holdings, LLC*, 5 A.3d 1008, 1019 (Del. Ch. 2010) (discussing “entire fairness” in the context of a limited partnership”); *Gottsacker v. Monnier*, 281 Wis. 2d 361, 379, 697 N.W.2d 436, 444 (Wisc. 2005) (referring to “a willful failure to deal fairly with the LLC or its other members”); *Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (discussing “entire fairness” in the context of a corporation’s merger with an affiliate).

**Subsection (h)** – This subsection is the modern, reformulated version of a language that sought to overturn the now-defunct notion that debts to partners were categorically inferior to debts to non-partner creditors. *See, e.g., ULPA* (2001) § 112 (“A partner may lend money to and transact other business with the limited partnership and has the same rights and obligations with respect to the loan or other transaction as a person that is not a partner.”). The reformulation makes clear that this provision has nothing to do with the fiduciary duty pertaining to conflict of interests. *See BT-I v. Equitable Life Assurance Soc’y of the United States*, 75 Cal. App. 4th 1406, 1415, 89 Cal. Rptr. 2d 811 (1999) (examining the prior formulation, explaining its history and stating “[w]e cannot discern anything in the purpose of [the prior formulation] that suggests an

intent to affect a general partner's fiduciary duty to limited partners”).

This subsection states a default rule. The partnership agreement may provide that debt to a general partner (or general partners generally) is subordinate to other partnership obligations. The agreement that creates the debt may do likewise.

## **[PART] 5**

### **CONTRIBUTIONS AND DISTRIBUTIONS**

#### **Introductory Comment**

With the exception of Section 4-505, this part applies in the same way to both general and limited partners.

**SECTION 4-501. FORM OF CONTRIBUTION.** A contribution may consist of property transferred to, services performed for, or another benefit provided to the limited partnership or an agreement to transfer property to, perform services for, or provide another benefit to the partnership.

#### **Comment**

This section is intentionally quite broad, encompassing past, present, and promised benefits. Comparable language exists in most, if not all, limited partnership statutes, and case law recognizes the intended broadness of this approach. *See, e.g., Rival 1981-IV Drilling Program, Ltd. v. Guar. Bank & Trust*, 732 P.2d 1233, 1234 (Colo. Ct. App. 1986) (letter of credit as contribution); *Rehfuss v. Moore*, 19 A. 756, 757 (Pa. 1890) (patent rights); *Belgard v. Manchac Technologies, LLC*, 92 So.3d 660, 664 (La. Ct. App. 3d Cir. 2012) (establishing a line of credit).

This article does not contain a statute of frauds specifically applicable to promised contributions. Generally applicable statutes of fraud might apply, however. For example, a promise to contribute land to the limited partnership would be subject to the statute of frauds pertaining to land transfers. *See Gunsorek v. Hearland Bank*, 707 N.E.2d 557, 564 (Ohio 1997) (holding that where terms of oral partnership agreement required limited partner to contribute real property, statute of frauds barred enforceability of the agreement). Likewise, a promise that by its terms requires performance that extends beyond one year from the making of the contract would be subject to the one-year provision of the statute of frauds. *See* the comment to Section 4-102(a)(9).

#### **SECTION 4-502. LIABILITY FOR CONTRIBUTION.**

(a) A person’s obligation to make a contribution to a limited partnership is not excused by the person’s death, disability, termination, or other inability to perform personally.

(b) If a person does not fulfill an obligation to make a contribution other than money, the person is obligated at the option of the limited partnership to contribute money equal to the value, as stated in the required information, of the part of the contribution which has not been made.

(c) The obligation of a person to make a contribution may be compromised only by the affirmative vote or consent of all the partners. If a creditor of a limited partnership extends credit or otherwise acts in reliance on an obligation described in subsection (a) without knowledge or notice of a compromise under this subsection, the creditor may enforce the obligation.

### Comment

**Subsection (a)** – Under common law principles of impracticability, an individual’s death or incapacity will sometimes discharge a duty to render performance. RESTATEMENT (SECOND) OF CONTRACTS §§ 261 (Discharge by Supervening Impracticability), 262 (Death or Incapacity of Person Necessary For Performance) (1981). This subsection overrides those principles. Moreover, the reference to “perform personally” is not limited to individuals but rather may refer to any legal person (including an entity) that has a non-delegable duty.

**Subsection (b)** – This subsection is a statutory liquidated damage provision, exercisable at the option of the limited partnership, with the damage amount set according to the value of the promised, non-monetary contribution.

EXAMPLE: In order to become a partner, a person promises to contribute to the limited partnership various assets which the partnership agreement values at \$150,000. In return for the person’s promise, and in light of the agreed value, the limited partnership admits the person as a partner with a right to receive 25% of the limited partnership’s distributions.

The promised assets are subject to a security agreement, but the partner promises to contribute them “free and clear.” Before the partner can contribute the assets, the secured party forecloses on the security interest and sells the assets at a public sale for \$75,000. Even if the \$75,000 reflects the actual fair market value of the assets, under this subsection the limited partnership has a claim against the partner for “money equal to the value . . . of the part of the contribution which has not been made” – *i.e.*, \$150,000.

EXAMPLE: Same facts as the previous example, except that the public sale brings \$225,000. The limited partnership is neither obliged to invoke this subsection nor limited to the \$150,000 valuation. The limited partnership may instead sue for breach of the promise to make the contribution, asserting the \$225,000 figure as evidence of the actual loss suffered as a result of the breach.

**Subsection (c)** – The unanimity requirement expressed in the first sentence might indirectly benefit creditors, but the requirement is nonetheless a default rule and therefore may be varied by the partnership agreement. The right of each partner to consent is not a “right[] under this [Code] of a person other than a partner.” *See* Section 4-105(c)(18) (preventing the partnership agreement from affecting such rights). In contrast, the creditor right stated in the second sentence fits squarely within Section 4-105(c)(18) and therefore may not be varied by the partnership agreement.

#### **SECTION 4-503. SHARING OF AND RIGHT TO DISTRIBUTIONS BEFORE DISSOLUTION.**

(a) Any distribution made by a limited partnership before its dissolution and winding up must be shared among the partners on the basis of the value, as stated in the required information when the limited partnership decides to make the distribution, of the contributions the limited partnership has received from each partner, except to the extent necessary to comply with a transfer effective under Section 4-702 or charging order in effect under Section 4-703.

(b) A person has a right to a distribution before the dissolution and winding up of a limited partnership only if the partnership decides to make an interim distribution. A person’s dissociation does not entitle the person to a distribution.

(c) A person does not have a right to demand or receive a distribution from a limited partnership in any form other than money. Except as otherwise provided in Section 4-810(f), a partnership may distribute an asset in kind only if each part of the asset is fungible with each other part and each person receives a percentage of the asset equal in value to the person’s share of distributions.

(d) If a partner or transferee becomes entitled to receive a distribution, the partner or transferee has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution. However, the partnership’s obligation to make a distribution is subject to offset for any amount owed to the partnership by the partner or a person

dissociated as a partner on whose account the distribution is made.

### Comment

Past uniform unincorporated entity acts and many current limited partnership acts provide default rules for allocation of profits, and UPA (1997) even provided a default structure for maintaining capital accounts. For the following reasons, this article, incorporating changes made by the Harmonization Project, provides a default rule only for rights to share in distributions:

- Capital accounts are maintained for one purpose, to determine how distributions will be made to partners. The rules for maintenance of capital accounts can be very complex. Generally, however, profits increase capital account balances (and increase the amounts that will be distributed to the partners) and losses reduce capital account balances (and reduce the amounts that will be distributed to the partners). If the statute has a simple default rule for how distributions are to be made to the partners, providing an additional set of default profit and loss allocation provisions and capital account rules will be, at best, duplicative and, at worse, inconsistent with the distribution rules.
- Some argue that capital account rules and profit and loss allocation provisions are necessary to comply with tax requirements. Tax income or loss is allocated to partners according to the partners' economic interests in the partnership, and these interests are based on distributions that would be made to partners on liquidation of the partnership. By including default distribution provisions, this article includes the information necessary to make these tax determinations. To the extent the tax law allows partners to make further tax elections or satisfy alternative safe harbors, the partners may look to the tax law for guidance and include necessary provisions in their agreements.

**Subsection (a)** – The rule stated applies to redemptions as well as operating distributions but is a default rule in both contexts. *See* the comment to Section 4-102(a)(3)(A).

**Subsection (b)** – The second sentence of this subsection accords with Section 4-602(a)(3) – upon dissociation a partner is treated as a mere transferee of the partner's own transferable interest. Like most *inter se* rules in this article, this one is subject to the limited partnership agreement. *See* the comment to Section 4-602(a)(3) and Section 4-605(a)(3).

**Subsection (d)** – *See also* Section 4-504(d) (pertaining to the rights of partners and transferees that receive a distribution in the form of indebtedness) and 4-504(e) (pertaining to solvency testing for payments on indebtedness issued to redeem an interest).

### SECTION 4-504. LIMITATIONS ON DISTRIBUTIONS.

(a) A limited partnership may not make a distribution, including a distribution under Section 4-810, if after the distribution:

- (1) the partnership would not be able to pay its debts as they become due in the



ordinary course of the partnership's activities and affairs; or

(2) the partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the partnership were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of partners and transferees whose preferential rights are superior to the rights of persons receiving the distribution.

(b) A limited partnership may base a determination that a distribution is not prohibited under subsection (a) on:

(1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

(2) a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subsection (e), the effect of a distribution under subsection (a) is measured:

(1) in the case of a distribution as defined in Section 4-102(a)(3)(A), as of the earlier of:

(A) the date money or other property is transferred or debt is incurred by the limited partnership; or

(B) the date the person entitled to the distribution ceases to own the interest or right being acquired by the partnership in return for the distribution;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs not later than 120

days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(d) A limited partnership's indebtedness to a partner or transferee incurred by reason of a distribution made in accordance with this section is at parity with the partnership's indebtedness to its general, unsecured creditors, except to the extent subordinated by agreement.

(e) A limited partnership's indebtedness, including indebtedness issued as a distribution, is not a liability for purposes of subsection (a) if the terms of the indebtedness provide that payment of principal and interest is made only if and to the extent that payment of a distribution could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is made.

(f) In measuring the effect of a distribution under Section 4-810, the liabilities of a dissolved limited partnership do not include any claim that has been disposed of under Section 4-806, 4-807, or 4-808.

### **Comment**

Both this section and Section 4-505 were derived essentially from the Model Business Corporation Act § 6.40. Both sections are necessary and appropriate because a limited partnership provides its limited partners a corporate-like liability shield and a limited liability limited partnership provides the shield to general partners as well. With the exception noted in the comment to Subsection (a)(2), the provisions of this section are non-waivable. Section 4-105(c)(18).

“Distribution” does not include “amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.” Section 4-102(a)(3)(B).

**Subsection (a)** – Insolvency is a fundamental issue under this section, and this subsection provides two tests of insolvency. The tests are disjunctive; a distribution violates this section if after the distribution the limited partnership fails either of the tests. The subsection applies both

to interim and liquidating distributions.

Solvency is also a fundamental issue under bankruptcy and fraudulent transfer law, which provide their own respective definitions of the concept.

**Subsection (a)(2)** – The reference to “preferential rights upon dissolution and winding up” is a default rule, because removing this protection for preferred partners or transferees is an *inter se* matter. See Section 4-105(d)(1)(B). The rest of the section is not subject to change in the partnership agreement. Section 4-105(c)(18).

**Subsection (b)** – This subsection states a standard of ordinary care, in contrast with the generally-applicable standard stated in Section 4-409(c) (gross negligence).

**Subsection (b)(2)** – This alternative valuation provision is likely to be both useful and fair when the limited partnership has appreciated assets but for accounting purposes these assets are valued at book value less depreciation.

**Subsection (c)** – This subsection provides three alternative rules for determining the point(s) in time of as which to apply the Subsection (a) solvency tests. The timing depends on which of three categories encompasses a distribution: (i) a distribution in the nature of a redemption (regardless of whether the distribution includes a distribution of indebtedness); (ii) any distribution of indebtedness other than a distribution in the nature of a redemption; and (iii) any distribution that involves neither a redemption nor a distribution of indebtedness. A requirement for additional solvency testing pertaining to distributions of indebtedness appears in Subsection (e).

**Subsection (c)(1)** – Section 4-102(a)(3)(A) encompasses distributions in the nature of a redemption.

**Subsection (c)(1)(A) and (B)** – Under Subparagraph (A), any beginning of payment activity triggers to the rule and sets the date as of when to apply the solvency tests. Under Subparagraph (B), the limited partnership’s complete acquisition of the rights is necessary to trigger the rule.

**Subsection (c)(2)** – This provision states the general rule for distributions that are in the form of debt and which are not connected with a redemption.

**Subsection (c)(3)** – This provision states alternative rules for all distribution of money or property (*i.e.*, not debt). The measuring date depends on the length of time between the authorization and payment of the distribution.

**Subsection (d)** – Compare Subsection (d), with Section 4-503(d) (characterizing as a creditor a person who has become entitled to receive a distribution).

**Subsection (e)** – This subsection contains two rules pertaining to indebtedness issued as part of a distribution and the solvency tests of Subsection (a). The first sentence states the

sensible rule that indebtedness that is essentially subordinated to the solvency requirement – *i.e.*, not payable if making payment would transgress that requirement - is not counted in determining liabilities for purposes of the solvency tests. The second sentence applies the solvency tests to each payment of principal and interest on any indebtedness issued as a distribution, in addition to any previous testing required by Subsection (c)(1)(A) or (c)(2).

**EXAMPLE:** A limited partnership and one of its partners agree that the limited partnership will buy out the partner's entire ownership interest in the partnership in return for a promissory note from the partnership, payable in installments. Under the redemption agreement, the partner yields up all its interests and rights on January 15 and the partnership signs and delivers the note to the dissociated partner on February 15. Under the note, payment of interest is due monthly beginning March 15, with a balloon payment of the principal due December 30.

Under Subsection (c)(1)(B), the solvency tests are applied as of January 15. Under Subsection (e), the solvency tests are again applied on the March 15, April 15, etc., and again on December 30.

**Subsection (f)** – The cited sections provide methods for extinguishing or limiting the debts of a limited partnership that is winding up its affairs and activities and thus any debt affected by any of the cited sections is irrelevant for purposes of solvency testing.

#### **SECTION 4-505. LIABILITY FOR IMPROPER DISTRIBUTIONS.**

(a) If a general partner consents to a distribution made in violation of Section 4-504 and in consenting to the distribution fails to comply with Section 4-409, the general partner is personally liable to the limited partnership for the amount of the distribution which exceeds the amount that could have been distributed without the violation of Section 4-504.

(b) A person that receives a distribution knowing that the distribution violated Section 4-504 is personally liable to the limited partnership but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 4-504.

(c) A general partner against which an action is commenced because the general partner is liable under subsection (a) may:

(1) implead any other person that is liable under subsection (a) and seek to enforce a right of contribution from the person; and

(2) implead any person that received a distribution in violation of subsection (b) and seek to enforce a right of contribution from the person in the amount the person received in violation of subsection (b).

(d) An action under this section is barred unless commenced not later than two years after the distribution.

### Comment

This section and Section 4-504 were derived essentially from Model Business Corporation Act § 6.40. As with Section 4-504, this section is appropriate and necessary due to the liability shield of a limited partnership. The provisions of this section are non-waivable. Section 4-105(c)(18).

This section contemplates two categories of liability: liability of those who have authorized improper distributions, Subsection (a), and the liability of those who have received improper distributions, Subsection (c). Liability that has accrued under this section is not affected by a person subsequently ceasing to be a partner or transferee.

The liability is to the entity, not to the creditors of an insolvent entity. *See Hullett v. Cousin*, 63 P.3d 1029, 1036 (Ariz. 2003) (holding that where limited partners had no intent to defraud creditors, and had no reason to know the partnership was insolvent at the time, return of the partners' contributions was not an improper distribution and could not be used to satisfy creditor's claim against the partnership). However, some cases accord a creditor standing to invoke the statute. *See, e.g., Henkels & McCoy, Inc. v. Adochio*, 906 F.Supp. 244, 249–50 (E.D. Pa. 1995), *aff'd*, 138 F.3d 491, 503–04 (3d Cir. 1998) (holding limited partners liable to creditor where general partner knew or should have known the distributions were in violation of partnership agreement).

This section does not preclude or interfere with claims for fraudulent transfer. *See* the comment to Subsection (d).

**Subsection (a)** – The liability is not strict liability but rather attaches only to the extent a decision maker has failed to comply with the duties stated in Section 4-409. To the extent those duties have been permissibly revised by the partnership agreement, the revised standards apply to this subsection. *See also* Section 4-504(b)(1) (permitting reasonable reliance on specified financial information).

**Subsection (b)** – Actual knowledge is necessary to impose liability. Reason to know does not suffice. *Compare* Subsection (b), *with* Section 4-103(a)-(b).

**Subsections (b) and (c)(2)** – Liability could apply to a person who receives a distribution under a charging order, but only if the person meets the knowledge requirement. That situation

is very unlikely unless the person with the charging order is also a general partner.

**Subsection (e)** – When the distribution is in the form of indebtedness, the distribution may occur on several different dates. *See* the comment to Section 4-504(e).

This statute of limitations applies only to actions “under this section” and does not affect claims under other applicable law, which most often is fraudulent transfer law. For a different approach, see DEL. CODE ANN. tit. 6, § 18-607(c) (West 2013) (applying a 3-year statute of limitations to claims “under this chapter or other applicable law”); N.Y. PTR. LAW § 121-607 (c) (same). *But see, e.g., In re The Heritage Org., LLC*, 413 BR 438, 461 (Bankr. ND Tex. 2009) (invoking the Texas Uniform Fraudulent Act [TUFTA] to recover distributions made by a Delaware LLC headquartered in Texas; rejecting DEL. CODE ANN. tit. 6, § 18-607(c) on choice of law grounds; stating that “the Delaware legislature cannot limit the reach of TUFTA”).

## **[PART] 6**

### **DISSOCIATION**

#### **SECTION 4-601. DISSOCIATION AS LIMITED PARTNER.**

(a) A person does not have a right to dissociate as a limited partner before the completion of the winding up of the limited partnership.

(b) A person is dissociated as a limited partner when:

(1) the limited partnership knows or has notice of the person’s express will to withdraw as a limited partner, but, if the person has specified a withdrawal date later than the date the partnership knew or had notice, on that later date;

(2) an event stated in the partnership agreement as causing the person’s dissociation as a limited partner occurs;

(3) the person is expelled as a limited partner pursuant to the partnership agreement;

(4) the person is expelled as a limited partner by the affirmative vote or consent of all the other partners if:

(A) it is unlawful to carry on the limited partnership’s activities and affairs with the person as a limited partner;

(B) there has been a transfer of all the person's transferable interest in the partnership, other than:

(i) a transfer for security purposes; or

(ii) a charging order in effect under Section 4-703 which has not been foreclosed;

(C) the person is an entity and:

(i) the partnership notifies the person that it will be expelled as a limited partner because the person has filed a statement of dissolution or the equivalent, the person has been administratively dissolved, the person's charter or the equivalent has been revoked, or the person's right to conduct business has been suspended by the person's jurisdiction of formation; and

(ii) not later than 90 days after the notification, the statement of dissolution or the equivalent has not been withdrawn, rescinded, or revoked, the person has not been reinstated, or the person's charter or the equivalent or right to conduct business has not been reinstated; or

(D) the person is an unincorporated entity that has been dissolved and whose activities and affairs are being wound up;

(5) on application by the limited partnership or a partner in a direct action under Section 4-901, the person is expelled as a limited partner by judicial order because the person:

(A) has engaged or is engaging in wrongful conduct that has affected adversely and materially, or will affect adversely and materially, the partnership's activities and affairs;

(B) has committed willfully or persistently, or is committing willfully and

persistently, a material breach of the partnership agreement or the contractual obligation of good faith and fair dealing under Section 4-305(a); or

(C) has engaged or is engaging in conduct relating to the partnership's activities and affairs which makes it not reasonably practicable to carry on the activities and affairs with the person as a limited partner;

(6) in the case of an individual, the individual dies;

(7) in the case of a person that is a testamentary or inter vivos trust or is acting as a limited partner by virtue of being a trustee of such a trust, the trust's entire transferable interest in the limited partnership is distributed;

(8) in the case of a person that is an estate or is acting as a limited partner by virtue of being a personal representative of an estate, the estate's entire transferable interest in the limited partnership is distributed;

(9) in the case of a person that is not an individual, the existence of the person terminates;

(10) the limited partnership participates in a merger under [Article] 2 and:

(A) the partnership is not the surviving entity; or

(B) otherwise as a result of the merger, the person ceases to be a limited partner;

(11) the limited partnership participates in an interest exchange under [Article] 2 and, as a result of the interest exchange, the person ceases to be a limited partner;

(12) the limited partnership participates in a conversion under [Article] 2;

(13) the limited partnership participates in a domestication under [Article] 2 and, as a result of the domestication, the person ceases to be a limited partner; or



(14) the limited partnership dissolves and completes winding up.

### Comment

**Subsection (a)** – This provision states a default rule.

**Subsection (b)** – This subsection states default rules, which the partnership agreement may vary. However, it would be nonsensical to vary some of the rules – *e.g.*, to provide that the death of a partner who is an individual does not cause the individual’s dissociation as a partner, Subsection (b)(6), or that an entity remains a partner even after the existence of the entity has terminated, Subsection (b)(9).

**Subsection (b)(1)** – The partnership agreement may vary this provision, even to the extent of eliminating a person’s power to dissociate as a limited partner. Section 4-105(c)(11) prohibits the limited partnership agreement from eliminating the power to dissociate of a person as a *general* partner, but neither Section 4-105(c) nor (d) preserve as mandatory the power of a person to dissociate as a *limited* partner.

**Subsection (b)(4)(B)** – This provision permits expulsion when a limited partner no longer has any “skin in the game.” Under this subparagraph (unless the limited partnership agreement provides otherwise), a limited partner’s transferee can protect itself from the vulnerability of “bare naked transferee” status by obligating the partner/transferor to retain a 1% interest and exercise the partner’s contract and governance rights (including the right to bring a derivative suit) to protect the transferee’s interests.

**Subsection (b)(5)** – By its terms, this provision does not permit a partner to bring a direct action for expulsion even if the partner could establish standing under Section 4-901(b). Dealing with a misbehaving limited partner is a management duty, properly reserved to the general partners. *Cf.* Section 4-603(5) (permitting an “application by the limited partnership or a partner in a direct action under Section 4-901” for a judicial order expelling a general partner).

Although the partnership agreement can revise or eliminate the possibility of judicial expulsion, doing so requires careful planning. *Cf. Huatuco v. Satellite Healthcare*, CV 8465-VCG, 2013 WL 6460898, at \*1, n.2 (Del. Ch. Dec. 9, 2013) (stating that “the right to judicial dissolution is a default right which the parties may eschew by contract” while reserving the question of “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires—leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre’s Huis Clos”).

For examples of conduct warranting an expulsion order in various contexts, see *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (discussing a pattern of conduct); *Sherwood Park Bus. Ctr., L.L.C. v. Taggart*, 323 P.3d 551, 561 (Or. Ct. App. 2014) (upholding expulsion of a member who “had stolen a large amount of money from [the limited liability company], had intentionally failed to provide financial information, and had made himself unavailable to carry on the business”); *CCD, L.C. v.*

*Millsap*, 116 P.3d 366, 373 (Utah 2005) (holding that a member’s “misappropriat[ion of] trust account funds totaling at least \$11,540.06 for his personal use” warranted expulsion, where the member’s “misconduct continued the pattern of behavior that [had previously] resulted in losses to the company of \$625,000[, where the new misconduct] . . . took place after [the member’s] prior wrongdoing had been discovered and after [the limited liability company] had assented to permit [the member] to atone for his misdeeds by fulfilling the terms of the amended operating agreement”).

For an analysis that helps distinguish Paragraph (5)(C) from Paragraphs (5)(A) and (B), see *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510, at \*15 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (interpreting predecessor law and noting that the “not reasonably practicable standard” does not require a showing of wrongful conduct). *Cf. Dunnagan v. Watson*, 204 S.W.3d 30, 40 (Tex. Ct. App. 2006) (same issue in the context of dissolution). Where grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives. *Robertson v. Jacobs Cattle Co.*, 830 N.W.2d 191, 201–02 (Neb. 2013) (discussing analogous provisions of UPA (1997)). “[T]here is no textual basis for imposing a higher burden of proof for dissociation than dissolution.” *Brennan v. Brennan Assocs.*, 977 A.2d 107, 121 (Conn. 2009) (general partnership).

**Subsection (b)(7) and (8)** – A change in trustee or personal representative does not cause dissociation.

**Subsection (b)(9)** – This provision is the entity analog to Subsection (b)(6) (death of an individual). Although in theory the partnership agreement could change this rule, doing so would be nonsensical. See the comment to Section 4-803(a) (noting that a terminated limited liability company cannot rescind its dissolution because “a ‘dead’ entity lacks both the capacity and power to bring itself back from the dead”). See also Subsection (b)(14).

**Subsection (b)(10)(A)** – If a limited partnership disappears as part of a merger, no person can continue as a partner of the limited partnership. When the merger takes effect, the partners of the disappearing entity are perforce dissociated. Depending on the plan of merger, those persons may become partners of a surviving limited partnership. In those circumstances, the merger will have dissociated them from one limited partnership and admitted them into partnership in the surviving entity. See Section 4-301(b)(2).

**Subsection (b)(10)(B)** – It is possible for a plan of merger to “shuffle the equity” of the surviving entity, even to the extent of “taking out” some or all of the owners of the surviving entity. A reverse triangular merger involving a limited partnership as the surviving entity would dissociate all the pre-merger partners of the partnership.

**Subsection (b)(12)** – By definition, a limited partnership that converts ceases to be a limited partnership. Thus, when the plan of conversion takes effect, all the partners of the converted entity are dissociated from that entity. In many cases, those persons will all be owners of the converted entity. In some cases, the conversion will “shuffle the equity” and “take out” some of the partners of the converting limited partnership.

**Subsection (b)(13)** – Domestication does not by itself dissociate a partner, because the domesticated entity remains both a limited partnership and “the same entity without interruption as the domesticating company.” Section 2-506(a)(1)(B). However, an “equity shuffle” could dissociate a partner.

#### **SECTION 4-602. EFFECT OF DISSOCIATION AS LIMITED PARTNER.**

(a) If a person is dissociated as a limited partner:

(1) subject to Section 4-704, the person does not have further rights as a limited partner;

(2) the person’s contractual obligation of good faith and fair dealing as a limited partner under Section 4-305(a) ends with regard to matters arising and events occurring after the person’s dissociation; and

(3) subject to Section 4-704 and [Article] 2, any transferable interest owned by the person in the person’s capacity as a limited partner immediately before dissociation is owned by the person solely as a transferee.

(b) A person’s dissociation as a limited partner does not of itself discharge the person from any debt, obligation, or other liability to the limited partnership or the other partners which the person incurred while a limited partner.

#### **Comment**

**Subsection (a)** – This provision makes no reference to power-to-bind matters, because this article provides that a limited partner *qua* limited partner has no power to bind the limited partnership. Section 4-302(a).

**Subsection (a)(2)** – This provision does not determine the effect of a person’s dissociation as a limited partner on the person’s future obligations or rights under the partnership agreement. Some contractual obligations typically extend beyond dissociation – *e.g.*, buyout arrangements. To the extent provisions of the partnership agreement continue to apply, the common law obligation of good faith continues to apply as well. *See* the comment to Section 4-409(d) (explaining that the subsection “invokes the implied obligation that exists in every contract” as a matter of common law).

**Subsection (a)(3)** – This paragraph accords with Section 4-503(b) – dissociation does not

entitle a person to any distribution, even if dissociation takes the form of expulsion. *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510 at \*12 (N.J. Super. Ct. App. Div. Dec. 24, 2012).

Like most *inter se* rules in this article, this one is subject to the partnership agreement. For example, the partnership agreement has the power to provide for the buyout of a person's transferable interest in connection with the person's dissociation.

**SECTION 4-603. DISSOCIATION AS GENERAL PARTNER.** A person is dissociated as a general partner when:

(1) the limited partnership knows or has notice of the person's express will to withdraw as a general partner, but, if the person has specified a withdrawal date later than the date the partnership knew or had notice, on that later date;

(2) an event stated in the partnership agreement as causing the person's dissociation as a general partner occurs;

(3) the person is expelled as a general partner pursuant to the partnership agreement;

(4) the person is expelled as a general partner by the affirmative vote or consent of all the other partners if:

(A) it is unlawful to carry on the limited partnership's activities and affairs with the person as a general partner;

(B) there has been a transfer of all the person's transferable interest in the partnership, other than:

(i) a transfer for security purposes; or

(ii) a charging order in effect under Section 4-703 which has not been foreclosed;

(C) the person is an entity and:

(i) the partnership notifies the person that it will be expelled as a general

partner because the person has filed a statement of dissolution or the equivalent, the person has been administratively dissolved, the person's charter or the equivalent has been revoked, or the person's right to conduct business has been suspended by the person's jurisdiction of formation; and

(ii) not later than 90 days after the notification, the statement of dissolution or the equivalent has not been withdrawn, rescinded, or revoked, the person has not been reinstated, or the person's charter or the equivalent or right to conduct business has not been reinstated; or

(D) the person is an unincorporated entity that has been dissolved and whose activities and affairs are being wound up;

(5) on application by the limited partnership or a partner in a direct action under Section 4-901, the person is expelled as a general partner by judicial order because the person:

(A) has engaged or is engaging in wrongful conduct that has affected adversely and materially, or will affect adversely and materially, the partnership's activities and affairs;

(B) has committed willfully or persistently, or is committing willfully or persistently, a material breach of the partnership agreement or a duty or obligation under Section 4-409; or

(C) has engaged or is engaging in conduct relating to the partnership's activities and affairs which makes it not reasonably practicable to carry on the activities and affairs of the limited partnership with the person as a general partner;

(6) in the case of an individual:

(A) the individual dies;

(B) a guardian or general conservator for the individual is appointed; or

(C) a court orders that the individual has otherwise become incapable of performing the individual's duties as a general partner under this [article] or the partnership agreement;

(7) the person:

(A) becomes a debtor in bankruptcy;

(B) executes an assignment for the benefit of creditors; or

(C) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the person or of all or substantially all the person's property;

(8) in the case of a person that is a testamentary or inter vivos trust or is acting as a general partner by virtue of being a trustee of such a trust, the trust's entire transferable interest in the limited partnership is distributed;

(9) in the case of a person that is an estate or is acting as a general partner by virtue of being a personal representative of an estate, the estate's entire transferable interest in the limited partnership is distributed;

(10) in the case of a person that is not an individual, the existence of the person terminates;

(11) the limited partnership participates in a merger under [Article] 2 and:

(A) the partnership is not the surviving entity; or

(B) otherwise as a result of the merger, the person ceases to be a general partner;

(12) the limited partnership participates in an interest exchange under [Article] 2 and, as a result of the interest exchange, the person ceases to be a general partner;

(13) the limited partnership participates in a conversion under [Article] 2;

(14) the limited partnership participates in a domestication under [Article] 2 and, as a

result of the domestication, the person ceases to be a general partner; or

(15) the limited partnership dissolves and completes winding up.

### Comment

This section mostly states default rules, which the limited partnership agreement may vary. However, it would make no sense to vary some of the rules – *e.g.*, to provide that death does *not* cause an individual’s dissociation, Paragraph (6)(A), or that person (other than an individual) remains a general partner even *after* “the existence of the person terminates.” Paragraph (10).

**Paragraph (1)** – Limited partnership agreements often require notice of dissociation to be in writing and to specify the effective date of the dissociation. The agreement cannot eliminate the power of a general partner to dissociate by express will, Section 4-105(c)(11) but can eliminate the right and thereby make the dissociation wrongful.

**Paragraph (3)** – Many partnership agreements provide for “no cause” expulsion, and courts considering such provisions have taken somewhat different approaches. *Compare Gelder Med. Grp. v. Webber*, 41 N.Y.2d 680, 684, 363 N.E.2d 573, 576 (1977) with *Winston & Strawn v. Nosal*, 279 Ill. App. 3d 231, 240, 664 N.E.2d 239, 245 (Ill. App. Ct. 1996). *See also* Section 4-409(d) and comment (stating and explaining the implied contractual covenant of good faith and fair dealing).

**Paragraph (4)(B)** – This paragraph permits expulsion when a general partner no longer has any “skin in the game.” Under this paragraph (unless the partnership agreement provides otherwise), a general partner’s transferee can protect itself from the vulnerability of “bare naked assignee” status, comment to Section 4-107(b), by obligating the general partner/transferor to retain a 1% interest and exercise the partner’s governance rights (including the right to bring a derivative suit) to protect the transferee’s interests.

**Paragraph (5)** – The reference to “a direct action under Section 4-901” reflects the “separate entity” nature of a limited partnership. Section 4-901 limits a partner’s standing to bring a direct action to circumstances in which the partner can “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 partnership.”

EXAMPLE: General Partner Alpha breaches the limited partnership agreement by purporting to oust General Partner Beta from General Partner Beta’s role in managing the limited partnership. General Partner Beta has a direct claim against General Partner Alpha, not only for breach of contract, but also for expulsion under Paragraph 5.

EXAMPLE: General Partner Alpha breaches the limited partnership agreement (and also Section 4-409(c)) through grossly negligent conduct which harms the profitability of the limited partnership. Depending on the terms of the limited partnership agreement and the allocation of power among the partners, General Partner Beta may be able to cause the

limited partnership to invoke Paragraph 5 and seek General Partner Alpha's expulsion. But General Partner Beta has no standing individually to seek General Partner Alpha's expulsion, except through a derivative claim. (The same is true for a claim of breach of contract. *See* the comment to Section 4-901(b).)

**Paragraph (5)(C)** – This provision has an analog among the causes for dissolution. *See* Section 4-801(a)(6)(B). For examples of conduct warranting an expulsion order, *see Della Ratta v. Dyas*, 183 Md. App. 344, 365-66, 961 A.2d 629, 642 (2008), *aff'd*, 414 Md. 556, 996 A.2d 382 (2010) (noting that “[t]he trial court expressly found that [two major capital] calls ‘were issued in bad faith’... [and the] court also found that, ‘[by] another improper accounting movement’ in [the partnership], \$580,000 was taken ‘for executive office expenses which was improper’”) (third bracket in original); *Brennan v. Brennan Associates*, 293 Conn. 60, 76-77, 977 A.2d 107, 117-18 (2009) (referring to the expelled partner’s “moral turpitude and criminal fraud, and failure to be honest in court as to the extent of his criminal wrongdoing” and “his baseless claims of fraud” against a fellow partner; stating “he has rung the bell and it cannot be unrung”).

For an analysis that helps distinguish Paragraph (5)(C) from Paragraphs (5)(A) and (B), *see All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510 at \*15 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (interpreting predecessor law and noting that the “not reasonably practicable standard” does not require a showing of wrongful conduct). *Cf. Dunnagan v. Watson*, 204 S.W.3d 30, 40 (Tex. App. 2006) (same issue in the context of dissolution).

Where grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives. *Robertson v. Jacobs Cattle Co.*, 285 Neb. 859, 870-72, 830 N.W.2d 191, 201-02 (2013) (discussing analogous provisions of UPA (1997)). “[T]here is no textual basis for imposing a higher burden of proof for dissociation than dissolution.” *Brennan v. Brennan Associates*, 293 Conn. 60, 83, 977 A.2d 107, 121 (2009) (general partnership).

**Paragraph (6)(B) and (C)** – No comparable provisions appear in Section 4-601 (dealing with the dissociation of a limited partner), because, given the limited rights and duties of limited partners, the stated occurrences do not necessarily justify dissociation.

**Paragraph 7(A)** – This provision is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating “ipso facto” clauses, subject to some exceptions).

**Paragraphs (8) and (9)** – A change in trustee or personal representative does not cause dissociation.

**Paragraph (10)** – This provision is the entity analog to Paragraph (7)(A) (death of an individual). Although in theory the partnership agreement could change this rule, doing so would be nonsensical. *See* the comment to Section 4-803(a) (noting that a terminated limited partnership cannot rescind its dissolution because “a ‘dead’ entity lacks both the capacity and power to bring itself back from the dead”). *See also* Paragraph (15).

**Paragraph (11)(A)** – If a limited partnership disappears as part of a merger, no person



can continue as a partner of the partnership. When the merger takes effect, the partners of the disappearing partnership are perforce dissociated. Depending on the plan of merger, those persons may become partners of a surviving limited partnership. In those circumstances, the merger will have dissociated them from one limited partnership and admitted them into partnership in the surviving limited partnership. *See* Section 4-401(b)(2).

**Paragraph (11)(B)** – It is possible for a plan of merger to “shuffle the equity” of the surviving entity, even to the extent of “taking out” some or all of the owners of the surviving entity. A reverse triangular merger involving a limited partnership as the surviving entity would dissociate all the pre-merger partners of the limited partnership.

**Paragraph (13)** – By definition, a limited partnership that converts ceases to be a limited partnership. *See* Section 2-406. Thus, when the plan of conversion takes effect, all the partners of the converted entity are dissociated from that entity. In many cases, those persons will all be owners of the converted entity. In some cases, the conversion will “shuffle the equity” and “take out” some of the partners of the converting LLC.

**Paragraph (14)** – Domestication does not by itself dissociate a partner, because the domesticated entity remains both a limited partnership and “the same entity without interruption as the domesticating company.” Section 2-506(a)(1)(B). However, an “equity shuffle” could dissociate a general partner.

#### **SECTION 4-604. POWER TO DISSOCIATE AS GENERAL PARTNER; WRONGFUL DISSOCIATION.**

(a) A person has the power to dissociate as a general partner at any time, rightfully or wrongfully, by withdrawing as a general partner by express will under Section 4-603(1).

(b) A person’s dissociation as a general partner is wrongful only if the dissociation:

(1) is in breach of an express provision of the partnership agreement; or

(2) occurs before the completion of the winding up of the limited partnership, and:

(A) the person withdraws as a general partner by express will;

(B) the person is expelled as a general partner by judicial order under

Section 4-603(5);

(C) the person is dissociated as a general partner under Section 4-603(7);

or

(D) in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person is expelled or otherwise dissociated as a general partner because it willfully dissolved or terminated.

(c) A person that wrongfully dissociates as a general partner is liable to the limited partnership and, subject to Section 4-901, to the other partners for damages caused by the dissociation. The liability is in addition to any debt, obligation, or other liability of the general partner to the partnership or the other partners.

### Comment

**Subsection (a)** – The limited partnership agreement may not eliminate this power. *See* Section 4-105(c)(11). In this respect, a general partner in a limited partnership is analogous to a general partner in general partnership. *See* Section 3-105(c)(9).

**Subsection (b)** – This subsection list exhaustively (“only if”) the dissociations that are “wrongful,” but the list is a default rule. The limited partnership agreement can expand the list; *e.g.*, by making wrongful a dissociation that breaches the implied contractual covenant of good faith and fair dealing. In theory, the partnership agreement can provide for liquidated damages (subject to the requirements of contract law) and, in theory, can also contract or even eliminate the list of wrongful dissociations.

**Subsection (b)(1)** – The reference to “an express provision of the partnership agreement” means that a person’s dissociation as a general partner in breach of the obligation of good faith and fair dealing is not wrongful dissociation for the purposes of this section. The breach might be actionable on other grounds.

**Subsection (b)(2)** – The reference to “before the termination of the limited partnership” reflects the expectation that each general partner will shepherd the limited partnership through winding up. *See* the comment to Section 4-406(f). A person’s obligation to remain as general partner through winding up continues even if another general partner dissociates and even if that dissociation leads to the limited partnership’s premature dissolution under Section 4-801(3)(A).

**Subsection (b)(2)(C)** – This subsection refers to Section 4-603(7), which involves *inter alia* dissociation on account of bankruptcy, which in turn is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating “ipso facto” clauses, subject to some exceptions).

**Subsection (c)** – A person who prematurely dissociates as a general partner risks liability for any resulting damages. For example, the limited partnership might incur substantial expenses in replacing the general partner’s expertise, reputation, or creditworthiness.

In effect, this subsection equates wrongful dissociation with breach of contract.

Accordingly, courts should look to contract law to determine what consequential damages are recoverable. *See Hadley v. Baxendale*, 9 Exch. 341 (1854); RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981); *see also Williams v. Hildebrand*, 247 S.W.2d 356, 358 (Ark. 1952) (interpreting UPA (1914) § 38(2)(a)(II), pertaining to wrongful dissolution, and stating that “the measure of damages, when the partnership was to have continued for a fixed term, is the profits that the injured partner would have received”).

The language “subject to Section 4-901” is intended to preserve the distinction between direct and derivative claims.

#### **SECTION 4-605. EFFECT OF DISSOCIATION AS GENERAL PARTNER.**

(a) If a person is dissociated as a general partner:

(1) the person’s right to participate as a general partner in the management and conduct of the limited partnership’s activities and affairs terminates;

(2) the person’s duties and obligations as a general partner under Section 4-409 end with regard to matters arising and events occurring after the person’s dissociation;

(3) the person may sign and deliver to the [Secretary of State] for filing a statement of dissociation pertaining to the person and, at the request of the limited partnership, shall sign an amendment to the certificate of limited partnership which states that the person has dissociated as a general partner; and

(4) subject to Section 4-704 and [Article] 2, any transferable interest owned by the person in the person’s capacity as a general partner immediately before dissociation is owned by the person solely as a transferee.

(b) A person’s dissociation as a general partner does not of itself discharge the person from any debt, obligation, or other liability to the limited partnership or the other partners which the person incurred while a general partner.

#### **Comment**

**Subsection (a)(1)** – Once a person dissociates as a general partner, the person loses all management rights as a general partner regardless of what happens to the limited partnership.

This rule contrasts with Section 3-603(b)(1), which permits a dissociated general partner to participate in winding up in some circumstances.

**Subsection (a)(2)** – This provision establishes a dividing line, separating out “matters arising and events occurring after the person’s dissociation.” If the limited partnership has continuing projects with clients, ongoing relationships with clients, or both, the dividing line requires special attention with regard to non-competition and partnership opportunities duties. See Section 4-409(b)(1) and (3).

Disputes involving law firms have generated much of the relevant case law. See, e.g., *Meehan v. Shaughnessy*, 404 Mass. 419, 422, 535 N.E.2d 1255, 1257 (1989); *Jewel v. Boxer*, 156 Cal. App. 3d 171, 175, 203 Cal. Rptr. 13, 15 (Ct. App. 1984). To a large extent, a well-drawn partnership agreement can delineate the parties’ respective rights and responsibilities and thereby avoid problems. However, if the partnership becomes insolvent, the bankruptcy court may well scrutinize the partners’ *inter se* arrangements. See *Geron v. Robinson & Cole LLP*, 476 B.R. 732, 743 (S.D.N.Y. 2012) (considering whether a law firm had “fraudulently transferred ... assets when its partners adopted the Jewel Waiver [releasing rights recognized by *Jewel v. Boxer*] on the eve of dissolution without consideration”).

This provision does not determine the effect of a person’s dissociation as a general partner on the person’s future obligations or rights under the partnership agreement. Some contractual obligations typically extend beyond dissociation – e.g., non-competition provisions, buyout arrangements. To the extent provisions of the partnership agreement continue to apply, the common law obligation of good faith continues to apply as well. See the comment to Section 4-409(d) (explaining that the subsection “invokes the implied obligation that exists in every contract” as a matter of common law).

**Subsection (a)(3)** – Both records covered by this provision have the same effect under Section 4-103(d) – namely, to give constructive notice that the person has dissociated as a general partner. The notice benefits the person by curtailing any further personal liability under Sections 4-607 and 4-805 and Article 2. The notice benefits the limited partnership by curtailing any lingering power to bind under Sections 4-606 and 4-804 and Article 2.

The limited partnership is in any event obligated to amend its certificate of limited partnership to reflect the dissociation of a person as general partner. See Section 4-202(d)(2). In most circumstances, the amendment requires the signature of the person that has dissociated. Section 4-203(a)(5)(C). If that signature is required and the person refuses or fails to sign, the limited partnership may invoke Section 1-210 (Signing and Filing Pursuant to Judicial Order).

**Subsection (a)(4)** – As provided in Section 4-503(b), dissociation does not result in a distribution. In general, when a person dissociates as a general partner, the person’s rights as a general partner disappear and, subject to Section 4-109 (Dual Capacity), the person’s status degrades to that of a mere transferee – even when the dissociation comes in the form of expulsion. *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510 at \*12 (N.J. Super. Ct. App. Div. Dec. 24, 2012). On distinguishing between a person’s rights of a general partner and as a limited partners, see Section 4-108(9)(C) (providing that, for any person that is both a general partner and a limited partner, the required information must state which

transferable interest is owned in which capacity).

Like most *inter se* rules in this article, this one is subject to the partnership agreement. For example, the limited partnership agreement might provide for the buyout of a person's transferable interest in connection with the person's dissociation.

Section 2-704 provides additional information rights when an individual's death has caused dissociation. Article 2 covers organic transactions such as mergers and conversions.

**Subsection (b)** – A general partner's obligation to safeguard trade secrets and other confidential or proprietary information is incurred when the partner learns or otherwise obtains the information. This subsection preserves the obligation post-dissociation.

## **SECTION 4-606. POWER TO BIND AND LIABILITY OF PERSON**

### **DISSOCIATED AS GENERAL PARTNER.**

(a) After a person is dissociated as a general partner and before the limited partnership is merged out of existence, converted, or domesticated under [Article] 2, or dissolved, the partnership is bound by an act of the person only if:

(1) the act would have bound the partnership under Section 4-402 before the dissociation; and

(2) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not know or have notice of the dissociation and reasonably believes that the person is a general partner.

(b) If a limited partnership is bound under subsection (a), the person dissociated as a general partner which caused the partnership to be bound is liable:

(1) to the partnership for any damage caused to the partnership arising from the obligation incurred under subsection (a); and

(2) if a general partner or another person dissociated as a general partner is liable for the obligation, to the general partner or other person for any damage caused to the general

partner or other person arising from the liability.

### **Comment**

A person's dissociation as a general partner ends immediately the person's actual authority to act for the partnership. *See* Section 4-605(a)(1). However, the person's apparent authority may linger.

This section does not affect a person's power to bind a partnership in another capacity – *e.g.*, as an employee with actual authority.

**Subsection (a)** – This subsection codifies and constrains the lingering apparent authority of a person dissociated as a general partner. The constraint is in the phrase “only if.”

The provision applies until the limited partnership dissolves or under Article 2 ceases to be governed by this article. Once a limited partnership dissolves, Section 4-804 applies.

**Subsection (a)(1)** – Section 4-402 states a general partner's statutory apparent authority. This provision causes the apparent authority to linger.

**Subsection (a)(2)(A)** – In any event, any lingering apparent authority ends two years after the dissociation.

**Subsection (a)(2)(B)** – A person might have notice under Section 4-103(d)(1) (statement of dissociation) as well as under Section 4-103(b)(1) (person “ha[ving] reason to know the fact from all the facts known to the person at the time in question”).

**Subsection (b)** – The liability stated in this subsection is not exhaustive. For example, if a person dissociated as a general partner causes a limited partnership to be bound under Subsection (a) and, due to a guaranty, some other person – not a general partner nor dissociated as a general partner – is liable on the resulting obligation, that other person may have a claim under other law against the person dissociated as a general partner.

### **SECTION 4-607. LIABILITY OF PERSON DISSOCIATED AS GENERAL PARTNER TO OTHER PERSONS.**

(a) A person's dissociation as a general partner does not of itself discharge the person's liability as a general partner for a debt, obligation, or other liability of the limited partnership incurred before dissociation. Except as otherwise provided in subsections (b) and (c), the person is not liable for a partnership obligation incurred after dissociation.

(b) A person whose dissociation as a general partner results in a dissolution and winding

up of the limited partnership's activities and affairs is liable on an obligation incurred by the partnership under Section 4-805 to the same extent as a general partner under Section 4-404.

(c) A person that is dissociated as a general partner without the dissociation resulting in a dissolution and winding up of the limited partnership's activities and affairs is liable on a transaction entered into by the partnership after the dissociation only if:

(1) a general partner would be liable on the transaction; and

(2) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not have knowledge or notice of the dissociation and reasonably believes that the person is a general partner.

(d) By agreement with a creditor of a limited partnership and the partnership, a person dissociated as a general partner may be released from liability for a debt, obligation, or other liability of the partnership.

(e) A person dissociated as a general partner is released from liability for a debt, obligation, or other liability of the limited partnership if the partnership's creditor, with knowledge or notice of the person's dissociation as a general partner but without the person's consent, agrees to a material alteration in the nature or time of payment of the debt, obligation, or other liability.

### **Comment**

To the extent a limited partnership has been a limited liability limited partnership throughout its existence, the liability rules stated in this section are moot. *See, e.g.*, subsection (c)(1).

**Subsection (a)** – A person's dissociation as a general partner does not categorically preclude the person being liable as a general partner for subsequently incurred obligations of the limited partnership. If the dissociation results in dissolution, Subsection (b) applies and the person will be liable as a general partner on any partnership obligation incurred under Section 4-

805. If the dissociation does not result in dissolution, Subsection (c) applies.

The phrase “liability as a general partner for an obligation of the limited partnership” refers to liability under Section 4-404. As stated in the comments to Section 4-404(b) and (c), other law determines when a partnership obligation is “incurred.”

**Subsection (b)** – In these circumstances, a person’s dissociation as a general partner has no effect on the person’s liability exposure, even if any or all of the following occur:

- The certificate of limited partnership is amended to state that the person has dissociated as a general partner, as required by Section 4-202(d)(2).
- The person has filed a statement of dissociation, as permitted by Section 4-605(a)(3).
- The person was the sole general partner, and the limited partnership is wound up by someone else under Section 4-802(c) or (d).

However, amending the certificate of limited partnership to indicate dissolution would protect the person to the same extent as the amendment would protect the remaining general partners. *See* Sections 4-802(b)(2)(A) and 4-804.

**Subsection (c)** – The rule stated here for the “lingering liability” of a person dissociated as a general partner parallels the rule stated in Section 4-606 for the lingering apparent authority of a person dissociated as a general partner.

**Subsection (c)(2)(B)** – A person might have notice under Section 4-103(d)(1) as well as under Section 4-103(b)(1).

**Subsections (c) and (d)** – These provisions trace back to UPA (1914) § 36(2), (3).

## [PART] 7

### TRANSFERABLE INTERESTS AND RIGHTS OF TRANSFEREES AND CREDITORS

**SECTION 4-701. NATURE OF TRANSFERABLE INTEREST.** A transferable interest is personal property.

#### Comment

For the definition of transferable interest, see Section 4-102(11). Absent a contrary provision in the partnership agreement or the consent of the partners, a “transferable interest” is the only interest in a limited partnership that can be transferred to a person not already a partner. *See* Section 4-702. As to whether a partner may transfer governance rights to a fellow partner, the question is moot absent a provision in the partnership agreement changing the default rule. *See* Section 4-406(a) (allocating general partner governance rights *per capita*) and 4-406(b) (requiring unanimous agreement of all partners to take specified action). In the default mode, a general partner’s transfer of governance rights to another general partner: (i) does not increase



the transferee's governance rights; (ii) eliminates the transferor's governance rights; and (iii) thereby changes the denominator but not the numerator in calculating governance rights

EXAMPLE: LCN Company is a limited partnership with three general partners, Laura, Charles, and Nora. The partnership agreement does not displace this article's default rule on the allocation of governance rights among general partners. Thus, each general partner has 1/3 of those rights. Laura transfers her entire ownership interest to Charles. The transfer does not increase Charles's governance rights but does eliminate Laura's. After the transfer, Laura has no governance rights (regardless of whether Charles and Nora agree to expel Laura under Section 4-603(4)(B)). As a result, Charles and Nora each have 1/2 of the governance rights.

Whether a transferable interest pledged as security is governed by Article 8 or 9 of the Uniform Commercial Code depends on the rules stated in those Articles.

#### **SECTION 4-702. TRANSFER OF TRANSFERABLE INTEREST.**

(a) A transfer, in whole or in part, of a transferable interest:

(1) is permissible;

(2) does not by itself cause a person's dissociation as a partner or a dissolution and winding up of the limited partnership's activities and affairs; and

(3) subject to Section 4-704, does not entitle the transferee to:

(A) participate in the management or conduct of the partnership's activities and affairs; or

(B) except as otherwise provided in subsection (c), have access to required information, records, or other information concerning the partnership's activities and affairs.

(b) A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled.

(c) In a dissolution and winding up of a limited partnership, a transferee is entitled to an account of the partnership's transactions only from the date of dissolution.

(d) A transferable interest may be evidenced by a certificate of the interest issued by a limited partnership in a record, and, subject to this section, the interest represented by the

certificate may be transferred by a transfer of the certificate.

(e) A limited partnership need not give effect to a transferee's rights under this section until the partnership knows or has notice of the transfer.

(f) A transfer of a transferable interest in violation of a restriction on transfer contained in the partnership agreement is ineffective if the intended transferee has knowledge or notice of the restriction at the time of transfer.

(g) Except as otherwise provided in Sections 4-601(b)(4)(B) and 4-603(4)(B), if a general or limited partner transfers a transferable interest, the transferor retains the rights of a general or limited partner other than the transferable interest transferred and retains all the duties and obligations of a general or limited partner.

(h) If a general or limited partner transfers a transferable interest to a person that becomes a general or limited partner with respect to the transferred interest, the transferee is liable for the transferor's obligations under Sections 4-502 and 4-505 known to the transferee when the transferee becomes a partner.

### **Comment**

One of the most fundamental characteristics of limited partnership law is its fidelity to the "pick your partner" principle. *See, e.g., Bynum v. Frisby*, 73 Nev. 145, 149-50, 311 P.2d 972, 975 (Nev. 1957) (stating: (i) "the assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners"; and (ii) absent consent by the remaining partners "[t]he stranger remains a stranger" with no rights to management or even information).

This section is the core of the article's provisions reflecting and protecting that principle. The provisions of this section apply regardless of whether the interest pertains to a general partner or a limited partner. A partner's rights in a limited partnership are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the partnership agreement otherwise provides, a partner acting without the consent of all other partners lacks both the power and the right to: (i) bestow partnership on a non-partner, Sections 4-301(b)(3), 4-401(b)(3); or (ii) transfer to a non-partner anything other than some or all of the partner's transferable interest, Section 4-702(a)(3). The rights of a mere transferee are quite limited – *i.e.*,

to receive distributions), Section 4-702(b), and, if the limited partnership dissolves and winds up, to receive specified information pertaining to the limited partnership from the date of dissolution. Section 4-702(c).

This section applies regardless of whether the transferor is a partner, a transferee of a partner, a transferee of a transferee, etc. *See* Section 4-102(25) (defining “transferable interest” in terms of a right “initially owned by a person in the person’s capacity as a partner” regardless of “whether or not the person remains a partner or continues to own any part of the right”).

This section does not directly consider whether a partner may transfer governance rights to another partner without obtaining consent from all the other partners. As noted above, comment to Section 4-701, the question is moot under this article’s default rule for allocating governance rights.

However, the question can be pivotal when the partnership agreement displaces the default rule on governance rights but does not determine whether transfer restrictions (whether contractual, statutory, or both) apply to transfers of governance rights from one partner to another. Case law is scant and pertains to LLCs. Nonetheless, the case law suggests that this article does not protect partners from control shifts that result from transfers among partners (as distinguished from transfers to non-partners who seek thereby to become partners). ). *Blythe v. Bell*, No. 11 CVS 933. 2012 WL 7807800, at ¶ 6 (N.C. Dist. Dec. 10, 2012) (holding in a case of “first impression in North Carolina” that “in the absence of articles of incorporation or an operating agreement to the contrary . . . the assignment of control [(i.e., governance)] interests between members is effective without unanimous member consent”); *Achaian, Inc. v. Leemon Family L.L.C.*, 25 A.3d 800, 810 (Del. Ch. 2011) (Strine, Ch.) (holding that the terms of the LLC agreement did not preclude one member of a three-member LLC from transferring the member’s entire interest (including governance rights) to a second member without first having the consent of the third member; stating that the third member’s “argument relies on a very thinly sliced version of [the ‘pick-your-partner principle, the strained version being] . . . that once one chooses his initial co-members, one continues to hold a veto over how much additional voting power they may acquire’; explaining that ‘[t]he problem for [the third member] is that nothing in the LLC Agreement supports [that member’s] reading of it that would require an already admitted Member, like [the acquirer (i.e., the second member)], to be become once, twice (or even three times) a Member each and every time that Member acquires an additional block of Interests”).

Other law may affect the applicability of this section. *See* 11 U.S.C. § 541(c)(1) (providing that, initially at least, all property of a debtor becomes part of the bankruptcy estate regardless of restrictions on transfer); UCC §§ 9-406, 9-408 (overriding specified restrictions on assignment in specified circumstances, regardless of whether state law or a contract impose the restrictions).

In any event, this section does not apply to the transfer of ownership interests in a partner that is an entity.

EXAMPLE: ABC, LP has three partners: one general partner—Ralph (an individual); and two limited partners—Alice, Inc. (“Alice”), and Norton, LLC (“Norton”). Section 4-

702 applies to any attempt by Ralph, Alice, or Norton to transfer their respective partnership interest in ABC. Section 4-702 is inapplicable, however, to a change in control of Alice or Norton, or even a complete change in their respective ownership.

**Subsection (a)**—The definition of “transfer,” Section 1-102(47), and this subsection’s reference to “in whole or in part” combine to mean that this section encompasses not only unconditional, permanent, and complete transfers but also temporary, contingent, and partial ones. Thus, for example, a charging order under Section 4-703 effects a transfer of part of the judgment debtor’s transferable interest, as does the pledge of a transferable interest as collateral for a loan and the gift of a life-interest in a partner’s rights to distribution.

**Subsection (a)(2)**—The phrase “by itself” contemplates Sections 4-601(b)(4)(B) and 4-603(4)(B); each create a risk of dissociation via expulsion when a partner transfers all of the partner’s transferable interest.

**Subsection (a)(3)**—Mere transferees have no right to participate in management or otherwise intrude as the partners carry on the affairs of the limited partnership and their activities as partners.

Because Section 1-102(47) defines “transfer” to include “a transfer by operation of law,” this section affects the power of other law to effect transfers of a partner’s ownership interest. For example, a divorce court lacks the power to award a partner’s spouse anything beyond the partner’s transferable interest. Nor does the partner have the power to enter into a property settlement purporting to effect any greater transfer.

For the divorce court, the best solution is to value the partner’s complete ownership interest (*i.e.*, the transferable interest as enhanced by the management and information rights and the standing to sue) and: (i) if possible, award the partner’s spouse marital property of equal value; or (ii) if not possible, award the partner’s spouse a money judgment and a charging order to enforce the judgment.

Granting the non-partner any part of the partner’s transferable interest is almost always imprudent; marital discord will almost inevitably carry over into the business relationship. Granting the partner’s ex-spouse the entire transferable interest is rarely a viable alternative. If the partner is an active participant in the limited partnership, the approach is impossible. The partner’s transferable interest will typically constitute much or all of the partner’s remuneration for the partner’s activity. Even if the partner is essentially passive, granting the transferable interest to the ex-spouse puts him or her at great risk as a “bare naked assignee.” *See* the comment to Section 4-107(b).

When a partner dies, subject to the limited partnership agreement other law may effect a transfer of the partner’s transferable interest to the partner’s estate or personal representative. However, for the reasons just stated, other law lacks the power to transfer anything more than a transferable interest. (Section 4-704 does provide extra information rights for the purposes of settling the estate of the deceased partner.)

**Subsection (a)(3)(B)**—*See* Sections 4-304(i) and 4-407(i) (providing that the information rights stated in those sections do not apply to transferees).

**Subsection (b)**—Amounts due under this subsection are of course subject to offset for any amount owed to the limited partnership by the partner or person dissociated as a partner on whose account the distribution is made. Section 4-503(d). As to whether a limited partnership may properly offset for claims against a transferor that was never a partner is matter for other law, specifically the law of contracts dealing with assignments.

**Subsection (c)**—This very limited grant of information rights encompasses only transactions occurring at or after the date of the limited partnership’s dissolution. The transferee has only the right to information as to the allocation of net assets among the limited partnership’s creditors, partners, and transferees—and only from the date of dissolution.

This subsection does not prevent a transferee from contracting with a partner-transferor to require the partner-transferor to disclose further information to the transferee. Whether such an agreement would breach the limited partnership agreement, the implied contractual obligation of good faith and fair dealing, Section 4-409(d), or a fiduciary duty depends on the circumstances.

If a dissolved limited partnership rescinds its dissolution, Section 4-803, this subsection no longer applies.

**Subsection (d)**—The use of certificates can raise issues relating to Articles 8 and 9 of the Uniform Commercial Code.

**Subsection (f)**—This provision originated as UPA (1997) § 503(e), was then consistent with UCC § 9-318(3), and is now consistent with UCC § 9-406(a) (stating that “an account debtor . . . may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee”).

The term “notice” includes “reason to know,” Section 4-103(b)(1), and ordinarily a potential transferee has reason to inquire about transfer restrictions that might be contained in the limited partnership agreement.

**Subsection (g)**—Under this subsection, a partner (whether general or limited) remains as such (with all attendant rights and obligations) even after permanently transferring the entirety of the transferable interest, unless: (i) the other partners opt for expulsion under Section 4-601(4)(B); or (ii) as otherwise provided in the partnership agreement.

#### **SECTION 4-703. CHARGING ORDER.**

(a) On application by a judgment creditor of a partner or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor’s transferable interest and requires the limited partnership to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a partner, and is subject to Section 4-702.

(d) At any time before foreclosure under subsection (c), the partner or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), a limited partnership or one or more partners whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) This [article] does not deprive any partner or transferee of the benefit of any exemption law applicable to the transferable interest of the partner or transferee.

(g) This section provides the exclusive remedy by which a person seeking in the capacity of a judgment creditor to enforce a judgment against a partner or transferee may satisfy the judgment from the judgment debtor's transferable interest.

## Comment

The charging order concept dates back to the English Partnership Act of 1890 and in the United States has been a fundamental part of law of unincorporated business organizations since 1914. *See* UPA (1914) § 28. As much a remedy limitation as a remedy, the charging order is the sole method by which a person acting as judgment creditor of a partner or transferee can extract value from the partner's or transferee's ownership interest in a limited partnership. *See* the comment to Subsection (g).

Under this section, the judgment creditor of a partner or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. However, the judgment creditor has no say in the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership.

This section applies regardless of whether the transferable interest at issue is owned by a person in the capacity of a general partner, limited partner, or transferee. The partnership agreement has no power to alter the provisions of this section to the prejudice of third parties. Section 4-105(c)(18).

By its terms, this section does not apply to foreign limited partnerships. *See* Section 4-102(a)(7) (defining "[l]imited partnership" to mean "an entity *formed under this [article] or which becomes subject to this [article]*") (emphasis added); *see also Fannie Mae v. Heather Apartments Ltd. P'ship*, A13-0562, 2013 WL 6223564, at \*6 (Minn. Ct. App. Dec. 2, 2013) (considering the remedies available to a judgment creditor with respect to the judgment debtor's interest in a Cook Islands LLC; rejecting the debtor's argument that the creditor's "only remedy is to obtain a charging order under" [the Minnesota LLC statute]; explaining that "this argument fails because that statute only applies to Minnesota limited liability companies," which that statute "defines . . . as 'a limited liability company, other than a foreign limited liability company, *organized or governed by this chapter*'") (emphasis added) (statutory citations omitted).

**Subsection (a)**—The phrase "judgment debtor" encompasses both partners and transferees. The lien pertains only to a distribution, which excludes "amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program." Section 4-102(a)(3)(B). A judgment creditor that wishes to levy on such amounts should use the appropriate creditor's remedy, such as garnishment (which may be subject to exemptions or exclusions not relevant to a charging order). *Cf. PB Real Estate, Inc. v. Dem II Props.*, 719 A.2d 73, 76 (Conn. 1998) (rejecting the contention of an LLC's two members that "payments of \$28,000 to each of them" should be treated "as expenses for wages" rather than as distributions).

Whether an application for a charging order must be served on the limited partnership, the judgment debtor, or both is a matter for other law; principally, the law of remedies and civil procedure. The order itself must be served on the limited partnership. Whether the order must

also be served on the judgment debtor is a matter for other law.

If a distribution consists of rights to acquire interests in a limited partnership, the charging order applies only to those rights within the definition of transferable interest. *See* Section 4-102(a)(11) (defining transferable interest).

**Subsection (b)**—Paragraph (2) refers to “other orders” rather than “additional orders.” Therefore, given appropriate circumstances, a court may invoke Paragraph (1), Paragraph (2), or both.

**Subsection (b)(1)**—The receiver contemplated here is emphatically not a receiver for the limited partnership, but rather a receiver for the distributions subject to the charging order. The principal advantage provided by this paragraph is an expanded right to information. However, that right goes no further than “the extent necessary to effectuate the collection of distributions pursuant to a charging order.” For a correctly narrow reading of this provision, see *Wells Fargo Bank, Nat’l Ass’n v. Continuous Control Solutions, Inc.*, No. 11–1285, 2012 WL 3195759 (Iowa Ct. App. Aug. 8, 2012).

**Subsection (b)(2)**—This paragraph must be understood in the context of: (i) the very limited nature of the charging order; and (ii) the importance of preventing overreaching on behalf of a person that is not a judgment creditor of the limited partnership, has no claim on the limited partnership’s assets, and has no right to interfere in the activities, affairs, and management of the limited partnership. In particular, the court’s power to make “all other orders” is limited to “orders necessary to give effect to the charging order.”

**EXAMPLE:** A judgment creditor with a charging order believes that the limited partnership should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the limited partnership to restrict re-investment. Subsection (b)(2) does not authorize the court to grant the motion.

**EXAMPLE:** A judgment creditor with a judgment for \$10,000 against a partner obtains a charging order against the partner’s transferable interest. Having been properly served with the order, the limited partnership nonetheless fails to comply and makes a \$3000 distribution to the partner. The court has the power to order the limited partnership to pay \$3000 to the judgment creditor to “give effect to the charging order.”

Under Subsection (b)(2), the court has the power to decide whether a particular payment is a distribution, because that decision determines whether the payment is part of a transferable interest subject to a charging order.

**EXAMPLE:** General Partner A of ABC, LP has for some years received distributions from the limited partnership. However, when a judgment creditor of General Partner A obtains a charging order against General Partner A’s transferable interest, the limited partnership ceases to make distributions to General Partner A and instead provides a salary to General Partner A equivalent to former distributions. A court might deem this



salary a disguised distribution. (In any event, however, the salary will be subject to garnishment.)

This article has no specific rules for determining the fate or effect of a charging order when the limited partnership undergoes a merger, conversion, interest exchange, or domestication under Article 2. In the proper circumstances, such an organic change might trigger an order under Subsection (b)(2).

**Subsection (c)**—The phrase “that distributions under the charging order will not pay the judgment debt within a reasonable period of time” comes from case law. *See, e.g., Nigri v. Lotz*, 453 S.E.2d 780, 783 (Ga. Ct. App. 1995). *Stewart v. Lanier Park Med. Office Bldg., Ltd.*, 578 S.E.2d 572, 574 (Ga. Ct. App. 2003) (“Judicial sale may be appropriate where . . . it is apparent that distributions under the charging order will not pay the judgment debt within a reasonable amount of time.”). A purchaser at a foreclosure sale obtains only the very limited rights of a mere transferee under Section 4-702 and is in some ways more vulnerable and less powerful than the holder of a charging order. After foreclosure and sale, Subsection (b) no longer applies. More generally, the court is no longer involved in the matter. For the vulnerability of a transferee, see the comment to Section 4-107(b).

**Subsection (d)**—This provision allows the judgment debtor to end the charging order without need for a hearing.

**Subsection (e)**—Traditionally, charging order provisions referred to the possibility of “redeeming” an interest subject to a charging order. That usage was confusing, leaving several important questions unanswered. This article substitutes a far simpler approach, contemplating the limited partnership or its partners buying the underlying judgment and thereby dispensing with any interference the judgment creditor might seek to inflict on the partnership.

In many circumstances, buying the judgment is superior to the mechanism provided by this subsection, because: (i) this subsection requires full satisfaction of the underlying judgment; and (ii) the limited partnership or the other partners might be able to buy the judgment for less than face value. On the other hand, this subsection operates without need for the judgment creditor’s consent, so it remains a valuable protection in the event a judgment creditor seeks to do mischief to the limited partnership.

Whether a limited partnership should invoke this provision is a question for the general partners. Section 4-406(a). If the charging order pertains to the transferable interest of a general partner, subject to the partnership agreement, that partner should not be involved in deciding the question. *See* Section 4-409(b)(2).

**Subsection (f)**—This subsection preserves otherwise applicable exemptions but does not create any. *In re Foos*, 405 B.R. 604, 609 (Bankr. N.D. Ohio 2009) (interpreting the comparable provision in UPA (1997) and stating that “it is clear that [the provision] does not create an exemption”).

**Subsection (g)**—This subsection does not override Article 9 of the Uniform Commercial

Code, which may provide different remedies for a secured creditor acting in that capacity. A secured creditor with a judgment might decide to proceed under Article 9 alone, under this section alone, or under both Article 9 and this section. In the last-mentioned circumstance, the constraints of this section would apply to the charging order but not to the Article 9 remedies.

This subsection is not intended to prevent a court from effecting a “reverse pierce” where appropriate. In a reverse pierce, the court conflates the entity and its owner to hold the entity liable for a debt of the owner. *Cf. Trust, Inc. v. First Flight L.P.*, 580 S.E.2d 806, 810 (Va. 2003) (stating that “Virginia does recognize the concept of outsider reverse piercing and that this concept can be applied to a Virginia limited partnership”); *In re Burwell*, 391 B.R. 831, 837 (B.A.P. 8th Cir. 2008) (applying Minnesota law). Likewise, this subsection does not supplant fraudulent transfer law.

#### **SECTION 4-704. POWER OF LEGAL REPRESENTATIVE OF DECEASED**

**PARTNER.** If a partner dies, the deceased partner’s legal representative may exercise:

- (1) the rights of a transferee provided in Section 4-702(c); and
- (2) for the purposes of settling the estate, the rights of a current limited partner under Section 4-304.

#### **Comment**

The estate and those claiming through the estate are transferees, and as such they have very limited rights to information. This section provides temporary, additional information rights to the legal representative of the estate. Sections 4-304 and 4-702(c) pertain only to information rights.

#### **[PART] 8**

### **DISSOLUTION AND WINDING UP**

#### **SECTION 4-801. EVENTS CAUSING DISSOLUTION.**

(a) A limited partnership is dissolved, and its activities and affairs must be wound up, upon the occurrence of any of the following:

- (1) an event or circumstance that the partnership agreement states causes dissolution;
- (2) the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or

consent is to be effective;

(3) after the dissociation of a person as a general partner:

(A) if the partnership has at least one remaining general partner, the affirmative vote or consent to dissolve the partnership not later than 90 days after the dissociation by partners owning a majority of the rights to receive distributions as partners at the time the vote or consent is to be effective; or

(B) if the partnership does not have a remaining general partner, the passage of 90 days after the dissociation, unless before the end of the period:

(i) consent to continue the activities and affairs of the partnership and admit at least one general partner is given by limited partners owning a majority of the rights to receive distributions as limited partners at the time the consent is to be effective; and

(ii) at least one person is admitted as a general partner in accordance with the consent;

(4) the passage of 90 consecutive days after the dissociation of the partnership's last limited partner, unless before the end of the period the partnership admits at least one limited partner;

(5) the passage of 90 consecutive days during which the partnership has only one partner, unless before the end of the period:

(A) the partnership admits at least one person as a partner;

(B) if the previously sole remaining partner is only a general partner, the partnership admits the person as a limited partner; and

(C) if the previously sole remaining partner is only a limited partner, the partnership admits a person as a general partner;

(6) on application by a partner, the entry by [the appropriate court] of an order dissolving the partnership on the grounds that:

(A) the conduct of all or substantially all the partnership's activities and affairs is unlawful; or

(B) it is not reasonably practicable to carry on the partnership's activities and affairs in conformity with the certificate of limited partnership and partnership agreement; or

(7) the signing and filing of a statement of administrative dissolution by the [Secretary of State] under Section 1-602.

(b) If an event occurs that imposes a deadline on a limited partnership under subsection (a) and before the partnership has met the requirements of the deadline, another event occurs that imposes a different deadline on the partnership under subsection (a):

(1) the occurrence of the second event does not affect the deadline caused by the first event; and

(2) the partnership's meeting of the requirements of the first deadline does not extend the second deadline.

### **Comment**

"Dissolution" has been a term of art in the law of unincorporated business organizations since at least the time of Roman law. JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 266, at 408 (2d ed. 1850) ("The Roman law . . . declared, that partnership might be dissolved in various ways . . ."). Dissolution does not end a limited partnership's existence but rather changes the purpose of that existence: "A dissolved limited partnership shall wind up its activities and affairs and . . . the partnership continues after dissolution only for the purpose of winding up." Section 4-802(a). The partnership may, but need not, amend its certificate of limited partnership to state that dissolution has occurred. Section 4-802(b)(2)(A). The limited partnership terminates when winding up is complete. The partnership may, but need not, file a statement of termination. Section 4-802(b)(2)(F).

Except for Paragraphs (a)(6) and (7), this section comprises default rules. Paragraph 7 is fully mandatory, Section 4-105(c)(3)(B); Paragraph 6 is mandatory only with regard to the stated grounds for dissolution. *See* the comment to Section 4-105(c)(12). Moreover, a partnership

agreement can provide additional causes of dissolution. *See* Subsection (a)(1). Variations to the statutory causes of dissolution are commonplace.

Section 4-803 permits rescission of dissolution in some circumstances. In some circumstances, an amendment to the limited partnership agreement might avert dissolution – *e.g.*, by revising an agreed-upon deadline for selling the partnership assets and winding up the business. A retroactive amendment may also be possible. *See Kindred Ltd. P'ship v. Screen Actors Guild, Inc.*, CV082220PSGPJWX, 2009 WL 279080, at \*5–6 (C.D. Cal. Feb. 3, 2009) (giving effect to an amendment that retroactively eliminated an event of dissolution; noting that UPA (1997) § 802(b) permitted a partnership to rescind dissolution).

**Subsection (a)(2)**—Although most actions involving limited partner consent require unanimous consent (*e.g.*, Section 4-406(b)), this provision requires only the specified majority consent. Rights to receive distributions owned by a person that is both a general and a limited partner figure into the limited partner determination only to the extent those rights are owned in the person's capacity as a limited partner. *See* Section 4-108(9)(C).

Example: XYZ is a limited partnership with three general partners, each of whom is also a limited partner, and five other limited partners. Rights to receive distributions are allocated as follows:

Partner #1 as general partner—3%  
Partner #2 as general partner—2%  
Partner #3 as general partner—1%  
Partner #1 as limited partner—7%  
Partner #2 as limited partner—3%  
Partner #3 as limited partner—4%  
Partner #4 as limited partner—5%  
Partner #5 as limited partner—5%  
Partner #6 as limited partner—5%  
Partner #7 as limited partner—5%  
Partner #8 as limited partner—5%  
Several non-partner transferees, in the aggregate—55%

Distribution rights owned by persons as limited partners amount to 39% of total distribution rights. A majority is therefore anything greater than 19.5%. If only Partners 1, 2, 3, and 4 consent to dissolve, the limited partnership is not dissolved. Together these partners own as limited partners 19% of the distribution rights owned by persons as limited partners—just short of the necessary majority. For purposes of this calculation, distribution rights owned by non-partner transferees are irrelevant. So, too, are distribution rights owned by persons as general partners. (However, dissolution under this provision requires “the consent of all general partners.”)

**Subsection (a)(3)**—Historically, the dissociation of any general partner from a limited partnership could lead to dissolution (subject of course to the partnership agreement). This provision continues that concept, albeit while modernizing the consent mechanisms.

**Subsection (a)(3)(A)**—Unlike Subsection (a)(2), this provision makes no distinction between distribution rights owned by persons as general partners and distribution rights owned by persons as limited partners. Distribution rights owned by non-partner transferees are irrelevant.

**Subsection (a)(4) and (5)**—These provisions reflect the number and type of partners required for a limited partnership to come into existence. Section 4-201(d).

**Subsection (a)(6)**—The partnership agreement cannot vary the causes of dissolution stated in this provision. However, the partnership agreement may contain a forum selection clause or change the forum from “the appropriate court” to binding arbitration. Section 4-105(c)(12), comment.

As to whether the court of another jurisdiction can properly order dissolution of a limited partnership formed under this article, the majority rule is clearly no. “[T]he courts of several states have held that jurisdiction to dissolve a corporation rests only in the courts of the state of incorporation.” *In re Blixseth*, 484 B.R. 360, 370 (B.A.P. 9th Cir. 2012) (citing cases, including a case involving an LLC). *But see In re Mercantile Guar. Co.*, 48 Cal. Rptr. 589, 591–93 (Cal. Ct. App. 1965) (explaining that “[w]e are . . . required to determine whether the courts of a state in which a foreign corporation has done business and in which its assets are there located have jurisdiction to wind up its affairs, even though the corporation was organized in another state,” stating that “the question is not one of jurisdiction or power in the court of the state which is not the legal domicile of a foreign corporation, but it is a question . . . of the balance of convenience, of whether considerations of public policy, efficiency, expedience and justice to all parties interested demand that jurisdiction be retained in the foreign court, or that it be declined under the rule of forum non conveniens,” and holding that “[t]he circumstances of the case at bench require a holding that the California courts assume jurisdiction of the winding up of [a Delaware corporation’s] affairs preparatory to a dissolution”).

**Subsection (a)(6)(B)**—For an analytic framework for applying this provision, see *Roth v. Laurus U.S. Fund, L.P.*, CIV.A. 5566-VCN, 2011 WL 808953, at \*3 (Del. Ch. Feb. 25, 2011); *see also Mandell v. Centrum Frontier Corp.*, 407 N.E.2d 821, 829 (Ill. App. Ct. 1980) (upholding a decree dissolving a limited partnership (“[b]ecause the partnership had a negative cash flow during 15 months of the 17 months prior to filing this suit” and “find[ing] that the trial court properly decreed dissolution . . . on the ground that [the limited partnership] could only be carried on at a loss”).

## **SECTION 4-802. WINDING UP.**

(a) A dissolved limited partnership shall wind up its activities and affairs and, except as otherwise provided in Section 4-803, the partnership continues after dissolution only for the purpose of winding up.

(b) In winding up its activities and affairs, the limited partnership:

(1) shall discharge the partnership's debts, obligations, and other liabilities, settle and close the partnership's activities and affairs, and marshal and distribute the assets of the partnership; and

(2) may:

(A) amend its certificate of limited partnership to state that the partnership is dissolved;

(B) preserve the partnership activities, affairs, and property as a going concern for a reasonable time;

(C) prosecute and defend actions and proceedings, whether civil, criminal, or administrative;

(D) transfer the partnership's property;

(E) settle disputes by mediation or arbitration;

(F) deliver to the [Secretary of State] for filing a statement of termination stating the name of the partnership and that the partnership is terminated; and

(G) perform other acts necessary or appropriate to the winding up.

(c) If a dissolved limited partnership does not have a general partner, a person to wind up the dissolved partnership's activities and affairs may be appointed by the affirmative vote or consent of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective. A person appointed under this subsection:

(1) has the powers of a general partner under Section 4-804 but is not liable for the debts, obligations, and other liabilities of the partnership solely by reason of having or exercising those powers or otherwise acting to wind up the dissolved partnership's activities and

affairs; and

(2) shall deliver promptly to the [Secretary of State] for filing an amendment to the partnership's certificate of limited partnership stating:

(A) that the partnership does not have a general partner;

(B) the name and street and mailing addresses of the person; and

(C) that the person has been appointed pursuant to this subsection to wind up the partnership.

(d) On the application of a partner, the [appropriate court] may order judicial supervision of the winding up of a dissolved limited partnership, including the appointment of a person to wind up the partnership's activities and affairs, if:

(1) the partnership does not have a general partner and within a reasonable time following the dissolution no person has been appointed pursuant to subsection (c); or

(2) the applicant establishes other good cause.

### Comment

Under the default rules of this article, dissolution does not change governance arrangements. However, dissolution does change the context for determining for the purposes of Section 4-406(b)(3) whether to “sell, lease, exchange, or otherwise dispose of all, or substantially all, of the limited partnership's property, with or without the good will” is “other than in the usual and regular course of the limited partnership's activities and affairs.”

**Subsection (a)**—*See* the comment to Section 4-801(a)(2).

**Subsection (b)**—The particular circumstances determine how long winding up may continue without giving “good cause” for court intervention under Section 4-702(d)(2). There is no “hard and fast” rule. *See, e.g., Mathis v. Meyeres*, 574 P.2d 447, 450 (Alaska 1978) (stating that we are aware of [no authority] requiring that deadlines be set in the winding up of a partnership”); *8182 Md. Assocs., Ltd. P'ship v. Sheehan*, 14 S.W.3d 576, 581 (Mo. 2000) (“The Uniform Partnership Law contemplates that dissolved partnerships may continue in business for a short, long or indefinite period of time . . . .”) (quoting *Schoeller v. Schoeller*, 497 S.W.2d 860, 867 (Mo. Ct. App. 1973)).

“Winding up usually entails the time necessary for the partners to finish old business, collect and pay debts, and finally distribute remaining assets to the partners.” *Gibson v. Deuth*,



270 N.W.2d 632, 635 (Iowa 1978). “Generally the best interests of the partnership will be served by winding up the partnership affairs as quickly as possible.” *Doting v. Trunk*, 856 P.2d 536, 540 (Mont. 1993). However, in some circumstances, a long period of winding up is not only appropriate but necessary. *Lebanon Trotting Ass’n v. Battista*, 306 N.E.2d 769, 772 (Ohio Ct. App. 1972) (“[I]f the only means of availing the partners of the benefit of the value of the lease would be to continue to operate under such lease until its expiration, then such operation may continue as part of the winding up of the partnership affairs after dissolution. It is not necessary that a partnership, in the absence of the consent of all the partners, abandon a valuable asset upon dissolution merely because it may have no ready market value, but the value of such asset can continue to inure to the benefit of the partners through the continuation of the partnership after dissolution.”).

**Subsection (b)(2)(A) and (F)**—For the constructive notice effect of the specified amendment and a statement of termination, see Sections 4-103(d)(2)(A) and (B).

**Subsection (c)**—Section 4-409 does not apply to a person appointed under this section. Such person will inevitably be an agent of the dissolved limited partnership, acting pursuant to a contract. Thus, agency and contract law will determine the person’s duties.

**Subsection (d)**—Section 4-409 does not apply to a person appointed under this section. The applicable standards of conduct might come from any or all of these sources: the court order, the state law pertaining to receiverships, agency law, and contract law.

### **SECTION 4-803. RESCINDING DISSOLUTION.**

(a) A limited partnership may rescind its dissolution, unless a statement of termination applicable to the partnership has become effective, [the appropriate court] has entered an order under Section 4-801(a)(6) dissolving the partnership, or the [Secretary of State] has dissolved the partnership under Section 4-811.

(b) Rescinding dissolution under this section requires:

(1) the affirmative vote or consent of each partner; and

(2) if the limited partnership has delivered to the [Secretary of State] for filing an amendment to the certificate of limited partnership stating that the partnership is dissolved and:

(A) the amendment has not become effective, delivery to the [Secretary of State] for filing of a statement of withdrawal under Section 1-204 applicable to the amendment;

or

(B) the amendment has become effective, delivery to the [Secretary of State] for filing of an amendment to the certificate of limited partnership stating that dissolution has been rescinded under this section.

(c) If a limited partnership rescinds its dissolution:

(1) the partnership resumes carrying on its activities and affairs as if dissolution had never occurred;

(2) subject to paragraph (3), any liability incurred by the partnership after the dissolution and before the rescission has become effective is determined as if dissolution had never occurred; and

(3) the rights of a third party arising out of conduct in reliance on the dissolution before the third party knew or had notice of the rescission may not be adversely affected.

### Comment

The Harmonization Project added this section.

**Subsection (a)**—The first exclusion results inevitably from the effect of a statement of termination – *i.e.*, the limited partnership ceases to exist as an entity. A “dead” entity lacks both the capacity and power to bring itself back from the dead.

The second and third exclusions pertain to dissolutions effected by outsiders – *i.e.*, the court and the filing office.

**Subsections (b)(1)**—The requirement of unanimous consent protects any vested rights of or reliance by partners. However, the partnership agreement may vary this provision.

**Subsection (c)(3)**—This paragraph protects third parties. *E.g.*, *Neurobehavioral Assocs., P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 331 (Tex. Ct. App. 1999) (“If the Hospital had the right to terminate the Agreement when it did because the Association was then dissolved, then even though the Association can revoke articles of dissolution and have that relate back to the date of dissolution, it would be grossly unfair to let the Association assert its *ex post facto* change as a defense. Surely the Association would be estopped from doing so, having created the very conditions that gave the Hospital the correct impression that it was then dissolved.”).

#### **SECTION 4-804. POWER TO BIND PARTNERSHIP AFTER DISSOLUTION.**

(a) A limited partnership is bound by a general partner's act after dissolution which:

(1) is appropriate for winding up the partnership's activities and affairs; or

(2) would have bound the partnership under Section 4-402 before dissolution if, at the time the other party enters into the transaction, the other party does not know or have notice of the dissolution.

(b) A person dissociated as a general partner binds a limited partnership through an act occurring after dissolution if:

(1) at the time the other party enters into the transaction:

(A) less than two years has passed since the dissociation; and

(B) the other party does not know or have notice of the dissociation and reasonably believes that the person is a general partner; and

(2) the act:

(A) is appropriate for winding up the partnership's activities and affairs; or

(B) would have bound the partnership under Section 4-402 before dissolution and at the time the other party enters into the transaction the other party does not know or have notice of the dissolution.

#### **Comment**

This section provides the "power to bind" rules applicable once dissolution occurs. The section originated in UPA (1997), which significantly departed from the approach of UPA (1914). ULPA (2001) accepted the UPA (1997) construct but revised the language for stylistic reasons. The Harmonization Project accepted the ULPA (2001) language.

In general, this section parallels Section 4-606 (power to bind of a person dissociated as general partner when dissolution does not result from the dissociation). However, one significant difference exists. Section 4-606(a)(2)(A) contains a provision analogous to a statute of repose. A person's power to bind the partnership terminates two years after the date of dissociation. Subsection (b) contains a comparable provision, but Subsection (a) does not.

**Subsections (a) and (b)**—Subsection (a) states the power-to-bind rules for persons still general partners when dissolution occurs. Subsection (b) pertains to persons dissociated as a general partner before dissolution, including a general partner whose dissociation results in dissolution.

**Subsection (a)(1)**—This paragraph states a rule of inherent agency power. *See* RESTATEMENT (SECOND) OF AGENCY § 8A (1958) (defining “inherent agency power” as “the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent”). Thus, a general partner might act without actual or apparent authority and still bind the limited partnership. The partnership agreement cannot change the stated rule, because the rule pertains to the rights of third parties under this article. *See* Section 4-105(c)(18).

If a general partner’s words or conduct trigger this paragraph, thereby binding the limited partnership, and the general partner lacks the actual authority to do so, the general partner breaches an agent’s duty to act within authority, and is liable to the limited partnership for any resulting damages. RESTATEMENT (THIRD) OF AGENCY § 8.09(1) (2006) (“An agent has a duty to take action only within the scope of the agent’s actual authority”). The general partner might also be liable for breach of the partnership agreement.

**Subsection (a)(2)**—A person might have notice under Section 4-103(d)(2)(A) (amendment of certificate of limited partnership to indicate dissolution) as well as under Section 4-103(b)(1) (reason to know).

**Subsection (b)**—This subsection deals with the post-dissolution power to bind of a person dissociated as a general partner. For the most part: (i) Paragraph 1 replicates Section 4-606, pertaining to the pre-dissolution power to bind of a person dissociated as a general partner; and (ii) Paragraph 2 replicates Subsection (a) of this section, which states the post-dissolution power to bind of a person who is still a general partner.

For a person dissociated as a general partner to bind a dissolved limited partnership:

- the person’s dissociation must have:
  - been rightful; and
  - resulted in dissolution; and
- the person’s act must satisfy both Paragraphs 1 and 2.

**Subsection (b)(1)(B)**—A person might have notice under Section 4-103(d)(1) (amendment to certificate of limited partnership indicating dissociation or statement of dissociation) as well as under Section 4-103(b)(1).

**Subsection (b)(2)(B)**—A person might have notice under Section 4-103(d)(2)(A) (amendment of certificate of limited partnership to indicate dissolution) as well as under Section 4-103(b)(1).

**SECTION 4-805. LIABILITY AFTER DISSOLUTION OF GENERAL PARTNER  
AND PERSON DISSOCIATED AS GENERAL PARTNER.**

(a) If a general partner having knowledge of the dissolution causes a limited partnership to incur an obligation under Section 4-804(a) by an act that is not appropriate for winding up the partnership's activities and affairs, the general partner is liable:

(1) to the partnership for any damage caused to the partnership arising from the obligation; and

(2) if another general partner or a person dissociated as a general partner is liable for the obligation, to that other general partner or person for any damage caused to that other general partner or person arising from the liability.

(b) If a person dissociated as a general partner causes a limited partnership to incur an obligation under Section 4-804(b), the person is liable:

(1) to the partnership for any damage caused to the partnership arising from the obligation; and

(2) if a general partner or another person dissociated as a general partner is liable for the obligation, to the general partner or other person for any damage caused to the general partner or other person arising from the obligation.

**Comment**

This section parallels Section 4-606(b). It is possible for more than one person to be liable under this section on account of the same limited partnership obligation. This article does not provide any rule for apportioning liability in that circumstance.

**Subsection (a)(2)**—If the limited partnership is not a limited liability limited partnership, the liability created by this paragraph includes liability under Sections 4-404(a), 4-607(b), and 4-607(c). The paragraph also applies when a partner or person dissociated as a general partner suffers damage due to a contract of guaranty.

Other law determines liability (if any) to a person that is neither a general partner nor

dissociated as a general partner.

**SECTION 4-806. KNOWN CLAIMS AGAINST DISSOLVED LIMITED PARTNERSHIP.**

(a) Except as otherwise provided in subsection (d), a dissolved limited partnership may give notice of a known claim under subsection (b), which has the effect provided in subsection (c).

(b) A dissolved limited partnership may in a record notify its known claimants of the dissolution. The notice must:

- (1) specify the information required to be included in a claim;
- (2) state that a claim must be in writing and provide a mailing address to which the claim is to be sent;
- (3) state the deadline for receipt of a claim, which may not be less than 120 days after the date the notice is received by the claimant;
- (4) state that the claim will be barred if not received by the deadline; and
- (5) unless the partnership has been throughout its existence a limited liability limited partnership, state that the barring of a claim against the partnership will also bar any corresponding claim against any general partner or person dissociated as a general partner which is based on Section 4-404.

(c) A claim against a dissolved limited partnership is barred if the requirements of subsection (b) are met and:

- (1) the claim is not received by the specified deadline; or
- (2) if the claim is timely received but rejected by the partnership:
  - (A) the partnership causes the claimant to receive a notice in a record stating that the claim is rejected and will be barred unless the claimant commences an action

against the partnership to enforce the claim not later than 90 days after the claimant receives the notice; and

(B) the claimant does not commence the required action not later than 90 days after the claimant receives the notice.

(d) This section does not apply to a claim based on an event occurring after the date of dissolution or a liability that on that date is contingent.

### **Comment**

Sections 4-806, 4-807, and 4-808 provide rules under which a dissolved limited partnership may achieve finality with regard to claims.

**Source** – This section is derived almost verbatim from Model Business Corporation Act § 14.06.

**Subsection (b)(5)** – *See* the comment to Section 4-809.

## **SECTION 4-807. OTHER CLAIMS AGAINST DISSOLVED LIMITED PARTNERSHIP.**

(a) A dissolved limited partnership may publish notice of its dissolution and request persons having claims against the partnership to present them in accordance with the notice.

(b) A notice under subsection (a) must:

(1) be published at least once in a newspaper of general circulation in the [county] in this state in which the dissolved limited partnership's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the partnership's registered agent is or was last located;

(2) describe the information required to be contained in a claim, state that the claim must be in writing, and provide a mailing address to which the claim is to be sent;

(3) state that a claim against the partnership is barred unless an action to enforce

the claim is commenced not later than three years after publication of the notice; and

(4) unless the partnership has been throughout its existence a limited liability limited partnership, state that the barring of a claim against the partnership will also bar any corresponding claim against any general partner or person dissociated as a general partner which is based on Section 4-404.

(c) If a dissolved limited partnership publishes a notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences an action to enforce the claim against the partnership not later than three years after the publication date of the notice:

(1) a claimant that did not receive notice in a record under Section 4-806;

(2) a claimant whose claim was timely sent to the partnership but not acted on;

and

(3) a claimant whose claim is contingent at, or based on an event occurring after, the date of dissolution.

(d) A claim not barred under this section or Section 4-806 may be enforced:

(1) against the dissolved limited partnership, to the extent of its undistributed assets;

(2) except as otherwise provided in Section 4-808, if assets of the partnership have been distributed after dissolution, against a partner or transferee to the extent of that person's proportionate share of the claim or of the partnership's assets distributed to the partner or transferee after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution; and



(3) against any person liable on the claim under Sections 4-404 and 4-607.

### **Comment**

**Source**—This section is derived almost verbatim from Model Business Corporation Act § 14.07.

**Subsection (b)(4)**—*See* the comment to Section 4-809.

**Subsection (d)(2)**—Liability under this paragraph extends to those who have received distributions under a charging order. *See* the comment to Section 4-702(a) (explaining that the beneficiary of a charging order is a transferee). Unlike Section 4-505(b) (recapture of improper interim distributions), this paragraph contains no “knowledge” element.

### **SECTION 4-808. COURT PROCEEDINGS.**

(a) A dissolved limited partnership that has published a notice under Section 4-807 may file an application with [the appropriate court] in the [county] where the partnership’s principal office is located or, if the principal office is not located in this state, where the office of its registered agent is or was last located, for a determination of the amount and form of security to be provided for payment of claims that are contingent, have not been made known to the partnership, or are based on an event occurring after the date of dissolution but which, based on the facts known to the partnership, are reasonably expected to arise after the date of dissolution. Security is not required for any claim that is or is reasonably anticipated to be barred under Section 4-807.

(b) Not later than 10 days after the filing of an application under subsection (a), the dissolved limited partnership shall give notice of the proceeding to each claimant holding a contingent claim known to the partnership.

(c) In a proceeding brought under this section, the court may appoint a guardian ad litem to represent all claimants whose identities are unknown. The reasonable fees and expenses of the guardian, including all reasonable expert witness fees, must be paid by the dissolved limited

partnership.

(d) A dissolved limited partnership that provides security in the amount and form ordered by the court under subsection (a) satisfies the partnership's obligations with respect to claims that are contingent, have not been made known to the partnership, or are based on an event occurring after the date of dissolution, and such claims may not be enforced against a partner or transferee on account of assets received in liquidation.

#### **Comment**

**Source**—This section is derived almost verbatim from Model Business Corporation Act § 14.08.

**SECTION 4-809. LIABILITY OF GENERAL PARTNER AND PERSON DISSOCIATED AS GENERAL PARTNER WHEN CLAIM AGAINST LIMITED PARTNERSHIP BARRED.** If a claim against a dissolved limited partnership is barred under Section 4-806, 4-807, or 4-808, any corresponding claim under Section 4-404 or 4-607 is also barred.

#### **Comment**

A general partner's liability under Sections 4-404 and 4-607 is vicarious liability—liability solely by status and solely for the “debts, obligations, and other liabilities of the limited partnership.” To the extent a claim pertaining to the underlying debt, obligation, or other liability is barred, a claim pertaining to the corresponding vicarious liability should likewise be barred.

**SECTION 4-810. DISPOSITION OF ASSETS IN WINDING UP; WHEN CONTRIBUTIONS REQUIRED.**

(a) In winding up its activities and affairs, a limited partnership shall apply its assets, including the contributions required by this section, to discharge the partnership's obligations to creditors, including partners that are creditors.

(b) After a limited partnership complies with subsection (a), any surplus must be

distributed in the following order, subject to any charging order in effect under Section 4-703:

(1) to each person owning a transferable interest that reflects contributions made and not previously returned, an amount equal to the value of the unreturned contributions; and

(2) among persons owning transferable interests in proportion to their respective rights to share in distributions immediately before the dissolution of the partnership.

(c) If a limited partnership's assets are insufficient to satisfy all of its obligations under subsection (a), with respect to each unsatisfied obligation incurred when the partnership was not a limited liability limited partnership, the following rules apply:

(1) Each person that was a general partner when the obligation was incurred and that has not been released from the obligation under Section 4-607 shall contribute to the partnership for the purpose of enabling the partnership to satisfy the obligation. The contribution due from each of those persons is in proportion to the right to receive distributions in the capacity of a general partner in effect for each of those persons when the obligation was incurred.

(2) If a person does not contribute the full amount required under paragraph (1) with respect to an unsatisfied obligation of the partnership, the other persons required to contribute by paragraph (1) on account of the obligation shall contribute the additional amount necessary to discharge the obligation. The additional contribution due from each of those other persons is in proportion to the right to receive distributions in the capacity of a general partner in effect for each of those other persons when the obligation was incurred.

(3) If a person does not make the additional contribution required by paragraph (2), further additional contributions are determined and due in the same manner as provided in that paragraph.

(d) A person that makes an additional contribution under subsection (c)(2) or (3) may recover from any person whose failure to contribute under subsection (c)(1) or (2) necessitated the additional contribution. A person may not recover under this subsection more than the amount additionally contributed. A person's liability under this subsection may not exceed the amount the person failed to contribute.

(e) If a limited partnership does not have sufficient surplus to comply with subsection (b)(1), any surplus must be distributed among the owners of transferable interests in proportion to the value of the respective unreturned contributions.

(f) All distributions made under subsections (b) and (c) must be paid in money.

### **Comment**

In some circumstances, this article requires a partner to make payments to the limited partnership. *See, e.g.*, Sections 4-502(b), 4-505(a), 4-505(b), 4-810(c). In other circumstances, this article requires a partner to make payments to other partners. *See, e.g.*, Sections 4-505(c), 4-810(d). In no circumstances does this article require a partner to make a payment for the purpose of equalizing or otherwise reallocating capital losses incurred by partners.

**EXAMPLE:** XYZ Limited Partnership ("XYZ") has one general partner and four limited partners. As indicated by its name, XYZ is not a limited liability limited partnership. According to XYZ's required information, the value of each partner's contributions to XYZ are:

General partner—\$5,000  
Limited partner #1—\$10,000  
Limited partner #2—\$15,000  
Limited partner #3—\$20,000  
Limited partner #4—\$25,000

XYZ is unsuccessful and eventually dissolves without ever having made a distribution to its partners. XYZ lacks any assets with which to return to the partners the value of their respective contributions. No partner is obliged to make any payment either to the limited partnership or to fellow partners to adjust these capital losses. These losses are not part of "the limited partnership's obligations to creditors." Section 4-810(a).

**EXAMPLE:** Same facts, except that Limited Partner #4 loaned \$25,000 to XYZ, and XYZ lacks the assets to repay the loan. The general partner must contribute to the limited partnership whatever funds are necessary to enable XYZ to satisfy the obligation

owned to Limited Partner #4 on account of the loan. Section 4-810(a) and (c).

**Subsection (a)**—This subsection is non-waivable as to creditors who are not partners. *See* Section 4-105(c)(18) (stating that the partnership agreement may not “restrict the rights under this [Code] of a person other than a partner”). However, if a creditor is willing, a dissolved limited partnership may certainly make agreements with the creditor specifying the terms under which the limited partnership will “discharge the partnership’s obligations to” the creditor.

**Subsection (b)**—For the most part, this subsection states default rules. For example, partnership agreements often provide for different distribution rights upon liquidation than during operations. However, distributions under these subsections (or otherwise under the partnership agreement) are subject to charging orders, Section 4-703. As to the extent the partnership agreement can be amended to affect the distribution rights of persons already transferees, *see* Section 4-107(b).

**Subsection (c)**—This section applies obligation by obligation, because a person—*qua* general partner or person dissociated as a general partner—is required to contribute to the limited partnership to satisfy a partnership obligation only if, when the obligation was incurred: (i) the person was a general partner; and (ii) the limited partnership was not an LLLP. *See* Section 4-404(b), (c). As for when a limited partnership obligation is incurred, *see* the comments to Section 4-404(b) and (c).

The partnership agreement can change the allocation *inter se* general partners and persons dissociated as general partners but cannot prejudice the rights of non-partner creditors.

EXAMPLE: The A-B Limited Partnership (the “Partnership”) owes Creditor \$150, an obligation incurred when General Partners A and B were the only general partners, sharing distributions equally, and the Limited Partnership was not an LLLP. The Partnership has no funds to pay Creditor. Although Subsection (c)(1) would require Partners A and B each to contribute equally (*i.e.*, \$75), the A-B Partnership Agreement provides that General Partner A has the entire contribution obligation and General Partner B has none. As between General Partners A and B, General Partner A is obligated to contribute \$150 and General Partner B nothing. However, as to Creditor, General Partner B still has a contribution obligation of \$75.

This formal distinction will have practical consequences only if General Partner A does not contribute the full \$150. Also, Creditor may have problems establishing standing. *Cf.* the comment to Section 4-505.

**Subsection (c)(2) and (3)**—These provisions are analogous to buy-sell provisions that: (i) provide that an owner’s effort to sell the ownership interest triggers an option to purchase allocated among all the other owners; (ii) make the option conditional on the entire interest being purchased; and (iii) provide for successive allocations to take up any previous allocations that were not unexercised.

**Subsection (e)**—If a limited partnership has been a limited liability limited partnership throughout the partnership’s existence, this subsection is consistent with this article’s approach to

loss sharing. If a partnership has been a limited liability limited partnership during only part of the partnership's existence, the issue of loss sharing upon dissolution: (i) can be exceedingly complicated, varying radically depending on the circumstances; (ii) is therefore not amenable to a statutory "gap filler"; and (iii) thus should always be addressed in the partnership agreement.

However, in case the partnership agreement does not address the issue, this article must provide a default rule. *See* the comment to Section 4-105(b) ("To the extent the partnership agreement does not determine an inter se matter, this article determines the matter."). This subsection applies to fill the gap. This approach has the virtues of simplicity and certainty but in no way resembles what "typical" partners might agree if they were to consider the matter *ab initio*, especially if the partnership was never a LLLP. *Cf.* Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 448 (1987) ("[T]he various norms established by the Act, applicable in the absence of agreements to the contrary, represent the supposed understandings partners most likely reach if they choose to bargain on the various issues.").

## **[PART] 9**

### **ACTIONS BY PARTNERS**

#### **SECTION 4-901. DIRECT ACTION BY PARTNER.**

(a) Subject to subsection (b), a partner may maintain a direct action against another partner or the limited partnership, with or without an accounting as to the partnership's activities and affairs, to enforce the partner's rights and otherwise protect the partner's interests, including rights and interests under the partnership agreement or this [Code] or arising independently of the partnership relationship.

(b) A partner 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 partnership.

(c) A right to an accounting on a dissolution and winding up does not revive a claim barred by law.

### **Comment**

**Subsection (a)**—A partner's rights under this subsection are subject to the rule of standing stated in Subsection (b). The phrase "otherwise protect the partner's interests" pertains to remedies and creates no additional causes of action.

The last phrase of this subsection (“or arising independently . . .”) does not create any new rights, obligations, or remedies, and is included merely to emphasize that a person being a partner in a limited partnership does not preclude the person from enforcing rights existing “independently of the partnership relationship” (e.g., as a creditor).

**Subsection (b)**—This subsection codifies the rule of standing that predominates in entity law. See, e.g., *Mallia v. PaineWebber, Inc.*, 889 F. Supp. 277, 282 (S.D. Tex. 1995) (“[T]o bring a direct representative action against a general partner, a limited partner must demonstrate either direct injury or an injury that exists independently of the partnerships.”); *Jones H. F. Ahmanson & Co.*, 460 P.2d 464, 470 (Cal. 1969) (stating that “the action is derivative, i.e., in the corporate right, if the gravamen of the complaint is injury to the corporation, or to the whole body of its stock or property without any severance or distribution among individual holders, or if it seeks to recover assets for the corporation or to prevent the dissipation of its assets” (quoting *Gagnon Co., Inc. v. Nevada Desert Inn*, 289 P.2d 466, 471 (Cal. 1955) (internal quotation marks omitted))); *Litman v. Prudential-Bache Properties, Inc.*, 611 A.2d 12, 17 (Del. Ch. 1992) (stating that direct action by holders of interest in partnership is not permitted for indirect injuries from general partners’ misconduct); *Tzolis v. Wolff*, 884 N.E.2d 1005, 1008 (N.Y. 2008) (holding that derivative actions exist under New York LLC law and referring to “the traditional line between direct and derivative claims”); see also *CML V, LLC v. Bax*, 6 A.3d 238, 245 (Del. Ch. 2010) (noting that issues of standing viz-a-viz direct and derivative claims are comparable regardless of whether the entity is a limited partnership, a limited liability company, or a corporation), *aff’d*, 28 A.3d 1037 (Del. 2011).

The distinction between direct and derivative claims protects the partnership agreement. If any partner can sue directly over any management issue, the mere threat of suit can interfere with the partners’ agreed-upon arrangements.

Although in ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract, within a limited partnership different circumstances typically exist. A partner does not have a direct claim against a general partner merely because the general partner has breached the partnership agreement. Likewise a general partner’s violation of this article does not automatically create a direct claim for every other partner. To have standing in his, her, or its own right, a partner plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the limited partnership.

**EXAMPLE:** Through grossly negligent conduct, in violation of Section 4-409(c), the general partner of a limited partnership reduces the net assets of the limited partnership by fifty percent, which in turns decreases the value of Limited Partner A’s investment by \$3,000,000. A has no standing to bring a direct claim; the damage is merely derivative of the damage first suffered by the limited partnership. The partner may, however, bring a derivative claim. Sections 4-902 through 4-906.

**EXAMPLE:** Same facts, except in addition to violating Section 4-409(c), the general partner’s conduct breaches an express provision of the partnership agreement to which Limited Partner A is a signatory. The analysis and the result are the same.

EXAMPLE: A partnership agreement defines “distributable cash” and requires the limited partnership to periodically distribute that cash among all partners. The limited partnership’s general partner fails to distribute the cash. Each partner has a direct claim against the general partner and the limited partnership.

The reference to “threatened injury” is to encompass potential claims for preventative relief, such as a temporary restraining order or preliminary injunction.

This section’s standing rule is subject to reasonable alterations by the partnership agreement. *See* the comment to Section 4-105(c)(14).

**Subsection (c)**—This subsection originated as UPA (1997) § 405(c) and reversed the rule stated in UPA (1914) § 43. This subsection inevitably implies that other law governs the accrual of a claim under Subsection (b) as well as the statute of limitations applicable to those claims. As a result, partners must take care not to “sit on their claims” waiting for the partnership to dissolve. *Veloski v. State Farm Mut. Auto Ins. Co.*, 719 N.E.2d 574, 576 (Ohio Ct. App. 1998).

**SECTION 4-902. DERIVATIVE ACTION.** A partner may maintain a derivative action to enforce a right of a limited partnership if:

(1) the partner first makes a demand on the general partners, requesting that they cause the partnership to bring an action to enforce the right, and the general partners do not bring the action within a reasonable time; or

(2) a demand under paragraph (1) would be futile.

### Comment

By its terms, this section permits a general partner as well as a limited partner to bring a derivative action, subject of course to Section 4-903.

**Paragraph (1)**—The demand requirement recognizes that, presumptively at least, the decision to cause a limited partnership to bring suit is a business decision, to be made by those who manage the business. Deborah A. DeMott, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5.9 (Westlaw, Nov. 4, 2012) (Demand on directors—Rationales for demand).

**Paragraph (2)**—Some jurisdictions have a “universal demand” requirement, but the approach stated here is by far the majority one. Deborah A. Demott, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5.12 (Westlaw, Nov. 4, 2012).

**SECTION 4-903. PROPER PLAINTIFF.** A derivative action to enforce a right of a limited partnership may be maintained only by a person that is a partner at the time the action is



commenced and:

(1) was a partner when the conduct giving rise to the action occurred; or

(2) whose status as a partner devolved on the person by operation of law or pursuant to the terms of the partnership agreement from a person that was a partner at the time of the conduct.

### Comment

The rule stated here is conventional in both the law of unincorporated entities and corporate law. Persons dissociated as partners have no standing to bring a derivative action. *A fortiori*, mere transferees have no standing. See the comment to Section 4-107(b) and Section 4-702.

**Paragraph (2)**—This paragraph will be inapposite if the limited partnership has only two partners, one of whom is the derivative plaintiff. In that limited circumstance, the plaintiff's death would cause the derivative action to abate. The “pick your partner” principal enshrined in Section 4-702 would prevent the decedent's heirs from succeeding to plaintiff status in the derivative action (except in the unlikely event that the remaining partner consents to the heirs becoming partners). The analysis and result will be the same if the derivative plaintiff is an entity whose existence terminates.

This article takes no position on whether:

- the death of partner abates a direct claim against the limited partnership or a fellow partner; and
- bringing a direct claim precludes a person from being a proper plaintiff for a derivative claim.

As to the latter issue, see, *e.g.*, *Cordts-Auth v. Crunk, L.L.C.*, 815 F. Supp. 2d 778, 793–94 (S.D.N.Y. 2011) (discussing the potential conflict of interest), *aff'd*, 479 F. App'x 375 (2d Cir. 2012).

**SECTION 4-904. PLEADING.** In a derivative action, the complaint must state with particularity:

(1) the date and content of plaintiff's demand and the response to the demand by the general partner; or

(2) why demand should be excused as futile.

## **Comment**

This section parallels Section 4-902. The pleading requirement first appeared in a uniform act in 1976. ULPA (1976) § 1003.

### **SECTION 4-905. SPECIAL LITIGATION COMMITTEE.**

(a) If a limited partnership is named as or made a party in a derivative proceeding, the partnership may appoint a special litigation committee to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests of the partnership. If the partnership appoints a special litigation committee, on motion by the committee made in the name of the partnership, except for good cause shown, the court shall stay discovery for the time reasonably necessary to permit the committee to make its investigation. This subsection does not prevent the court from:

(1) enforcing a person's right to information under Section 4-304 or 4-407; or

(2) granting extraordinary relief in the form of a temporary restraining order or preliminary injunction.

(b) A special litigation committee must be composed of one or more disinterested and independent individuals, who may be partners.

(c) A special litigation committee may be appointed:

(1) by a majority of the general partners not named as parties in the proceeding; or

(2) if all general partners are named as parties in the proceeding, by a majority of the general partners named as defendants.

(d) After appropriate investigation, a special litigation committee may determine that it is in the best interests of the limited partnership that the proceeding:

(1) continue under the control of the plaintiff;

(2) continue under the control of the committee;

(3) be settled on terms approved by the committee; or

(4) be dismissed.

(e) After making a determination under subsection (d), a special litigation committee shall file with the court a statement of its determination and its report supporting its determination and shall serve each party with a copy of the determination and report. The court shall determine whether the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof. If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court shall enforce the determination of the committee. Otherwise, the court shall dissolve the stay of discovery entered under subsection (a) and allow the action to continue under the control of the plaintiff.

### **Comment**

Although special litigation committees are best known in the corporate field, they are no more inherently corporate than derivative litigation or the notion that an organization is a person distinct from its owners. An “SLC” can serve as an ADR mechanism, help protect an agreed upon arrangement from strike suits, protect the interests of partners who are neither plaintiffs nor defendants (if any), and bring the benefits of a specially tailored business judgment to any judicial decision.

This section’s approach corresponds to established law in most jurisdictions, modified to fit the typical governance structures of a limited partnership. Use of an SLC is optional. A partnership agreement can preclude the use of SLCs, rendering this section inapplicable, but cannot otherwise vary this section. *See* Section 4-105(c)(15).

**Subsection (a)(1)**—Sections 4-304 and 4-407 pertain to information rights. On the availability of these remedies pending the SLC’s investigation, *compare* Section 4-410, *with Kaufman v. Computer Assoc. Int’l, Inc.*, No. Civ.A. 699-N, 2005 WL 3470589, at \*1 (Del. Ch. Dec. 21, 2005) (presenting “the question of whether to stay a books and records action under 8 Del. C. § 220 at the request of a special litigation committee when a derivative action encompassing substantially the same allegations of wrongdoing filed by different plaintiffs is pending in another jurisdiction”; concluding “[f]or reasons that have much to do with the light burden imposed by the plaintiff’s demand in this case . . . that the special litigation committee’s motion to stay the books and records action should be denied”).

**Subsection (e)**—The standard stated for judicial review of the SLC determination follows *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979) rather than *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), because the latter’s reference to a court’s business judgment has generally not been followed in other states. In essence, an SLC is intended to function as a surrogate decision-maker, allowing the limited partnership to make what is fundamentally a business decision. If a court determines that “the members of the committee were disinterested and independent and [that] . . . the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof,” it makes no sense to substitute the court’s legal judgment for the business judgment of the SLC.

*Houle v. Low*, 556 N.E.2d 51, 58 (Mass. 1990) contains an excellent explanation of the court’s role in reviewing an SLC decision:

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the [entity]’s best interest, a good deal of judicial oversight is necessary in each case. At the same time, however, courts must be careful not to usurp the committee’s valuable role in exercising business judgment. . . . [A] special litigation committee must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the plaintiff’s derivative suit. . . . The burden of proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof—the [entity].

For a discussion of how a court should approach the question of independence, see *Einhorn v. Culea*, 612 N.W.2d 78, 91 (Wis. 2000).

#### **SECTION 4-906. PROCEEDS AND EXPENSES.**

(a) Except as otherwise provided in subsection (b):

(1) any proceeds or other benefits of a derivative action, whether by judgment, compromise, or settlement, belong to the limited partnership and not to the plaintiff; and

(2) if the plaintiff receives any proceeds, the plaintiff shall remit them immediately to the partnership.

(b) If a derivative action is successful in whole or in part, the court may award the plaintiff reasonable expenses, including reasonable attorney’s fees and costs, from the recovery of the limited partnership.

(c) A derivative action on behalf of a limited partnership may not be voluntarily dismissed or settled without the court's approval.

**Comment**

**Subsection (c)**—This provision is intended to prevent collusion.

**ARTICLE 5**

**LIMITED LIABILITY COMPANIES**

**[PART] 1**

**GENERAL PROVISIONS**

**SECTION 5-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Limited Liability Companies.

**Comment**

This article replaces a state's current limited liability company statute, whether or not that statute is based on ULLCA (1996) or ULLCA (2006). Section 5-110 contains transition provisions for the applicability of this article to limited liability companies formed before the effective date of the Code (Section 1-708).

**SECTION 5-102. DEFINITIONS.**

(a) In this [article]:

(1) "Certificate of organization" means the certificate required by Section 5-201.

The term includes the certificate as amended or restated.

(2) "Contribution", except in the phrase "right of contribution", means property or a benefit described in Section 5-402 which is provided by a person to a limited liability company to become a member or in the person's capacity as a member.

(3) "Distribution" means a transfer of money or other property from a limited liability company to a person on account of a transferable interest or in the person's capacity as a member. The term:

(A) includes:

(i) a redemption or other purchase by a limited liability company of a transferable interest; and

(ii) a transfer to a member in return for the member's relinquishment of any right to participate as a member in the management or conduct of the company's activities and affairs or to have access to records or other information concerning the company's activities and affairs; and

(B) does not include amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.

(4) "Limited liability company" means an entity formed under this [article] or which becomes subject to this [article] under [Article] 2 or Section 5-110.

(5) "Manager" means a person that under the operating agreement of a manager-managed limited liability company is responsible, alone or in concert with others, for performing the management functions stated in Section 5-407(c).

(6) "Manager-managed limited liability company" means a limited liability company that qualifies under Section 5-407(a).

(7) "Member" means a person that:

(A) has become a member of a limited liability company under Section 5-401 or was a member in a company when the company became subject to this [article] under Section 5-110; and

(B) has not dissociated under Section 5-602.

(8) "Member-managed limited liability company" means a limited liability

company that is not a manager-managed limited liability company.

(9) “Operating agreement” means 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 5-105(a). The term includes the agreement as amended or restated.

(10) “Organizer” means a person that acts under Section 5-201 to form a limited liability company.

(11) “Transferable interest” means the right, as initially owned by a person in the person’s capacity as a member, to receive distributions from a limited liability company, whether or not the person remains a member or continues to own any part of the right. The term applies to any fraction of the interest, by whomever owned.

(12) “Transferee” means a person to which all or part of a transferable interest has been transferred, whether or not the transferor is a member. The term includes a person that owns a transferable interest under Section 5-603(a)(3).

(b) The following definitions outside this [article] apply to this [article]:

(1) “Debtor in bankruptcy” – Section 1-102(6).

(2) “Foreign” – Section 1-102(14).

(3) “Jurisdiction” – Section 1-102(21).

(4) “Jurisdiction of formation” – Section 102(22).

(5) “Person” – Section 1-102(34).

(6) “Principal office” – Section 1-102(35).

(7) “Property” – Section 1-102(38).

(8) “Receipt” – Section 1-102(40).

(9) “Record” – Section 1-102(41).

(10) “Registered agent” – Section 1-102(42).

(11) “Sign” – Section 1-102(44).

(12) “State” – Section 1-102(45).

(13) “Transfer” – Section 1-102(47).

### Comment

**Subsection (a)** contains definitions for terms used throughout this article.

**Subsection (b)** – Subsection (b) contains a list of definitions in Article 1 that are applicable to limited liability companies.

**“Certificate of organization” [(a)(1)]**—The original ULLCA (1996) and most other LLC statutes use “articles of organization” rather than “certificate of organization.” This article 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. For the relationship between the certificate of organization and the operating agreement, see Section 5-107(d).

**“Contribution” [(a)(2)]**—This definition serves to distinguish capital contributions from other circumstances under which a member or would-be member might provide benefits to a limited liability company (*e.g.*, providing services to the LLC as an employee or independent contractor, leasing property to the LLC).

This definition also distinguishes “contributions” from capital raised from transferees who invest; to be a contribution, the property or benefit must be “provided by a person to a limited liability company to become a member or in the person’s capacity as a member.” This approach is common in LLC statutes. *See, e.g.*, N.Y. LTD. LIAB. CO. LAW § 102(f) (McKinney 2013) (“‘Contribution’ means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to render services that a member contributes to a limited liability company in his or her capacity as a member.”); DEL. CODE ANN. tit. 6, § 18-101(3) (West 2013) (“‘Contribution’ means any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, which a person contributes to a limited liability company in the person’s capacity as a member.”).

In contrast, operating agreements sometimes provide for contributions from transferees. In such circumstances, the default rules for liquidating distributions should be altered accordingly. *See* Section 5-707(b)(1) (referring to distributions to be made “to each person



owning a transferable interest that reflects *contributions* made and not previously returned”) (emphasis added).

**“Distribution” [(a)(3)(A)—redemptions included]**—This provision specifically refers to transactions between a limited liability company and one of its members, which in the corporate context would be labeled a “redemption.” The paragraph has subparts because ownership interests in an LLC are conceptually bifurcated into economic rights (“transferable interests”) and governance and information rights.

Under Section 5-404(a), “[a]ny distribution made by a limited liability company before its dissolution and winding up must be in equal shares among members and persons dissociated as members . . . .” Since a redemption is a distribution, absent authorization in the operating agreement an LLC may not redeem the interest of one member or transferee without redeeming (or at least offering to redeem) the interests of all other members and transferees to a comparable extent.

The law of close corporations has flirted with a similar notion. *See, e.g., Donahue v. Rodd Electrottype Co. of New England, Inc.*, 367 Mass. 578, 598, 328 N.E.2d 505, 518 (1975) (stating, with regard to closely held corporations, “if the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price”); *Toner v. Baltimore Envelope Co.*, 304 Md. 256, 273, 498 A.2d 642, 650 (1985) (rejecting the “per se breach of duty” approach); *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 850, 353 N.E.2d 657, 663 (1976) (stating that “untempered application of the strict good faith standard enunciated in *Donahue* to . . . will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned”).

An operating agreement can override Section 5-404(a)’s equal treatment requirement without specifically mentioning redemptions.

EXAMPLE: Ryan, LLC is a manager-managed limited liability company whose operating agreement: (i) includes a list (the “protected list”) of decisions or actions that may be taken only with the consent of all members; and (ii) provides that all other decisions and acts may be taken as the manager determines. The protected list does not include redemptions. The operating agreement overrides the Section 5-404(a)’s equal treatment requirement.

**[(a)(3)(B)—exclusion]**—This exclusion affects the reach of: (i) the charging order remedy under Section 5-503; and (ii) Section 5-405’s clawback provision. The effect on the clawback provision reflects the law in several states, *see, e.g.,* DEL. CODE ANN., tit. 6, § 18-607(b) (2012) and VA. CODE ANN. § 13.1-1036 (2012), and makes sense conceptually and as a

matter of policy. *See In re Tri-River Trading, LLC*, 329 B.R. 252, 266 (B.A.P. 8th Cir. 2005), *aff'd*, 452 F.3d 756 (8th Cir. 2006) (“We know of no principle of law which suggests that a manager of a company is required to give up agreed upon salary to pay creditors when business turns bad.”).

**“Limited liability company” [(a)(4)]**—This definition makes no reference to a limited liability company having members upon formation, but Section 5-201(d) does.

**“Manager” [(a)(5)]**—The article uses “manager” as a term of art, whose applicability under this article is confined to manager-managed LLCs. The phrase “manager-managed” is itself a term of art, referring only to an LLC whose operating agreement refers to the LLC as such. *See* Subsection (a)(6) (defining “manager-managed limited liability company”). Thus, for purposes of this article, if the members of a *member*-managed LLC delegate plenipotentiary management authority to one person (whether or not a member), this article’s references to “manager” do not apply to that person, even if the members or their operating agreement refers to the person as a “manager.”

This approach has the potential for confusion, but confusion around the term “manager” is common to all LLC statutes. The confusion stems from the choice to define “manager” as a term of art in a way that can be at odds with other, common usages of the word. For example, a member-managed LLC might well have an “office manager” or a “property manager.” Moreover, in a manager-managed LLC, the “property manager” is not likely to be a manager as the term is used in many LLC statutes. For this nomenclature problem, the best solution is to have the operating agreement carefully delineate who is and is not a manager as this article uses that label.

For cases exemplifying the complexity and problems, *see, e.g., In re Weddle*, 353 BR 892, 895 n.2 (Bankr. D. Idaho 2006) (“Plaintiff appears to argue that Debtors were managers of the LLC. However, Plaintiff’s use of the term ‘managers’ to describe Debtors’ duties under their employment agreement is not synonymous with ‘manager’ of the LLC within the use of that term in the operating agreement, the articles of incorporation, or chapter 6 of title 53 of the Idaho Code. The court views Debtors’ ‘management’ role in the daily operation of the lodge as separate and distinct from management of the LLC.”); *Brown v. MR Group, LLC*, 693 N.W.2d 138, 143 (Wis. App. 2005) (declining to use the dictionary definition of “manager” in determining coverage of a policy applicable to a limited liability company and its “managers” and relying instead on the meaning of the term under the Wisconsin LLC act); *Old Nat’l Villages, LLC v. Lenox Pine, LLC*, 659 S.E. 2d 891, 893 (Ga. Ct. App. 2008) (treating the label “general manager” as a manager “under Georgia’s LLC statute”).

Under this article, the category of “person” is not limited to individuals. Therefore, a “manager” need not be a natural person. For example, one limited liability company can serve as the manager of another limited liability company.

After a person ceases to be a manager, the term “manager” continues to apply to the person’s conduct while a manager. *See* Section 5-407(c)(6).

**“Manager-managed limited liability company” [(a)(6)]**—This article authorizes a private agreement (the operating agreement) rather than a public document (certificate or articles of organization) to establish an LLC’s status as a manager-managed limited liability company, thereby departing from most existing LLC statutes. Using the operating agreement makes sense, because under this article managerial structure creates no statutory power to bind the entity. *See* Section 5-301 (eliminating statutory apparent authority).

The only direct consequences of manager-managed status are *inter se*—principally the triggering of a set of rules concerning management structure, fiduciary duty, and information rights. *See* Sections 5-407 through 5-410. The rules on management structure are entirely default provisions—subject to change in whole or in part by the operating agreement. The operating agreement can also significantly affect the provisions on fiduciary duty and information rights. *See* Section 5-105.

An LLC that is “manager-managed” under this definition does not change its management structure simply because the members fail to designate anyone to act as a manager. In that situation, absent additional facts, the LLC is manager-managed and the manager position is vacant. Non-manager members who exercise managerial functions during the vacancy (or at any other time) will have duties as determined by other law, most particularly the law of agency.

**“Member” [(a)(7)]**—After a person has been dissociated as a member under Section 5-602, the term “member” continues to apply to the person’s conduct while a member. *See* Section 5-603(b).

**“Member-managed limited liability company” [(a)(8)]**—Under this article, member-management is the default mode. *See* Section 5-407(a).

Some member-managed LLCs give important managerial responsibilities to one or more members. Because “manager” is a term of art under this article and applies only to manager-managed LLC, referring to such members as “managers” risks confusion. *See* the comment to Subsection (a)(5) (Manager). In contrast, “managing member” or some other designation such as Chief Executive Officer avoids the defined term of “manager” and thereby avoids confusion.

**“Operating agreement” [(a)(9)]**—This definition must be read in conjunction with Sections 5-105 through 5-107, which further describe the operating agreement. In particular, although this definition refers to “the agreement . . . of all the members,” the limited liability company itself is bound by and may enforce the agreement. Section 5-106(a).

An operating agreement is a contract, and therefore all statutory language pertaining to the operating agreement must be understood in the context of the law of contracts.

The definition of “operating agreement” is very broad and recognizes a wide scope of authority for the operating agreement: “the matters described in Section 5-105(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 5-105(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.”

Unless the operating agreement itself provides otherwise:

- an operating agreement may comprise a number of separate documents (or records), however denominated; and
- subject to Section 5-106(b) (deeming new members to assent to the then-existing operating agreement), a document, record, understanding, etc. can be part of the operating agreement only with the assent of all persons then members.

An agreement among less than all members might well be enforceable among those members as parties, but would not be part of the operating agreement. However, under Section 5-105(a)(4), an amendment to an operating agreement can be made with less than unanimous consent if the operating agreement itself so provides.

An agreement to form an LLC is not itself an operating agreement. The term “operating agreement” presupposes at least one “member,” and a person cannot be a member of an LLC before the LLC exists. However, as soon as a limited liability company has any members, the limited liability company perforce has an operating agreement. 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. An operating agreement exists. In the words of Subsection (a)(9), “all 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 5-105(a).” To the extent the agreement does not provide the *inter se* “rules of the game,” this article “fills in the gaps.” Section 5-105(b).

The result is the same when a person becomes the sole initial member of an LLC, so long as the person has any understanding or intention with regard to the LLC. Any such understanding or intention constitutes an “agreement of all the members of the limited liability company, including a sole member.” Subsection (a)(9).

It may seem oxymoronic to refer an “agreement of . . . a sole member,” but this approach is common in LLC statutes. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-601 (14)(b) (2012) (defining operating agreement to mean “[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 purporting to govern the affairs of a limited liability company or the conduct of its business as of the effective time of

the statement”); WASH. REV. CODE ANN. § 25.15.005 (5) (2012) (defining limited liability company agreement to include “any written statement of the sole member”).

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.

This article states no rule as to whether the statute of frauds applies to operating agreements. Case law suggests that the answer is yes. *Olson v. Halvorsen*, 986 A.2d 1150, 1161 (Del. 2009) (“The legislative history of the LLC Act does not demonstrate the General Assembly’s intent to place LLC agreements outside of the statute of frauds.”) (applying the one-year provision to an alleged oral buy-out agreement), *negated by* 2010 DEL. LAWS, ch. 287 (H.B. 372), §§ 1, 31 (pertaining to statutes of fraud generally).

The Delaware court decision is consistent with partnership cases.

Partnership agreements, like other contracts, are subject to the Statute of Frauds. A contract of partnership for a term exceeding one year is within the Statute of Frauds and is void unless it is in writing [and signed by the party to be bound]; however, a contract establishing a partnership terminable at the will of any partner is generally held to be capable of performance by its terms within one year of its making and, therefore, to be outside the Statute of Frauds.

*Abbott v. Hurst*, 643 So. 2d 589, 592 (Ala. 1994) (citations omitted).

Likewise, the land provision of the statute of frauds:

applies to an oral contract to transfer or convey partnership real property, and the interest of the other partners therein, to one partner as an individual, as well as to a parol contract by one of the parties to convey certain land owned by him individually to the partnership, or to another partner, or to put it into the partnership stock.

*Froiseth v. Nowlin*, 156 Wash. 314, 316, 287 P. 55, 56 (Wash. 1930) (quoting 27 C.J.S. § 220); *see also E. Piedmont 120 Associates, L.P. v. Sheppard*, 209 Ga. App. 664, 665, 434 S.E.2d 101, 102 (1993) (same, stating that “the fact that promises covered by the Statute of Frauds are made in the context of a partnership or joint venture agreement does not render the statute inapplicable”); *Filippi v. Filippi*, 818 A.2d 608, 618 (R.I. 2003) (applying the statute of frauds to an alleged oral agreement to transfer land owned by a limited partnership to one of its partners).

In contrast, the land provision does not apply to a member’s ownership interest in an

LLC, no matter how much the LLC owns or deals in real property. Interests in a limited liability company are personal property and reflect no direct interest in the entity's assets. *See* Sections 5-102(24), 5-501. Thus, the real property issues pertaining to the LLC's ownership of land do not "flow through" to the members and membership interests. *See, e.g., Wooten v. Marshall*, 153 F. Supp. 759, 763–64 (S.D. N.Y. 1957) (involving an "oral agreement for a joint venture concerning the purchase, exploitation and eventual disposition of this 160 acre tract" and stating "[t]he real property acquired and dealt with by the venturers takes on the character of personal property as between the partners in the enterprise, and hence is not covered by [the Statute of Frauds]"); *see also Wade v. DeHart*, 1926 WL 2944 (Ohio Com. Pl. 1926), *aff'd sub nom., Wade v. De Hart*, 26 Ohio App. 177, 159 N.E. 838 (1927) (same).

On the question of how far a written (or "in a record") operating agreement can go to prevent oral or implied-in-fact terms, see the comment to Section 5-105(a)(4). For the effect of a pre-formation agreement, see Section 5-106(c). For the limited liability company's status *viz-a-viz* the operating agreement, see Section 5-106(a).

**"Organizer" [(a)(10)]**—An organizer need not be a prospective member of the limited liability company. Unless the organizer will be the sole initial member of the limited liability company, as a matter of agency law and Section 5-401(a) and (b), the organizer is acting on behalf of the person or persons who have agreed to become the initial member or members of the limited liability company. The organizer does not act on behalf of the limited liability company, because a person cannot be an agent of an organization that does not yet exist. RESTATEMENT (THIRD) OF AGENCY § 4.04, cmt. c (2006) (Nonexistent Principals).

**"Transferable interest" [(a)(11)]**—Absent a contrary provision in the operating agreement or the consent of the members, a "transferable interest" is the only interest in an LLC which can be transferred to a non-member. *See* the comment to Section 5-502.

This paragraph defines "transferable interest" as an interest "initially owned by a person in the person's capacity as a member," because this article does not contemplate an LLC directly creating interests that comprise only economic rights. *See* Sections 5-401 (addressing how a person becomes a member) and 5-502 (addressing how a person becomes a transferee).

**"Transferee" [(a)(12)]**—This definition should be read in light of Section 5-603(a)(3), which subject to limited exceptions provides that "any transferable interest owned by the person in the person's capacity as a member immediately before dissociation as a member is owned by the person solely as a transferee."

### **SECTION 5-103. KNOWLEDGE; NOTICE.**

(a) A person knows a fact if the person:

(1) has actual knowledge of it; or

(2) is deemed to know it under subsection (d)(1) or law other than this [Code].

(b) A person has notice of a fact if the person:

(1) has reason to know the fact from all the facts known to the person at the time in question; or

(2) is deemed to have notice of the fact under subsection (d)(2).

(c) Subject to Section 1-212, a person notifies another person of a fact by taking steps reasonably required to inform the other person in ordinary course, whether or not those steps cause the other person to know the fact.

(d) A person not a member is deemed:

(1) to know of a limitation on authority to transfer real property as provided in Section 5-302(g); and

(2) to have notice of a limited liability company's:

(A) dissolution 90 days after a statement of dissolution under Section 5-702(b)(2)(A) becomes effective;

(B) termination 90 days after a statement of termination under Section 5-702(b)(2)(F) becomes effective; and

(C) participation in a merger, interest exchange, conversion, or domestication, 90 days after articles of merger, interest exchange, conversion, or domestication under [Article] 2 become effective.

### **Comment**

This section is substantially slimmer than the corresponding provisions of previous uniform acts pertaining to business organizations: UPA (1997), ULLCA (1996), and ULPA (2001). Each of those acts borrowed heavily from the comparable Uniform Commercial Code provision. This article relies instead on generally applicable principles of agency law, *see* Section 1-702; therefore, this section is confined mostly to rules specifically tailored to this article.

Several facets of this section warrant particular note. First, and most fundamentally,

because this article does not provide for “statutory apparent authority,” Section 5-301, this section contains no special rules for attributing to an LLC information possessed, communicated to, or communicated by a member or manager.

Second, the section contains no generally applicable provisions determining when an organization is charged with knowledge or notice, because those imputation rules: (i) comprise core topics within the law of agency; (ii) are very complicated; (iii) should not have any different content under this article than in other circumstances; and (iv) are the subject of considerable attention in the Restatement (Third) of Agency (2006).

Third, this article does not define “notice” to include “knowledge.” Although conceptualizing the latter as giving the former makes logical sense and has a long pedigree, that conceptualization is counter-intuitive for the uninitiated. In ordinary usage, notice has a meaning separate from knowledge. This article follows ordinary usage and therefore contains some references to “knowledge or notice.”

**Subsection (a)(2)**—In this context, the most important source of “law other than this [Code]” is the common law of agency.

**Subsection (b)(1)**—The “facts known to the person at the time in question” include facts the person is deemed to know under Subsection (a)(2).

**Subsection (c)**—If a person “notifies” another person of a fact, the other person has “reason to know” the fact and therefore has notice under Subsection (b)(1). However, a person can have “notice” of a fact without having been “notifie[d]” of the fact.

Section 1-212 pertains to delivery of records *by* the filing office.

**Subsection (d)**—This subsection provides constructive notice of facts stated in specified filed public records.

**Subsection (d)(2)**—Under this , the power to bind a limited liability company to a third party is primarily a matter of agency law. *See* the comment to Section 5-301. The constructive notice provided under this paragraph will be relevant if a third party makes a claim under agency law that someone who purported to act on behalf of a limited liability company had the apparent authority to do so.

**SECTION 5-104. GOVERNING LAW.** 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.



## Comment

**Paragraph (1)**—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. *Compare* Paragraph 1, with 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”).

“Internal affairs” do not encompass the power *vel non* of a person to bind a limited liability company. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 292(2) (1971) (“The principal will be held bound by the agent’s action if he would so be bound under the local law of the state where the agent dealt with the third person, provided at least that the principal had authorized the agent to act on his behalf in that state or had led the third person reasonably to believe that the agent had such authority.”); *Id.* § 295(1) (“Whether a partnership is bound by action taken on its behalf by an agent in dealing with a third person is determined by the local law of the state selected by application of the rule of § 292.”); RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 345, cmt. c (1934) (Law Governing Effect of Act of Agent or Partner) (“If... the principal or partner sends the agent or other partner into a state to act on his behalf, he assumes the risk of liability not only for authorized but for unauthorized conduct of the agent or partner in accordance with the law of that state.”). *See also Farm & Ranch Services, Ltd. v. LT Farm & Ranch, L.L.C.*, 779 F. Supp. 2d 949, 960 (S.D. Iowa 2011).

The operating agreement cannot alter this section. *See* Section 5-105(c)(1). This approach comports with the law of other businesses entities whose formation or legal status depends at least in part on a publicly-filed record. *See, e.g.*, Section 4-104 (stating that the law of the state of formation is the governing law of a limited partnership).

However, an operating agreement may lawfully incorporate by reference the provisions of another state’s LLC statute. If done correctly, this incorporation makes the foreign statutory language part of the operating agreement, and the incorporated terms (together with the rest of the operating agreement) then govern the members (and those claiming through the members) to the extent not prohibited by this article. *See* Section 5-105. This approach: (i) does *not* switch the limited liability company’s governing law to that of another state; (ii) instead takes the provisions of another state’s law and incorporates them by reference into the contract among the members; (iii) raises complex drafting issues – *e.g.*, how to address subsequent changes to the incorporated law (whether occurring by statutory amendment or court decision); and (iv) thus is rarely, if ever, a good idea.

**Paragraph (2)**—This paragraph obviously encompasses Section 5-304 (the liability shield) but does not necessarily encompass a claim that a member or manager is liable to a third party for: (i) having purported inaccurately to have the actual authority to bind a limited liability company to the third party; or (ii) having committed a tort against the third party while acting on the limited liability company’s behalf or in the course of the company’s business. That liability is not by status (*i.e.*, not “as member . . . [or] as manager”) but rather results from function or conduct. *Compare* Paragraph 2, with Section 5-301(b) (stating that, although this article does not make a member as member the agent of a limited liability company, other law may make an LLC liable for the conduct of a member).

“Internal affairs” and the “liability of a member as a member” are mentioned separately because it can be argued that the liability of members and managers to third parties is not an internal affair. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 (1971) (treating shareholders’ liability separately from the internal affairs doctrine). A few cases subsume owner/manager liability into internal affairs, but many do not. *See, e.g., Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 132 (2nd Cir. 1993) (holding that the corporation’s “primary purpose is to insulate shareholders from legal liability” and therefore “the state of incorporation has the greater interest in determining when and if that insulation is to be stripped away”) (quoting *Soviet Pan Am Travel Effort v. Travel Comm., Inc.*, 756 F. Supp. 126, 131 (S.D.N.Y. 1991) (internal quotation marks omitted)).

In any event, most (if not all) LLC statutes follow the rule stated in this paragraph. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-801(A)(1) (2013) (stating that “[t]he laws of the state or another jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its members”); GA. CODE ANN. § 14-11-701 (West 2013)(a) (stating that “[t]he laws of the jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its managers, members, and other owners”); N.Y. LTD. LIAB. CO. LAW § 801(a) (McKinney 2013) (stating that “[t]he laws of the jurisdiction under which a foreign limited liability company is formed govern its organization and internal affairs and the liability of its members and managers”).

Moreover, in the case law, “[t]he 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.” *Rual Trade Ltd. v. Viva Trade L.L.C.*, 549 F. Supp. 2d 1067, 1077 (E.D. Wis. 2008); *see also In re Gulf Fleet Holdings, Inc.*, 491 B.R. 747, 787 (Bankr. W.D. La. 2013) (stating both conceptual and policy rationales for choosing the law of the state of formation); *In re Saba Enterprises, Inc.*, 421 B.R. 626, 648–51 (Bankr. S.D.N.Y. 2009) (examining the issue in detail and applying the state of formation rule).

**SECTION 5-105. OPERATING AGREEMENT; SCOPE, FUNCTION, AND LIMITATIONS.**

(a) Except as otherwise provided in subsections (c) and (d), the operating agreement governs:

(1) relations among the members as members and between the members and the limited liability company;

(2) the rights and duties under this [Code] of a person in the capacity of manager;

(3) the activities and affairs of the company and the conduct of those activities and affairs; and

(4) the means and conditions for amending the operating agreement.

(b) To the extent the operating agreement does not provide for a matter described in subsection (a), this [article] governs the matter.

(c) An operating agreement may not:

(1) vary the law applicable under Section 5-104;

(2) vary a limited liability company's capacity under Section 5-109 to sue and be sued in its own name;

(3) vary any requirement, procedure, or other provision of this [Code] pertaining to:

(A) registered agents; or

(B) the [Secretary of State], including provisions pertaining to records authorized or required to be delivered to the [Secretary of State] for filing under this [Code];

(4) vary the provisions of Section 5-204;

(5) alter or eliminate the duty of loyalty or the duty of care, except as otherwise

provided in subsection (d);

(6) eliminate the contractual obligation of good faith and fair dealing under Section 5-409(d), but the operating agreement may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured;

(7) relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law;

(8) unreasonably restrict the duties and rights under Section 5-410, but the operating agreement may impose reasonable restrictions on the availability and use of information obtained under that section and may define appropriate remedies, including liquidated damages, for a breach of any reasonable restriction on use;

(9) vary the causes of dissolution specified in Section 5-701(a)(4);

(10) vary the requirement to wind up the company's activities and affairs as specified in Section 5-702(a), (b)(1), and (e);

(11) unreasonably restrict the right of a member to maintain an action under [Part] 8;

(12) vary the provisions of Section 5-805, but the operating agreement may provide that the company may not have a special litigation committee;

(13) vary the right of a member to approve a merger, interest exchange, conversion, or domestication under Section 2-203(a)(2), 2-303(a)(2), 2-403(a)(2), or 2-503(a)(2);

(14) vary the required contents of a plan of merger under Section 2-202(a), plan of interest exchange under Section 2-302(a), plan of conversion under Section 2-402(a), or plan of domestication under Section 2-502(a); or

(15) except as otherwise provided in Sections 5-106 and 107(b), restrict the rights

under this [Code] of a person other than a member or manager.

(d) Subject to subsection (c)(7), without limiting other terms that may be included in an operating agreement, the following rules apply:

(1) The operating agreement may:

(A) specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts; and

(B) alter the prohibition in Section 5-405(a)(2) so that the prohibition requires only that the company's total assets not be less than the sum of its total liabilities.

(2) 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 [Code] and imposes the responsibility on one or more other members, the agreement also may eliminate or limit any fiduciary duty of the member relieved of the responsibility which would have pertained to the responsibility.

(3) If not manifestly unreasonable, the operating agreement may:

(A) alter or eliminate the aspects of the duty of loyalty stated in Section 5-409(b) and (i);

(B) identify specific types or categories of activities that do not violate the duty of loyalty;

(C) alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law; and

(D) alter or eliminate any other fiduciary duty.

(e) The court shall decide as a matter of law whether a term of an operating agreement is

manifestly unreasonable under subsection (c)(6) or (d)(3). The court:

(1) shall make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes, activities, and affairs of the limited liability company, it is readily apparent that:

(A) the objective of the term is unreasonable; or

(B) the term is an unreasonable means to achieve the term's objective.

### **Comment**

#### *Principal Provisions of this Article Concerning the Operating Agreement*

The operating agreement is pivotal to a limited liability company, and Sections 5-105 through 5-107 are pivotal to this article. They must be read together, along with Section 5-102(a)(9) (defining the operating agreement).

This section performs five essential functions. Subsection (a) establishes the primacy of the operating agreement in establishing relations *inter se* the limited liability company, its member or members, and any manager. Subsection (b) recognizes this article as comprising mostly default rules—*i.e.*, gap fillers for issues as to which the operating agreement provides no rule. Subsection (c) lists the few mandatory provisions of the article. Subsection (d) lists some provisions frequently found in operating agreements, authorizing some unconditionally and others so long as “not manifestly unreasonable.” Subsection (e) delineates in detail both the meaning of “not manifestly unreasonable” and the information relevant to a determining a claim that a provision of an operating agreement is manifestly unreasonable.

Section 5-106 details the effect of an operating agreement on the limited liability company and on persons becoming members of an LLC. Section 5-107 concerns the effect of an operating agreement on third parties.

#### *Role and Inevitability of Operating Agreement*

A limited liability company is as much a creature of contract as of statute, *TravelCenters of Am., L.L.C. v. Brog*, CIV.A. 3516-CC, 2008 WL 1746987, at \*1 (Del. Ch. Apr. 3, 2008) (stating that “limited liability companies are creatures of contract”); *Gottsacker v. Monnier*, 281 Wis. 2d 361, 370, 697 N.W.2d 436, 440 (2005) (stating that “from the partnership form, the LLC borrows . . . internal governance by contract”), and Section 102(a)(9) delineates a very broad scope for “operating agreement.” As a result, once an LLC comes into existence and has a

member, the LLC necessarily has an operating agreement. *See* the comment to Section 5-102(a)(9). Accordingly, this article refers to “the operating agreement” rather than “an operating agreement.” This phrasing should not, however, be read to require a limited liability company or its members to take any formal action to adopt an operating agreement.

The operating agreement is the exclusive consensual process for modifying this article’s various default rules pertaining to relationships *inter se* the members and between the members and the limited liability company. Section 5-105(b). The operating agreement also has power over “the rights and duties under this [Code] of a person in the capacity of manager,” Subsection (a)(2), and “the obligations of a limited liability company and its members to a person in the person’s capacity as a transferee or person dissociated as a member,” Section 5-107(b). For the relationship between the operating agreement and certificate of formation, see Section 5-107(d).

### *The Operating Agreement and the Fiduciary and Other Duties of Those Who Manage*

One of the most complex questions in the law of unincorporated business organizations is the extent to which an agreement among the organization’s owners can affect the fiduciary and other duties of those who manage the organization (*e.g.*, members in a member-managed LLC; managers in a manager-managed LLC). As explained in detail in the comment to Subsection (d)(3), this article rejects the notion that a contract can completely transform an inherently fiduciary relationship into a merely arm’s length association. Within that limitation, however, this section provides substantial power to the operating agreement to reshape, limit, and eliminate fiduciary and other managerial duties.

Subsection (a) recognizes that the operating agreement is the map to the parties’ deal and that any claim by a member of managerial misconduct must be assessed first under the relevant terms of the operating agreement. Subsection (d) specifically validates arrangements commonly used to reshape managerial duties and limit the consequences of breaching those duties. Subsection (c) contains relevant limitations, but those limitations: (i) must be read together with subsection (d); and (ii) do not preclude the operating agreement fundamentally redesigning the duties applicable to those who manage the organization. For the article’s design of those duties, see Sections 5-409 and 5-410.

**Subsection (a)**—This section describes the very broad scope of a limited liability company’s operating agreement, which includes all matters constituting “internal affairs.” *Compare* Subsection (a), *with* Section 5-104(1) (using the phrase “internal affairs” in stating a choice of law rule). This broad grant of authority is subject to the restrictions stated in Subsection (c), including the broad restriction stated in Paragraph (c)(15) (concerning the rights of third parties under this article).

**Subsection (a)(1)**—This paragraph encompasses all the rights and duties of each member, including rights and duties pertaining to transactions under Article 2.

**Subsection (a)(2)**—Under this paragraph, the operating agreement has the power to affect the rights and duties of managers (including non-member managers). Because the term “[o]perating agreement . . . includes the agreement as amended or restated,” Section 5-102(a3)(9), this paragraph gives the members the ongoing power to define the role of an LLC’s managers. Power is not the same as right, however, and exercising the power provided by this paragraph might constitute a breach of a separate contract between the LLC and the manager. A non-member manager might also have rights under Section 5-107(a).

**Subsection (a)(4)**—Under this provision, the operating agreement can control both the quantum of consent required (*e.g.*, majority of members) and the means by which the consent is manifested (*e.g.*, prohibiting modifications except when consented to in writing). *See* the comment to Section 5-107(a).

Under Subsection (b), if the operating agreement does not address the issue, this article provides the rule. Section 5-407(b)(4)(C) and 5-407(c)(3)(C) each require the affirmative vote or consent of all the members. Under Section 1-702 (Supplemental Principles of Law) the parol evidence rule will apply to a written operating agreement when appropriate under contract law.

**Subsection (b)**—To the extent the operating agreement does not determine an *inter se* matter, this article determines the matter. The operating agreement may vary any provision of this article pertaining to *inter se* matters, except as provided in Subsections (c) and (d).

Sometimes—but not always—the comments to this article refer to a variable provision as a “default rule” and a non-waivable provision as “mandatory.” These references are merely to draw attention to the default/mandatory distinction in particular contexts and have neither the intent nor the power to affect the default/mandatory status of provisions of this article whose comments lack a comparable reference.

**Subsection (c)**—This subsection lists provisions of this article whose respective effects cannot be varied or may be varied subject to a stated limitation. For historical reasons, this subsection uses the words “vary” and “alter” interchangeably. No difference in meaning is intended.

If a person claims that a term of the operating agreement violates this subsection, as a matter of ordinary procedural law the burden of proof is on the person making the claim.

**Subsection (c)(1)**—Section 5-104 states that this article provides the law applicable to: (i) the internal affairs of an LLC formed under this article; and (ii) the liability of members and managers for obligations of the LLC. The organizers of an LLC make this choice of law by choosing to form an LLC under this article. Domestication to another jurisdiction will re-set the choice of law, *see* Sections 2-501 through 2-506, but the operating agreement cannot, *see* the comment to Section 5-104(1).



Subsection (c) contains no parallel prohibition on varying Section 1-501 (stating the governing law for foreign limited liability companies), because a prohibition is unnecessary. As a matter of fundamental contract law, an agreement among members of one limited liability company is powerless to govern the affairs of another limited liability company.

**Subsection (c)(2)**—Under this article, a limited liability company is emphatically an entity, and the members lack the power to alter that characteristic.

**Subsection (c)(3)**—This prohibition is arguably implicit in Subsection (c)(15) (affecting rights of third parties under this article) but is specifically noted to avoid doubt.

**Subsection (c)(4)**—This provision means that the operating agreement cannot affect the right of an “aggrieved” person to seek the court’s help when “a person required by this [Code] to sign a record or deliver a record to the [Secretary of State] for filing under this [Code] does not do so.” Section 5-204(a).

**Subsection (c)(5)**—This limitation is less powerful than might first appear, because Subsection (d) specifically authorizes substantial alterations to the duties of loyalty and care, including restricting and substantially eliminating those duties.

**Subsection (c)(6)**—Section 5-409(d) refers to the “contractual obligation of good faith and fair dealing,” which contract law implies in every contract. The operating agreement cannot eliminate this obligation, neither in whole (*i.e.*, generally) nor in part (*i.e.*, as applicable to specified situations).

However, an operating agreement may “prescribe the standards . . . by which the performance of the obligation is to be measured.”

EXAMPLE: The operating agreement of a manager-managed LLC gives the manager the discretion to cause the LLC enter into contracts with affiliates of the manager (so-called “Conflict Transactions”). The agreement further provides: “When causing the Company to enter into a Conflict Transaction, the manager complies with Section 5-409(d) of [this article] if a disinterested person, knowledgeable in the subject matter, states in writing that the terms and conditions of the Conflict Transaction are equivalent to the terms and conditions that would be agreed to by persons at arm’s length in comparable circumstances.” This provision “prescribe[s] the standards by which the performance of the [Section 5-409(d)] obligation is to be measured.”

EXAMPLE: Same facts as the previous example, except that, during the performance of a Conflict Transaction, the manager causes the LLC to waive material protections under the applicable contract. The standard stated in the previous example is inapposite to this conduct. Section 5-409(d) therefore applies to the conduct without any direct contractual delineation. (However, other terms of the agreement may be relevant to determining whether the conduct violates Section 5-409(d). *See* the comment to Section 5-409(d).)

EXAMPLE: 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 5-409(d) of [this article] 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 5-409(d)] obligation is to be measured.” *Compare* Section 5-105(c)(6), *with Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010) (considering such a situation in the context of the right to call preferred stock and deciding by a 3-2 vote that exercising the call did not breach the implied covenant of good faith and fair dealing).

An operating agreement that seeks to prescribe standards for measuring the contractual obligation of good faith and fair dealing under Section 5-409(d) should expressly refer to the obligation. *See Gerber v. Enter. Prods. Hldgs., L.L.C.*, 67 A.3d 400, 418 (Del. 2013) (distinguishing between the implied contractual covenant and an express contractual obligation of “good faith” as stated in a limited partnership agreement).

For an explanation of the function and role of the covenant of good faith and fair dealing, see the comment to Section 5-409(d). For the rules delimiting the “not manifestly unreasonable” requirement, see Subsection (e).

**Subsection (c)(7)**—These restrictions are ubiquitous in the law of business entities and, in conjunction with other provisions of this section, control the otherwise very broad power of an operating agreement to affect fiduciary and other duties. The restrictions are central to the raft of exculpatory provisions that sprung up in corporate statutes in response to *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). Delaware led the response with DEL. CODE ANN. tit. 8, § 102(b)(7), and a number of LLC statutes have similar provisions. *E.g.*, GA. CODE ANN. § 14-11-305(4)(A) (2011). For an extreme example, *see* VA. CODE ANN. § 13.1-1025 (B) (2012). In this context, “conduct” includes both acts and omissions. BLACK’S LAW DICTIONARY (9th ed. 2009) (defining conduct as “[p]ersonal behavior, whether by action or inaction”).

The term “bad faith” has multiple meanings, and the context determines which meaning applies. In the context of the duty of loyalty, “bad faith” includes conduct motivated by ill will or other intent purposely to harm another person. The concept also includes conduct from which a person derives an improper personal benefit. *See, e.g., Mroz v. Hoaloha Na Eha, Inc.*, 410 F. Supp. 2d 919, 936–37 (D. Haw. 2005) (denying a motion to dismiss a claim that “the Majority Partners” were personally liable for the partnership’s wrongful termination of the plaintiff;

quoting the complaint as alleging that “the Majority Partners, individually and as a group, acted with malice and/or ill will, and/or with an intent to serve their own personal interests and/or without an intent to serve company interests, and/or outside of the scope of their authority and/or without justification”); *BOGNC, L.L.C. v. Cornelius NC Self-Storage L.L.C.*, 10 CVS 19072, 2013 WL 1867065, at \*9 (N.C. Super. [Business Court] May 1, 2013) (noting that “no . . . [exculpatory] provision may limit a manager’s liability for acts known to be in conflict with the interests of the limited liability company, or for acts from which the manager derived an improper personal benefit”) (citing N.C. GEN. STAT. § 57C–3–32(b)); *Lasica v. Savers Grp. of Minn., L.L.C.*, A12-0092, 2012 WL 3553246, at \*2 (Minn. Ct. App. Aug. 20, 2012) (noting that an “individual seeking indemnification [under statute providing for indemnification] must have acted in good faith and must not have received an improper personal benefit”) (citing MINN. STAT. § 322B.699, subdvs. 2(a)(2), (3) (2010)).

In the context of the duty of care, the concept of bad faith comes primarily from corporate law and means an extreme breach of the duty (*i.e.*, “the failure to exercise “*honest judgment* in the lawful and legitimate furtherance of corporate purposes.” *Deblinger v. Sani-Pine Products Co., Inc.*, 107 A.D.3d 659, 661, 967 N.Y.S.2d 394 (2013) (quoting *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 393 N.E.2d 994 (1979) (emphasis added) (internal quotation marks omitted)).

Thus, when a plaintiff alleges bad faith as pertaining to the duty of care, “[t]he burden . . . is to show irrationality: a plaintiff must demonstrate that no reasonable business person could possibly authorize the action in good faith. Put positively, the decision must go so far beyond the bounds of reasonable business judgment that its only explanation is bad faith.” *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005) (discussing then prevailing Delaware law) (citation omitted); *see also KDW Restructuring & Liquidation Servs. LLC v. Greenfield*, 874 F. Supp. 2d 213, 226 (S.D.N.Y. 2012) (referring to a lack of “a rationale corporate purpose” and “a disregard for the duty to examine all available information—*information that was readily at hand*”) (emphasis added).

With regard to both the duty of loyalty and the duty of care, “bad faith” is entirely distinct from the meaning of “good faith” in the contractual covenant of good faith and fair dealing. *See* the comment to Section 5-409(d).

Subsection (c)(7) pertains to indirect as well as direct efforts to “relieve or exonerate” and thus limits how far an operating agreement can go in providing for indemnification. *See* Section 5-408(b) (stating a default rule for indemnification). Also, in accordance with this paragraph, an exculpatory provision cannot shield against a member’s claim of oppression. *See* Section 5-701(a)(4)(C).

Although this paragraph does not expressly address contracts between an LLC and a member or manager, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

EXAMPLE: A manager-managed LLC enters into a management contract with its sole manager, and the contract provides the manager exoneration for liability to the LLC even

for willful and intentional misconduct. Most likely, contract law will treat the provision as against public policy and therefore unenforceable. RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981) (“A term exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on grounds of public policy.”). If not, a court should hold the provision unenforceable to avoid evisceration of Subsection (c)(7). (Or, the court could invoke the policy expressed in Subsection (c)(7) as grounds for holding the provision unenforceable under contract law.)

**Subsection (c)(8)**—Although phrased as a restriction, this provision grants substantial power to the operating agreement.

EXAMPLE: A law firm operates as a limited liability company, and the operating agreement provides that a “Compensation Committee” periodically decides each member’s compensation. The agreement also states that only members who are on the Compensation Committee may have access to the Committee’s compensation decisions pertaining to other members. This restriction is reasonable.

This article also empowers the LLC “as a matter within the ordinary course of its activities and affairs [to] impose reasonable restrictions and conditions on access to and use of information” obtained under Section 5-410. *See* Section 5-410(h).

In determining whether a restriction is reasonable, a court might consider: (i) the danger or other problem the restriction seeks to avoid; (ii) the purpose for which the information is sought; and (iii) whether, in light of both the problem and the purpose, the restriction is reasonably tailored. In addition, a restriction that is reasonable *viz-a-viz* a non-managing member in a manager-managed LLC might be unreasonable *viz-a-viz* a managing member or in the context of a member-managed LLC.

**Subsection (c)(9)**—The operating agreement may not change the stated grounds for judicial dissolution but may determine the forum in which a claim for dissolution under Section 5-701(a)(4) is determined. For example, arbitration and forum selection clauses are commonplace in business relationships in general and in operating agreements in particular.

The approach of this paragraph differs from the law of Delaware. *Huatuco v. Satellite Healthcare*, CV 8465-VCG, 2013 WL 6460898, at \*1, n.2 (Del. Ch. Dec. 9, 2013) (stating that “the right to judicial dissolution is a default right which the parties may eschew by contract” but reserving the question of “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires—leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre’s *Huis Clos*”).

**Subsection (c)(10)**—The cited provisions comprise the non-waivable aspects of winding up a dissolved limited liability company. The other provisions of Section 5-702 are default rules.

**Subsection (c)(11)**—Part 8 delineates a member’s rights to bring direct and derivative actions. It would be unreasonable to frustrate these rights but not unreasonable to channel their exercise. For example, the operating agreement might select a forum, require pre-suit mediation, provide for arbitration of both direct and derivative claims, or override Section 5-802 and require “universal demand” in all derivative cases. Similarly, it is not unreasonable to provide for liquidated damages consonant with the law of contracts. In contrast, it would be unreasonable for an operating agreement to both: (i) require a would-be derivative plaintiff to make demand regardless of futility and (ii) bar taking the claim to court no matter how long the management group ponders the demand.

**Subsection (c)(12)**—An operating agreement may not alter this article’s rules for a special litigation committee but may preclude entirely the use of such a committee.

**Subsection (c)(13)**—Section 2-203(a)(1), 2-303(a)(1), 2-403(a)(1), and 2-503(a)(1) each requires the consent or the affirmative vote of all members. The operating agreement may modify these requirements. In contrast, under the sections stated in this subsection:

- each member is protected from being merged, exchanged, converted, or domesticated “into” the status of a partner in a general partnership that is not a limited liability partnership (or a comparable “unshielded” position in some other organization) without the member having directly consented to either:
  - the merger, interest exchange, conversion, or domestication; or
  - an operating agreement provision that permits such transactions to occur with less than unanimous consent of the members; and
- merely consenting to an operating agreement provision that permits amendment of the agreement with less than unanimous consent of the members does not qualify as the requisite direct consent.

**Subsection (c)(14)**—Because these plans are the basic “deal documents” for each of the organic transactions contemplated in Article 2, the operating agreement may not vary the contents of these plans.

**Subsection (c)(15)**—This limitation pertains only to “the rights under this [Code] of” third parties other than members and managers. Moreover, the limitation is subject to two substantial exceptions: Section 5-106 (pertaining to the operating agreement’s relationship to the limited liability company itself and to persons becoming members) and Section 5-107(b) (pertaining to the operating agreement’s power over the rights of transferees).

**Subsection (d)**—The operating agreement has plenipotentiary power over the matters described in Subsection (a), except as specifically limited by Subsections (c) and (d)(3). However, for the convenience of practitioners and the courts, Paragraphs 1 and 2 list various terms often found in operating agreements. No negative inference should be drawn about terms not listed; the listing is provided “without limiting other terms that may be included in an operating agreement.”

Paragraph 3 lists terms subject to the “not manifestly unreasonable” standard. Subsection (e) delineates that standard. The same standard applies to terms of an operating agreement which seek to “prescribe the standards . . . by which the performance of the [Section 5-409(d)] obligation [of good faith and fair dealing] is to be measured.” Subsection (c)(6).

**Subsection (d)(1)(A)**—An arrangement *not* involving “one or more disinterested and independent persons” acting “after full disclosure of all material facts” would “alter . . . the aspects of the duty of loyalty stated in Section 5-409(b) and (i)” and would therefore be subject to the “not manifestly unreasonable standard” of Subsection (d)(3)(A).

For the meaning of “material” as applied to information, see the comment to Section 5-409(f).

**Subsection (d)(1)(B)**—Section 5-405(a)(2) prohibits distributions:

- not merely when, after the distribution, “the company’s total assets would be less than the sum of its total liabilities,”
- but also when, after the distribution, the assets would be less than the total liabilities “plus the amount that would be needed, if the company were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of members and transferees whose preferential rights are superior to those of persons receiving the distribution.”

The second part of the solvency test pertains to preferential rights to distributions, is thus a matter *inter se* the members and any transferees, and is therefore subject to change in the operating agreement.

In contrast, the first part of the solvency test protects third parties—creditors of the LLC—and therefore cannot be changed by the operating agreement. Subsection (c)(15). Likewise, the operating agreement cannot change the solvency test stated in Section 5-405(a)(1) (providing that “the company would not be able to pay its debts as they become due in the ordinary course of the company’s activities and affairs”).

**Subsection (d)(2)**—This provision is limited to member-managed limited liability companies on the premise that: (i) managers are collectively responsible; and (ii) managers may properly delegate a duty but the delegation does not discharge the duty. However, in a manager-managed LLC (as well as in a member-managed LLC), subject to Subsection (d)(3) the operating agreement may alter or even eliminate fiduciary duties.

EXAMPLE: ABC LLC (“ABC”) is a member-managed LLC. ABC has two entirely separate lines of business, the Alpha business and the Beta business. Under ABC’s operating agreement:

- Member 1’s responsibilities pertain exclusively to the Alpha business, while responsibility for:
  - the Beta business is allocated exclusively to Member 2; and
  - ABC’s overall operations is allocated exclusively to Member 3.
- Member 2’s responsibilities pertain exclusively to the Beta business, while responsibility for:
  - the Alpha business is allocated exclusively to Member 1; and
  - ABC’s overall operations is allocated exclusively to Member 3.
- Member 1 has no fiduciary duties pertaining to the Beta business.
- Member 2 has no fiduciary duties pertaining to the Alpha business.

The elimination of Member 1’s fiduciary duties with regard to the Beta business and Member 2’s fiduciary duties with regard to the Alpha business are enforceable, without regard to the “manifestly unreasonable” standard of Subsection (d)(3).

**Subsection (d)(3)**—This article rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of “freedom of contract” against the dangers that inescapably exist when some persons have power over the interests of others. *Cf.* Leo E. Strine, Jr. J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, ELGAR HANDBOOK ON ALTERNATIVE ENTITIES (Eds. Mark Lowenstein and Robert Hillman), forthcoming 2014,, Edward Elgar Publishing 2014) (noting that an “argument often made in favor of [Delaware] alternative entity statutes is that they allow for the elimination of fiduciary duties and the establishment of a purely contractual relationship between entity managers and investors” and stating that “[a]s judges who have seen our fair share of alternative entity disputes, we do not immediately grasp why this would be seen as a compelling advantage”); available at SSRN: <http://ssrn.com/abstract=2481039>, at 9-10 (footnote omitted).

Under this article, a properly drafted operating agreement may substantially alter and even eliminate fiduciary duties. However, two important limitations exist.

First, arrangements subject to this subsection may not be “manifestly unreasonable.” *See* Subsection (e) (delineating this standard).

Second, the operating agreement may not transform the relationship *inter se* members, managers, and the LLC into an entirely arm’s length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. This rule is fundamental in the jurisprudence of fiduciary duty. *See, e.g., Paige Capital Mgmt, L.L.C. v. Lerner Master Fund, L.L.C.*, Civ. A. No. 5502-CS, 2011 WL 3505355, at \*31 (Del. Ch. Aug. 8, 2011) (Del. Ch. 2011) (stating that, even under a statute that “permits the waiver of fiduciary duties . . . such waivers must be set forth clearly”); *Kelly v. Blum*, Civ. A. No. 4516-VCP, 2010 WL 629850, at \*10, n.70 (Del. Ch. Feb. 24, 2010) (“Having been granted great contractual freedom by the LLC Act, drafters of or parties to an LLC agreement should be expected to provide . . . clear and unambiguous provisions when they desire to expand, restrict or

eliminate the operation of traditional fiduciary duties”). It would therefore be manifestly unreasonable for an operating agreement to negate this rule.

Although Subsection (d)(3) does not expressly address contracts between an LLC and a member or manager, the stated constraints must also apply to such contracts. If not, those constraints are effectively meaningless.

EXAMPLE: A manager-managed LLC enters into a management contract with its sole manager, and the contract provides that the duties of loyalty stated in Section 409(b) and (i) are entirely eliminated. If the operating agreement were to so provide, the provision would be subject to the “manifestly unreasonable standard.” Section 105(d)(3)(A). Absent the authorization provided by Section 105(d)(3)(A), the management contract’s attempt to waive fiduciary duties may be unenforceable as a matter of public policy and contract law. *See Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57, 133 Cal. Rptr. 2d 218 (2003) (stating that “waiver of corporate directors’ and majority shareholders’ fiduciary duties to minority shareholders in private close corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void”). If not, a court should hold the provision unenforceable nonetheless so as to avoid eviscerating Subsection (d)(3).

**Subsection (d)(3)(A)**—Subject to the “not manifestly unreasonable” standard, this paragraph empowers the operating agreement to eliminate *all* aspects of the duty of loyalty listed in Section 409(b). The obligation of good faith and fair dealing, Section 409(d), would remain. See Subsection (c)(6). As to any other, uncoded aspects of the duty of loyalty, see Subsection (d)(3)(D) (empowering the operating agreement to “alter or eliminate any other fiduciary duty”).

EXAMPLE: Joint Venture LLC (“JV”) is a manager-managed limited liability company, with two members, Kappa, Inc. (“Kappa”) and Lambda, LLC (“Lambda”). The operating agreement provides that:

- JV is managed by a “board of managers” consisting of one person appointed by Kappa and one person appointed by Lambda;
- each appointee:
  - owes fiduciary and any other duties exclusively to the member that made the appointment; and
  - owes no duties to the other member and the limited liability company.

The “not manifestly unreasonable” standard applies to provisions under Subsection (d)(3)(A) and (D), and the provisions are not manifestly unreasonable. Note that the provisions do not affect the duties of Kappa and Lambda to:

- the limited liability company, under applicable case law (pertaining to the obligations of owners of an entity who control the entity indirectly); and
- each other, under applicable case law and Section 5-701(a)(4)(C)(ii) (providing for judicial dissolution when “the managers or those members in control of the



company . . . have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the [member seeking dissolution”).

EXAMPLE: ABC LLC (“ABC”) is a manager-managed limited liability company with three managers and two entirely separate lines of business, the Alpha business and the Beta business. Under ABC’s operating agreement:

- Manager 1’s responsibilities pertain exclusively to the Alpha business; responsibility for:
  - the Beta business is allocated exclusively to Manager 2; and
  - ABC’s overall operations is allocated exclusively to Manager 3.
- Manager 2’s responsibilities pertain exclusively to the Beta business; responsibility for:
  - the Alpha business is allocated exclusively to Manager 1; and
  - ABC’s overall operations is allocated exclusively to Manager 3.
- Manager 1 has no fiduciary duties pertaining to the Beta business.
- Manager 2 has no fiduciary duties pertaining to the Alpha business.

The “not manifestly unreasonable” standard applies to these provisions under Subsection (d)(3)(A) and (D), and the provisions are not manifestly unreasonable.

**Subsection (d)(3)(B)**—Under this paragraph, an operating agreement might provide that an affiliate of a manager of a manager-managed LLC will provide compensated services to the LLC at a price not exceeding market price, or that the manager may pursue opportunities that otherwise would be company opportunities. Such arrangements are commonplace and permissible.

**Subsection (d)(3)(C)**—In this context, “conduct” includes both acts and omissions. BLACK’S LAW DICTIONARY (9th ed. 2009) (defining conduct as “[p]ersonal behavior, whether by action or inaction”). Subject to the “not manifestly unreasonable” standard and the bedrock requirements stated here and in Subsection (c)(7), the operating agreement can reduce the duty of care substantially. In particular, the operating agreement can eliminate the aspects of the duty of care pertaining to gross negligence and recklessness.

This provision replicates in a particular context the general rule stated in Subsection (c)(7). For the meaning of “bad faith” in the context of the duty of care, see the comment to Subsection (c)(7).

**Subsection (e)**—The “not manifestly unreasonable” concept became part of uniform business entity statutes when UPA (1997) imported the concept from the Uniform Commercial Code. (In the current version of the Uniform Commercial Code, the concept appears in Section 1-302(b).)

This subsection provides rules for applying the concept, specifying:

- who decides the issue of “manifestly unreasonable”
  - “the court . . . as a matter of law,” Subsection (e);
- the framework for determining the issue
  - determination to be made “in light of the purposes, activities, and affairs of the limited liability company,” Subsection (e)(2);
- the temporal setting for determining the issue
  - “determination [to be made] as of the time the challenged term became part of the operating agreement,” Subsection (e)(1); and
- what information is admissible for determining the issue
  - “only circumstances existing” when “the challenged term became part of the operating agreement,” Subsection (e)(1).

The subsection also provides a very demanding standard for persons claiming that a term of an operating agreement is “manifestly unreasonable.” “The court . . . may invalidate the term only if, in light of the purposes, activities, and affairs of the limited liability company, it is *readily apparent* that: (A) the objective of the term is unreasonable; or (B) the term is an unreasonable means to achieve the term’s objective.” Subsection (e)(2) (emphasis added).

Subsection (e) is fundamental to this article, because: (i) this article generally defers to the agreement among the members; and (ii) Subsection (e) safeguards the operating agreement in at least four ways:

- Determining manifest unreasonableness *inter se* owners of an organization is a different task than doing so in a commercial context, where concepts like “usages of trade” are available to inform the analysis. Each business organization must be understood in its own terms and context.
- If loosely applied, the concept of “manifestly unreasonable” would permit a court to rewrite the members’ agreement, which would destroy the balance this article seeks to establish between freedom of contract and fiduciary duty.
- Case law has not adequately delineated the concept. *See, e.g., In re Brobeck, Phleger & Harrison L.L.P.*, 408 B.R. 318, 335 (Bankr. N.D. Cal. 2009) (“RUPA [UPA (1997)] does not define what is ‘manifestly unreasonable’ and the parties have not cited, nor can the court locate, a decision that defines the term. Absent case law or even a dictionary definition, the court must rely on its common sense to recognize something as manifestly unreasonable.”).
- In the context of statutes permitting stock transfer restrictions unless “manifestly unreasonable,” courts have often ignored the word “manifestly.” *See, e.g., Brandt v. Somerville*, 692 N.W.2d 144, 152 (N.D. 2005) (stating that “in close corporations, a majority of courts have sustained restrictions that are determined to be reasonable in light of the relevant circumstances”); *Roof Depot, Inc. v. Ohman*, 638 N.W.2d 782, 786 (Minn. Ct. App. 2002) (stating that “the restrictions [on share transfer] are not ‘manifestly unreasonable’ because they are reasonable means to ensure that the management and control of the business remains in the group of investors or with people well known to them”); *Castriota v. Castriota*, 633 A.2d 1024, 1027–28 (App. Div. 1993) (“We are obliged to apply the statute in a manner consonant with its

essential purpose to permit reasonable restrictions upon alienation.”).

**Subsection (e)(1)**—The significance of the phrase “as of the time the term as challenged became part of the operating agreement” is best shown by example.

EXAMPLE: When a particular manager-managed LLC comes into existence, its business plan is quite unusual and its success depends on the willingness of a particular individual to serve as the LLC’s sole manager. This individual has a rare combination of skills, experiences, and contacts, which are particularly appropriate for the LLC’s start-up. In order to induce the individual to accept the position of sole manager, the members are willing to have the operating agreement significantly limit the manager’s fiduciary duties. Several years later, when the LLC’s operations have turned prosaic and the manager’s talents and background are not nearly so crucial, a member challenges the fiduciary duty limitations as manifestly unreasonable. The relevant time under Subsection (e)(1) is when the LLC began. Subsequent developments are not relevant, except as they might inferentially bear on the circumstances in existence at the relevant time.

EXAMPLE: As initially adopted, an operating agreement identifies a category of decisions ordinarily subject to the duty of loyalty and provides that “the manager’s sole, reasonable discretion” satisfies the duty. A year later, the agreement is amended to delete the word “reasonable.” Later, a member claims that, without the word “reasonable,” the provision is manifestly unreasonable. The relevant time under Subsection (e)(1) is when the agreement was amended, not when the agreement was initially adopted.

**Subsection (e)(2)**—If a person claims that a term of the operating agreement is manifestly unreasonable under Subsections (c)(6) or (d)(3), as a matter of ordinary procedural law the person making the claim has the burden of proof.

## **SECTION 5-106. OPERATING AGREEMENT; EFFECT ON LIMITED LIABILITY COMPANY AND PERSON BECOMING MEMBER; PREFORMATION AGREEMENT.**

(a) 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.

(b) A person that becomes a member is deemed to assent to the operating agreement.

(c) Two or more persons intending to become the initial members of a limited liability company may make an agreement providing that upon the formation of the company the

agreement will become the operating agreement. One person intending to become the initial member of a limited liability company may assent to terms providing that upon the formation of the company the terms will become the operating agreement.

### Comment

**Subsection (a)**—This subsection resolves twin questions that have troubled some courts – namely, whether an unincorporated entity that has not signed its foundational agreement nonetheless is bound by and may enforce the agreement. The questions have been particularly troubling in the context of agreements to arbitrate. *See, e.g., Elkjer v. Scheef & Stone, L.L.P.*, 3:13-CV-1655-K, --- F. Supp.2d ---, 2014 WL 1255844 at \*5-6 (N.D. Tex. Mar. 27, 2014) (concluding that a limited liability partnership “is a party to the Partnership Agreement,” even though the partnership itself never signed or otherwise assented to the agreement; enforcing arbitration provision to the benefit of the LLP). *Contra Trover v. 419 OCR, Inc.*, 397 Ill. App. 3d 403, 409, 921 N.E.2d 1249, 1255 (2010) (finding that “neither FODG [an LLC] nor the Golf Club [a related LLC] was a party to the operating agreements and that they are therefore not bound by the arbitration clauses therein”).

Developments pertaining to the Virginia LLC Act further illustrate the difficulties. In *Mission Residential, L.L.C. v. Triple Net Properties, L.L.C.*, 654 S.E.2d 888, 891 (2008), the Virginia Supreme Court held that a member’s derivative claim was not subject to the arbitration provision in the operating agreement, because: (i) the LLC was “the real party in interest”; (ii) the LLC had not signed the operating agreement; and (iii) requiring the claim to be arbitrated would “ignore[] the separate existence of Holdings [the LLC].” The Virginia legislature promptly disagreed and amended the LLC act to state: “A limited liability company is bound by its operating agreement whether or not the limited liability company executes the operating agreement.” VA. CODE ANN. § 13.1–1023.A.1 (2012). The legislature left open the question of a limited liability company’s power to enforce an operating agreement that the company has not executed.

This subsection answers the twin questions, categorically and in the affirmative.

This subsection does not consider whether a limited liability company is an indispensable party to a suit concerning the operating agreement. That question is one of procedural law, and the answer can determine whether federal diversity jurisdiction exists.

**Subsection (b)**—Given the possibility of oral and implied-in-fact terms in the operating agreement, a person becoming a member of an existing limited liability company should take precautions to ascertain fully the contents of the operating agreement. *See* the comment to Section 5-105(a)(4).

**Subsection (c)**—The second sentence refers to “assent to terms” rather than “make an agreement” because, under venerable principles of contract law, an agreement presupposes at

least two parties, and Section 5-102(a)(9) specifically contemplates an operating agreement in a single member LLC.

A pre-formation arrangement is not an operating agreement. An operating agreement presupposes at least one member, and, under this article, the earliest a person can become a member is upon the formation of the limited liability company. *See* Section 5-401.

**SECTION 5-107. OPERATING AGREEMENT; EFFECT ON THIRD PARTIES  
AND RELATIONSHIP TO RECORDS EFFECTIVE ON BEHALF OF LIMITED  
LIABILITY COMPANY.**

(a) An operating agreement may specify that its amendment requires the approval of a person that is not a party to the agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.

(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. Subject only to a court order issued under Section 5-503(b)(2) to effectuate a charging order, an 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.

(c) If a record delivered by a limited liability company to the [Secretary of State] for filing becomes effective and contains a provision that would be ineffective under Section 5-105(c) or (d)(3) if contained in the operating agreement, the provision is ineffective in the record.

(d) Subject to subsection (c), if a record 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.

### Comment

**Subsection (a)**—This subsection, derived from DEL. CODE ANN. tit. 6, § 18-302(e), permits the operating agreement to: (i) accord a non-member veto rights over amendments to the agreement; and (ii) establish other preconditions for amendments. An amendment made in derogation of a veto right or precondition is ineffective.

Veto rights are likely to be sought by lenders but may also be attractive to non-member managers.

**EXAMPLE:** A non-member manager enters into a management contract with an LLC, and that agreement provides in part that the LLC may remove the manager without cause only with the consent of members holding 2/3 of the profits interests. The operating agreement contains a parallel provision (the “operating agreement’s quantum provision”), but the non-member manager is not a party to the operating agreement. Later, the LLC members amend the operating agreement’s quantum provision to reduce the quantum to a simple majority of profits interests and thereafter purport to remove the manager without cause. Although the LLC has undoubtedly breached its contract with the manager and subjected itself to a damage claim, the LLC has the *power* under Section 5-105(a)(2) to effect the removal—unless the operating agreement provides the manager a veto right over changes in the operating agreement’s quantum provision.

This subsection does not refer to member veto rights because, unless otherwise provided in the operating agreement, the consent of each member is necessary to effect an amendment. *See* Section 5-407(b)(4)(B), (c)(3)(B).

Because “[a]n operating agreement may specify that its amendment requires . . . the satisfaction of a condition,” an operating agreement can require that any amendment be made through a writing or a record signed by each member. *See* Section 5-105(a)(4) (empowering the operating agreement to determine “the means and conditions for amending the operating

agreement”).

**Subsection (b)**—The law of unincorporated business organizations is only beginning to grapple in a modern way with the tension between the rights of an organization’s owners to carry on their activities as they see fit (or have agreed) and the rights of transferees of the organization’s economic interests. Such transferees can include the heirs of business founders as well as former owners who are “locked in” as transferees of their own interests. *See* Section 5-603(a)(3).

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.

There is little case law in this area, and almost all of it pertains to limited partnerships rather than LLCs. The partnership case law clearly favors the remaining owners over former owners and other transferees. *See, e.g., Bauer v. Blomfield Co./Holden Joint Venture*, 849 P.2d 1365, 1367, n.2 (Alaska 1993) (holding that a mere assignee “was not entitled to complain about a decision made with the consent of all the partners” and stating “[w]e are unwilling to hold that partners owe a duty of good faith and fair dealing to assignees of a partner's interest”); *Bynum v. Frisby*, 73 Nev. 145, 149-50, 311 P.2d 972, 975 (1957) (“[A]n assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners nor require them to resort to dissolution in order to prevent such a relationship from arising. The stranger remains a stranger entitled only to share in the partnership's worth and to demand an accounting upon dissolution.”) (applying UPA (1914) § 27, pertaining to rights of an assignee). *See generally* Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 SUFFOLK L. REV. 587 (2009).

This subsection follows *Bauer* and other cases by expressly subjecting transferees (including a person dissociated as a member) to operating agreement amendments made after the transfer or dissociation, except amendments that increase obligations on transferees. For example, an amendment might extend the duration of a limited liability company but may not institute a new capital call obligation on transferees.

The question 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. An unreported LLC case suggests the answer might be yes, but the decision rests primarily on the wording of the LLC’s operating agreement. In *Kohannim v. Katoli*, 08-11-00155-CV, 2013 WL 3943078, at \*10-11 (Tex. App. July 24, 2013), 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”; (ii) also 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." *Id.* at \*11.

For the very limited rights of transferees, see Section 5-502.

**Subsection (b)(1)**—This provision is inapposite when "a member or transferee becomes entitled to receive a distribution." Section 5-404(d). In that circumstance:

- "the member or transferee has the status of . . . a creditor of the limited liability company with respect to the distribution," *Id.*; and
- the relevant obligation is not owed to "a person in the person's capacity as a transferee or person dissociated as a member," Subsection (b), but rather to the person in the person's capacity as a creditor.

**Subsection (c)**—This provision precludes using the certificate of organization to make an end run around the strictures of Section 5-105(c) and (d)(3).

**Subsection (d)**—It will be possible, albeit improvident, for a limited liability company's operating agreement to be inconsistent with the certificate of organization or other public filings pertaining to the company. For those circumstances, this subsection provides rules for determining which source of information prevails:

- For members, managers and transferees, the operating agreement is paramount.
- Third parties may invoke the public record upon a showing of reasonable reliance, which presupposes actual knowledge – *i.e.*, deemed knowledge under Section 5-103(d) does not suffice.

The mere fact that a term is present in a publicly filed record and not in the operating agreement, or *vice versa*, does not automatically establish a conflict. This subsection does not expressly cover a situation in which: (i) one of the specified filed records contains information in addition to, but not inconsistent with, the operating agreement; and (ii) a person, other than a member or transferee, reasonably relies on the additional information. However, the policy reflected in this subsection seems equally applicable to that situation. Moreover, to argue that the operating agreement prevails over the filed record is to argue that the additional term does conflict with the operating agreement, at least in effect.



Section 5-105(a)(4) might also be relevant to the subject matter of this subsection. Absent a contrary provision in the operating agreement, language in an LLC's certificate of organization or other record delivered to the filing office for filing on behalf of the LLC might be evidence of the members' agreement and might thereby constitute or at least imply a term of the operating agreement.

This subsection does not apply to records delivered to the filing office for filing on behalf of a person other than a limited liability company.

## **SECTION 5-108. NATURE, PURPOSE, AND DURATION OF LIMITED LIABILITY COMPANY.**

(a) A limited liability company is an entity distinct from its member or members.

(b) A limited liability company may have any lawful purpose, regardless of whether for profit.

(c) A limited liability company has perpetual duration.

### **Comment**

**Subsection (a)**—The “separate entity” characteristic is fundamental to a limited liability company and is inextricably connected to both the liability shield, Section 5-304, and the inability of creditors of a member or transferee to reach the assets of the limited liability company absent a “reverse pierce” or a claim of fraudulent transfer. *See, e.g., Litchfield Asset Mgmt Corp. v. Howell*, 799 A2d 298 (Conn. Ct. App. 2002) (applying an “outside reverse pierce” to allow judgment creditor of member to reach assets of LLC) (overruled on other grounds by *Robinson v. Coughlin*, 830 A2d 1114 (Conn. 2003)); *Egle v. Egle*, 817 So. 2d 136, 140 (La. Ct. App. 2002) (allowing plaintiff to proceed with claims that transfers made by her ex-spouse *inter alia* to an LLC were sham transactions).

**Subsection (b)**—Although some LLC statutes continue to require a business purpose, this article follows the current trend and takes a more expansive approach. The phrase “any lawful purpose, regardless of whether for profit” encompasses even charitable activities, but this article does not include any comprehensive protections pertaining to charitable assets and purposes. Section 2-104(b) does contain a “nondiversion” provision, but the provision applies only to the organic transactions contemplated by Article 2. Comprehensive protections must be (and typically are) found in other law, although sometimes that “other law” appears within a state's non-profit corporation statute. *See, e.g., MINN. STAT. § 317A.811* (2012) (providing restrictions on charitable organizations that seek to “dissolve, merge, or consolidate, or to transfer all or substantially all of their assets” but imposing those restrictions only on “corporations,” which are elsewhere defined as corporations incorporated under the non-profit corporation act).

**Subsection (c)**—The word “perpetual” is a misnomer, albeit one commonplace in LLC statutes. In this context, “perpetual” means merely that the article: (i) does not require a definite term; and (ii) creates no nexus between the dissociation of a member and the dissolution of the entity.

Moreover, the public record pertaining to a limited liability company will not necessarily reveal whether the company actually has a perpetual duration or has in fact dissolved, because: (i) this article, like all LLC statutes, provides several consent-based methods to dissolve a limited liability company; and (ii) none of those methods involve a public filing. For example, dissolution and winding up of a limited liability company may result from a term specified in the operating agreement or the affirmative vote or consent of all members. *See* Sections 5-701 (events causing dissolution) and 5-702 (winding up required upon dissolution). An operating agreement is not a publicly filed document, and a member vote to dissolve a limited liability company is not a public event. A dissolved limited partnership may deliver to the filing office for filing a statement of dissolution, Section 5-702(b)(2)(A), and later a statement of termination, Section 5-702(b)(2)(F), or both, but the filing of such statements is permissive rather than mandatory, *id.*

Likewise, the public record will not reveal when (or even whether) a limited liability company has come into existence. *See* Section 5-201(d) (“A limited liability company is formed when the company’s certificate of becomes effective and at least one person becomes a member.”).

**SECTION 5-109. POWERS.** A limited liability company has the capacity to sue and be sued in its own name and the power to do all things necessary or convenient to carry on its activities and affairs.

### **Comment**

Continuing the approach initiated in ULPA (2001) § 105, this article omits as unnecessary any detailed list of specific powers.

The operating agreement cannot vary a limited liability company’s capacity to sue and be sued. Section 5-105(c)(2). An LLC’s standing to enforce the operating agreement is a separate matter, which is covered by Section 5-106(a) (stating, as a default rule, that the limited liability company “may enforce the operating agreement”).

### **SECTION 5-110. APPLICATION TO EXISTING RELATIONSHIPS.**

(a) Before [all-inclusive date], this [article] governs only:

(1) a limited liability company formed on or after [the effective date of this [article]];

and

(2) except as otherwise provided in subsection (c), a limited liability company formed before [the effective date of this [article]] which elects, in the manner provided in its operating agreement or by law for amending the operating agreement, to be subject to this [article].

(b) Except as otherwise provided in subsection (c), on and after [all-inclusive date] this [article] governs all limited liability companies.

(c) For purposes of applying this [article] to a limited liability company formed before [the effective date of this [article]]:

(1) the company's articles of organization are deemed to be the company's certificate of organization; and

(2) for purposes of applying Section 5-102(a)(6) and subject to Section 5-107(d), language in the company's articles of organization designating the company's management structure operates as if that language were in the operating agreement.

***Legislative Note:***

***For states that have previously enacted ULLCA (2006):*** For these states this section is unnecessary. There is no need for a delayed effective date, even with regard to pre-existing limited liability companies.

***For states that have not previously enacted ULLCA (2006):***

*Each enacting jurisdiction should consider whether: (i) this article makes material changes to the "default" (or "gap filler") rules of a predecessor statute; and (ii) if so, whether Subsection (c) should carry forward any of those rules for pre-existing limited liability companies. In this assessment, the focus is on pre-existing limited liability companies that have left default rules in place, whether advisedly or not. The central question is whether, for such limited liability companies, expanding Subsection (c) is necessary to prevent material changes to the members' "deal."*

*Section 5-301 (de-codifying statutory apparent authority) does not require any special transition provisions, because: (i) applying the law of agency, as explained in the Comments to*

*Sections 5-301 and 5-407, will produce appropriate results; and (ii) the notion of “lingering apparent authority” will protect any third party that has previously relied on the statutory apparent authority of a member of a particular member-managed LLC or a manager of a particular manager-managed LLC. RESTATEMENT (THIRD) OF AGENCY § 3.11, cmt. c (2006).*

*The effective date of this article will be the effective date of the Code (Section 1-708) unless the bill enacting this article specifies a different effective date.*

*It is recommended that the “all-inclusive” date should be at least one year after the effective date of this article, Section 1-701, but no more than two years.*

### **Comment**

**Subsection (c)**—When a pre-existing limited liability company becomes subject to this article, the company ceases to be governed by the predecessor act, including whatever requirements that act might have imposed for the contents of the articles of organization.

**SECTION 5-111. SUBJECTS COVERED OUTSIDE [ARTICLE].** The following subjects are covered in whole or in part outside this [article]:

- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Name of entity – Part 3 of Article 1.
- (4) Registered agent of entity – Part 4 of Article 1.
- (5) Foreign entities – Part 5 of Article 1.
- (6) Administrative dissolution – Part 6 of Article 1.
- (7) Miscellaneous provisions, including supplemental principles of law and reservation of power to amend or repeal – Part 7 of Article 1.
- (8) Entity transactions generally – Part 1 of Article 2.
- (9) Merger – Part 2 of Article 2.
- (10) Interest exchange – Part 3 of Article 2.
- (11) Conversion – Part 4 of Article 2.
- (12) Domestication – Part 5 of Article 2.

### **Comment**

This section lists the principal parts of the Code that are applicable to limited liability companies.

### **[PART] 2**

### **FORMATION; CERTIFICATE OF ORGANIZATION AND OTHER FILINGS**

#### **SECTION 5-201. FORMATION OF LIMITED LIABILITY COMPANY; CERTIFICATE OF ORGANIZATION.**

(a) One or more persons may act as organizers to form a limited liability company by delivering to the [Secretary of State] for filing a certificate of organization.

(b) A certificate of organization must state:

(1) the name of the limited liability company, which must comply with Sections 1-301 and 1-302(d);

(2) the street and mailing addresses of the company's principal office; and

(3) the name and street and mailing addresses in this state of the company's registered agent.

(c) A certificate of organization may contain statements as to matters other than those required by subsection (b), but may not vary or otherwise affect the provisions specified in Section 5-105(c) and (d) in a manner inconsistent with that section. However, a statement in a certificate of organization is not effective as a statement of authority.

(d) A limited liability company is formed when the certificate of organization becomes effective and at least one person has become a member.

### **Comment**

For a limited liability company to be formed (*i.e.*, to come into existence), two conditions must be met: (i) a certificate of organization must become effective; and (ii) at least one person must become a member.

By definition, the earliest a person can become a member is when the certificate of organization takes effect. *See* Section 5-102(a)(7) (defining “member” as a person that “has become a member of a limited liability company”). However, a certificate of organization can take effect long before any person becomes a member, and this article does not require any public filing to indicate that a person has become a member. Therefore, the public record will not reflect when (and even whether) a limited liability company has come into existence.

**Subsection (b)** – Consistent with the modern trend, this article requires only the most “bare bones” of disclosure.

Unlike many LLC statutes, this article does not require that the certificate of organization state whether the limited liability company is manager-managed or member-managed. Placing that information in a public record pertains primarily to “statutory apparent authority,” which this article has eschewed. *See* the comment to Section 5-301(a). Under this article, the manager-managed and member-managed characterizations pertain principally to *inter se* relations, and this article therefore looks to the operating agreement to make the characterization. *See* Sections 5-102(a)(6) and (a)(8); Section 5-407(a).

**Subsection (c)** – This provision permits the certificate of organization to contain information beyond that required in Subsection (b). An LLC should have good reason, however, before choosing to include additional information. Such information: (i) is available to the public (including competitors); (ii) increases the chances of a conflict between the certificate of organization and the operating agreement, *see* Section 5-107(d); (iii) permits the argument that the additional information is part of the operating agreement, *see* the comment to Section 5-102(a)(9) (stating that “[u]nless the operating agreement itself provides otherwise . . . an operating agreement may comprise a number of separate documents (or records), however denominated”); and (iv) can be confusing to the extent the information appears to delineate the power of persons to act for the LLC. (Subsection (c) states explicitly that information in a certificate of formation “is not effective as a statement of authority.”). In any event, placing additional information in the certificate of formation does not enable an LLC to “end run” the provisions of Section 5-105(c) (limiting the power of the operating agreement to vary specified provisions of this article).

**Subsection (d)** – ULLCA (2006) flirted with the concept of a “shelf” LLC – *i.e.*, a limited liability company duly formed without having at least one member upon formation. As the Prefatory Note to ULLCA (2006) explains:

[T]he Act: (i) permits an organizer to file a certificate of organization without a person “waiting in the wings” to become a member upon formation; but (ii) provides that the LLC is not formed until and unless at least one person becomes a member and the organizer makes a second filing stating that the LLC has at least one member.

Prefatory Note, *The Ability to “Pre-File” a Certificate of Organization*.

Subsection (d) clearly precludes a “shelf” LLC, which is consistent with Section 4-201(d) (providing that a limited partnership is formed when the certificate of limited partnership becomes effective, at least two persons have become partners, at least one person has become a general partner, and at least one person has become a limited partner).

## **SECTION 5-202. AMENDMENT OR RESTATEMENT OF CERTIFICATE OF ORGANIZATION.**

(a) A certificate of organization may be amended or restated at any time.

(b) To amend its certificate of organization, a limited liability company must deliver to the [Secretary of State] for filing an amendment stating:

- (1) the name of the company;
- (2) the date of filing of its initial certificate; and
- (3) the text of the amendment.

(c) To restate its certificate of organization, a limited liability company must deliver to the [Secretary of State] for filing a restatement, designated as such in its heading.

(d) If a member of a member-managed limited liability company, or a manager of a manager-managed limited liability company, knows that any information in a filed certificate of organization was inaccurate when the certificate was filed or has become inaccurate due to changed circumstances, the member or manager shall promptly:

- (1) cause the certificate to be amended; or
- (2) if appropriate, deliver to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

### **Comment**

Like other provisions of this article requiring records to be delivered to the filing officer for filing, this section is not subject to change by the operating agreement. *See* Section 5-105(c)(3). Except for Subsection (d), this section is essentially mechanical.

**Subsection (d)** – This subsection imposes an obligation directly on the members and managers rather than on the limited liability company. A member’s or manager’s failure to meet the obligation exposes the member or manager to liability to third parties under Section 5-205(a)(2) and might constitute a breach of the member or manager’s duties under Section 5-409(c) and (i). In addition, an aggrieved person may seek a remedy under Sections 1-210 (Signing and Filing Pursuant to Judicial Order), 1-211 (Liability for Inaccurate Information in Filed Record), and 5-204 (Liability of Members and Managers for Inaccurate Information in Filed Record).

Like other provisions of the Code requiring records to be delivered to the filing officer for filing, this section is not subject to change by the operating agreement. *See* Section 5-105(c)(3).

**SECTION 5-203. SIGNING OF RECORDS TO BE DELIVERED FOR FILING TO [SECRETARY OF STATE].** A record delivered to the [Secretary of State] for filing pursuant to this [Code] must be signed as follows:

(1) Except as otherwise provided in paragraphs (2) and (3), a record signed by a limited liability company must be signed by a person authorized by the company.

(2) A company’s initial certificate of organization must be signed by at least one person acting as an organizer.

(3) A record delivered on behalf of a dissolved company that has no member must be signed by the person winding up the company’s activities and affairs under Section 5-702(c) or a person appointed under Section 5-702(d) to wind up the activities and affairs.

(4) A statement of denial by a person under Section 5-303 must be signed by that person.

(5) Any other record delivered on behalf of a person to the [Secretary of State] for filing must be signed by that person.

### **Comment**

Section 5-102(21) defines “sign” broadly, including “an electronic symbol, sound, or process.”

**Paragraph (1)** – From the perspective of the filing office, it is not necessary that a record delivered for filing on behalf of a limited liability company be signed by a member or, in the case



of a manager-managed LLC, a manager. The operating agreement can impose such a requirement as an *inter se* matter, but the requirement would not affect this provision. *See* Section 5-105(c)(3)(B) (stating that the operating agreement may not “vary any requirement, procedure, or other provision of this [Code] pertaining to ... the [Secretary of State], including provisions pertaining to records authorized or required to be delivered to the [Secretary of State] for filing under this [Code]”).

The filing office will not check whether a person who purports to be authorized to sign a record on behalf of an LLC actually has that authority, even if a statement of authority pertaining to the matter is in effect. Indeed, even if the filing office somehow “knows” of a statement limiting authority, the office lacks the authority to reject a record on that basis. *See* the comment to Section 1-206 (stating the requirements for filing and noting that the filing office’s review is ministerial and limited to information pertaining to the stated requirements) and the comment to Section 5-302(c) (explaining why such a statement of authority does not affect the filing office).

#### **SECTION 5-204. LIABILITY OF MEMBERS AND MANAGERS FOR INACCURATE INFORMATION IN FILED RECORD.**

(a) Subject to subsection (b), if a record delivered to the [Secretary of State] for filing under this [Code] and filed by the [Secretary of State] contains inaccurate information, a person that suffers loss by reliance on the information may recover damages for the loss from a member of a member-managed limited liability company or a manager of a manager-managed limited liability company if:

(1) the record was delivered for filing on behalf of the company; and

(2) the member or manager knew or had notice of the inaccuracy for a reasonably sufficient time before the information was relied upon so that, before the reliance, the member or manager reasonably could have:

(A) effected an amendment under Section 5-202;

(B) filed a petition under Section 1-210; or

(C) delivered to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

(b) To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of responsibility for maintaining the accuracy of information contained in records delivered on behalf of the company to the [Secretary of State] for filing under this [Code] and imposes that responsibility on one or more other members, the liability stated in subsection (a)(2) applies to those other members and not to the member that the operating agreement relieves of the responsibility.

### **Comment**

**Subsection (a)** – This subsection relates to liability to third parties for inaccurate information in a filed record. Paragraph 1 requires actual knowledge because the paragraph can inculcate a person who is neither a member of a member-managed limited liability company nor a manager of a manager-managed limited liability company. Under Paragraph 2(B), notice suffices, because: (i) the provision applies only to members of a member-managed LLC and managers of a manager-managed LLC; (ii) by status these persons have overall management authority; and (iii) therefore it is reasonable to impose liability when a person either knows or “has reason to know ... from all the facts known to the person at the time in question.” Section 5-103(b)(1) (defining notice). For the same reason, Paragraph 1 applies only to “information [known] to be inaccurate at the time the record was signed,” while Paragraph 2 applies whenever a “member or manager knew or had notice of the inaccuracy for a reasonably sufficient time before the information was relied upon so that, before the reliance, the member or manager reasonably could have [taken corrective action].” Paragraph (2)(B).

**Subsection (a)(2)** – Although this article establishes the avoidance of gross negligence as the standard of care for those who manage a limited liability company, this provision encompasses liability to third parties. Accordingly, the standard here is more demanding. The phrases “reasonably sufficient time” and “reasonably could have” indicate a standard of ordinary care. “[N]otice of the inaccuracy” involves “reason to know.” Section 5-103(b)(1)

**Subsection (b)** – Section 5-105(d)(2) authorizes the operating agreement to establish an analogous rule *inter se* the members. This subsection goes where the operating agreement cannot reach and affects the rights of third parties.

### [PART] 3

## RELATIONS OF MEMBERS AND MANAGERS TO PERSONS DEALING WITH LIMITED LIABILITY COMPANY

### SECTION 5-301. NO AGENCY POWER OF MEMBER AS MEMBER.

(a) A member is not an agent of a limited liability company solely by reason of being a member.

(b) A person's status as a member does not prevent or restrict law other than this [article] from imposing liability on a limited liability company because of the person's conduct.

#### Comment

**Subsection (a)** – 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.

This article rejects the statutory apparent authority approach, for reasons summarized in a “Progress Report on the Revised Uniform Limited Liability Company Act,” published in the March 2006 issue of the newsletter of the ABA Committee on Partnerships and Unincorporated Business Organizations:

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.

PUBOGRAM, Vol. XXIII, no. 2 at 9-10.

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.

Under this article, other law – most especially the law of agency – will handle power-to-bind questions. Thus, LLCs formed under this article and corporations are subject to the same principles for attributing to the entity the conduct of those who act or purport to act on the entity's behalf. *See* RESTATEMENT (THIRD) AGENCY §§ 1.03, cmt. c (2006) (manifestations of authority by organizations); 2.01, cmt. e (actual authority); 2.03, cmts. (c) – (e) (apparent authority). Section 5-407 provides the default rules on the actual authority of those who manage an LLC.

This subsection does not address the power to bind of a manager in a manager-managed LLC, although this article does consider a manager's management responsibilities. *See* Section 5-407(c) (allocating management authority, subject to the operating agreement). For a discussion of how agency law will approach the actual and apparent authority of managers, see Section 5-407(c), comment.

**Subsection (b)** – As the “flip side” to Subsection (a), this subsection expressly preserves the power of other law to hold an LLC directly or vicariously liable on account of conduct by a person who happens to be a member. For example, given the proper set of circumstances: (i) a member might have actual or apparent authority to bind an LLC to a contract; (ii) the doctrine of *respondeat superior* might make an LLC liable for the tortious conduct of a member (*i.e.*, in some circumstances a member acts analogously to a “servant” or “employee” of the LLC); and (iii) an LLC might be liable for negligently supervising a member who is acting on behalf of the LLC. A person's status as a member does not weigh against these or any other relevant theories

of law.

Moreover, subsection (a) does not prevent member status from being relevant to one or more elements of an “other law” theory. *See* Section 1-702 (Supplemental Principles of Law). The most likely “other law” theory is the agency doctrine of apparent authority. Of course, if a member lacking actual authority binds an LLC through conduct within the member’s apparent authority, the LLC has a claim against the member. RESTATEMENT (THIRD) OF AGENCY § 8.09 (2006) (Duty to Act Only Within Scope of Actual Authority and to Comply with Principal’s Lawful Instructions). In contrast, if the member lacked even the power to bind the LLC, the member him, her, or itself will be liable to the vendor as a matter of agency law. RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006) (Agent’s Implied Warranty of Authority).

For example, the common law of agency will determine the apparent authority of a member to bind a member-managed LLC. In that analysis what the particular third party knows or has reason to know about the management structure and business practices of the particular LLC will always be relevant. RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. b (2006) (“A principal may also make a manifestation by placing an agent in a defined position in an organization . . . . Third parties who interact with the principal through the agent will naturally and reasonably assume that the agent has authority to do acts consistent with the agent’s position . . . unless they have notice of facts suggesting that this may not be so.”)

Under Section 5-301(a), however, the mere fact that a person is a member of a member-managed limited liability company cannot *by itself* establish apparent authority by position. A course of dealing, however, may easily change the analysis:

EXAMPLE: David is a one of two members of DS, LLC, a member-managed LLC. David orders paper clips on behalf of the LLC, signing the purchase agreement, “David, as a member of DS, LLC.” Absent further facts, David has no apparent authority to bind the LLC.

However, the vendor accepts the order, sends an invoice to the LLC’s address, and in due course receives a check drawn on the LLC’s bank account. When David next places an order with the vendor, the LLC’s payment of the first order is a manifestation that the vendor may use in asserting that David had apparent authority to place the second order. A successful apparent authority claim also presupposes that: (i) the vendor believed that David was authorized; and (ii) the belief was reasonable. RESTATEMENT (THIRD) OF AGENCY § 3.03 (2006) (Creation of Apparent Authority).

In general, a member’s actual authority to act for an LLC will depend fundamentally on the operating agreement. *See* the comment to Section 5-407(b).

## **SECTION 5-302. STATEMENT OF LIMITED LIABILITY COMPANY**

### **AUTHORITY.**

(a) A limited liability company may deliver to the [Secretary of State] for filing a statement of authority. The statement:

(1) must include the name of the company and the name and street and mailing addresses of its registered agent;

(2) with respect to any position that exists in or with respect to the company, may state the authority, or limitations on the authority, of all persons holding the position to:

(A) sign an instrument transferring real property held in the name of the company; or

(B) enter into other transactions on behalf of, or otherwise act for or bind, the company; and

(3) may state the authority, or limitations on the authority, of a specific person to:

(A) sign an instrument transferring real property held in the name of the company; or

(B) enter into other transactions on behalf of, or otherwise act for or bind, the company.

(b) To amend or cancel a statement of authority filed by the [Secretary of State], a limited liability company must deliver to the [Secretary of State] for filing an amendment or cancellation stating:

(1) the name of the company;

(2) the name and street and mailing addresses of the company's registered agent;

(3) the date the statement being affected became effective; and

(4) the contents of the amendment or a declaration that the statement is canceled.

(c) A statement of authority affects only the power of a person to bind a limited liability company to persons that are not members.

(d) Subject to subsection (c) and Section 5-103(d), and except as otherwise provided in subsections (f), (g), and (h), a limitation on the authority of a person or a position contained in an effective statement of authority is not by itself evidence of any person's knowledge or notice of the limitation.

(e) Subject to subsection (c), a grant of authority not pertaining to transfers of real property and contained in an effective statement of authority is conclusive in favor of a person that gives value in reliance on the grant, except to the extent that when the person gives value:

(1) the person has knowledge to the contrary;

(2) the statement has been canceled or restrictively amended under subsection (b);

or

(3) a limitation on the grant is contained in another statement of authority that became effective after the statement containing the grant became effective.

(f) Subject to subsection (c), an effective statement of authority that grants authority to transfer real property held in the name of the limited liability company, a certified copy of which statement is recorded in the office for recording transfers of the real property, is conclusive in favor of a person that gives value in reliance on the grant without knowledge to the contrary, except to the extent that when the person gives value:

(1) the statement has been canceled or restrictively amended under subsection (b), and a certified copy of the cancellation or restrictive amendment has been recorded in the office for recording transfers of the real property; or

(2) a limitation on the grant is contained in another statement of authority that became effective after the statement containing the grant became effective, and a certified copy of the later-effective statement is recorded in the office for recording transfers of the real property.

(g) Subject to subsection (c), if a certified copy of an effective statement containing a limitation on the authority to transfer real property held in the name of a limited liability company is recorded in the office for recording transfers of that real property, all persons are deemed to know of the limitation.

(h) Subject to subsection (i), an effective statement of dissolution or termination is a cancellation of any filed statement of authority for the purposes of subsection (f) and is a limitation on authority for the purposes of subsection (g).

(i) After a statement of dissolution becomes effective, a limited liability company may deliver to the [Secretary of State] for filing and, if appropriate, may record a statement of authority that is designated as a post-dissolution statement of authority. The statement operates as provided in subsections (f) and (g).

(j) Unless earlier canceled, an effective statement of authority is canceled by operation of law five years after the date on which the statement, or its most recent amendment, becomes effective. This cancellation operates without need for any recording under subsection (f) or (g).

(k) An effective statement of denial operates as a restrictive amendment under this section and may be recorded by certified copy for purposes of subsection (f)(1).

### **Comment**

This section is derived from and builds on UPA (1997) § 303, which was refined in ULLCA (2006) and further refined in the Harmonization Project. This section is conceptually divided into two realms: statements pertaining to the power to transfer interests in the LLC's real property and statements pertaining to other matters. In the latter realm, statements are filed only



in the records of the filing office and operate only to the extent the statements are actually known and relied on by a third party. Section 5-302(d) and (e).

As to interests in real property, in contrast, this section: (i) requires double-filing – with the filing office and in the appropriate land records; and (ii) provides for constructive knowledge of statements limiting authority. Thus, a properly filed and recorded statement can protect the limited liability company, Section 5-302(g), and, in order for a statement pertaining to real property to be a sword in the hands of a third party, the statement must have been both filed and properly recorded. Section 5-302(f). Experience suggests that statements of authority will most often be used in connection with transactions in real estate.

The requirements for filing records with the filing office are found in Part 2 of Article 1. *See also* Section 1-104 (Delivery of Record).

By its terms, this section applies only to domestic limited liability companies. A foreign LLC cannot make use of this section even as to real property located in this state. The section refers throughout to “limited liability company,” which this article defines as a domestic limited liability company. *See* Section 5-102(a)(4) (““Limited liability company’ ... means an entity formed under this [article] or which becomes subject to this [article]”). *Cf. Fannie Mae v. Heather Apartments Ltd. P’ship*, A13-0562, 2013 WL 6223564 at \*6 (Minn. Ct. App. Dec. 2, 2013) (considering the remedies available to a judgment creditor with respect to the judgment debtor’s interest in a Cook Islands LLC; rejecting the debtor’s argument that the creditor’s “only remedy is to obtain a charging order under” [the Minnesota LLC statute]; explaining that “this argument fails because that statute only applies to Minnesota limited liability companies” which the Minnesota LLC statute “defines ... as ‘a limited liability company, other than a foreign limited liability company, *organized or governed by this chapter*’”) (emphasis added; statutory citations omitted).

**Subsection (a)(2)** – This paragraph permits a statement to designate authority by position (or office) rather than by specific person, thus avoiding the need to file anew whenever a new person assumes the position or the office. This type of a statement will enable LLCs to provide evidence of ongoing power to enter into transactions without having to disclose to third parties the entirety of the operating agreement.

**Subsection (a)(2)(A) and (a)(3)(A)** – The authority to “sign” an instrument includes the authority to commit the partnership to the transfer reflected in the agreement. *See* Subsection (f) (referring not merely to signing but also to “an effective statement of authority that grants authority to transfer real property”).

Here and elsewhere in the section, the phrase “real property” includes all interests in real property, such as mortgages, easements, etc.

**Subsection (c)** – This subsection expresses a very important limitation – *i.e.*, that this

section's rules do not operate viz-a-viz members. For members, the operating agreement is controlling. Section 5-107(d). However, like any other record delivered for filing on behalf of an LLC, a statement of authority might be some evidence of the contents of the operating agreement. *See* the comment to Section 5-107(d).

Another important limitation exists. The filing office is not affected by a statement of authority that purports to delineate the authority of persons to sign documents to be delivered for filing of behalf of a limited liability company. The Code does define “[p]erson” to include a “government or governmental subdivision, agency, or instrumentality,” Section 1-102(34), but “a limitation on the authority of a person or a position contained in an effective statement of authority is not by itself evidence of knowledge or notice of the limitation by any person.” Subsection (d).

Moreover, even if an employee of the filing office happened to see that a statement of authority purported to delineate the authority of persons to sign records to be delivered on behalf of an LLC, that information would not pertain to a “fact [that] is material to the agent's duties to the principal” and therefore would not be attributed to the filing office. RESTATEMENT (THIRD) OF AGENCY § 5.03 (2006).

**Subsection (d)** – The phrase “by itself” is important, because the existence of a limitation of authority could be evidence if, for example, the person in question reviewed the public record at a time when the limitation was of record.

**Subsection (e)(1)** – What happens if a statement of authority conflicts with the contents of an LLC's certificate of organization? The contents of the certificate are not statements of authority, Section 5-201(c), so the information in the certificate does not directly figure into the operation of this section. However, if the person claiming to rely on a statement of authority had read the certificate's conflicting information before giving value, that fact might be evidence that person gave value with “knowledge to the contrary” of the statement.

**Subsection (e)(2)** – This paragraph by its terms does not affect a claim of lingering apparent authority. A person could: (i) assert knowledge of a statement of authority as the statement existed before a cancellation or restrictive amendment; and (ii) characterize the original statement as a manifestation of authority traceable to the limited liability company. RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. b (2006) (“Apparent authority is present only when a third party's belief is traceable to manifestations of the principal.”).

However, for apparent authority to exist, the purported agent must *reasonably* appear to be authorized. RESTATEMENT (THIRD) OF AGENCY § 2.03 (2006) (stating that apparent authority can only exist when “a third party reasonably believes the actor has authority to act on behalf of the principal”). Given the possibility of cancellation or restrictive amendment, it might not be reasonable for a person to know of a statement of authority, let time pass, and then rely on the statement without re-checking the public record.

**Subsections (f) through (h)** – These subsections: (i) pertain to transactions in real property; (ii) provide a mechanism by which authority to transfer an LLC’s real property can be made to appear in the real estate records; and (iii) thus address the principal concerns (raised by real estate lawyers) that led the drafters of UPA (1997) to provide for statements of authority.

**Subsection (f)** – This subsection provides a sword for a vendee of real property. If the vendee has “give[n] value in reliance on the grant without knowledge to the contrary,” the statement of authority protects the vendee against claims that contradict the grant.

**Subsection (f)(1) and (2)** – As a claim of lingering apparent authority, see the comment to Subsection (e)(2). The analysis stated there applies even more strongly in the context of customary practices involving land transfers.

**Subsection (g)** – This subsection provides a shield for the limited liability company as alleged vendor. If a vendee’s claim contradicts the stated limitation, constructive knowledge (“deemed to know”) defeats the claim even if the vendee gave value and lacked actual knowledge.

**Subsection (h)** – This subsection integrates statements of dissolution and termination, Section 5-702, into the operation of this section.

The effect of a statement of dissolution depends on the circumstances.

EXAMPLE: ABC, LLC has in effect a properly filed and recorded statement of authority authorizing ABC’s CEO to transfer real estate owned by the LLC. The proper filing and recording by ABC of a statement of dissolution cancels the statement of authority. Subsequently, Buyer gives value in return for a deed signed by the CEO on behalf of ABC. Due to Subsections (h) and (f)(1), Subsection (f) does not protect Buyer. Moreover, under Subsections (g) and (h), Buyer is “deemed to know” of the dissolution. Whether that deemed knowledge functions to deprive the CEO of authority to bind ABC depends on agency law and additional facts. For example, the CEO might have had actual or apparent authority to transfer the real estate despite the dissolution of the LLC.

If properly filed with the filing office and properly recorded in the office for land records, a statement of termination eliminates the power of any person to transfer real property owned in the name of the LLC. No one can have the authority to act for a non-existent entity. *Cf.* RESTATEMENT (THIRD) OF AGENCY § 4.04(1)(a) (2006) (precluding ratification by a principal that did not exist at the time of the unauthorized act).

**Subsection (i)** – This provision permits an LLC to use statements of authority during winding up. As an additional protection for third parties, a statement must be “designated as a post-dissolution statement of authority” to be effective under this provision.

**Subsection (k)** – Presumably, when real property is involved, a person who obtains the

filing of a statement of denial under Section 5-303 will cause a certified copy of the statement to be “recorded by certified copy for purposes of subsection (f)(1)” [undercutting constructive notice as to authority to transfer real property]. However, nothing in this subsection prevents the limited liability company from causing a certified copy to appear in the land records; due the section’s use of the passive voice (“may be recorded”), this article does not delimit who has the authority to act under this subsection.

**SECTION 5-303. STATEMENT OF DENIAL.** A person named in a filed statement of authority granting that person authority may deliver to the [Secretary of State] for filing a statement of denial that:

(1) provides the name of the limited liability company and the caption of the statement of authority to which the statement of denial pertains; and

(2) denies the grant of authority.

#### **Comment**

A person whose powers are delineated in the public record by another person should have the right to dissent from that delineation. This section takes an “all or nothing” approach; a person may not deny in part and confirm in part. For the effect of a statement of denial, see Section 5-302(k).

#### **SECTION 5-304. LIABILITY OF MEMBERS AND MANAGERS.**

(a) 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. This subsection applies regardless of the dissolution of the company.

(b) The failure of a limited liability company to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager for a debt, obligation, or other liability of the company.

## Comment

**Derivation** – ULLCA (2006) derived this section from UPA (1997) § 306, which was also the source for ULPA (2001) § 404. The Harmonization Project brought the two partnership acts and the limited liability company act into accord to the extent the three acts overlap.

**Subsection (a)** – This subsection provides a corporate-like liability shield to members and managers, protecting them against (and only against) the debts, obligations and liabilities of the limited liability company – *i.e.*, against a member’s or manager’s alleged vicarious liability for the obligations of the entity. The shield “applies regardless of the dissolution of the company” and thus continues in effect through the completion of winding up (*i.e.*, termination). The shield applies regardless of the law giving rise to a claim against a limited liability company.

### *Shield Applicable Regardless of the Identity of the Plaintiff*

What makes the shield relevant is the nature of the claim. If the complaint seeks to hold a member vicariously liable for the LLC’s obligations, the shield applies. If not, not. Thus, there is no distinction between a claim arising from an LLC’s debt to a commercial creditor, a member’s claim that the LLC has failed to return a contribution as required by the operating agreement, and a claim by a former member that the LLC has failed to follow through on a buy-out agreement. *See Rappaport v. Gelfand*, 197 Cal. App.4th 1213, 1230-1232, 129 Cal. Rptr. 3d 670, 682-84 (Cal. App. 2 Dist. 2011) (involving a claim by a former partner). *Accord Ederer v. Gursky*, 9 N.Y.3d 514, 526, 881 N.E.2d 204, 212-213 (N.Y. 2007) (Smith, J., dissenting).

### *Shield Inapposite for Claims Arising from a Member’s or Manager’s Own Conduct*

Because the member or manager liability at issue is solely vicarious, the shield is irrelevant to claims seeking to hold a member or manager directly liable on account of the member’s or manager’s own conduct. Put another way, “[t]here is no question” that “the member-manager of a limited liability company who causes his business to breach common law and statutory duties may be held independently liable for his personal torts.” *Dep’t of Agric. v. Appletree Mktg., L.L.C.*, 485 Mich. 1, 4, 18, 779 N.W.2d 237, 239, 247 (2010).

A few judges have failed to understand this point. *See Puleo v. Topel*, 368 Ill. App. 3d 63, 68-69, 856 N.E.2d 1152, 1157 (Ill. App. Ct. 2006) (basing its holding on a legislative amendment that “removed ... language which explicitly provided that a member or manager of an LLC could be held personally liable for his or her own actions or for the actions of the LLC to the same extent as a shareholder or director of a corporation could be held personally liable”).

This mistaken view: (i) ignores the actual words of LLC shield provisions (which protect members and managers only against liability for obligations *of* an LLC and make no reference to direct obligations of a member or manager); and (ii) flouts public policy (which recoils from the idea of immunizing a person’s misconduct solely because the person acts on behalf of an

organization). Moreover, the mistaken view is contrary to the overwhelming weight of the case law. *See, e.g., Mbahaba v. Morgan*, 163 N.H. 561, 565, 44 A.3d 472, 476 (2012) (“When ... a member or manager commits or participates in the commission of a tort, whether or not he acts on behalf of his LLC, he is liable to third persons injured thereby.”); *Sturm v. Harb Dev., LLC*, 298 Conn. 124, 138, 2 A.3d 859, 870 (2010) (holding that the liability shield of an LLC is subject to “the common-law tort exception ... [for] individual claims against LLC members”); *Allen v. Dackman*, 413 Md. 132, 154, 991 A.2d 1216, 1229 (2010) (“An LLC member is liable for torts he or she personally commits, inspires, or participates in because he or she personally committed a wrong, not ‘solely’ because he or she is a member of the LLC.”); *Weber v. U.S. Sterling Sec., Inc.*, 282 Conn. 722, 732–34, 924 A.2d 816, 824–25 (2007) (stating that the Delaware LLC Act “does not preclude individual liability for members of a limited liability company if that liability is not based simply on the member’s affiliation with the company” and holding, in particular, that the Act “does not bar the defendants’ liability for tortious conduct”).

EXAMPLE: A manager personally guarantees a debt of a limited liability company. Subsection (a) is irrelevant to the manager’s liability as guarantor.

EXAMPLE: A member purports to bind a 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” (an agency law doctrine). Subsection (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 own, direct liability. Indeed, the liability exists because the limited liability company is *not* indebted, obligated or liable. RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006).

EXAMPLE: A manager of a limited liability company defames a third party in circumstances that render the limited liability company vicariously liable under agency law. Under Subsection (a), the third party cannot hold the manager accountable for the *company’s* liability, but that protection is immaterial. The manager is the tortfeasor and in that role is directly liable to the third party.

EXAMPLE: A limited liability company provides professional services, and one of its members commits malpractice. The liability shield is irrelevant to the member’s direct liability in tort. However, if the member’s malpractice liability is attributed to the LLC under agency law principles, the liability shield will protect the other members of the LLC against a claim that they must make good on the LLC’s liability.

EXAMPLE: A single member limited liability company enters into a contract to build a home, and the member performs substantial amounts of the work. The homeowner sues both the LLC and the member for allegedly defective work, but the complaint sounds in contract rather than in tort. The LLC may be liable, but the member is not. *See Ogea v. Merritt* --- So.3d ---, 2013 WL 6439355 at \*24-25 (La. 2013).

Subsection (a) pertains only to claims based on the LLC's liability and is irrelevant to claims by a limited liability company against a member or manager and *vice versa*. *E.g.*, Sections 5-408 (pertaining to a limited liability company's obligation to indemnify a member or manager), 5-409 (pertaining to management duties) and 5-801 (pertaining to a member's rights to bring a direct claim against a limited liability company).

### *Shield Inapposite to Role Liability Claims*

Provisions of regulatory law may impose liability on a member or manager due to a role the person plays in the LLC. *See, e.g., Food Team Intern., Ltd. v. Unilink, LLC*, 872 F. Supp. 2d 405, 424 (E.D. Pa. 2012) (holding several individuals "subject to secondary individual liability under PACA [Perishable Agricultural Commodities Act]" because their roles within the LLC enabled them to control the relevant assets) (citing *Bear Mountain Orchards, Inc. v. Mich-Kim, Inc.*, 623 F.3d 163, 172 (3d Cir. 2010)).

### *The Shield and Dissolution.*

The rule stated here is inherent in the nature of LLC dissolution. "[D]issolution does not end a limited liability company's existence but rather changes the purpose of that existence." Comment to Section 5-701. "A dissolved limited liability company shall wind up its activities and affairs and ... continues after dissolution ... for the purpose of winding up." Section 5-702(a). Put another way: dissolution and winding up are part of the life cycle of a limited liability company – sometimes the most complicated part. There is no logical reason to remove the shield during the last part of an LLC's life cycle.

This subsection makes this point expressly, because it is possible to misinterpret some outlying LLP cases as holding to the contrary. *See, e.g., Carolina Cas. Ins. Co. v. L.M. Ross Law Grp., LLP*, 151 Cal. Rptr. 3d 628, 635 (2012) (affirming the trial court's decision to hold an LLP's named partner liable for a judgment against his limited liability partnership; noting that "[c]entral to the decision to amend the judgment to add Ross [the named partner] as a judgment debtor ... is the trial court's finding that Ross Law Group dissolved"; recognizing, however, that, before the partnership incurred the liability, Ross had signed and filed with the California Secretary of State a form stating that the law firm had "cease[d] to be a registered limited liability partnership and is hereby filing this notice with the California Secretary of State that [it] is no longer a registered limited partnership") (quotation marks omitted).

### *The Shield and Termination*

This subsection does not expressly provide that, when a limited liability company's existence terminates, the liability shield remains in place as to any debt, obligation, or other liability of the LLC incurred before the termination. However, the point follows ineluctably from Section 5-304(a) which provides that the shield applies to "debts, obligations, or other liabilities of a limited liability company." A debt, obligation, or other liability of an LLC does not disappear merely because the LLC has terminated.

Moreover, any other result would: (i) create huge holes in the shield; (ii) put the law of unincorporated businesses at odds with the law of corporations; (iii) render surplus this article's

distribution recapture provision, Section 5-406; and (iv) render nonsensical the otherwise logical extension of the equitable trust fund theory to limited liability companies. *Cf. Velasquez v. Franz*, 589 A.2d 143, 146 (N.J. 1991) (explaining that “the trust-fund doctrine... renders shareholders who receive distributed assets of the corporation liable as ‘trustees’ for claims of the corporation's creditors”).

### *Dangers of Indemnification Provisions Inter Se the Members*

Despite the phrase “by way of contribution or otherwise,” the LLC shield has no effect on contribution or indemnification requirements running directly from member to member or from members to a manager. These obligations are not obligations of the LLC but rather personal to each member. Indirectly they pose a risk to the shield as to liability arising from the misconduct of a member or manager.

**EXAMPLE:** A law firm operates as a professional limited liability company. One practice area (the “Practice Area”) brings in large fees but also exposes its practitioners (the “Practitioners”) to liability risks substantially higher than the risks faced by other lawyers in the firm. Fees in the Practice Area are episodic, so it makes sense for the Practitioners to share profits with the rest of the firm, where returns are lower but more regular.

The firm carries liability insurance, and the operating agreement provides broad indemnification rights to all the firm’s lawyers. However, the Practitioners are mindful that the LLC liability shield sets a practical limit to the firm’s indemnification obligations and that policies of insurance have limits. The Practitioners obtain a provision in the operating agreement by which each member of the LLC makes a personal promise of indemnification (subject to a cap).

The tortious conduct of one of the Practitioners (the “Tortfeasor”) results in a substantial judgment against the Tortfeasor and, per Section 5-305(a), against the LLC. For unrelated reasons, the LLC has become insolvent and its liability coverage is “maxed out.” The Tortfeasor’s right to indemnification from fellow members is an asset of the Tortfeasor. The judgment creditor can levy on that asset, thereby defeating the liability shield in effect if not in form.

**Subsection (b)** – This subsection pertains to the equitable doctrine of “piercing the veil” – *i.e.*, conflating an entity and its owners to hold one liable for the obligations of the other. The doctrine of “piercing the corporate veil” is well-established, and courts regularly (and sometimes almost reflexively) apply that doctrine to limited liability companies. In the corporate realm, “disregard of corporate formalities” is a key factor in the piercing analysis. In the realm of LLCs, that factor is inappropriate, because informality of organization and operation is both common and desired. *See, e.g., In re Packer*, Bankruptcy No. 13–41304, 2014 WL 5100095 (Bankr. E.D. Tex. Oct. 10, 2014) (noting the informality of LLC governance, recognizing that



“the disregard of corporate formalities ... [is] one of the key factors in [corporate] veil-piercing determinations”; but holding that ““it makes no sense to imperil the shield simply because the members do not undergo meaningless formalities such as formal meetings””) (citing Carter G. Bishop & Daniel S. Kleinberger, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* ¶ 6.03 at \*3 (Thomson Reuters Tax and Accounting 2014)).

The formalities at issue are the process formalities of governance – both those few created by this article and however few or many might be created by the operating agreement.

EXAMPLE: The operating agreement of a three-member, member-managed limited liability company requires formal monthly meetings of the members. Each of the members works in the LLC’s business, and they consult each other regularly. They have forgotten or ignore the requirement of monthly meetings. Under Subsection (b), that fact is irrelevant to a piercing claim.

In contrast, this subsection is inapposite to another key piercing factor – disregard of the separateness between entity and owner. *E.g.*, *Vanderford Co. v. Knudson*, 165 P.3d 261, 271 (Idaho 2007) (noting that managing member and “his accountant testified that the LLC's checking account was so confusing that the accountant could not be sure whose money was in the account at what times”); *Utzler v. Braca*, 972 A.2d 743 (Conn. App. 2009) (holding that veil piercing was appropriate under alter-ego theory when owner deposited LLC funds into a commingled bank account from which he made withdrawals for personal needs and unrelated projects).

EXAMPLE: The sole owner of a limited liability company uses a car titled in the company’s name for personal purposes and writes checks on the company’s account to pay for personal expenses. These facts are relevant to a piercing claim; they pertain to economic separateness, not Subsection (b) formalities.

This subsection also is inapposite to a member’s claim of oppression under Section 701(a)(4)(C)(ii). In some circumstances, disregard of agreed-upon formalities can be a “freeze out” mechanism. Likewise, this subsection has no relevance to a member’s claim that the disregard of agreed-upon formalities is a breach of the operating agreement.

This subsection addresses claims to “impos[e] liability on a member or manager for a debt, obligation, or other liability of the company” – *i.e.*, for what is sometimes termed a “direct pierce.” Whether the same approach should apply to claims for a “reverse pierce” is a question for the courts. *See Comm’r of Envtl. Prot. v. State Five Indus. Park, Inc.*, 304 Conn. 128, 140, 37 A.3d 724, 732-33 (2012) (stating that “[a]lthough some courts have adopted reverse veil piercing with little distinction as a logical corollary of traditional veil piercing, because the two share the same equitable goals, others wisely have recognized important differences between them”).

## **[PART] 4**

### **RELATIONS OF MEMBERS TO EACH OTHER AND TO LIMITED LIABILITY COMPANY**

#### **SECTION 5-401. BECOMING MEMBER.**

(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.

(c) After formation of a limited liability company, a person becomes a member:

- (1) as provided in the operating agreement;
- (2) as the result of a transaction effective under [Article] 2;
- (3) with the affirmative vote or consent of all the members; or
- (4) as provided in Section 5-701(a)(3).

(d) A person may become a member without:

- (1) acquiring a transferable interest; or
- (2) making or being obligated to make a contribution to the limited liability company.

#### **Comment**

Most LLC statutes address in separate provisions: (i) how an LLC obtains its initial member or members; and (ii) how additional persons might later become members. This article follows that approach.

**Subsections (a) and (b)** – These subsections make explicit the agency relationship between the person acting as organizer and the initial member or members.

**Subsection (c)(3)** – A limited liability company being in part a creature of contract, consent is determined on an objective basis (*i.e.*, contract law’s “reasonable person” standard). Depending on the terms of an LLC’s operating agreement, the members’ manifestation of consent might involve detailed formalities, entirely informal activities, or anything in between. Moreover, the operating agreement might reduce the quantum of consent necessary or shift the consent right to a manager.

A limited liability company being a voluntary association, a person cannot become a member without manifesting consent to do so. That consent also is judged objectively.

Under Section 5-106(b), “[a] person that becomes a member of a limited liability company is deemed to assent to the operating agreement,” and the agreement binds the member regardless of whether the member has actually indicated assent in any way.

**Subsection (d)(1)** – 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.”

**SECTION 5-402. FORM OF CONTRIBUTION.** 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.

### Comment

This section is intentionally quite broad, encompassing past, present, and promised benefits. Comparable language exists in most, if not all, LLC statutes, and case law recognizes the intended broadness of this approach. *See, e.g., Belgard v. Manchac Technologies, LLC*, 92 So.3d 660, 664 (La.App. 3 Cir. 2012) (stating that “the creation of an obligation to establish a \$1.8 million line of credit was valid consideration for the transfer of 24% of the membership interest in Manchac”); *In re Eight of Swords, LLC*, 96 A.D.3d 839, 840, 946 N.Y.S.2d 248, 249 (N.Y.A.D. 2 Dept. 2012) (referring to “the petitioner’s contributions to the LLC, which overwhelmingly consisted of services rendered to the LLC in the form of preparing and filing start-up documentation and performing activities associated with the renovation of the business’s premises”).

This article does not contain a statute of frauds specifically applicable to promised contributions. Generally applicable statutes of fraud might apply, however. For example, a

promise to contribute land to the LLC would be subject to the statute of frauds pertaining to land transfers. Likewise, a promise that by its terms requires performance that extends beyond one year from the making of the contract would be subject to the one-year provision of the statute of frauds. *See* the comment to Section 5-102(a)(9).

### **SECTION 5-403. LIABILITY FOR CONTRIBUTIONS.**

(a) A person's obligation to make a contribution to a limited liability company is not excused by the person's death, disability, termination, or other inability to perform personally.

(b) If a person does not fulfill an obligation to make a contribution other than money, the person is obligated at the option of the limited liability company to contribute money equal to the value of the part of the contribution which has not been made.

(c) The obligation of a person to make a contribution may be compromised only by the affirmative vote or consent of all the members. If a creditor of a limited liability company extends credit or otherwise acts in reliance on an obligation described in subsection (a) without knowledge or notice of a compromise under this subsection, the creditor may enforce the obligation.

### **Comment**

**Subsection (a)** – Under common law principles of impracticability, an individual's death or incapacity will sometimes discharge a duty to render performance. RESTATEMENT (SECOND) OF CONTRACTS §§ 261 (Discharge by Supervening Impracticability), 262 (Death or Incapacity of Person Necessary For Performance). This subsection overrides those principles. Moreover, the reference to "perform personally" is not limited to individuals but rather may refer to any legal person (including an entity) that has a non-delegable duty.

**Subsection (b)** – This subsection is a statutory liquidated damage provision, exercisable at the option of the limited liability company, with the damage amount set according to the value of the promised, non-monetary contribution.

**EXAMPLE:** In order to become a member, a person promises to contribute to the limited liability company various assets "free and clear," which the operating agreement values at \$150,000. In return for the person's promise, and in light of the agreed value, the limited liability company admits the person as a member with a right to receive 25% of the LLC's distributions.

However, the promised assets are subject to a security agreement, and, before the member can contribute the assets, the secured party forecloses on the security interest and sells the assets at a public sale for \$75,000. Even if the \$75,000 reflects the actual fair market value of the assets, under this subsection the limited liability company has a claim against the member for “money equal to the value of the part of the contribution which has not been made” – *i.e.*, \$150,000.

EXAMPLE: Same facts as the previous example, except that the public sale brings \$225,000. The limited liability company is neither obliged to invoke this subsection nor limited to the \$150,000. The LLC may instead sue for breach of the promise to make the contribution, asserting the \$225,000 figure as evidence of the actual loss suffered as a result of the breach.

**Subsection (c)** – The unanimity requirement expressed in the first sentence might indirectly benefit creditors, but the requirement is nonetheless a default rule and therefore may be varied by operating agreement. The right of each member to consent is not a “right[] under this [Code] of a person other than a member or manager.” *See* Section 5-105(c)(15) (preventing the operating agreement from affecting such rights). In contrast, the creditor right stated in the second sentence fits squarely within Section 5-105(c)(15) and therefore may not be varied by the operating agreement.

## **SECTION 5-404. SHARING OF AND RIGHT TO DISTRIBUTIONS BEFORE DISSOLUTION.**

(a) Any distribution made by a limited liability company before its dissolution and winding up must be in equal shares among members and persons dissociated as members, except to the extent necessary to comply with a transfer effective under Section 5-502 or charging order in effect under Section 5-503.

(b) A person has a right to a distribution before the dissolution and winding up of a limited liability company only if the company decides to make an interim distribution. A person’s dissociation does not entitle the person to a distribution.

(c) A person does not have a right to demand or receive a distribution from a limited liability company in any form other than money. Except as otherwise provided in Section 5-707(d), a company may distribute an asset in kind only if each part of the asset is fungible with

each other part and each person receives a percentage of the asset equal in value to the person's share of distributions.

(d) If a member or transferee becomes entitled to receive a distribution, the member or transferee has the status of, and is entitled to all remedies available to, a creditor of the limited liability company with respect to the distribution. However, the company's obligation to make a distribution is subject to offset for any amount owed to the company by the member or a person dissociated as a member on whose account the distribution is made.

### Comment

Past uniform unincorporated entity acts and many current LLC acts provide default rules for allocation of profits, and UPA (1997) even provided a default structure for maintaining capital accounts. For the following reasons, this article, incorporating changes made by the Harmonization Project, provides a default rule only for rights to share in distributions:

- Capital accounts are maintained for one purpose, to determine how distributions will be made to members. The rules for maintenance of capital accounts can be very complex. Generally, however, profits increase capital account balances (and increase the amounts that will be distributed to the members) and losses reduce capital account balances (and reduce the amounts that will be distributed to the members). If the statute has a simple default rule for how distributions are to be made to the members, providing an additional set of default profit and loss allocation provisions and capital account rules will be, at best, duplicative and, at worse, inconsistent with the distribution rules.
- Some argue that capital account rules and profit and loss allocation provisions are necessary to comply with tax requirements. Tax income or loss is allocated to "partners" (including members of an LLC taxed as a partnership) according to the partners' economic interests in the LLC, and these interests are based on distributions that would be made to partners on liquidation of the LLC. By including default distribution provisions, this article includes the information necessary to make these tax determinations. To the extent the tax law allows partners to make further tax elections or satisfy alternative safe harbors, the partners may look to the tax law for guidance and include necessary provisions in their agreements.

**Subsection (a)** – The rule stated applies to redemptions as well as operating distributions but is a default rule in both contexts. *See* the comment to Section 5-102(a)(3)(A).

**Subsection (b)** – The second sentence of this subsection accords with Section 5-603(a)(3) – upon dissociation a person is treated as a mere transferee of its own transferable interest. Like most *inter se* rules in this article, this one is subject change by the operating

agreement. *See* the comment to Section 5-603(a)(3).

**Subsection (d)** – *See also* Section 5-405(d) (pertaining to the rights of members and transferees that receive a distribution in the form of indebtedness) and 5-405(e) (pertaining to solvency testing for payments on indebtedness issued to redeem an interest).

#### **SECTION 5-405. LIMITATIONS ON DISTRIBUTIONS.**

(a) A limited liability company may not make a distribution, including a distribution under Section 5-707, if after the distribution:

(1) the company would not be able to pay its debts as they become due in the ordinary course of the company's activities and affairs; or

(2) the company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of members and transferees whose preferential rights are superior to the rights of persons receiving the distribution.

(b) A limited liability company may base a determination that a distribution is not prohibited under subsection (a) on:

(1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

(2) a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subsection (e), the effect of a distribution under subsection (a) is measured:

(1) in the case of a distribution as defined in Section 5-102(a)(3)(A), as of the earlier of:

(A) the date money or other property is transferred or debt is incurred by

the limited liability company; or

(B) the date the person entitled to the distribution ceases to own the interest or right being acquired by the company in return for the distribution;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs not later than 120 days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(d) A limited liability company's indebtedness to a member or transferee incurred by reason of a distribution made in accordance with this section is at parity with the company's indebtedness to its general, unsecured creditors, except to the extent subordinated by agreement.

(e) A limited liability company's indebtedness, including indebtedness issued as a distribution, is not a liability for purposes of subsection (a) if the terms of the indebtedness provide that payment of principal and interest is made only if and to the extent that payment of a distribution could then be made under this section. If the indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is made.

(f) In measuring the effect of a distribution under Section 5-707, the liabilities of a dissolved limited liability company do not include any claim that has been disposed of under Section 5-704, 5-705, or 5-706.

### **Comment**

Both this section and Section 5-406 were derived essentially from the MODEL BUS. CORP.



ACT § 6.40. Both sections are necessary and appropriate because a limited liability company provides its members and managers a corporate-like liability shield. With the exception noted in the comment to Subsection (a)(2), the provisions of this section are non-waivable. Section 5-105(c)(15).

“Distribution” does not include “amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program.” Section 5-102(a)(3)(B).

**Subsection (a)** – Insolvency is a fundamental issue under this section, and this subsection provides two tests of insolvency. The tests are disjunctive; a distribution violates this section if after the distribution the LLC fails either of the tests. The subsection applies both to interim and liquidating distributions.

Solvency is also a fundamental issue under bankruptcy and fraudulent transfer law, which provide their own respective definitions of the concept.

**Subsection (a)(2)** – The reference to “preferential rights upon dissolution and winding up” is a default rule, because removing this protection for preferred members or transferees is an *inter se* matter. See Section 5-105(d)(1)(B). The rest of the section is not subject to change in the operating agreement. Section 5-105(c)(9).

**Subsection (b)** – This subsection states a standard of ordinary care, in contrast with the generally-applicable standard stated in Section 5-409(c) (gross negligence).

**Subsection (b)(2)** – This alternative valuation provision is likely to be both useful and fair when the limited liability company has appreciated assets but for accounting purposes these assets are valued at book value less depreciation.

**Subsection (c)** – This subsection provides three alternative rules for determining the point(s) in time of as which to apply the Subsection (a) solvency tests. The timing depends on which of three categories encompasses a distribution: (i) a distribution in the nature of a redemption (regardless of whether the distribution includes a distribution of indebtedness); (ii) any distribution of indebtedness other than a distribution in the nature of a redemption; and (iii) any distribution that involves neither a redemption nor a distribution of indebtedness. A requirement for additional solvency testing pertaining to distributions of indebtedness appears in Subsection (e).

**Subsection (c)(1)** – Section 5-102(a)(3)(A) encompasses distributions in the nature of a redemption.

**Subsection (c)(1)(A) and (B)** – Under Subparagraph (A), any beginning of payment activity triggers the rule and sets the date as of when to apply the solvency tests. Under Subparagraph (B), the LLC’s complete acquisition of the rights is necessary to trigger the rule.

**Subsection (c)(2)** – This provision states the general rule for distributions in the form of debt which are not connected with a redemption.

**Subsection (c)(3)** – This provision states alternative rules for all distributions of money or property (*i.e.*, not debt). The measuring date depends on the length of time between the authorization and payment of the distribution.

**Subsection (d)** – *Compare* Subsection (d), *with* Section 5-404(d) (characterizing as a creditor a person who has become entitled to receive a distribution).

**Subsection (e)** – This subsection contains two rules pertaining to indebtedness issued as part of a distribution and the solvency tests of Subsection (a). The first sentence states the sensible rule that indebtedness that is essentially subordinated to the solvency requirement – *i.e.*, not payable if making payment would transgress that requirement – is not counted in determining liabilities for purposes of the solvency tests. The second sentence applies the solvency tests to each payment of principal and interest on any indebtedness issued as a distribution, in addition to any previous testing required by Subsection (c)(1)(A) or (c)(2).

EXAMPLE: An LLC and one of its members agree that the LLC will buy out the member's entire ownership interest in the LLC in return for a promissory note from the LLC, payable in installments. Under the redemption agreement, the member surrenders all its interests and rights on January 15 and the LLC signs and delivers the note to the person dissociated as a member on February 15. Under the note, payment of interest is due monthly beginning March 15, with a balloon payment of the principal due December 30.

Under Subsection (c)(1)(B), the solvency tests are applied as of January 15. Under Subsection (e), the solvency tests are again applied on the March 15, April 15, etc., and again on December 30.

**Subsection (f)** – The cited sections provide methods for extinguishing or limiting the debts of an LLC that is winding up its affairs and activities and thus any debt affected by any of the cited sections is irrelevant for purposes of solvency testing.

#### **SECTION 5-406. LIABILITY FOR IMPROPER DISTRIBUTIONS.**

(a) Except as otherwise provided in subsection (b), if a member of a member-managed limited liability company or manager of a manager-managed limited liability company consents to a distribution made in violation of Section 5-405 and in consenting to the distribution fails to comply with Section 5-409, the member or manager is personally liable to the company for the amount of the distribution which exceeds the amount that could have been distributed without the violation of Section 5-405.

(b) To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of the authority and responsibility to consent to distributions and imposes that authority and responsibility on one or more other members, the liability stated in subsection (a) applies to the other members and not the member that the operating agreement relieves of the authority and responsibility.

(c) A person that receives a distribution knowing that the distribution violated Section 5-405 is personally liable to the limited liability company but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 5-405.

(d) A person against which an action is commenced because the person is liable under subsection (a) may:

(1) implead any other person that is liable under subsection (a) and seek to enforce a right of contribution from the person; and

(2) implead any person that received a distribution in violation of subsection (c) and seek to enforce a right of contribution from the person in the amount the person received in violation of subsection (c).

(e) An action under this section is barred unless commenced not later than two years after the distribution.

### **Comment**

This section and Section 5-405 were derived essentially from MODEL BUS. CORP. ACT § 6.40. As with Section 5-405, this section is appropriate and necessary due to the liability shield of a limited liability company. The provisions of this section are non-waivable. Section 5-105(c)(15).

This section contemplates two categories of liability: liability of those who have authorized improper distributions, Subsection (a), and the liability of those who have received improper distributions, Subsection (c). Liability that has accrued under this section is not

affected by a person subsequently ceasing to be a member, manager or transferee.

The liability is to the LLC, not to the creditors of an insolvent LLC. *Weinstein v. Colborne Foodbotics, LLC*, 302 P.3d 263, 268 (2013); *Rev O, Inc. v. Woo*, 725 S.E.2d 45, 52 (N.C. Ct. App. 2012).

This section does not preclude or interfere with claims for fraudulent transfer. *See* the comment to Subsection (e).

**Subsection (a)** – The liability is not strict liability but rather attaches only to the extent a decision maker has failed to comply with the duties stated in Section 5-409. To the extent those duties have been permissibly revised by the operating agreement, the revised standards apply to this subsection. *See also* Section 5-405(b)(1) (permitting reasonable reliance on specified financial information).

**Subsection (b)** – *Compare* Subsection (b), *with* Section 5-105(d)(2) (generally permitting provisions of this type).

**Subsection (c)** – Actual knowledge is necessary to impose liability. Reason to know does not suffice. *Compare* Subsection (c), *with* Section 5-103(a)-(b).

**Subsections (c) and (d)(2)** – Liability could apply to a person who receives a distribution under a charging order, but only if the person meets the knowledge requirement. That situation is very unlikely unless the person with the charging order is also a member or manager.

**Subsection (e)** – When the distribution is in the form of indebtedness, the distribution may occur on several different dates. *See* the comment to Section 5-405(e).

This statute of limitations applies only to actions “under this section” and does not affect claims under other applicable law, which most often is fraudulent transfer law. For a different approach, see DEL. CODE ANN. tit. 6, § 17-607(c) (West 2013) (applying a 3-year statute of limitations to claims “under this chapter or other applicable law”); NY LTD. LIAB. CO. § 508(c) (McKinney 2013) (same). *But see, e.g., In re The Heritage Org., LLC*, 413 BR 438, 461 (Bankr. ND Tex. 2009) (invoking the Texas Uninform Fraudulent Act [TUFTA] to recover distributions made by a Delaware LLC headquartered in Texas; rejecting DEL. CODE ANN. tit. 6, § 18-607(c) on choice of law grounds; stating that “the Delaware legislature cannot limit the reach of TUFTA”).

#### **SECTION 5-407. MANAGEMENT OF LIMITED LIABILITY COMPANY.**

(a) A limited liability company is a member-managed limited liability company unless the operating agreement:

(1) expressly provides that:

- (A) the company is or will be “manager-managed”;
- (B) the company is or will be “managed by managers”; or
- (C) management of the company is or will be “vested in managers”; or

(2) includes words of similar import.

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

(1) Except as expressly provided in this [article], the management and conduct of the company are vested in the members.

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

(3) A difference arising among members as to a matter in the ordinary course of the activities and affairs of the company may be decided by a majority of the members.

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

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

(B) amend the operating agreement.

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

(1) Except as expressly provided in this [article], 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.

(d) An action requiring the vote or consent of members under this [Code] may be taken without a meeting, and a member may appoint a proxy or other agent to vote, consent, or otherwise act for the member by signing an appointing record, personally or by the member's agent.

(e) The dissolution of a limited liability company does not affect the applicability of this section. However, a person that wrongfully causes dissolution of the company loses the right to participate in management as a member and a manager.

(f) A limited liability company shall reimburse a member for an advance to the company beyond the amount of capital the member agreed to contribute.

(g) A payment or advance made by a member which gives rise to a limited liability company obligation under subsection (f) or Section 5-408(a) constitutes a loan to the company which accrues interest from the date of the payment or advance.

(h) A member is not entitled to remuneration for services performed for a member-managed limited liability company, except for reasonable compensation for services rendered in winding up the activities of the company.

### Comment

**Subsection (a)** – This subsection follows implicitly from the definitions of “manager-managed” and “member-managed” limited liability companies, Section 5-102(a)(6) and (a)(8), but is included here for the sake of clarity. Although this article has eliminated the link between management structure and statutory apparent authority, the article retains the manager-managed and member-managed constructs as options for members to use to structure their *inter se* relationship. *See also* the comments to Sections 5-301 (No Agency Power of Member as Member), and 5-409 (Standards of Conduct).

**Subsection (b)** – The subsection follows essentially the long-standing default paradigm for management rights of general partners. *See* UPA (1914) § 18; UPA (1997) (Last Amended 2013) § 401. The stated rules are subject to change by the operating agreement. Section 5-105.

In general, a member’s actual authority to act for an LLC will depend fundamentally on the operating agreement.

EXAMPLE: Rachael and Sam, who have known each other for years, decide to go into business arranging musical tours. They fill out and electronically sign a one page form available on the website of the filing office and become the organizers of MMT, LLC. They are the only members of the LLC, and their understanding of who will do what in managing the enterprise is based on several lengthy, late-night conversations that preceded the LLC’s formation. Sam is to “get the acts,” and Rachael is to manage the tour logistics. There is no written operating agreement.

In the terminology of this article, MMT, LLC is member-managed, Section 5-407(a), and the understanding reached in the late night conversations has become part of the LLC’s operating agreement, Section 5-102(a)(9). In the terminology of agency law, the operating agreement constitutes a manifestation by the LLC to Rachael and Sam concerning the scope of their respective authority to act on behalf of the LLC.

RESTATEMENT (THIRD) OF AGENCY § 2.01, cmt. c (2006) (explaining that a person’s actual authority depends first on some manifestation attributable to the principal and stating:

“[a]ctual authority is a consequence of a principal's expressive conduct toward an agent, through which the principal manifests assent to be affected by the agent's action, and the agent's reasonable understanding of the principal's manifestation”).

Circumstances outside the operating agreement can also be relevant to determining the scope of a member's actual authority.

EXAMPLE: Homeworks, LLC is a manager-managed LLC with three members. The LLC's written operating agreement:

- specifies in considerable detail the management responsibilities of Margaret, the LLC's manager-member, and also states that Margaret is responsible for “the day-to-day operations” of the company;
- puts Garrett, a non-manager member, in charge of the LLC's transportation department; and
- specifies no management role for Brooksley, the third member.

When the LLC's chief financial officer quits suddenly, Margaret asks Brooksley, a CPA, to “step in until we can hire a replacement.”

Under the operating agreement, Margaret's request to Brooksley is within Margaret's actual authority and is a manifestation attributable to the LLC. If Brooksley manifests assent to Margaret's request, Brooksley will have the actual authority to act as the LLC's chief financial officer.

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 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 5-407(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 5-407(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.

For an explanation of this result, see the comment to Section 5-407(c) which provides a detailed analysis in the context of a multi-manager LLC whose operating agreement is silent on the analogous question.

For a discussion of the apparent authority of a member to bind an LLC, see the comment to Section 5-301(b).

**Subsection (b)(4)** – This list is not exhaustive. Other approval rights appear in the



context of the provisions to which the rights apply. *E.g.*, Section 5-401(c)(3) (providing that “[a]fter formation of a limited liability company, a person becomes a member ... with the affirmative vote or consent of all the members”); Section 5-703(b)(1) requiring “the affirmative vote or consent of each member” to rescind dissolution); Sections 2-203, 2-303, 2-403, 2-503 (same with regard to Article 2 transactions).

**Subsection (c)** – Like Subsection (b), this subsection states default rules that, under Section 5-105, are subject to the operating agreement. For example, a limited liability company’s operating agreement might state “This company is manager-managed,” Sections 5-102(a)(6) and 5-407(a), while providing that managers must submit specified ordinary matters for review by the members.

The actual authority of an LLC’s manager or managers is a question of agency law and depends fundamentally on the contents of the operating agreement and any separate management contract between the LLC and its manager or managers. These agreements are the primary source of the manifestations of the LLC (as principal) from which a manager (as agent) will form the reasonable beliefs that delimit the scope of the manager’s actual authority. RESTATEMENT (THIRD) OF AGENCY § 3.01 (2006). *See also* RESTATEMENT (SECOND) OF AGENCY §§ 15, 26 (1958).

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. *See* the comment to Section 5-105(a)(4) (stating that the operating agreement governs “the means and conditions for amending the operating agreement”).

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 to Section 5-105(a)(2) (stating that the operating agreement governs “the rights and duties under this [Code] of a person in the capacity of manager”). *See also* RESTATEMENT (THIRD) OF AGENCY § 8.13, cmt. b (2006) and RESTATEMENT (SECOND) OF AGENCY § 432, cmt. b (1958) (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).

If: (i) an LLC’s operating agreement merely states that the LLC is manager-managed and does not further specify the managerial responsibilities; and (ii) the LLC has only one manager, the actual authority analysis is simple. In that situation, this subsection:

- serves as “gap filler” to the operating agreement; and thereby
- constitutes the LLC’s manifestation to the manager as to the scope of the manager’s authority; and thereby
- delimits the manager’s actual authority, subject to whatever subsequent

manifestations the LLC may make to the manager (*e.g.*, by a vote of the members, or an amendment of the operating agreement).

If the operating agreement states only that the LLC is manager-managed and the LLC has more than one manager, the question of actual authority has an additional aspect. It is necessary to determine what actual authority any one manager has to act alone.

Paragraphs (c)(1)-(3), combine to provide the answer. A single manager of a multi-manager LLC:

- has no actual authority to commit the LLC to any matter encompassed in Paragraph (c)(3) or for which the Code 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 Paragraph (c)(3) and other 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) 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. To the contrary, subject to the operating agreement Subsection (c)(2) expressly provides that “each manager has equal rights in the management and conduct of the company’s activities and affairs.”
- 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 unreasonableness 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”).

The common law of agency will also determine the apparent authority of an LLC’s manager or managers, and in that analysis what the particular third party knows or has reason to

know about the management structure and business practices of the particular LLC will always be relevant. RESTATEMENT (THIRD) OF AGENCY § 3.03, cmt. d (2006) (“The nature of an organization's business or activity is relevant to whether a third party could reasonably believe that a [manager] is authorized to commit the organization to a particular transaction.”).

As a general matter, absent countervailing facts, courts may see the position of manager as clothing its occupants with the apparent authority to take actions that reasonably appear within the ordinary course of the company's business. The actual authority analysis stated above supports that proposition; absent a reason to believe to the contrary, a third party could reasonably believe that a manager possesses the authority contemplated by the gap-fillers of this article. *But see* the comment to Section 5-102(a)(5) (stating that “confusion around the term ‘manager’ is common to almost all LLC statutes”).

**Subsection (c)(1)** – For limited liability companies that have more than one manager, this article provides that in most circumstances a “matter relating to the activities and affairs of the company is decided ... by a majority of the managers.” However, unlike corporate statutes, this article does not provide a rule for the quantum of participation necessary to constitute “a majority.” *Cf., e.g.,* MINN. STAT. § 302A.237 (2014) (providing rules for determining the votes need to constitute “an act of the board”). If a manager-managed LLC has more than one manager, the operating agreement should consider what “a majority” means in the event a manager position is vacant.

**Subsection (c)(3)** – This list is not exhaustive. *See* the comment to Subsection (b)(4).

**Subsection (c)(4)** – Under the default rule stated in this paragraph, dissolution of an entity that is a manager of an LLC does not end the entity's status as manager. Likewise, dissolution of entity that is a member does not cause the entity to dissociate. *See* Section 5-602(11) (providing that termination of such an entity causes dissociation).

An LLC does not cease to be “manager-managed” simply because no managers are in place. In that situation, absent additional facts, the LLC is manager-managed and the manager position is vacant. Non-manager members who exercise managerial functions during the vacancy (or at any other time) will have duties as determined by other law, most particularly the law of agency.

**Subsection (c)(6)** – For example, the obligation to safeguard trade secrets and other confidential or proprietary information learned when the person is a manager remains in force after the person ceases to be a manager.

**Subsection (d)** – In this context, the doctrine of *noscitur a sociis* limits the authorized extent of a proxy holder or other agent. (The doctrine of *noscitur a sociis* holds “that the meaning of an unclear word or phrase should be determined by the words immediately surrounding it.” BLACK'S LAW DICTIONARY (9th ed. 2009).

In particular, unless the operating agreement so provides, neither a proxy nor other agent may be used to circumvent the transfer restrictions that are fundamental to the law of limited liability companies. *See* Article 5 and RESTATEMENT (SECOND) OF CONTRACTS § 318(2) (1981) (stating that “a promise requires performance by a particular person ... to the extent that the obligee has a substantial interest in having that person perform or control the acts promised”).

**Subsection (e), second sentence** – The default rules of this article do not contemplate a person wrongfully causing dissolution, as distinguished from wrongfully dissociating. *Compare* Section 5-701, *with* Section 5-601(b). However, the operating agreement might contemplate wrongful dissolution, and then the second sentence of this subsection would apply unless the operating agreement provided otherwise.

**Subsection (h)** – This provision traces back to the UPA (1914) § 18(f) and is included to avoid its absence being misinterpreted as implying a contrary rule.

This article does not provide for remuneration to a manager of a manager-managed LLC. That issue is for the operating agreement, or a separate agreement between the LLC and the manager. A manager may also have a common law right to compensation. RESTATEMENT (THIRD) AGENCY § 8.13, cmt. d (2006) (“Unless an agreement between a principal and an agent indicates otherwise, a principal has a duty to pay compensation to an agent for services that the agent provides.”).

#### **SECTION 5-408. REIMBURSEMENT; INDEMNIFICATION; ADVANCEMENT; AND INSURANCE.**

(a) A limited liability company shall reimburse a member of a member-managed company or the manager of a manager-managed company for any payment made by the member or manager in the course of the member’s or manager’s activities on behalf of the company, if the member or manager complied with Sections 5-405, 5-407, and 5-409 in making the payment.

(b) A limited liability company shall indemnify and hold harmless a person with respect to any claim or demand against the person and any debt, obligation, or other liability incurred by the person by reason of the person’s former or present capacity as a member or manager, if the claim, demand, debt, obligation, or other liability does not arise from the person’s breach of Section 5-405, 5-407, or 5-409.

(c) In the ordinary course of its activities and affairs, a limited liability company may

advance reasonable expenses, including attorney's fees and costs, incurred by a person in connection with a claim or demand against the person by reason of the person's former or present capacity as a member or manager, if the person promises to repay the company if the person ultimately is determined not to be entitled to be indemnified under subsection (b).

(d) A limited liability company may purchase and maintain insurance on behalf of a member or manager against liability asserted against or incurred by the member or manager in that capacity or arising from that status even if, under Section 5-105(c)(7), the operating agreement could not eliminate or limit the person's liability to the company for the conduct giving rise to the liability.

### **Comment**

**Subsections (a) and (b)** – A limited liability company's obligation, if any, to reimburse or indemnify others (*e.g.*, employees, independent contractors, other agents) is a question for other law, including the law of agency, contract and restitution. The fact a person has dissociated as a member or ceased to be a manager does not affect any obligations incurred by the limited liability company under these subsections for conduct occurring before the dissociation or cessation.

**Subsection (a)** – The reimbursement obligation stated here is a default rule and roughly parallels a rule of agency law. RESTATEMENT (THIRD) OF AGENCY § 8.14(2)(a) (2006) (stating that “[a] principal has a duty to indemnify an agent ... when the agent makes a payment (i) within the scope of the agent's actual authority, or (ii) that is beneficial to the principal, unless the agent acts officiously in making the payment”).

This subsection applies only to managers of manager-managed limited liability companies and members of member-managed companies. The definite article in the phrase “the member or manager” and “the member's” refers back to the original phrase: “A limited liability company shall reimburse a member of a member-managed company or the manager of a manager-managed company ....”

A limited liability company's obligation, if any, to reimburse others (including LLC employees and non-managing members of a manager-managed LLC) is a question for other law, including the law of agency and restitution. The fact a person has ceased to be a member of a member-managed LLC or a manager of a manager-managed LLC does not affect any obligations incurred by the LLC under this subsection for payments made before the cessation.

To the extent an operating agreement modifies or displaces the default rules stated in Sections 5-407 and 5-409, the agreement should also address this section. For example, if the operating agreement establishes a duty of ordinary care (modifying Section 5-409(c)), the agreement should specify which level of care is necessary to satisfy this subsection. It is not necessary that the levels of care be the same, only that the operating agreement make the situation clear and thereby avoid difficult issues of interpretation.

**Subsection (b)** – This subsection provides for indemnification but only as a default rule. Subject only to Section 5-105(c)(7), the operating agreement can relax these preconditions substantially. The agreement can also impose stricter preconditions.

The rule's eligibility requirements correspond to the default rules on management duties, which is appropriate because otherwise the statutory default rule on indemnification could undercut or even vitiate the statutory default rules on duty. To the extent an operating agreement modifies or displaces the default rules stated in Sections 5-405, 5-407, or 5-409, the agreement should also address this section. *See* the comment to Subsection (a).

Although referring broadly to any “person,” this subsection is actually limited to present and former members or managers. The indemnification obligation applies only to a “debt, obligation, or other liability incurred by the person by reason of the person’s former or present capacity as a member or manager.” Thus, by its terms this subsection does not apply to a person in the capacity of an “officer,” unless being an officer constitutes being a manager. For a discussion of the vagaries of the term “manager,” see the comment to Section 5-102(a)(5).

Of course, the operating agreement may mandate indemnification to officers, employees, and other persons providing services to or acting for the limited liability company. Within the limitations stated in Section 5-105(c)(7), the operating agreement may obligate an LLC to indemnify a person even when the person has breached a managerial duty or the operating agreement itself.

**Subsection (c)** – This subsection authorizes but does not require a limited liability company to provide advances to cover expenses. *Cf. Majkowski v. American Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 589 (Del. Ch. 2006) (“Because rights to indemnification and advancement differ in important ways, our courts have refused to recognize claims for advancement not granted in specific language clearly suggesting such rights.”). The phrase “hold harmless” likewise does not encompass advances. *Id.* The authorization applies only to those persons eligible for indemnification under Subsection (b), but the operating agreement certainly can authorize a broader scope and also make advances obligatory.

The reference to “ordinary course” pertains to Section 5-407(b)(3) (stating that any “difference arising among members [in a member-managed LLC] as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members”). As for a manager-managed LLC, see Section 5-407(c)(1) (“Except as expressly provided in this [Code],

any matter relating to the activities and affairs of the [manager-managed] company is decided exclusively by the manager, or, if there is more than one manager, by a majority of the managers.”) (emphasis added).

**Subsection (d)** – This subsection’s language is very broad and authorizes an LLC to purchase insurance to cover, *e.g.*, a manager’s intentional misconduct. It is unlikely that such insurance would be available. In contrast to Subsection (a), this subsection encompasses all members, not just members in a member-managed LLC. This authorization comes from this article, not the operating agreement, and therefore is not subject to Section 5-105(c)(7).

## **SECTION 5-409. STANDARDS OF CONDUCT FOR MEMBERS AND MANAGERS.**

(a) A member of a member-managed limited liability company owes to the company and, subject to Section 5-801, the other members the duties of loyalty and care stated in subsections (b) and (c).

(b) The fiduciary duty of loyalty of a member in a member-managed limited liability company 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 and affairs;

(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.

(c) 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.

(d) A member shall discharge the duties and obligations under this [Code] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.

(e) A member does not violate a duty or obligation under this [Code] or under the operating agreement solely because the member's conduct furthers the member's own interest.

(f) All the members of a member-managed limited liability company or a manager-managed limited liability company may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

(g) It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the limited liability company.

(h) If, as permitted by subsection (f) or (i)(6) or the operating agreement, a member enters into a transaction with the limited liability company which otherwise would be prohibited by subsection (b)(2), the member's rights and obligations arising from the transaction are the same as those of a person that is not a member.

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

(1) Subsections (a), (b), (c), and (g) apply to the manager or managers and not the members.

(2) The duty stated under subsection (b)(3) continues until winding up is completed.

(3) Subsection (d) applies to managers and members.



(4) Subsection (e) applies only to members.

(5) The power to ratify under subsection (f) applies only to the members.

(6) Subject to subsection (d), a member does not have any duty to the company or to any other member solely by reason of being a member.

### Comment

This section states some of the core aspects of the fiduciary duty of loyalty, provides a duty of care, and incorporates the contractual obligation of good faith and fair dealing. The section follows the structure of many LLC acts, first stating the duties of members in a member-managed limited liability company and then using that statement and a “switching” mechanism, Subsection (i), to allocate duties in a manager-managed company. The duties stated in this section are subject to the operating agreement, but Section 5-105(c) and (d) contain important limitations on the power of the operating agreement to affect fiduciary and other duties and the obligation of good faith and fair dealing.

For the effect of dissociation on a person’s duties under this section, see Section 5-603(a)(2).

**Subsection (a)** – This subsection recognizes two core managerial duties but, unlike some earlier uniform acts, does not purport to state all managerial duties. Indeed, many cases characterize a manager’s duty to disclose as a fiduciary duty. *E.g.*, *Salm v. Feldstein*, 20 A.D.3d 469, 470, 799 N.Y.S.2d 104, 105 (N.Y. App. Div. 2005) (stating that, “[a]s the managing member of the [limited liability] company and as a co-member with the plaintiff, the defendant owed the plaintiff a fiduciary duty to make full disclosure of all material facts”); *Metro Commc’n Corp. BVI v. Advanced Mobilecomm Technologies Inc.*, 854 A.2d 121, 156 n. 78 (Del. Ch. 2004) (referring to “certain standards governing the disclosure-related duties of the fiduciaries of Delaware business entities;” noting that “[t]hese standards have been mostly articulated in the corporate context but the corporate standards often serve as the default rule in the alternative entity context”).

**Subsection (b)** – This subsection states three core aspects of the fiduciary duty of loyalty: (i) not “usurping” company opportunities or otherwise wrongly benefiting from the company’s operations or property; (ii) avoiding conflict of interests in dealing with the company (whether directly or on behalf of another); and (iii) refraining from competing with the company. Essentially the same duties exist in agency law and under the law of all types of business organizations.

The subsection applies beginning with “the conduct of the company’s activities and affairs,” which by definition cannot exist before the company exists; thus the stated duties do not

apply to pre-formation activities. In some circumstances, comparable duties might arise from other law, particular the law of agency. *See, e.g.*, Section 5-401(a) and (b) (stating that the organizer acts “on behalf of others”).

The stated duties comprise a default rule. Under Section 5-105(d)(3)(A): “If not manifestly unreasonable, the operating agreement may ... alter or eliminate the aspects of the duty of loyalty stated in Section 5-409(b).”

**Subsection (b)(1)** – The phrase “hold as trustee” dates back to UPA (1914) § 21 and reflects the availability of disgorgement remedies, such as a constructive trust. In contrast to an actual trustee, a person subject to this duty does not: (i) face the special obstacles to consent characteristic of trust law; or (ii) enjoy protection for decisions taken in reliance on the governing instrument and other sources of information. *Cf.* Section 8-506 (“A trustee [of a statutory trust] ... is not liable to the trust or to a beneficial owner for breach of any duty, *including a fiduciary duty*, to the extent the breach results from reasonable reliance on: (i) a term of the governing instrument; (ii) a record of the statutory trust; or (iii) an opinion, report, or statement of another person that the person to which the opinion, report, or statement is made or delivered reasonably believes is within the other person’s professional or expert competence and is made or delivered to the trustee ... .”) (emphasis added).

**Subsection (b)(1)(A)** – This provision is consistent with a basic principle of agency law – namely, that an agent may not benefit at all from the performance of the agency unless the principal consents. RESTATEMENT (THIRD) OF AGENCY § 8.06, cmt. c (2006). Typically, however, the operating agreement will legitimize particular benefits – *e.g.*, a management fee paid to a managing member in addition to that member’s share of distributions. Also, an agreed allocation of distributions takes those benefits outside the reach of this provision.

**Subsection (b)(1)(B)** – For the expansive meaning of “property,” see Section 1-102(38). The term includes confidential information.

**Subsection (b)(1)(C)** – This article does not specify what constitutes “a company opportunity,” but ample case law exists. *See, e.g., Ebenezer United Methodist Church v. Riverwalk Development Phase, II, LLC*, 45 A.3d 883, 887 (Md. App. 2012) (discussing the “interest or reasonable expectancy test”); *In re McCook Metals, L.L.C.*, 319 B.R. 570, 596 (Bkrcty. N.D.Ill. 2005) (discussing the “line of business test”).

This duty continues through winding up, although in that context the scope of company opportunities inevitably narrows.

In most, if not all, situations, usurping a company opportunity also breaches the duty not to compete, Paragraph (b)(3), but not *vice versa*.

**Subsection (b)(2)** – In this context, the phrase “adverse interest” is a term of art, meaning

“to be on the other side of the table” in some dealing with the limited liability company. Absent informed consent by the LLC, this duty is breached by the mere existence of the conflict of interest; the LLC need not prove that the outcome of the dealing was adverse to the LLC. *But see* Subsection (g) (permitting the defense of fairness). This duty continues through winding up.

**Subsection (b)(3)** – Although competition is often thought of in terms of potential customers, this duty applies equally to competition for resources, including employees. The duty not to compete continues longer in a manager-managed LLC. *See* Subsection (i)(2).

**Subsection (c)** – ULLCA (2006) §409(c) stated a different rule: “Subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company’s activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company.” As part of the Harmonization Project, the ULLCA duty of care was conformed to the duty of care stated in ULPA (2001) and UPA (1997).

Neither this article nor the two harmonized partnership acts refer to the duty of care as a fiduciary duty, because: (i) the duty of care applies in many non-fiduciary situations; and (ii) breach of the duty of care is remediable only in damages while breach of a fiduciary duty gives rise also to equitable remedies, including disgorgement, constructive trust, and rescission. *See* ULPA (2001) (Last Amended 2013) § 409(c) and UPA (1997) (Last Amended 2013) § 409(c).

The change in label is consistent with the RESTATEMENT (THIRD) OF AGENCY § 8.02 (2006), which refers to the agent’s “fiduciary duty to act loyally, but eschews the word “fiduciary” when stating the agent’s duties of “care, competence, and diligence.” *Id.* § 8.08. However, the change in label is merely semantics; no change in the law is intended.

The operating agreement can raise the standard of care, or subject to Section 5-105(c)(7) and (d)(3)(C), lower it. A person’s practical exposure for breaching the duty of care involves not only the standard of care but also any operating agreement provision that: (i) exonerates the person from liability for breach of the duty of care, Section 5-105(c)(7); or (ii) entitles the person to indemnification despite such breach, comment to Section 5-408(b).

**Subsection (d)** – This subsection refers to the “*contractual* obligation of good faith and fair dealing” (emphasis added) and thereby invokes the implied obligation that exists in every contract. *See* RESTATEMENT (SECOND) CONTRACTS § 205 (1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”). The adjective (“contractual”) should help avoid decisions like *Phelps v. Frampton*, 2007 MT 263, 339 Mont. 330, 342-43, 170 P.3d 474, 483 (2007) (holding that Montana’s version of UPA (1997) creates a statutory obligation of good faith and fair dealing separate from the implied contractual covenant).

At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights – *i.e.*, duties and rights “under this [Code].” However, for the most part those duties and rights apply to relationships *inter se* the members and the LLC and function only to the extent not displaced by the operating agreement. These statutory default rules are intended in essence to function like a contract; applying the contractual notion of good faith and fair dealing therefore makes sense.

The contractual obligation of “good faith” has nothing to do with 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.” DEL. CODE ANN. tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty. *See Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006).

Likewise, the contractual obligation of good faith and fair dealing has nothing to do with the “utmost good faith” sometimes used to describe the fiduciary duties that owners of closely held businesses owe each other. *See, e.g., Meinhard v. Salmon*, 249 N.Y. 458, 477, 164 N.E. 545, 551 (1928) (“[W]here parties engage in a joint enterprise each owes to the other the duty of the utmost good faith in all that relates to their common venture. Within its scope they stand in a fiduciary relationship.”); *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975) (“[S]tockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise<sup>1</sup> 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 omitted) (citations omitted) (internal quotations omitted)).

To the contrary, the contractual obligation of good faith and fair dealing is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a member from acting in the member’s own self-interest:

“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.

*Gerber v. Enter. Products Holdings, LLC*, 67 A.3d 400, 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*). *See also* Subsection (e).

Courts should not use the contractual obligation to change *ex post facto* the parties' or this article's allocation of risk and power. To the contrary, 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.

The operating agreement or this article may grant discretion to a member or manager, and the contractual obligation of good faith and fair dealing is especially salient when discretion is at issue. However, a member or manager may properly exercise discretion even though another member suffers as a consequence. Conduct does not violate the obligation of good faith and fair dealing merely because that conduct substantially prejudices a party. Indeed, parties allocate risk precisely because prejudice may occur.

The exercise of discretion constitutes a breach of the obligation of good faith and fair dealing only when the party claiming breach shows that the conduct has no honestly-held purpose that legitimately comports with the parties' agreed-upon arrangements:

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.*

*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*).

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.

As to the power of the operating agreement to affect the contractual obligation of good faith and fair dealing, see Section 5-105(c)(6) (prohibiting elimination but allowing the agreement to “prescribe standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured”). For examples, see Section 5-105(c)(6), comment. As to whether the obligation stated in this subsection applies to transferees, see the comment to Section 5-107(b).

**Subsection (e)** – A member in a member-managed LLC has at least two different roles:

(i) as a party to the operating agreement, with rights and obligations under that agreement; and (ii) as manager or co-manager of the enterprise. This provision pertains to the first role. A member's exercise of rights under the operating agreement is subject to the obligation of good faith and fair dealing, Subsection (d), but a person does not breach that contractual obligation "solely because the [person's exercise of rights] furthers the [person's] own interest." In contrast, this provision is ineffective with regard to a member's duties as manager or co-manager. For example, a member's liability under Section 5-409(b)(3) (prohibiting competition) is not "solely because the member's conduct furthers the member's own interest." Rather, the liability results from the breach of a specific obligation – *i.e.*, the codified aspect of the duty of loyalty that prohibits competition.

With regard to a manager-managed LLC: (i) the same analysis applies to a member that is a manager; and (ii) with regard to a non-managing member the analysis as to contractual rights applies and the analysis as to managerial duties is inapposite.

**Subsection (f)** – Here and elsewhere in this article, information "is material if there is a substantial likelihood that a reasonable [decision maker] would consider it important in deciding how to vote" or take other action under this Code or the operating agreement. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132 (1976).

The operating agreement can provide additional or different methods of authorization or ratification, subject to the strictures of Section 5-105(c)(5), (d)(1), and (d)(3)(A)(B) and (D).

**Subsection (g)** – This subsection codifies judge-made law applicable to all business entities. *See, e.g., Gottsacker v. Monnier*, 281 Wis. 2d 361, 379, 697 N.W.2d 436, 444 (Wisc. 2005) (referring to "a willful failure to deal fairly with the LLC or its other members"); *Loneragan v. EPE Holdings, LLC*, 5 A.3d 1008, 1019 (Del. Ch. 2010) (discussing "entire fairness" in the context of a limited partnership"); *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1116 (Del. 1994) (discussing "entire fairness" in the context of a corporation's merger with an affiliate); *Loneragan v. EPE Holdings, LLC*, 5 A.3d 1008, 1019 (Del. Ch. 2010) (discussing "entire fairness" in the context of a limited partnership").

**Subsection (h)** – This subsection is the modern, reformulated version of a language that sought to overturn the now-defunct notion that debts to owners were categorically inferior to debts to non-owner creditors. *See, e.g., ULP*A (2001) § 112 ("A partner may lend money to and transact other business with the limited partnership and has the same rights and obligations with respect to the loan or other transaction as a person that is not a partner."). The reformulation makes clear that this provision has nothing to do with the fiduciary duty pertaining to conflict of interests. *See BT-I v. Equitable Life Assurance Soc'y of the United States*, 75 Cal. App. 4th 1406, 1415, 89 Cal. Rptr. 2d 811 (1999) (examining the prior formulation, explaining its history and stating "[w]e cannot discern anything in the purpose of [the prior formulation] that suggests an intent to affect a general partner's fiduciary duty to limited partners").

This subsection states a default rule. The operating agreement may provide that debt to a member (or members generally) is subordinate to other limited liability company obligations. The agreement that creates the debt may do likewise.

**Subsection (i)** – This is the “switching” mechanism, referred to in the introduction to this comment. The list does not include Subsection (h).

**Subsection (i)(1)** – This provision switches most managerial duties to the managers and away from members. Of course, if a member is a manager, the duties apply to the member-manager in the person’s capacity of manager.

**Subsection (i)(2)** – On the assumption that the members of a manager-managed LLC are dependent on the manager, this paragraph extends the duty not to compete longer than in a member-managed LLC.

**Subsection (i)(3)** – The contractual obligation of good faith and fair dealing applies to members regardless of whether they are managers; non-managing members have rights and perhaps duties under the operating agreement and under this article. As to non-member managers, the operating agreement (and the corresponding obligation of good faith and fair dealing) are relevant regardless of whether the manager is party to the agreement. *See* Section 5-105(a)(2) (stating that the operating agreement “governs ... the rights and duties under this [Code] of a person in the capacity of manager”). Also, non-member managers will have rights and obligations under this article, which per Subsection (d) are also subject to the obligation of good faith and fair dealing.

**Subsection (i)(4)** – As explained in the comment to Subsection (e), that provision does not apply to the managerial function.

**Subsection (i)(5)** – The power to ratify belongs to the entity’s owners; thus Subsection (f) does not switch from members to managers.

**Subsection (i)(6)** – This paragraph merely negates a claim of fiduciary duty that is exclusively status-based and does not immunize misconduct.

**EXAMPLE:** Although a limited liability company is manager-managed, one member who is not a manager owns a controlling interest and effectively, albeit indirectly, controls the company’s activities. A member owning a minority interest brings an action for dissolution under Section 5-701(a)(4)(C)(ii) (oppression by “the managers or those members in control of the company”). This paragraph does not prevent the court from construing the claim as alleging a breach of fiduciary duty by the controlling member.

**SECTION 5-410. RIGHTS TO INFORMATION OF MEMBER, MANAGER,  
AND PERSON DISSOCIATED AS MEMBER.**

(a) In a member-managed limited liability company, the following rules apply:

(1) On reasonable notice, a member may inspect and copy during regular business hours, at a reasonable location specified by the company, any record maintained by the company regarding the company's activities, affairs, financial condition, and other circumstances, to the extent the information is material to the member's rights and duties under the operating agreement or this [Code].

(2) The company shall furnish to each member:

(A) without demand, any information concerning the company's activities, affairs, financial condition, and other circumstances which the company knows and is material to the proper exercise of the member's rights and duties under the operating agreement or this [Code], except to the extent the company can establish that it reasonably believes the member already knows the information; and

(B) on demand, any other information concerning the company's activities, affairs, financial condition, and other circumstances, except to the extent the demand for the information demanded is unreasonable or otherwise improper under the circumstances.

(3) The duty to furnish information under paragraph (2) also applies to each member to the extent the member knows any of the information described in paragraph (2).

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

(1) The informational rights stated in subsection (a) and the duty stated in subsection (a)(3) apply to the managers and not the members.

(2) During regular business hours and at a reasonable location specified by the



company, a member may inspect and copy information regarding the activities, affairs, financial condition, and other circumstances of the company as is just and reasonable if:

(A) the member seeks the information for a purpose reasonably related to the member's interest as a member;

(B) the member makes a demand in a record received by the company, describing with reasonable particularity the information sought and the purpose for seeking the information; and

(C) the information sought is directly connected to the member's purpose.

(3) Not later than 10 days after receiving a demand pursuant to paragraph (2)(B), the company shall inform in a record the member that made the demand of:

(A) what information the company will provide in response to the demand and when and where the company will provide the information; and

(B) the company's reasons for declining, if the company declines to provide any demanded information.

(4) Whenever this [Code] or an operating agreement provides for a member to vote on or give or withhold consent to a matter, before the vote is cast or consent is given or withheld, the company shall, without demand, provide the member with all information that is known to the company and is material to the member's decision.

(c) Subject to subsection (h), on 10 days' demand made in a record received by a limited liability company, a person dissociated as a member may have access to the information to which the person was entitled while a member if:

(1) the information pertains to the period during which the person was a member;

(2) the person seeks the information in good faith; and

(3) the person satisfies the requirements imposed on a member by subsection (b)(2).

(d) A limited liability company shall respond to a demand made pursuant to subsection (c) in the manner provided in subsection (b)(3).

(e) A limited liability company may charge a person that makes a demand under this section the reasonable costs of copying, limited to the costs of labor and material.

(f) A member or person dissociated as a member may exercise the rights under this section through an agent or, in the case of an individual under legal disability, a legal representative. Any restriction or condition imposed by the operating agreement or under subsection (h) applies both to the agent or legal representative and to the member or person dissociated as a member.

(g) Subject to Section 5-504, the rights under this section do not extend to a person as transferee.

(h) In addition to any restriction or condition stated in its operating agreement, a limited liability company, as a matter within the ordinary course of its activities and affairs, may impose reasonable restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient. In a dispute concerning the reasonableness of a restriction under this subsection, the company has the burden of proving reasonableness.

### **Comment**

This section is derived from the Uniform Limited Partnership Act (2001) §§ 304 (rights to information of limited partners and former limited partners) and 407 (rights to information of general partners and former general partners). The rules stated here are what might be termed “quasi-default rules” – subject to some change by the operating agreement. *See* Section 5-105(c)(8) (prohibiting unreasonable restrictions on the information rights stated in this section).

Although the rights and duties stated in this section are extensive, they are not necessarily all-inclusive. This article's statement of fiduciary duties is not exhaustive, *see* the comment to Section 5-409(a), and some cases characterize owners' information rights as reflecting a fiduciary duty of those with management power. *E.g.*, *Bakerman v. Sidney Frank Importing Co., Inc.*, No. Civ.A. 1844–N, 2006 WL 3927242 at \*14 (Del. Ch. Oct. 16, 2006) (holding that an LLC manager owed “certain duties to members of the LLC” and stating that “[w]hen fiduciaries communicate with their beneficiaries in the context of asking the beneficiary to make a discretionary decision—such as whether to consent to a sale of substantially all the assets of an LLC—the fiduciary has a duty to disclose all material facts bearing on the decision at issue”) (citing *Loudon v. Archer–Daniels–Midland Co.*, 700 A.2d 135, 137 (Del.1997)). Also, the rights stated in this section are in addition to whatever discovery rights a party has in a civil suit.

**Subsection (a)** – Paragraph 1 states the rule pertaining to information memorialized in “any record maintained by the company.” Paragraph 2 applies to information not in such a record. Appropriately, Paragraph (2) sets a more demanding standard for those seeking such information.

**Subsection (a)(2) and (3)** – In appropriate circumstances, violation of either or both of these provisions might cause a court to enjoin or even rescind action taken by the LLC, especially when the violation has interfered with an approval or veto mechanism involving member consent. *E.g.*, *Blue Chip Emerald LLC v. Allied Partners Inc.*, 299 A.D.2d 278, 279-80 (N.Y. App. Div. 2002) (invoking partnership law precedent as reflecting a duty of full disclosure and holding that “[a]bsent such full disclosure, the transaction is voidable”).

**Subsection (a)(2)** – This paragraph imposes a duty on the limited liability company, not the members who manage the LLC. However, a member could be liable in damages if the member were to: (i) breach a duty under Section 5-409 or the operating agreement; and (ii) in doing so cause or suffer the LLC to breach the duty stated in this paragraph.

**Subsection (a)(2)(A)** – For the meaning of “material” as applied to information, see the comment to Section 5-409(f).

**Subsection (a)(3)** – This paragraph imposes a duty directly on each member. Therefore, a member's violation of this paragraph is actionable in damages without need to show a violation of a duty stated in Section 5-409.

**Subsection (b)(1)** – This is a switching provision. The comments to Paragraph (a)(2) and (3) apply here by analogy.

**Subsection (b)(2)** – This paragraph refers to “information” rather than “records maintained by the company” so in some circumstances the company might have an obligation to memorialize information. *Compare* Subsection (b)(2), *with* Subsection (a). Such circumstances will likely be rare or at least unusual. This section generally concerns providing existing information, not creating it. In any event, a member does not trigger the company's obligation

under this paragraph merely by satisfying Subparagraphs (A) through (C). The member must also satisfy the “just and reasonable” requirement.

**Subsection (b)(4)** – For the meaning of “material” as applied to information, see the comment to Section 5-409(f).

**Subsection (c)** – When a member dies, Section 5-504 provides information rights to the legal representative of the deceased member.

**Subsection (c)(1)** – A person dissociated as a member has information rights in that capacity only as to the period during which the person was a member. To the extent that further information is accessible under Section 5-504(2) (providing access to the legal representative of a deceased partner), that access is limited both in purpose (“for purposes of settling the estate”) and in scope (“the rights the deceased partner had under Section 5-410”).

**Subsection (f)** – Some old cases involved conflicts over whether a shareholder could exercise inspection rights through another person. *White v. Coeur D'Alene Big Creek Mining Co.*, 55 P.2d 720, 723 (Idaho 1936) (stating that “[t]he refusal to permit respondent [shareholder] to appoint his own attorney or agent to make the examination [of the corporation’s books] was in effect a denial of his right” of inspection); *State v. Monida & Yellowstone Stage Co.*, 124 N.W. 971, 972 (Minn. 1910) (upholding a trial court’s mandamus order, “which shall provide that [the shareholder complainant], or such attorney or agent as he may select, ... shall be allowed to inspect the books, records, and papers of the defendant [corporation]”). In light of that history, for the avoidance of doubt, this subsection expressly authorizes taking action through an agent. No negative inference should be drawn about using agents to take other action under this article.

**Subsection (h)** – This provision provides fallback protection for gaps in the operating agreement. For example, those managing an LLC may protect trade secrets from disclosure prohibit various misuses of confidential information even if the operating agreement omits to do so.

The reference to “ordinary course” pertains to Section 5-407(b)(3) (stating that any “difference arising among members [in a member-managed LLC] as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members”). As for a manager-managed LLC, see Section 5-407(c)(1) (“Except as expressly provided in this [article], *any* matter relating to the activities and affairs of the [manager-managed] company is decided exclusively by the manager, or, if there is more than one manager, by a majority of the managers.”) (emphasis added). This approach is necessary, lest a requesting member (or manager-member) have the power to block imposition of a reasonable restriction or condition needed to prevent the requestor from abusing the LLC.

The burden of persuasion under this subsection contrasts with the burden of persuasion under Section 5-105(c)(8) (prohibiting unreasonable limitations on the information rights provided by this section). Under that subsection, as a matter of ordinary procedural law the burden is on the person making the claim.

## [PART] 5

### TRANSFERABLE INTERESTS AND RIGHTS OF TRANSFEREES AND CREDITORS

**SECTION 5-501. NATURE OF TRANSFERABLE INTEREST.** A transferable interest is personal property.

#### Comment

For the definition of transferable interest, see Section 5-102(a)(11). Absent a contrary provision in the operating agreement or the consent of the members, a “transferable interest” is the only interest in an LLC which can be transferred to a person who is not already a member. *See* Section 5-502. As to whether a member may transfer governance rights to a fellow member, the question is moot absent a provision in the operating agreement changing the default rule, *see* Section 5-407(b)(2) (allocating governance rights *per capita*). In the default mode, a member’s transfer of governance rights to another member: (i) does not increase the transferee’s governance rights; (ii) eliminates the transferor’s governance rights; and (iii) thereby changes that denominator but not the numerator in calculating governance rights.

**EXAMPLE:** LCN Company, LLC is a member-managed limited liability company with three members, Laura, Charles, and Nora. The operating agreement does not displace this act’s default rule on the allocation of governance rights among members. Thus, each member has 1/3 of those rights. Laura transfers her entire ownership interest to Charles. The transfer does not increase Charles’s governance rights but does eliminate Laura’s. After the transfer, Laura has no governance rights (regardless of whether Charles and Nora agree to expel Laura under Section 5-602(5)(B)). As a result, Charles and Nora each have 1/2 of the governance rights.

Whether a transferable interest pledged as security is governed by Article 8 or 9 of the Uniform Commercial Code depends on the rules stated in those articles.

#### **SECTION 5-502. TRANSFER OF TRANSFERABLE INTEREST.**

(a) Subject to Section 5-503(f), a transfer, in whole or in part, of a transferable interest:

(1) is permissible;

(2) does not by itself cause a person’s dissociation as a member or a dissolution and winding up of the limited liability company’s activities and affairs; and

(3) subject to Section 5-504, does not entitle the transferee to:

(A) participate in the management or conduct of the company’s activities

and affairs; or

(B) except as otherwise provided in subsection (c), have access to records or other information concerning the company's activities and affairs.

(b) A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled.

(c) In a dissolution and winding up of a limited liability company, a transferee is entitled to an account of the company's transactions only from the date of dissolution.

(d) A transferable interest may be evidenced by a certificate of the interest issued by a limited liability company in a record, and, subject to this section, the interest represented by the certificate may be transferred by a transfer of the certificate.

(e) A limited liability company need not give effect to a transferee's rights under this section until the company knows or has notice of the transfer.

(f) A transfer of a transferable interest in violation of a restriction on transfer contained in the operating agreement is ineffective if the intended transferee has knowledge or notice of the restriction at the time of transfer.

(g) Except as otherwise provided in Section 5-602(5)(B), if a member transfers a transferable interest, the transferor retains the rights of a member other than the transferable interest transferred and retains all the duties and obligations of a member.

(h) If a member transfers a transferable interest to a person that becomes a member with respect to the transferred interest, the transferee is liable for the member's obligations under Sections 5-403 and 5-406 known to the transferee when the transferee becomes a member.

### **Comment**

One of the most fundamental characteristics of LLC law is its fidelity to the "pick your partner" principle. *See, e.g., Bynum v. Frisby*, 73 Nev. 145, 149-50, 311 P.2d 972, 975 (1957)

(stating that (i) “the assignment of a partnership interest from one partner to a stranger does not bring that stranger into fiduciary relationship with the remaining partners” and (ii) absent consent by the remaining partners “[t]he stranger remains a stranger” with no rights to management or even information).

This section is the core of this article’s provisions reflecting and protecting that principle. A member’s rights in a limited liability company are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the operating agreement otherwise provides, a member acting without the consent of all other members lacks both the power and the right to: (i) bestow membership on a non-member, Section 5-401(d); or (ii) transfer to a non-member anything other than some or all of the member’s transferable interest, Section 5-502(a)(3). The rights of a mere transferee are quite limited – *i.e.*, to receive distributions, Section 5-502(b), and, if the LLC dissolves and winds up, to receive specified information pertaining to the LLC from the date of dissolution. Section 5-502(c).

This section applies regardless of whether the transferor is a member, a transferee of a member, a transferee of a transferee, etc. *See* Section 5-102(a)(11) (defining “transferable interest” in terms of a right “initially owned by a person in the person’s capacity as a member” regardless of “whether or not the person remains a member or continues to own any part of the right”).

This section does not directly consider whether a member may transfer governance rights to another member without obtaining consent from all the other members. As noted above in the comment to Section 5-501, the question is moot under this article’s default rule for allocating governance rights.

However, the question can be pivotal when the operating agreement displaces the default rule on governance rights but does not determine whether transfer restrictions (whether contractual, statutory, or both) apply to transfers of governance rights from one member to another. Case law is scant but suggests that this article does not protect members from control shifts that result from transfers among members (as distinguished from transfers to non-members who seek thereby to become members). *Blythe v. Bell*, No. 11 CVS 933. 2012 WL 7807800, at ¶ 6 (N.C. Dist. Dec. 10, 2012) (holding in a case of “first impression in North Carolina” that “in the absence of articles of incorporation or an operating agreement to the contrary . . . the assignment of control (*i.e.*, governance) interests between members is effective without unanimous member consent;” *Achaian, Inc. v. Leemon Family L.L.C.*, 25 A.3d 800, 810 (Del. Ch. 2011) (Strine, Ch.) (holding that the terms of the LLC agreement did not preclude one member of a three-member LLC from transferring the member’s entire interest (including governance rights) to a second member without first having the consent of the third member; stating that the third member’s “argument relies on a very thinly sliced version of [the “pick-your-partner principle, the strained version being] . . . that once one chooses his initial co-

members, one continues to hold a veto over how much additional voting power they may acquire;” explaining that “[t]he problem for [the third member] is that nothing in the LLC Agreement supports [that member’s] reading of it that would require an already admitted Member, like [the acquirer – *i.e.*, the second member], to become once, twice (or even three times) a Member each and every time that Member acquires an additional block of Interests”).

Other law may affect the applicability of this section. *See* 11 U.S.C. § 541(c)(1) (providing that, initially at least, all property of a debtor becomes part of the bankruptcy estate regardless of restrictions on transfer); UCC §§ 9-406, 9-408 (overriding specified restrictions on assignment in specified circumstances, regardless of whether state law or a contract imposes the restrictions).

In any event, this section does not apply to the transfer of ownership interests in a member that is an entity.

**EXAMPLE:** ABC, LLC has three members: Ralph (an individual), Alice, Inc. (“Alice”), and Norton, LLC (“Norton”). Section 5-502 applies to any attempt by Ralph, Alice, or Norton to transfer their respective membership interest in ABC. Section 5-502 is inapplicable, however, to a change in control of Alice or Norton or even a complete change in their respective membership.

**Subsection (a)**—The definition of “transfer,” Section 1-102(47), and this subsection’s reference to “in whole or in part” combine to mean that this section encompasses not only unconditional, permanent, and complete transfers but also temporary, contingent, and partial ones. Thus, for example, a charging order under Section 5-503 effects a transfer of part of the judgment debtor’s transferable interest, as does the pledge of a transferable interest as collateral for a loan and the gift of a life-interest in a member’s rights to distribution.

**Subsection (a)(2)**—The phrase “by itself” contemplates Section 5-602(5)(B), which creates a risk of dissociation via expulsion when a member transfers all of the member’s transferable interest.

**Subsection (a)(3)**—Mere transferees have no right to participate in management or otherwise intrude as the members carry on the affairs of the limited liability company and their activities as members.

Because Section 1-102(47)(G) defines “transfer” to include “a transfer by operation of law,” this section affects the power of other law to effect transfers of a member’s ownership interest. For example, a divorce court lacks the power to award a member’s spouse anything beyond the member’s transferable interest. Nor does the member have the power to enter into a property settlement purporting to effect any greater transfer.

For the divorce court, the best solution is to value the member’s complete ownership



interest (*i.e.*, the transferable interest as enhanced by the management and information rights and the standing to sue) and: (i) if possible, award the member's spouse marital property of equal value; or (ii) if not possible, award the member's spouse a money judgment and a charging order to enforce the judgment.

Granting the non-member any part of member's transferable interest is almost always imprudent; marital discord will almost inevitably carry over into the business relationship. Granting the member's ex-spouse the entire transferable interest is rarely a viable alternative. If the member is an active participant in the limited liability company, the approach is impossible. The member's transferable interest will typically constitute much or all of the member's remuneration for the partner's activity. Even if the member is essentially passive, granting the transferable interest to the ex-spouse puts him or her at great risk as a "bare naked assignee." *See* the comment to Section 5-107(b).

When a member dies, subject to the operating agreement other law may effect a transfer of the member's transferable interest to the member's estate or personal representative. However, for the reasons just stated, other law lacks the power to transfer anything more than a transferable interest. (Section 5-504 does provide extra information rights for the purposes of settling the estate of the deceased member.)

**Subsection (a)(3)(B)**—*See* Section 5-410(g) (providing that that section's information rights do not apply to transferees).

**Subsection (b)**—Amounts due under this subsection are of course subject to offset for any amount owed to the limited liability company by the member or person dissociated as a member on whose account the distribution is made. Section 5-404(d). As to whether an LLC may properly offset for claims against a transferor that was never a member is matter for other law, specifically the law of contracts dealing with assignments.

**Subsection (c)**—This very limited grant of information rights encompasses only transactions occurring at or after the date of the LLC's dissolution. The transferee has only the right to information as to the allocation of net assets among the LLC's creditors, members, and transferees—and only from the date of dissolution.

This subsection does not prevent a transferee from contracting with a member-transferor to require the member-transferor to disclose further information to the transferee. Whether such an agreement would breach the operating agreement, the implied contractual obligation of good faith and fair dealing, Section 5-409(d), or a fiduciary duty depends on the circumstances.

If a dissolved LLC rescinds its dissolution, Section 5-703, this subsection no longer applies.

**Subsection (d)**—The use of certificates can raise issues relating to Articles 8 and 9 of the

Uniform Commercial Code.

**Subsection (f)**—This provision originated as UPA (1997) § 503(e), was then consistent with UCC section 9-318(3), and is now consistent with UCC section 9-406(a) (stating that “an account debtor . . . may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee”).

The term “notice” includes “reason to know,” Section 5-103(b)(1), and ordinarily a potential transferee has reason to inquire about transfer restrictions that might be contained in the operating agreement.

**Subsection (g)**—Under this subsection, a member remains a member (with all attendant rights and obligations) even after permanently transferring the entirety of the transferable interest, unless: (i) the other members opt for expulsion under Section 5-602(5)(B); or (ii) as otherwise provided in the operating agreement.

#### **SECTION 5-503. CHARGING ORDER.**

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. Except as otherwise provided in subsection (f), a charging order constitutes a lien on a judgment debtor’s transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the

transferable interest. Except as otherwise provided in subsection (f), the purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to Section 5-502.

(d) At any time before foreclosure under subsection (c), the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) If a court orders foreclosure of a charging order lien against the sole member of a limited liability company:

- (1) the court shall confirm the sale;
- (2) the purchaser at the sale obtains the member's entire interest, not only the member's transferable interest;
- (3) the purchaser thereby becomes a member; and
- (4) the person whose interest was subject to the foreclosed charging order is dissociated as a member.

(g) This [article] does not deprive any member or transferee of the benefit of any exemption law applicable to the transferable interest of the member or transferee.

(h) This section provides the exclusive remedy by which a person seeking in the capacity of judgment creditor to enforce a judgment against a member or transferee may satisfy the

judgment from the judgment debtor's transferable interest.

### Comment

The charging order concept dates back to the English Partnership Act of 1890 and in the United States has been a fundamental part of law of unincorporated business organizations since 1914. *See* UPA (1914) § 28. As much a remedy limitation as a remedy, the charging order is the sole method by which a person acting as judgment creditor of a member or transferee can extract value from the member's or transferee's ownership interest in a limited liability company. *See* the comment to Subsection (h).

Under this section, the judgment creditor of a member or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the member or transferee whose interest is subject to the order. However, the judgment creditor has no say in the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited liability company.

By its terms, this section does not apply to foreign limited liability companies. *See* Section 5-102(a)(4) (defining "[l]imited liability company" to mean "an entity *formed under this [article] or which becomes subject to this [article]*") (emphasis added); *see also Fannie Mae v. Heather Apartments Ltd. P'ship*, A13-0562, 2013 WL 6223564, at \*6 (Minn. Ct. App. Dec. 2, 2013) (considering the remedies available to a judgment creditor with respect to the judgment debtor's interest in a Cook Islands LLC; rejecting the debtor's argument that the creditor's "only remedy is to obtain a charging order under" [the Minnesota LLC statute]; explaining that "this argument fails because that statute only applies to Minnesota limited liability companies" which that statute "defines . . . as 'a limited liability company, other than a foreign limited liability company, *organized or governed by this chapter*'") (emphasis added) (statutory citations omitted).

The operating agreement has no power to alter the provisions of this section to the prejudice of third parties. Section 5-105(c)(15).

**Subsection (a)**—The phrase "judgment debtor" encompasses both members and transferees. The lien pertains only to a distribution, which excludes "amounts constituting reasonable compensation for present or past service or payments made in the ordinary course of business under a bona fide retirement plan or other bona fide benefits program." Section 5-102(a)(3)(B). A judgment creditor that wishes to levy on such amounts should use the appropriate creditor's remedy, such as garnishment (which may be subject to exemptions or exclusions not relevant to a charging order). *Cf. PB Real Estate, Inc. v. Dem II Props.*, 719 A.2d 73, 76 (Conn. 1998) (rejecting the contention of an LLC's two members that "payments of

\$28,000 to each of them” should be treated “as expenses for wages” rather than as distributions).

Whether an application for a charging order must be served on the limited liability company, the judgment debtor, or both is a matter for other law, principally the law of remedies and civil procedure. The order itself must be served on the limited liability company. Whether the order must also be served on the judgment debtor is a matter for other law.

If a distribution consists of rights to acquire interests in a limited liability company, the charging order applies only to those rights within the definition of transferable interest. *See* Section 5-102(a)(11) (defining transferable interest).

**Subsection (b)**—Paragraph (2) refers to “other orders” rather than “additional orders.” Therefore, given appropriate circumstances, a court may invoke Paragraph (1), Paragraph (2), or both.

**Subsection (b)(1)**—The receiver contemplated here is emphatically not a receiver for the limited liability company, but rather a receiver for the distributions subject to the charging order. The principal advantage provided by this paragraph is an expanded right to information. However, that right goes no further than “the extent necessary to effectuate the collections of distributions pursuant to a charging order.” For a correctly narrow reading of this provision, see *Wells Fargo Bank, Nat. Ass’n v. Continuous Control Solutions, Inc.*, No. 11-1285, 2012 WL 3195759 (Iowa Ct. App. Aug. 8, 2012).

**Subsection (b)(2)**—This paragraph must be understood in the context of: (i) the very limited nature of the charging order; and (ii) the importance of preventing overreaching on behalf of a person that is not a judgment creditor of the LLC, has no claim on the LLC’s assets, and has no right to interfere in the activities, affairs, and management of the LLC. In particular, the court’s power to make “all other orders” is limited to “orders necessary to give effect to the charging order.”

EXAMPLE: A judgment creditor with a charging order believes that the limited liability company should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the limited liability company to restrict re-investment. Subsection (b)(2) does not authorize the court to grant the motion.

EXAMPLE: A judgment creditor with a judgment for \$10,000 against a member obtains a charging order against the member’s transferable interest. Having been properly served with the order, the limited liability company nonetheless fails to comply and makes a \$3000 distribution to the member. The court has the power to order the limited liability company to pay \$3000 to the judgment creditor to “give effect to the charging order.”

Under Subsection (b)(2), the court has the power to decide whether a particular payment is a distribution, because that decision determines whether the payment is part of a transferable interest subject to a charging order.

EXAMPLE: Member A of ABC, LLC has for some years received distributions from the LLC. However, when a judgment creditor of Member A obtains a charging order against Member A's transferable interest, the LLC ceases to make distributions to Member A and instead provides a salary to Member A equivalent to former distributions. A court might deem this salary a disguised distribution. (In any event, however, the salary will be subject to garnishment.)

This article has no specific rules for determining the fate or effect of a charging order when the limited liability company undergoes a merger, conversion, interest exchange, or domestication under [Article] 2. In the proper circumstances, such an organic change might trigger an order under Subsection (b)(2).

**Subsection (c)**—The phrase “that distributions under the charging order will not pay the judgment debt within a reasonable period of time” comes from case law. *See, e.g., Stewart v. Lanier Park Med. Office Bldg., Ltd.*, 578 S.E.2d 572, 574 (Ga. Ct. App. 2003) (“Judicial sale may be appropriate where . . . it is apparent that distributions under the charging order will not pay the judgment debt within a reasonable amount of time.”); *Nigri v. Lotz*, 453 S.E.2d 780, 783 (Ga. Ct. App. 1995). ). A purchaser at a foreclosure sale obtains only the very limited rights of a transferee under Section 5-502 and is in some ways more vulnerable and less powerful than the holder of a charging order. After foreclosure and sale, Subsection (b) no longer applies. More generally, the court is no longer involved in the matter. For the vulnerability of a transferee, see Section 5-107(b), comment.

**Subsection (d)**—This provision allows the judgment debtor to end the charging order without need for a hearing.

**Subsection (e)**—Traditionally, charging order provisions referred to the possibility of “redeeming” an interest subject to a charging order. That usage was confusing, leaving several important questions unanswered. This article substitutes a far simpler approach, contemplating the limited partnership or its members buying the underlying judgment and thereby dispensing with any interference the judgment creditor might seek to inflict on the partnership.

In many circumstances, buying the judgment is superior to the mechanism provided by this subsection, because: (i) this subsection requires full satisfaction of the underlying judgment; and (ii) the LLC or the other members might be able to buy the judgment for less than face value. On the other hand, this subsection operates without need for the judgment creditor's consent, so it remains a valuable protection in the event a judgment creditor seeks to do mischief to the LLC.

Whether a member-managed LLC's decision to invoke this subsection is “ordinary

course” or “outside the ordinary course,” Section 5-407(b)(3) and (4)(A), depends on the circumstances. However, the involvement of this subsection does not by itself make the decision “outside the ordinary course.” For a manager-managed LLC, the distinction is irrelevant. Section 5-407(c)(1).

**Subsection (f)**—The charging order remedy—and, more particularly, the exclusiveness of the remedy—protect the “pick your partner” principle. That principle is inapposite when a limited liability company has only one member. The exclusivity of the charging order remedy was never intended to protect a judgment debtor, but rather only to protect the interests of the judgment debtor’s co-owners.

Put another way, the charging order remedy was never intended as an “asset protection” device for judgment debtors. *See Olmstead v. F.T.C.*, 44 So. 3d 76, 83 (Fla. 2010) (recognizing “the full scope of a judgment creditor's rights with respect to a judgment debtor's freely alienable membership interest in a single-member LLC”); *In re Albright*, 291 B.R. 538, 540 (Bankr. D. Colo. 2003) (holding that, “[b]ecause there are no other members in the LLC, . . . the Debtor’s bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and the Trustee obtained all her rights, including the right to control the management of the LLC”). Accordingly, when a charging order against an LLC’s sole member is foreclosed, the member’s entire ownership interest is sold and the buyer replaces the judgment debtor as the LLC’s sole member.

This subsection was added during the Harmonization Project but not for the purposes of harmonization. The subsection addresses an issue that does not exist with partnerships; neither a general nor a limited partnership can continue perpetually in existence with only one partner. *See* Section 4-801(a)(5) (stating that dissolution is caused upon “the passage of 90 consecutive days during which the [limited] partnership has only one partner”); Section 3-801(6) (stating that dissolution is caused upon “the passage of 90 consecutive days during which [a general] partnership does not have at least two partners”).

**Subsection (g)**—This subsection preserves otherwise applicable exemptions but does not create any. *In re Foos*, 405 B.R. 604, 609 (Bankr. N.D. Ohio 2009) (interpreting the comparable provision in UPA (1997) and stating, “it is clear that [the provision] does not create an exemption”).

**Subsection (h)**—This subsection does not override Uniform Commercial Code, Article 9, which may provide different remedies for a secured creditor acting in that capacity. A secured creditor with a judgment might decide to proceed under Article 9 alone, under this section alone, or under both Article 9 and this section. In the last-mentioned circumstance, the constraints of this section would apply to the charging order but not to the Article 9 remedies.

This subsection is not intended to prevent a court from effecting a “reverse pierce” where appropriate. In a reverse pierce, the court conflates the entity and its owner to hold the entity

liable for a debt of the owner. *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298, 312 (Conn. App. Ct. 2002) (approving a reverse pierce where a judgment debtor had established a limited liability company in a patent attempt to frustrate the judgment creditor), *overruled on other grounds by*, *Robinson v. Coughlin*, 830 A.2d 1114 (Conn. 2003). Likewise, this subsection does not supplant fraudulent transfer law.

#### **SECTION 5-504. POWER OF LEGAL REPRESENTATIVE OF DECEASED**

**MEMBER.** If a member dies, the deceased member's legal representative may exercise:

- (1) the rights of a transferee provided in Section 5-502(c); and
- (2) for the purposes of settling the estate, the rights the deceased member had under

Section 5-410.

#### **Comment**

The estate and those claiming through the estate are transferees, and as such they have very limited rights to information. This section provides temporary, additional information rights to the legal representative of the estate. Sections 5-410 and 5-502(c) pertain only to information rights.

### **[PART] 6**

#### **DISSOCIATION**

#### **SECTION 5-601. POWER TO DISSOCIATE AS MEMBER; WRONGFUL**

#### **DISSOCIATION.**

(a) A person has the power to dissociate as a member at any time, rightfully or wrongfully, by withdrawing as a member by express will under Section 5-602(1).

(b) A person's dissociation as a member is wrongful only if the dissociation:

- (1) is in breach of an express provision of the operating agreement; or
- (2) occurs before the completion of the winding up of the limited liability

company and:

- (A) the person withdraws as a member by express will;
- (B) the person is expelled as a member by judicial order under Section 5-



602(6);

(C) the person is dissociated under Section 5-602(8); or

(D) in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person is expelled or otherwise dissociated as a member because it willfully dissolved or terminated.

(c) A person that wrongfully dissociates as a member is liable to the limited liability company and, subject to Section 5-801, to the other members for damages caused by the dissociation. The liability is in addition to any debt, obligation, or other liability of the member to the company or the other members.

### Comment

This article deals with the dissociation of a person as a member. Part 7 deals with the dissolution of a limited liability company.

**Subsection (a)** – The operating agreement can vary this provision, even to the extent of negating a member’s power to dissociate. Doing so, however, is fundamentally at odds with the concept of a limited liability company as a creature of contract. *See* the comment to Section 5-105 (Role and Inevitability of Operating Agreement). Only in exceptional circumstances does a party to a contract lack the power to breach, and courts will not enjoin a person to remain in an ongoing contractual relationship that involves trust and confidence. E. ALLAN FARNSWORTH, *CONTRACTS* § 12.7, at 781 (3d ed. 1999) (“A court will not grant specific performance of a contract to provide a service that is personal in nature. This refusal . . . is based [in part] of the undesirability of compelling the continuance of personal relations after disputes have arisen and confidence and loyalty have been shaken and the undesirability, in some instances, of imposing what might seem like involuntary servitude.”) (footnote omitted). Moreover, eliminating or even substantially restricting a member’s power to dissociate may have dreadful practical consequences.

**Subsection (b)** – This subsection list exhaustively (“only if”) the dissociations that are “wrongful,” but the list is a default rule. The operating agreement can expand the list; *e.g.*, by making wrongful a dissociation that breaches the implied contractual covenant of good faith and fair dealing. In theory, the operating agreement can provide for liquidated damages (subject to the requirements of contract law) and, in theory, can also contract or even eliminate the list of wrongful dissociations.

**Subsection (b)(1)** – The reference to “an express provision of the operating agreement”

means that a person's dissociation as a member in breach of the obligation of good faith and fair dealing is not wrongful dissociation for the purposes of this section. The breach might be actionable on other grounds.

**Subsection (b)(2)(C)** – This subsection refers to Section 5-602(8), which involves *inter alia* dissociation on account of bankruptcy, which in turn is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating “ipso facto” clauses, subject to some exceptions).

**Subsection (c)** – A person who prematurely dissociates as a member risks liability for any resulting damages. For example, the limited liability company might incur substantial expenses in replacing the member's expertise, reputation, or creditworthiness.

In effect, this subsection equates wrongful dissociation with breach of contract. Accordingly, courts should look to contract law to determine what consequential damages are recoverable. *See Hadley v. Baxendale*, 9 Exch. 341 (1854); RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981); *see also Williams v. Hildebrand*, 247 S.W.2d 356, 358 (Ark. 1952) (interpreting UPA (1914) § 38(2)(a)(II), pertaining to wrongful dissolution, and stating that “the measure of damages, when the partnership was to have continued for a fixed term, is the profits that the injured partner would have received”).

**SECTION 5-602. EVENTS CAUSING DISSOCIATION.** A person is dissociated as a member when:

- (1) the limited liability company knows or has notice of the person's express will to withdraw as a member, but, if the person has specified a withdrawal date later than the date the company knew or had notice, on that later date;
- (2) an event stated in the operating agreement as causing the person's dissociation occurs;
- (3) the person's entire interest is transferred in a foreclosure sale under Section 5-503(f);
- (4) the person is expelled as a member pursuant to the operating agreement;
- (5) the person is expelled as a member by the affirmative vote or consent of all the other members if:
  - (A) it is unlawful to carry on the limited liability company's activities and affairs with the person as a member;
  - (B) there has been a transfer of all the person's transferable interest in the

company, other than:

(i) a transfer for security purposes; or

(ii) a charging order in effect under Section 5-503 which has not been foreclosed;

(C) the person is an entity and:

(i) the company notifies the person that it will be expelled as a member because the person has filed a statement of dissolution or the equivalent, the person has been administratively dissolved, the person's charter or the equivalent has been revoked, or the person's right to conduct business has been suspended by the person's jurisdiction of formation; and

(ii) not later than 90 days after the notification, the statement of dissolution or the equivalent has not been withdrawn, rescinded, or revoked, the person has not been reinstated, or the person's charter or the equivalent or right to conduct business has not been reinstated; or

(D) the person is an unincorporated entity that has been dissolved and whose activities and affairs are being wound up;

(6) on application by the limited liability company or a member in a direct action under Section 5-801, the person is expelled as a member by judicial order because the person:

(A) has engaged or is engaging in wrongful conduct that has affected adversely and materially, or will affect adversely and materially, the company's activities and affairs;

(B) has committed willfully or persistently, or is committing willfully or persistently, a material breach of the operating agreement or a duty or obligation under Section 5-409; or

(C) has engaged or is engaging in conduct relating to the company's activities and affairs which makes it not reasonably practicable to carry on the activities and affairs with the person as a member;

(7) in the case of an individual:

(A) the individual dies; or

(B) in a member-managed limited liability company:

(i) a guardian or general conservator for the individual is appointed; or

(ii) a court orders that the individual has otherwise become incapable of performing the individual's duties as a member under this [Code] or the operating agreement;

(8) in a member-managed limited liability company, the person:

(A) becomes a debtor in bankruptcy;

(B) signs an assignment for the benefit of creditors; or

(C) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the person or of all or substantially all the person's property;

(9) in the case of a person that is a testamentary or inter vivos trust or is acting as a member by virtue of being a trustee of such a trust, the trust's entire transferable interest in the limited liability company is distributed;

(10) in the case of a person that is an estate or is acting as a member by virtue of being a personal representative of an estate, the estate's entire transferable interest in the limited liability company is distributed;

(11) in the case of a person that is not an individual, the existence of the person terminates;

(12) the limited liability company participates in a merger under [Article] 2 and:

(A) the company is not the surviving entity; or

(B) otherwise as a result of the merger, the person ceases to be a member;

(13) the limited liability company participates in an interest exchange under [Article] 2 and, as a result of the interest exchange, the person ceases to be a member;

(14) the limited liability company participates in a conversion under [Article] 2;

(15) the limited liability company participates in a domestication under [Article] 2 and, as a result of the domestication, the person ceases to be a member; or

(16) the limited liability company dissolves and completes winding up.

### Comment

This section mostly states default rules, which the operating agreement may vary. However, it would make no sense to vary some of the rules – *e.g.*, to provide that the death of a member who is an individual does not cause the individual’s dissociation as a member, Paragraph (7)(A), or that an entity remains a member even *after* the existence of the person has terminated. Paragraph (11).

**Paragraph (1)**—Operating agreements often require notice of dissociation to be in writing and to specify the effective date of the dissociation.

**Paragraph (3)**—The cited section pertains to a charging order against the transferable interest of the sole member of a limited liability company.

**Paragraph (4)**—Many operating agreements provide for “no cause” expulsion, and courts considering such provisions will likely look to cases addressing the issue in the context of partnerships. In that context, courts have taken somewhat different approaches. *Compare Gelder Med. Grp. v. Webber*, 363 N.E.2d 573, 576 (N.Y. 1977), with *Winston & Strawn v. Nosal*, 664 N.E.2d 239, 245 (Ill. App. Ct. 1996). *See also* the comment to Section 5-409(d) (stating and explaining the implied contractual covenant of good faith and fair dealing).

**Paragraph (5)(B)**—This paragraph permits expulsion when a member no longer has any “skin in the game.” Under this paragraph (unless the operating agreement provides otherwise), a member’s transferee can protect itself from the vulnerability of “bare naked assignee” status, comment to Section 5-107(b), by obligating the member/transferor to retain a one-percent interest and exercise the member’s governance rights (including the right to bring a derivative suit) to protect the transferee’s interests.

**Paragraph (6)**—The reference to “a direct action under Section 5-801(b)” reflects the

“separate entity” nature of a limited liability company. Section 5-801(b) limits a member’s standing to bring a direct action to circumstances in which the member can “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.” For example, a member might invoke Paragraph (6)(B) if another member’s breach of the operating agreement harmed the first member directly. If a member has suffered only indirect harm, the Paragraph (6)(B) claim belongs to the LLC and not the member. If the LLC fails to bring suit, the member may assert the claim derivatively. *See* Sections 5-802 through 5-806.

Although the operating agreement can revise or eliminate the possibility of judicial expulsion, doing so requires careful planning. *Cf. Huatuco v. Satellite Healthcare*, CV 8465-VCG, 2013 WL 6460898, at \*1, n.2 (Del. Ch. Dec. 9, 2013) (stating that “the right to judicial dissolution is a default right which the parties may eschew by contract” while reserving the question of “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires—leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre’s Huis Clos”).

For examples of conduct warranting an expulsion order, see *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (discussing a pattern of conduct); *Sherwood Park Bus. Ctr., L.L.C. v. Taggart*, 323 P.3d 551, 561 (Or. Ct. App. 2014) (upholding expulsion of a member who “had stolen a large amount of money from [the limited liability company], had intentionally failed to provide financial information, and had made himself unavailable to carry on the business”); *CCD, L.C. v. Millsap*, 116 P.3d 366, 373 (Utah 2005) (holding that a member’s “misappropriat[ion of] trust account funds totaling at least \$11,540.06 for his personal use” warranted expulsion, where the member’s “misconduct continued the pattern of behavior that [had previously] resulted in losses to the company of \$625,000[, where the new misconduct] . . . took place after [the member’s] prior wrongdoing had been discovered and after [the limited liability company] had assented to permit [the member] to atone for his misdeeds by fulfilling the terms of the amended operating agreement”).

For an analysis that helps distinguish Paragraph (6)(C) from Paragraphs (6)(A) and (B), see *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510, at \*15 (N.J. Super. Ct. App. Div. Dec. 24, 2012) (interpreting predecessor law and noting that the “not reasonably practicable standard” does not require a showing of wrongful conduct). *Cf. Dunnagan v. Watson*, 204 S.W.3d 30, 40 (Tex. Ct. App. 2006) (same issue in the context of dissolution). Where grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives. *Robertson v. Jacobs Cattle Co.*, 830 N.W.2d 191, 201–02 (Neb. 2013) (discussing analogous provisions of UPA (1997)). “[T]here is no textual basis for imposing a higher burden of proof for dissociation than dissolution.” *Brennan v. Brennan Assocs.*, 977 A.2d 107, 121 (Conn. 2009) (general partnership).

**Paragraph (6)(C)**—This provision has an analog among the causes for dissolution. *See* Section 5-701(a)(4)(B).

**Paragraph (7)(B)**—This provision does not apply to a manager-managed limited liability company because, given the limited rights of non-manager members, the stated occurrences do not necessarily justify dissociation. For a parallel provision approach with respect to limited partnerships, see Sections 4-601(b)(6) (limited partner) and 4-603(6)(B) and (C) (general partner). As for the effect of the stated occurrences on a person’s role as a manager, see Section 5-407(c)(4) (permitting the removal of a manager “at any time by the affirmative vote or consent of a majority of the members without notice or cause”).

**Paragraph 8(A)**—This provision is subject to bankruptcy law. *See, e.g.*, 11 U.S.C.A. § 365(e) (invalidating “ipso facto” clauses, subject to some exceptions).

**Paragraphs (9) and (10)**—A change in trustee or personal representation does not cause dissociation.

**Paragraph (11)**—This provision is the entity analog to Paragraph (7)(A) (death of an individual). Although in theory the operating agreement could change this rule, doing so would be nonsensical. *See* the comment to Section 5-703(a) (noting that a terminated limited liability company cannot rescind its dissolution because “a ‘dead’ entity lacks both the capacity and power to bring itself back from the dead”).

**Paragraph (12)(A)**—If a limited liability company disappears as part of a merger, no person can continue as a member of the company. When the merger takes effect, the members of the disappearing company are perforce dissociated. Depending on the plan of merger, those persons may become members of a surviving limited liability company. In those circumstances, the merger will have dissociated them from one LLC and admitted them into membership in the surviving LLC. *See* Sections 5-401(c)(2), 2-206(c)(10).

**Paragraph (12)(B)**—It is possible for a plan of merger to “shuffle the equity” of the surviving entity, even to the extent of “taking out” some or all of the owners of the surviving entity. A reverse triangular merger involving a limited liability company as the surviving entity would dissociate all the members of the LLC.

**Paragraph (14)**—By definition, a limited liability company that converts ceases to be a limited liability company. *See* Section 2-406. Thus, when the plan of conversion takes effect, all the members of the converted entity are dissociated from that entity. In many cases, those persons will all be owners of the converted entity. In some cases, the conversion will “shuffle the equity” and “take out” some of the members of the converting LLC.

**Paragraph (15)**—Domestication does not by itself dissociate a member, because the domesticated entity remains both a limited liability company and “the same entity without

interruption as the domesticating company.” Section 2-506(a)(1)(B). However, an “equity shuffle” could dissociate a member.

### **SECTION 5-603. EFFECT OF DISSOCIATION.**

(a) 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 5-409 as a member end with regard to matters arising and events occurring after the person’s dissociation; and

(3) subject to Section 5-504 and [Article] 2, 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.

(b) A person’s dissociation as a member does not of itself discharge the person from any debt, obligation, or other liability to the limited liability company or the other members which the person incurred while a member.

### **Comment**

**Subsection (a)**—This provision makes no reference to power-to-bind matters, because this article provides that a member *qua* member has no power to bind the LLC. Section 5-301.

**Subsection (a)(2)**—This provision establishes a dividing line, separating out “matters arising and events occurring after the person’s dissociation.” If the limited liability company has continuing projects with clients, ongoing relationships with clients, or both, the dividing line requires special attention with regard to non-competition and partnership opportunities duties. *See* Section 5-409(b)(1), (3).

Disputes involving law firms have generated much of the relevant case law. *See, e.g., Jewel v. Boxer*, 156 Cal. App. 3d 171, 175 (Cal. Ct. App. 1984); *Meehan v. Shaughnessy*, 535 N.E.2d 1255, 1257 (Mass. 1989). To a large extent, a well-drawn operating agreement can delineate the parties’ respective rights and responsibilities and thereby avoid problems. However, if the company becomes insolvent, the bankruptcy court may well scrutinize the members’ *inter se* arrangements. *See Geron v. Robinson & Cole L.L.P.*, 476 B.R. 732, 743 (S.D.N.Y. 2012) (considering whether a law firm had “fraudulently transferred . . . assets when



its partners adopted the Jewel Waiver [releasing rights recognized by *Jewel v. Boxer*] on the eve of dissolution without consideration”).

This provision applies regardless of whether the limited liability company is member-managed or manager-managed. However, in the latter case, the pre-dissociation duties will be much narrower, because in a manager-managed LLC a member *qua* member has no management duties. Section 5-409(i)(1). But each member remains subject to the obligation of good faith and fair dealing. Section 5-409(i)(3).

This provision does not determine the effect of a person’s dissociation as a member on the person’s future obligations or rights under the operating agreement. Some contractual obligations typically extend beyond dissociation – *e.g.*, non-competition provisions, buyout arrangements. To the extent provisions of the operating agreement continue to apply, the common law obligation of good faith continues to apply as well. *See* the comment to Section 5-409(d) (explaining that the subsection “invokes the implied obligation that exists in every contract” as a matter of common law).

**Subsection (a)(3)**—This paragraph accords with Section 5-404(b)—dissociation does not result in a distribution. In general, when a person dissociates as a member, the person’s rights as a member disappear and the person’s status degrades to that of a mere transferee—even when the dissociation takes the form of expulsion. *All Saints Univ. of Med. Aruba v. Chilana*, A-2628-09T1, 2012 WL 6652510, at \*12 (N.J. Super. Ct. App. Div. Dec. 24, 2012).

Like most *inter se* rules in this article, this one is subject to the operating agreement. For example, the operating agreement has the power to provide for the buyout of a person’s transferable interest in connection with the person’s dissociation.

Section 5-504 provides additional information rights when an individual’s death has caused dissociation. Article 2 covers organic transactions such as mergers and conversions.

**Subsection (b)**—In a member-managed limited liability company, a member’s obligation to safeguard trade secrets and other confidential or proprietary information is incurred when the member learns or otherwise obtains the information. This subsection preserves the obligation post-dissociation. (In a manager-managed LLC, any obligations of a non-manager member *viz*—*a*—*viz* proprietary information would be a matter for the operating agreement, the obligation of good faith and fair dealing, or other law.)

## [PART] 7

### DISSOLUTION AND WINDING UP

#### SECTION 5-701. EVENTS CAUSING DISSOLUTION.

(a) A limited liability company is dissolved, and its activities and affairs must be wound

up, upon the occurrence of any of the following:

(1) an event or circumstance that the operating agreement states causes dissolution;

(2) the affirmative vote or consent of all the members;

(3) the passage of 90 consecutive days during which the company has no members unless before the end of the period:

(A) consent to admit at least one specified person as a member is given by transferees owning the rights to receive a majority of distributions as transferees at the time the consent is to be effective; and

(B) at least one person becomes a member in accordance with the consent;

(4) on application by a member, the entry by [the appropriate court] of an order dissolving the company on the grounds that:

(A) the conduct of all or substantially all the company's activities and affairs is unlawful;

(B) it is not reasonably practicable to carry on the company's activities and affairs in conformity with the certificate of organization and the operating agreement; or

(C) the managers or those members in control of the company:

(i) have acted, are acting, or will act in a manner that is illegal or fraudulent; or

(ii) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant; or

(5) the signing and filing of a statement of administrative dissolution by the [Secretary of State] under Section 1-602.

(b) In a proceeding brought under subsection (a)(4)(C), the court may order a remedy other than dissolution.

### Comment

“Dissolution” has been a term of art in the law of unincorporated business organizations since at least the time of Roman law. JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 266, at 408 (2d ed. 1850) (“The Roman law . . . declared, that partnership might be dissolved in various ways . . .”). Dissolution does not end a limited liability company’s existence but rather changes the purpose of that existence: “A dissolved limited liability company shall wind up its activities and affairs and . . . the company continues after dissolution only for the purpose of winding up.” Section 5-702(a). The company may, but need not, file a statement of dissolution. Section 5-702(b)(2)(A). The limited liability company terminates when winding up is complete. The company may, but need not, file a statement of termination. Section 5-702(b)(2)(F).

Except for Paragraphs (a)(4) and (5), this section comprises default rules. Paragraph 5 is fully mandatory, Section 5-105(c)(3)(B); Paragraph 4 is mandatory only with regard to the stated grounds for dissolution. *See* the comment to Section 5-105(c)(9). Moreover, an operating agreement can provide additional causes of dissolution. *See* Subsection (a)(1). Variations to the statutory causes of dissolution are commonplace.

Section 5-703 permits rescission of dissolution in some circumstances. In some circumstances, an amendment to the operating agreement might avert dissolution (*e.g.*, by revising an agreed-upon deadline for selling the LLC’s assets and winding up the business). A retroactive amendment may also be possible. *See Kindred Ltd. P’ship v. Screen Actors Guild, Inc.*, CV082220PSGPJWX, 2009 WL 279080, at \*5–6 (C.D. Cal. Feb. 3, 2009) (giving effect to an amendment that retroactively eliminated an event of dissolution; noting that UPA (1997) § 802(b) permitted a partnership to rescind dissolution).

**Subsection (a)(4)**—The operating agreement cannot vary the causes of dissolution stated in this provision. However, the operating agreement may contain a forum selection clause or change the forum from “the appropriate court” to binding arbitration. Comment to Section 5-105(c)(9).

As to whether the court of another jurisdiction can properly order dissolution of a limited liability company formed under this article, the majority rule is clearly no. “[T]he courts of several states have held that jurisdiction to dissolve a corporation rests only in the courts of the state of incorporation.” *In re Blixseth*, 484 B.R. 360, 370 (B.A.P. 9th Cir. 2012) (citing cases, including a case involving an LLC). *But see In re Mercantile Guar. Co.*, 238 Cal. App. 2d 426, 430–33 (Cal. Ct. App. 1965) (explaining that “[w]e are . . . required to determine whether the courts of a state in which a foreign corporation has done business and in which its assets are there located have jurisdiction to wind up its affairs, even though the corporation was organized in another state,” stating that “the question is not one of jurisdiction or power in the court of the

state which is not the legal domicile of a foreign corporation, but it is a question . . . of the balance of convenience, of whether considerations of public policy, efficiency, expedience and justice to all parties interested demand that jurisdiction be retained in the foreign court, or that it be declined under the rule of forum *non conveniens*,” and holding that “[t]he circumstances of the case at bench require a holding that the California courts assume jurisdiction of the winding up of [a Delaware corporation’s] affairs preparatory to a dissolution”).

**Subsection (a)(4)(B)**—The standard stated here is conventional, deriving originally from the law of limited partnerships. *See, e.g., Kirksey v. Grohmann*, 754 N.W.2d 825, 828–30 (S.D. 2008) (discussing cases and noting that “cases interpreting language similar to our statutory terminology, whether involving a partnership or a limited liability company, are instructive”). For discussion of the meaning of the standard, see *Venture Sales, L.L.C. v. Perkins*, 86 So. 3d 910, 914–15 (Miss. 2012) (discussing cases); *In re 1545 Ocean Ave., LLC*, 72 A.D.3d 121, 129–30 (N.Y. 2010) (same).

The court-ordered expulsion of a miscreant member can negate a claim for dissolution. *Dunbar Grp., LLC v. Tignor*, 267 Va. 361, 367-68, 593 S.E.2d 216, 219 (2004) (“Although Tignor’s actions in [the] capacities [of member and manager of Xpert] had created numerous problems in the operation of Xpert, his expulsion as a member changed his role from one of an active participant in the management of Xpert to the more passive role of an investor in the company. The record fails to show that after this change in the daily management of Xpert, it would not be reasonably practicable for Xpert to carry on its business pursuant to its operating authority.”).

However, where grounds exist for both dissociation and dissolution, a court has the discretion to choose between the alternatives. *Robertson v. Jacobs Cattle Co.*, 830 N.W.2d 191 201–02 (Neb. 2013). “[T]here is no textual basis for imposing a higher burden of proof for dissociation than dissolution.” *Brennan v. Brennan Assocs.*, 977 A.2d 107, 121 (Conn. 2009) (general partnership).

This provision has an analog among the grounds for dissociation. *See* Section 5-602(6)(c).

**Subsection (a)(4)(C)**—The provision’s reference to “those members in control of the company” implies that such members have a duty to avoid acting oppressively toward fellow members.

This article does not define “oppressively,” but “oppression” is a concept well-grounded in the law of close corporations. *See, e.g., Kiriakides v. Atlas Food Sys. & Servs., Inc.*, 541 S.E.2d 257, 264–66 (S.C. 2001); Robert B. Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 69, 70 (1993) (referring to then “evolving cause of action of shareholder oppression”). In many jurisdictions the concept equates to or at least includes the frustration of the plaintiff’s reasonable expectations. *Baur v. Baur Farms, Inc.*, 832 N.W.2d 663,

670 (Iowa 2013) (stating that “perhaps the most widely adopted [approach] links oppression to the frustration of the reasonable expectations of the corporation's shareholders”). (This concept of reasonable expectations is entirely separate from the “fruits of the bargain” and “reasonable expectations” language sometimes used in explaining the implied contractual obligation of good faith and fair dealing.)

Courts have extrapolated close corporation doctrine to unincorporated organizations. *See, e.g., Alloy v. Wills Family Trust*, 944 A.2d 1234, 1262–64 (Md. Ct. Spec. App. 2008) (discussing cases). Indeed many cases simply conflate the two contexts. *E.g. Kohanim v. Katoli*, 08-11-00155-CV, 2013 WL 3943078, at \*9 (Tex. Ct. App. July 24, 2013) (“A member oppression claim may exist when: (i) a majority shareholder's conduct substantially defeats the minority’s expectations that objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or (ii) burdensome, harsh, or wrongful conduct, a lack of probity and fair dealing in the company's affairs to the prejudice of some members, or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.”); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188, 196 (Tex. Ct. App. 2003) (explaining oppression of “members” in terms of shareholder oppression).

However, applying close corporation law to limited liability companies requires some caution. Close corporation law developed in part because the standard corporate governance structure exalts majority power and does not presuppose contractual relationships among the shareholders.

In contrast, while an LLC depends on the sovereign for legal existence and the all-important liability shield, LLC governance is fundamentally contractual. Therefore, in most situations, the operating agreement should reflect and comprise members’ reasonable expectations. As a result, a court considering a claim of oppression by an LLC member should consider, with regard to each reasonable expectation invoked by the plaintiff, whether the expectation: (i) contradicts any term of the operating agreement or any reasonable implication of any term of that agreement; (ii) was central to the plaintiff’s decision to become a member of the limited liability company or for a substantial time has been centrally important in the member’s continuing membership; (iii) was known to other members, who expressly or impliedly acquiesced in it; (iv) is consistent with the reasonable expectations of all the members, including expectations pertaining to the plaintiff’s conduct; and (v) is otherwise reasonable under the circumstances. *See* the comments to Sections 5-102(a)(9) (“[T]he definition [of ‘operating agreement’] 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.’”) and 5-105(a)(4) (explaining how a written operating agreement, if properly drafted, can provide that amendments must be in writing and signed to be effective).

EXAMPLE: From its formation, Work-Here, LLC has had three members, been

member-managed, involved all three members in company operations, and allocated distributions in part in reference to the members' work for the company. The operating agreement is brief, informal, contains no integration clause, and makes no reference to a member's right to work for the company.

After ten years, two of the members: (i) take a vote; (ii) purport to oust the third member from any continuing role in company operations; and (iii) announce that the third member's distributions will be substantially reduced.

The ousted member has at least three theories of recovery:

- breach of an implied-in-fact term of the operating agreement, under which each member is entitled to work for the company and be compensated for the work;
- violation of Section 5-407(b)(4)(A) (requiring "[t]he affirmative vote or consent of all the members . . . to . . . undertake an act outside the ordinary course of the activities and affairs of the company"); and
- oppression under Section 5-701(4)(C)(ii).

On the limited facts stated, these theories are undoubtedly plausible, although of course not necessarily persuasive. *See* Section 5-409(d) (incorporating "the contractual obligation of good faith and fair dealing").

**Subsection (a)(5)**—The operating agreement may not vary this provision.

**Subsection (b)**—In the close corporation context, many courts have reached this position without express statutory authority, most often with regard to court-ordered buyouts of oppressed shareholders. *See, e.g., Kirtz v. Grossman*, 463 S.W.2d 541, 545 (Mo. Ct. App. 1971) (per curiam); *Brenner v. Berkowitz*, 634 A.2d 1019, 1031 (N.J. 1993); *N.D. ex rel. Heitkamp v. Family Life Servs.*, 616 N.W.2d 826, 838 (N.D. 2000); *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387, 394–96 (Or. 1973); *Davis v. Sheerin*, 754 S.W.2d 375, 380 (Tex. Ct. App. 1988). *Contra White v. Perkins*, 189 S.E.2d 315, 320 (Va. 1972).

This subsection saves courts and litigants the trouble of re-inventing that wheel in the LLC context. However, unlike Subsection (a)(4), Subsection (b) can be overridden by the operating agreement. Thus, the members may agree to restrict or eliminate a court's power to craft a lesser remedy, even to the extent of confining the court (and themselves) to the all-or-nothing remedy of dissolution.

## **SECTION 5-702. WINDING UP.**

(a) A dissolved limited liability company shall wind up its activities and affairs and, except as otherwise provided in Section 5-703, the company continues after dissolution only for the purpose of winding up.

(b) In winding up its activities and affairs, a limited liability company:

(1) shall discharge the company's debts, obligations, and other liabilities, settle and close the company's activities and affairs, and marshal and distribute the assets of the company; and

(2) may:

(A) deliver to the [Secretary of State] for filing a statement of dissolution stating the name of the company and that the company is dissolved;

(B) preserve the company activities, affairs, and property as a going concern for a reasonable time;

(C) prosecute and defend actions and proceedings, whether civil, criminal, or administrative;

(D) transfer the company's property;

(E) settle disputes by mediation or arbitration;

(F) deliver to the [Secretary of State] for filing a statement of termination stating the name of the company and that the company is terminated; and

(G) perform other acts necessary or appropriate to the winding up.

(c) If a dissolved limited liability company has no members, the legal representative of the last person to have been a member may wind up the activities and affairs of the company. If the person does so, the person has the powers of a sole manager under Section 5-407(c) and is deemed to be a manager for the purposes of Section 5-304(a).

(d) If the legal representative under subsection (c) declines or fails to wind up the limited liability company's activities and affairs, a person may be appointed to do so by the consent of transferees owning a majority of the rights to receive distributions as transferees at the time the consent is to be effective. A person appointed under this subsection:

(1) has the powers of a sole manager under Section 5-407(c) and is deemed to be a manager for the purposes of Section 5-304(a); and

(2) shall deliver promptly to the [Secretary of State] for filing an amendment to the company's certificate of organization stating:

(A) that the company has no members;

(B) the name and street and mailing addresses of the person; and

(C) that the person has been appointed pursuant to this subsection to wind up the company.

(e) [The appropriate court] may order judicial supervision of the winding up of a dissolved limited liability company, including the appointment of a person to wind up the company's activities and affairs:

(1) on the application of a member, if the applicant establishes good cause;

(2) on the application of a transferee, if:

(A) the company does not have any members;

(B) the legal representative of the last person to have been a member declines or fails to wind up the company's activities; and

(C) within a reasonable time following the dissolution a person has not been appointed pursuant to subsection (c); or

(3) in connection with a proceeding under Section 5-701(a)(4).

### **Comment**

Under the default rules of this article, dissolution does not change governance arrangements. However, dissolution does change the context for determining, with regard to a member-managed LLC, whether a matter is in or outside "the ordinary course of the activities of the company." Section 5-407(b)(3), (4).

As for determining the post-dissolution power of a member or manager to bind the LLC,



other law, primarily agency law, supplies the rules. Thus, dissolution does not change the applicable source of law for determining actual and apparent authority. Comment to Section 5-301.

**Subsection (a)**—See the comment to Section 5-701(a).

**Subsection (b)**—The particular circumstances determine how long winding up may continue without giving “good cause” for court intervention under Section 5-702(e). The case law is partnership law and applies by analogy. There is no “hard and fast” rule. See, e.g., *Mathis v. Meyeres*, 574 P.2d 447, 450 (Alaska 1978) (stating that we are aware of [no authority] requiring that deadlines be set in the winding up of a partnership”); *8182 Md. Assocs., Ltd. P’ship v. Sheehan*, 14 S.W.3d 576, 581 (Mo. 2000) (“The Uniform Partnership Law contemplates that dissolved partnerships may continue in business for a short, long or indefinite period of time ....”) (quoting *Schoeller v. Schoeller*, 497 S.W.2d 860, 867 (Mo. Ct. App. 1973)).

“Winding up usually entails the time necessary for the partners to finish old business, collect and pay debts, and finally distribute remaining assets to the partners.” *Gibson v. Deuth*, 270 N.W.2d 632, 635 (Iowa 1978). “Generally the best interests of the partnership will be served by winding up the partnership affairs as quickly as possible.” *Doting v. Trunk*, 259 Mont. 343, 349, 856 P.2d 536, 540 (1993). However, in some circumstances, a long period of winding up is not only appropriate but necessary. *Lebanon Trotting Ass’n v. Battista*, 306 N.E.2d 769, 772 (Ohio Ct. App. 1972) (“[I]f the only means of availing the partners of the benefit of the value of the lease would be to continue to operate under such lease until its expiration, then such operation may continue as part of the winding up of the partnership affairs after dissolution. It is not necessary that a partnership, in the absence of the consent of all the partners, abandon a valuable asset upon dissolution merely because it may have no ready market value, but the value of such asset can continue to inure to the benefit of the partners through the continuation of the partnership after dissolution.”)

**Subsection (b)(2)(A) and (F)**—For the constructive notice effect of a statement of dissolution or termination, see Sections 5-103(d)(2)(A) and (B) and 5-302(h).

**Subsection (c)**—Section 5-304 provides a shield for managers as well members against automatic, vicarious liability for an LLC’s debts, obligations, and other liabilities. Section 5-407 provides default rules for a manager’s actual authority. Some of those rules provide for consent by members. See Section 5-407(c)(3). Those rules are inapposite in the circumstances contemplated by this subsection.

Section 5-409 does not apply to a person appointed under this section. Such person will inevitably be an agent of the dissolved limited liability company, acting pursuant to a contract. Thus, agency and contract law will determine the person’s duties.

**Subsection (d)(1)**—See the comment to Subsection (c).

**Subsection (e)**—Section 5-409 does not apply to a person appointed under this section.

The applicable standards of conduct might come from any or all of these sources: the court order, state law pertaining to receiverships, agency law, and contract law.

**Subsection (e)(1)**—Managers do not have standing under this provision. If a non-member manager has so lost control of the limited liability company as to desire dissolution, the non-manager's remedy is to: (i) seek court enforcement of the relevant provisions of the operating agreement, management agreement, or both; or (ii) resign.

### **SECTION 5-703. RESCINDING DISSOLUTION.**

(a) A limited liability company may rescind its dissolution, unless a statement of termination applicable to the company has become effective, [the appropriate court] has entered an order under Section 5-701(a)(4) dissolving the company, or the [Secretary of State] has dissolved the company under Section 1-602.

(b) Rescinding dissolution under this section requires:

(1) the affirmative vote or consent of each member; and

(2) if the limited liability company has delivered to the [Secretary of State] for filing a statement of dissolution and:

(A) the statement has not become effective, delivery to the [Secretary of State] for filing of a statement of withdrawal under Section 1-204 applicable to the statement of dissolution; or

(B) if the statement of dissolution has become effective, delivery to the [Secretary of State] for filing of a statement of rescission stating the name of the company and that dissolution has been rescinded under this section.

(c) If a limited liability company rescinds its dissolution:

(1) the company resumes carrying on its activities and affairs as if dissolution had never occurred;

(2) subject to paragraph (3), any liability incurred by the company after the

dissolution and before the rescission has become effective is determined as if dissolution had never occurred; and

(3) the rights of a third party arising out of conduct in reliance on the dissolution before the third party knew or had notice of the rescission may not be adversely affected.

### **Comment**

The Harmonization Project added this section, which is based on UPA (1997) § 802(b)(1) permitting the partners to “waive the right to have the partnership’s business wound up and the partnership terminated” after which “the partnership resumes carrying on its business as if dissolution had never occurred”).

**Subsection (a)**—The first exclusion results inevitably from the effect of a statement of termination (*i.e.*, the limited liability company ceases to exist). A “dead” entity lacks both the capacity and power to bring itself back from the dead.

The second and third exclusions pertain to dissolutions affected by outsiders (*i.e.*, the court and the filing office).

**Subsections (b)(1)**—The requirement of unanimous consent protects any vested rights of, or reliance by, members. However, the operating agreement may vary this provision.

**Subsection (c)(3)**—This paragraph protects third parties. *E.g.*, *Neurobehavioral Assocs., P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 331 (Tex. Ct. App. 1999) (“If the Hospital had the right to terminate the Agreement when it did because the Association was then dissolved, then even though the Association can revoke articles of dissolution and have that relate back to the date of dissolution, it would be grossly unfair to let the Association assert its *ex post facto* change as a defense. Surely the Association would be estopped from doing so, having created the very conditions that gave the Hospital the correct impression that it was then dissolved.”).

## **SECTION 5-704. KNOWN CLAIMS AGAINST DISSOLVED LIMITED LIABILITY COMPANY.**

(a) Except as otherwise provided in subsection (d), a dissolved limited liability company may give notice of a known claim under subsection (b), which has the effect provided in subsection (c).

(b) A dissolved limited liability company may in a record notify its known claimants of

the dissolution. The notice must:

- (1) specify the information required to be included in a claim;
- (2) state that a claim must be in writing and provide a mailing address to which the claim is to be sent;
- (3) state the deadline for receipt of a claim, which may not be less than 120 days after the date the notice is received by the claimant; and
- (4) state that the claim will be barred if not received by the deadline.

(c) A claim against a dissolved limited liability company is barred if the requirements of subsection (b) are met and:

- (1) the claim is not received by the specified deadline; or
- (2) if the claim is timely received but rejected by the company:
  - (A) the company causes the claimant to receive a notice in a record stating that the claim is rejected and will be barred unless the claimant commences an action against the company to enforce the claim not later than 90 days after the claimant receives the notice; and
  - (B) the claimant does not commence the required action not later than 90 days after the claimant receives the notice.

(d) This section does not apply to a claim based on an event occurring after the date of dissolution or a liability that on that date is contingent.

### **Comment**

Sections 5-704 through 5-706 provide rules under which a dissolved limited liability company may achieve finality with regard to claims.

This section is derived almost verbatim from Model Business Corporation Act § 14.06.

**SECTION 5-705. OTHER CLAIMS AGAINST DISSOLVED LIMITED LIABILITY COMPANY.**

(a) A dissolved limited liability company may publish notice of its dissolution and request persons having claims against the company to present them in accordance with the notice.

(b) A notice under subsection (a) must:

(1) be published at least once in a newspaper of general circulation in the [county] in this state in which the dissolved limited liability company's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the company's registered agent is or was last located;

(2) describe the information required to be contained in a claim, state that the claim must be in writing, and provide a mailing address to which the claim is to be sent; and

(3) state that a claim against the company is barred unless an action to enforce the claim is commenced not later than three years after publication of the notice.

(c) If a dissolved limited liability company publishes a notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences an action to enforce the claim against the company not later than three years after the publication date of the notice:

(1) a claimant that did not receive notice in a record under Section 5-704;

(2) a claimant whose claim was timely sent to the company but not acted on; and

(3) a claimant whose claim is contingent at, or based on an event occurring after, the date of dissolution.

(d) A claim not barred under this section or Section 5-704 may be enforced:

(1) against a dissolved limited liability company, to the extent of its undistributed

assets; and

(2) except as otherwise provided in Section 5-706, if assets of the company have been distributed after dissolution, against a member or transferee to the extent of that person's proportionate share of the claim or of the company's assets distributed to the member or transferee after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution.

### **Comment**

This section is derived almost verbatim from Model Business Corporation Act § 14.07.

**Subsection (d)(2)**—Liability under this paragraph extends to those who have received distributions under a charging order. *See* the comment to Section 5-502(a) (explaining that the beneficiary of a charging order is a transferee). Unlike Section 5-406(c) (recapture of improper distributions), this paragraph contains no “knowledge” element.

### **SECTION 5-706. COURT PROCEEDINGS.**

(a) A dissolved limited liability company that has published a notice under Section 5-705 may file an application with [the appropriate court] in the [county] where the company's principal office is located or, if the principal office is not located in this state, where the office of its registered agent is or was last located, for a determination of the amount and form of security to be provided for payment of claims that are reasonably expected to arise after the date of dissolution based on facts known to the company and:

(1) at the time of application:

(A) are contingent; or

(B) have not been made known to the company; or

(2) are based on an event occurring after the date of dissolution.

(b) Security is not required for any claim that is or is reasonably anticipated to be barred

under Section 5-705.

(c) Not later than 10 days after the filing of an application under subsection (a), the dissolved limited liability company shall give notice of the proceeding to each claimant holding a contingent claim known to the company.

(d) In a proceeding under this section, the court may appoint a guardian ad litem to represent all claimants whose identities are unknown. The reasonable fees and expenses of the guardian, including all reasonable expert witness fees, must be paid by the dissolved limited liability company.

(e) A dissolved limited liability company that provides security in the amount and form ordered by the court under subsection (a) satisfies the company's obligations with respect to claims that are contingent, have not been made known to the company, or are based on an event occurring after the date of dissolution, and such claims may not be enforced against a member or transferee on account of assets received in liquidation.

### **Comment**

This section is derived almost verbatim from Model Business Corporation Act § 14.08.

### **SECTION 5-707. DISPOSITION OF ASSETS IN WINDING UP.**

(a) In winding up its activities and affairs, a limited liability company shall apply its assets to discharge the company's obligations to creditors, including members that are creditors.

(b) After a limited liability company complies with subsection (a), any surplus must be distributed in the following order, subject to any charging order in effect under Section 5-503:

(1) to each person owning a transferable interest that reflects contributions made and not previously returned, an amount equal to the value of the unreturned contributions; and

(2) among persons owning transferable interests in proportion to their respective

rights to share in distributions immediately before the dissolution of the company.

(c) If a limited liability company does not have sufficient surplus to comply with subsection (b)(1), any surplus must be distributed among the owners of transferable interests in proportion to the value of the respective unreturned contributions.

(d) All distributions made under subsections (b) and (c) must be paid in money.

### **Comment**

**Subsection (a)**—This subsection is non-waivable as to creditors who are not members. *See* Section 5-105(c)(15) (stating that the operating agreement may not “restrict the rights under this [Code] of a person other than a member or manager”). However, if a creditor is willing, a dissolved limited liability company may certainly make agreements with the creditor specifying the terms under which the LLC will “discharge its obligations” to the creditor.

**Subsections (b), (c) and (d)**—For the most part, these subsections state default rules. For example, operating agreements often provide for different distribution rights upon liquidation than during operations. However, distributions under these subsections (or otherwise under the operating agreement) are subject to Section 5-503 (charging orders). As to the extent the operating agreement can be amended to affect the distribution rights of persons already transferees, *see* Section 5-107(b).

## **[PART] 8**

### **ACTIONS BY MEMBERS**

#### **SECTION 5-801. DIRECT ACTION BY MEMBER.**

(a) Subject to subsection (b), a member may maintain a direct action against another member, a manager, or the limited liability company to enforce the member’s rights and protect the member’s interests, including rights and interests under the operating agreement or this [Code] or arising independently of the membership relationship.

(b) 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.



## Comment

**Subsection (a)**—A member’s rights under this subsection are subject to the rule of standing stated in Subsection (b). The phrase “otherwise protect the member’s interests” pertains to remedies and creates no additional causes of action.

The last phrase of this subsection (“or arising independently . . .”) does not create any new rights, obligations, or remedies, and is included merely to emphasize that a person’s membership in an LLC does not preclude the person from enforcing rights existing “independently of the membership relationship” (*e.g.*, as a creditor).

**Subsection (b)**—This subsection codifies the rule of standing that predominates in entity law. *See, e.g., PacLink Commc’ns Int’l, Inc. v. Superior Court*, 109 Cal. Rptr. 2d 436, 441 (Cal. Ct. App. 2001) (noting that, “[i]n determining whether an individual action as opposed to a derivative action lies, a court looks at ‘the gravamen of the wrong alleged in the pleadings’”; holding that “[a] contextual reading of [plaintiffs’] complaint makes clear that they are not suing based upon a claim that as members of the LLC they were entitled to a distribution which was not made, but instead are suing for financial injury caused by fraudulent transfer of the company’s assets”) (quoting *Nelson v. Anderson*, 84 Cal. Rptr. 2d 753. (Cal. Ct. App. 1999)); *Mallia v. PaineWebber, Inc.*, 889 F. Supp. 277, 282 (S.D. Tex. 1995) (“[T]o bring a direct representative action against a general partner, a limited partner must demonstrate either direct injury or an injury that exists independently of the partnerships.”); *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004) (expressly disapproving “both the concept of ‘special injury’ and the concept that a claim is necessarily derivative if it affects all stockholders equally,” stating that “a court should look to the nature of the wrong and to whom the relief should go,” requiring that any “claimed direct injury . . . be independent of any alleged injury to the [entity]”); *Tzolis v. Wolff*, 884 N.E.2d 1005, 1008 (N.Y. 2008) (holding that derivative actions exist under New York LLC law and referring to “the traditional line between direct and derivative claims”); *see also CML V, LLC v. Bax* 6 A.3d 238, 245 (Del. Ch. 2010) (noting that issues of standing viz-a-viz direct and derivative claims are comparable regardless of whether the entity is a limited partnership, a limited liability company, or a corporation), *aff’d*, 28 A.3d 1037 (Del. 2011).

The distinction between direct and derivative claims protects the operating agreement. If any member can sue directly over any management issue, the mere threat of suit can interfere with the members’ agreed-upon arrangements.

Although in ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract, within a limited liability company different circumstances typically exist. A member does not have a direct claim against a manager or another member merely because the manager or other member has breached

the operating agreement. Likewise a member's violation of this article does not automatically create a direct claim for every other member. To have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the limited liability company.

**EXAMPLE:** Through grossly negligent conduct, in violation of Section 5-409(c), the manager of a manager-managed LLC reduces the net assets of an LLC by fifty percent, which in turns decreases the value of Member A's investment by \$3,000,000. Member A has no standing to bring a direct claim; the damage is merely derivative of the damage first suffered by the LLC. Member A may, however, bring a derivative claim. Sections 5-802 through 5-806.

**EXAMPLE:** Same facts, except in addition to violating Section 5-409(c), the manager's conduct breaches an express provision of the operating agreement to which Member A is a signatory. The analysis and the result are the same.

**EXAMPLE:** An operating agreement defines "distributable cash" and requires the LLC to periodically distribute that cash among all members. The LLC's manager fails to distribute the cash. Each member has a direct claim against the manager and the LLC.

The reference to "threatened injury" is to encompass potential claims for preventative relief, such as a temporary restraining order or preliminary injunction.

This section's standing rule is subject to reasonable alterations by the operating agreement. *See* the comment to Section 5-105(c)(11).

**SECTION 5-802. DERIVATIVE ACTION.** A member may maintain a derivative action to enforce a right of a limited liability company if:

(1) the member first makes a demand on the other members in a member-managed limited liability company, or the managers of a manager-managed limited liability company, requesting that they cause the company to bring an action to enforce the right, and the managers or other members do not bring the action within a reasonable time; or

(2) a demand under paragraph (1) would be futile.

### **Comment**

**Paragraph (1)**—The demand requirement recognizes that, presumptively at least, the decision to cause a limited liability company to bring suit is a business decision, to be made by those who manage the business. Deborah A. DeMott, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5.9 (Westlaw, November 4, 2012) (Demand on directors—Rationales for demand).

**Paragraph (2)**—Some jurisdictions have a “universal demand” requirement, but the approach stated here is by far the majority one. Deborah A. DeMott, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 5.12 (Westlaw, November 4, 2012).

**SECTION 5-803. PROPER PLAINTIFF.** A derivative action to enforce a right of a limited liability company may be maintained only by a person that is a member at the time the action is commenced and:

- (1) was a member when the conduct giving rise to the action occurred; or
- (2) whose status as a member devolved on the person by operation of law or pursuant to the terms of the operating agreement from a person that was a member at the time of the conduct.

### Comment

The rule stated here is conventional in both the law of unincorporated entities and corporate law. Persons dissociated as members have no standing to bring a derivative action. *A fortiori*, mere transferees have no standing. See the comments to Sections 5-107(b) and 5-502.

**Paragraph (2)**—This paragraph will be inapposite if the limited liability company has only two members, one of whom is the derivative plaintiff. In that limited circumstance, the plaintiff’s death would cause the derivative action to abate. The “pick your partner” principal enshrined in Section 5-502 would prevent the decedent’s heirs from succeeding to plaintiff status in the derivative action (except in the unlikely event that the remaining member consents to the heirs becoming members). The analysis and result will be the same if the derivative plaintiff is an entity whose existence terminates.

This article takes no position on whether:

- the death of member abates a direct claim against the LLC or a fellow member; and
- bringing a direct claim precludes a person from being a proper plaintiff for a derivative claim.

As to the latter issue, see, *e.g.*, *Cordts-Auth v. Crunk, L.L.C.*, 815 F. Supp. 2d 778, 793–94 (S.D.N.Y. 2011) (discussing the potential conflict of interest), *aff’d*, 479 F. App’x 375 (2d Cir. 2012).

**SECTION 5-804. PLEADING.** In a derivative action, the complaint must state with particularity:

- (1) the date and content of plaintiff’s demand and the response to the demand by the

managers or other members; or

(2) why demand should be excused as futile.

### **Comment**

This section parallels Section 5-802. The pleading requirement first appeared in a uniform act in 1976. ULPA (1976) § 1003.

### **SECTION 5-805. SPECIAL LITIGATION COMMITTEE.**

(a) If a limited liability company is named as or made a party in a derivative proceeding, the company may appoint a special litigation committee to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests of the company. If the company appoints a special litigation committee, on motion by the committee made in the name of the company, except for good cause shown, the court shall stay discovery for the time reasonably necessary to permit the committee to make its investigation. This subsection does not prevent the court from:

(1) enforcing a person's right to information under Section 5-410; or

(2) granting extraordinary relief in the form of a temporary restraining order or preliminary injunction.

(b) A special litigation committee must be composed of one or more disinterested and independent individuals, who may be members.

(c) A special litigation committee may be appointed:

(1) in a member-managed limited liability company:

(A) by the affirmative vote or consent of a majority of the members not named as parties in the proceeding; or

(B) if all members are named as parties in the proceeding, by a majority of the members named as defendants; or

(2) in a manager-managed limited liability company:

(A) by a majority of the managers not named as parties in the proceeding;

or

(B) if all managers are named as parties in the proceeding, by a majority of the managers named as defendants.

(d) After appropriate investigation, a special litigation committee may determine that it is in the best interests of the limited liability company that the proceeding:

(1) continue under the control of the plaintiff;

(2) continue under the control of the committee;

(3) be settled on terms approved by the committee; or

(4) be dismissed.

(e) After making a determination under subsection (d), a special litigation committee shall file with the court a statement of its determination and its report supporting its determination and shall serve each party with a copy of the determination and report. The court shall determine whether the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof. If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court shall enforce the determination of the committee. Otherwise, the court shall dissolve the stay of discovery entered under subsection (a) and allow the action to continue under the control of the plaintiff.

### **Comment**

Although special litigation committees are best known in the corporate field, they are no more inherently corporate than derivative litigation or the notion that an organization is a person

distinct from its owners. An “SLC” can serve as an ADR mechanism, help protect an agreed upon arrangement from strike suits, protect the interests of members who are neither plaintiffs nor defendants (if any), and bring the benefits of a specially tailored business judgment to any judicial decision.

This section’s approach corresponds to established law in most jurisdictions, modified to fit the typical governance structures of a limited liability company. Use of an SLC is optional. An operating agreement can preclude the use of SLCs, rendering this section inapplicable, but cannot otherwise vary this section. *See* Section 5-105(c)(12).

**Subsection (a)(1)**—Section 5-410 pertains to information rights. On the availability of remedies pending the SLC’s investigation, *compare* Section 5-410, with *Kaufman v. Computer Assocs. Int’l, Inc.*, No. Civ.A. 699-N, 2005 WL 3470589, at \*1 (Del. Ch. Dec. 21, 2005) (presenting “the question of whether to stay a books and records action under 8 Del. C. § 220 at the request of a special litigation committee when a derivative action encompassing substantially the same allegations of wrongdoing filed by different plaintiffs is pending in another jurisdiction”; concluding “[f]or reasons that have much to do with the light burden imposed by the plaintiff’s demand in this case . . . that the special litigation committee’s motion to stay the books and records action should be denied”).

**Subsection (e)**—The standard stated for judicial review of the SLC determination follows *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979) rather than *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), because the latter’s reference to a court’s business judgment has generally not been followed in other states. In essence, an SLC is intended to function as a surrogate decision-maker, allowing the limited liability company to make what is fundamentally a business decision. If a court determines that “the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof,” it makes no sense to substitute the court’s legal judgment for the business judgment of the SLC.

*Houle v. Low*, 556 N.E.2d 51, 58 (Mass. 1990) contains an excellent explanation of the court’s role in reviewing an SLC decision:

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the [entity]’s best interest, a good deal of judicial oversight is necessary in each case. At the same time, however, courts must be careful not to usurp the committee’s valuable role in exercising business judgment. . . . [A] special litigation committee must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the plaintiff’s derivative suit. . . . The burden of

proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof—the [entity].

For an extensive discussion of how a court should approach the question of independence, see *Einhorn v. Culea*, 612 N.W.2d 78, 91 (Wis. 2000).

#### **SECTION 5-806. PROCEEDS AND EXPENSES.**

(a) Except as otherwise provided in subsection (b):

(1) any proceeds or other benefits of a derivative action, whether by judgment, compromise, or settlement, belong to the limited liability company and not to the plaintiff; and

(2) if the plaintiff receives any proceeds, the plaintiff shall remit them immediately to the company.

(b) If a derivative action is successful in whole or in part, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees and costs, from the recovery of the limited liability company.

(c) A derivative action on behalf of a limited liability company may not be voluntarily dismissed or settled without the court's approval.

#### **Comment**

**Subsection (c)**—This provision is intended to prevent collusion.

### **ARTICLE 6**

#### **LIMITED COOPERATIVE ASSOCIATIONS**

#### **[PART] 1**

#### **GENERAL PROVISIONS**

**SECTION 6-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Limited Cooperative Associations.

#### **Comment**

The title of this article indicates a limited cooperative association is a type of cooperative

different from cooperatives modeled on a corporate form, is an unincorporated association, and has aspects of limited partnerships and other unincorporated limited liability entities combined with features of cooperative organizations thought by many to be the “traditional” cooperative.

A limited cooperative association formed under this article is a type of cooperative that is different from cooperative statutes modeled on a corporate form. A limited cooperative association is an unincorporated association; and it has aspects of limited partnerships and other unincorporated limited liability entities combined with features of cooperative organizations thought by many to be the “traditional” cooperative.

Generally, statutes authorizing traditional cooperatives are limited to a specific purpose, for example, a statute authorizing electric cooperatives, or a statute authorizing a cooperative that can engage in agriculture and agricultural products. The ability to attract equity capital from outside investors is also limited in many of the more traditional cooperative statutes. A limited cooperative association formed under this article, however, can engage in any lawful purpose, regardless of whether for profit, and can have outside investor members who can have governance and voting rights, although the total voting power of the patron members must be at least a majority of the entire voting power. Moreover, a limited cooperative association may engage in restructuring transactions such as mergers and interest exchanges with other cooperatives or any other type of entity, can convert into any other form of entity, or domesticate in another state, assuming the other state has a cooperative statute similar to this article.

Unlike the other entity statutes in the Code, this article does not replace any existing cooperative statutes in this state. Existing cooperatives continue to be governed by the state’s statutes under which they were formed. A limited cooperative association is an additional legal form for a cooperative association.

## **SECTION 6-102. DEFINITIONS.**

(a) In this [article]:

(1) “Articles of organization” means the articles of organization of a limited cooperative association required by Section 6-301. The term includes the articles as amended or restated.

(2) “Board of directors” means the board of directors of a limited cooperative association.

(3) “Bylaws” means the bylaws of a limited cooperative association. The term includes the bylaws as amended or restated.

(4) “Contribution,” except as used in Section 6-1008(c), means a benefit that a



person provides to a limited cooperative association to become or remain a member or in the person's capacity as a member.

(5) "Cooperative" means a limited cooperative association or an entity organized under any cooperative law of any jurisdiction.

(6) "Director" means a director of a limited cooperative association.

(7) "Distribution," except as used in Section 6-1007(a), means a transfer of money or other property from a limited cooperative association to a member because of the member's financial rights or to a transferee of a member's financial rights.

(8) "Financial rights" means the right to participate in allocations and distributions as provided in [Parts] 10 and 12 but does not include rights or obligations under a marketing contract governed by [Part] 7.

(9) "Governance rights" means the right to participate in governance of a limited cooperative association.

(10) "Investor member" means a member that has made a contribution to a limited cooperative association and

(A) is not required by the organic rules to conduct patronage with the association in the member's capacity as an investor member in order to receive the member's interest; or

(B) is not permitted by the organic rules to conduct patronage with the association in the member's capacity as an investor member in order to receive the member's interest.

(11) "Limited cooperative association" means an association formed under this [article] or that becomes subject to this [article] under [Article] 2.

(12) “Member” means a person that is admitted as a patron member or investor member, or both, in a limited cooperative association. The term does not include a person that has dissociated as a member.

(13) “Member’s interest” means the interest of a patron member or investor member under Section 6-601.

(14) “Members meeting” means an annual members meeting or special meeting of members.

(15) “Organic rules” means the articles of organization and bylaws of a limited cooperative association.

(16) “Organizer” means an individual who signs the initial articles of organization.

(17) “Patron member” means a member that has made a contribution to a limited cooperative association and:

(A) is required by the organic rules to conduct patronage with the association in the member’s capacity as a patron member in order to receive the member’s interest; or

(B) is permitted by the organic rules to conduct patronage with the association in the member’s capacity as a patron member in order to receive the member’s interest.

(18) “Patronage” means business transactions between a limited cooperative association and a person which entitle the person to receive financial rights based on the value or quantity of business done between the association and the person.

(19) “Required information” means the information a limited cooperative

association is required to maintain under Section 6-110.

(20) “Voting group” means any combination of one or more voting members in one or more districts or classes that under the organic rules or this [Code] are entitled to vote and can be counted together collectively on a matter at a members meeting.

(21) “Voting member” means a member that, under the organic law or organic rules, has a right to vote on matters subject to vote by members under the organic law or organic rules.

(22) “Voting power” means the total current power of members to vote on a particular matter for which a vote may or is to be taken.

(b) The following definitions outside this [article] apply to this [article]:

- (1) “Entity” – Section 1-102(10).
- (2) “Foreign” – Section 1-102(14).
- (3) “Jurisdiction” – Section 1-102(21).
- (4) “Jurisdiction of formation” – Section 102(22).
- (5) “Organic law” – Section 1-102(32).
- (6) “Person” – Section 1-102(34).
- (7) “Principal office” – Section 1-102(35).
- (8) “Property” – Section 1-102(38).
- (9) “Receipt” – Section 1-102(40).
- (10) “Record” – Section 1-102(41).
- (11) “Registered agent” – Section 1-102(42).
- (12) “Sign” – Section 1-102(44).
- (13) “State” – Section 1-102(45).

(14) “Transfer” – Section 1-102(47).

### **Comment**

**Subsection (a)** – This subsection contains definitions for terms used throughout this article.

**Subsection (b)** – This subsection contains a list of definitions in Article 1 that are applicable to limited cooperative associations.

**“Articles of organization” [(a)(1)]** – This article purposely uses the term “articles of organization” instead of “certificate of organization” or “articles of incorporation.” The articles of organization may state substantive rules that together with the bylaws, govern the limited cooperative association and its members. For example, throughout this article there are references to “unless the organic rules otherwise provide.” The organic rules of an association are its articles of organization and bylaws. Section 6-102(16). Persons forming an association under this article may find it advisable in some circumstances to place provisions varying the default rules under the article in articles of organization. Therefore, the articles of organization filed under this article may be more detailed in practice than a certificate of organization of a limited liability company filed under Section 5-201. Items required to be placed in the articles are listed in Section 6-301. In addition, other sections of this article require items to be included in the articles of organization to be effective. *See* Section 6-109(b). Because an association under this article is not an incorporated entity, it would be inappropriate to call the “articles” articles of incorporation.

**“Bylaws” [(a)(3)]** – This definition must be read in conjunction with Section 6-303 and the various provisions permitting default rules to be varied by the organic rules. The definition is very broad when examined in light of Section 6-303(b) that permits the bylaws to contain any provision for managing and regulating the affairs of the association, unless prohibited by the article or the articles of organization.

Section 6-303(a) states bylaws must be in a record (Section 1-201(41)).

Courts examining the relationship between a traditional cooperative and its members have found the relationship to be contractual with bylaws of the cooperative, and in some cases, other records being part of the contract. *See* the comment to Section 6-601. “Bylaws” has been used in this article instead of operating agreement as used by limited liability companies or partnership agreement as used by partnerships to reflect the custom and practice in traditional cooperatives. Under this article, bylaws may have a look and feel similar to corporate bylaws or may have a look and feel similar to a limited liability company operating agreement or a partnership agreement.

**“Contribution” [(a)(4)]** – This definition helps to distinguish capital contributions from other benefits which a member or other person provides to a limited cooperative association in a different capacity under Section 6-111. For example, if an individual provides services to the association in exchange for a membership in the association, the value of the services are a

capital contribution. If the association hires the individual as an employee, the value of the services rendered to the association as an employee are not contributions.

The term “contribution” plays an important role in the sections of this article relating to financial rights and governance rights.

**“Cooperative” [(a)(5)]** – In this article the term “cooperative” includes limited cooperative associations and all other types of cooperatives organized under any other cooperative law whether or not formed in this state. It includes entities formed under organic laws commonly considered cooperative laws. It does not include entities formed under other organic laws but operating on a cooperative basis as permitted, for example, under Subchapter T of the Internal Revenue Code.

**“Distribution” [(a)(7)]** – The term includes a transfer of money or other property by a limited cooperative association to a member or transferee in the form of a payment or other transfer of profits previously allocated to the member, dividends, cash portions of patronage dividends or refunds, repurchase redemption of retained allocated amounts not previously distributed, or any other form of payment or transfer with respect to the member’s or transferee’s financial rights. A distribution is different from an allocation. An allocation is a bookkeeping and accounting concept under this article. “Allocation” may have important implications under income tax law. The term “distribution” does not typically include money or other property paid to a member for goods or services.

The term does not include amounts payable to a member by a limited cooperative association under commercial, contractual or other arrangements that are not within the association/member relationship even if these arrangements are made available only to members.

EXAMPLE: Wages paid to a worker in a worker owned limited cooperative association are not distributions.

EXAMPLE: A farmer sells oranges to an association for a fixed price. Payment of the price by the association is not a distribution.

EXAMPLE: A farmer sells oranges to an association for a price determined by the association’s proceeds from resale, less its expenses. Payment of the price by the association is not a distribution.

**“Financial rights” [(a)(8)]** – “Financial rights” include rights to participate in the financial results of the operations of a limited cooperative association. For example, the term includes the right to be allocated profits and losses, to receive a proportionate share of distributions made to members, to receive dividends if dividends are a method used to distribute funds, to receive patronage allocations and dividends, to receive rebates, to have retained patronage allocations and per unit retains credited to the member’s capital account, to receive an allocated share of losses, to receive payments for redemptions of retained patronage allocations or per unit retains, to receive a return of capital however described, to receive distributions upon dissolution and winding-up, as well as to receive any other allocations or distributions from the

association that are a result of membership in the association.

Financial rights are separate and distinct from governance rights and other rights of a member, if any, to contract or otherwise transact business with a limited cooperative association. For example, in an agricultural limited cooperative association, membership may be required for an agricultural producer to be entitled to deliver his or her production to the association for processing. In an association where workers are the patron members, membership in the association may be required to be an employee of the association. Neither of these constitutes financial or governance rights but would be an integral part of the membership in the association.

**“Governance rights” [(a)(10)]** – “Governance rights” include, but are not limited to, the right of a member to vote on matters affecting a limited cooperative association to the extent the article or the organic rules provide voting power to the member, the right to receive notices of members meetings and the right to participate in members meetings. “Governance rights” also include the right to petition the association or the board of directors and may be a required qualification, director or member of a committee of an association.

**“Investor member” [(a)(11)]** – An “investor member” is a member who contributes capital to a limited cooperative association, may be provided governance rights, and is not required to conduct business with the association. The existence of investor members and patron members in a single entity is unusual, but not entirely novel, in traditional cooperatives whose organic law generally allows for preferred stockholders without governance rights. Allowing investor members to possess governance rights is an identifying feature of this article.

**“Member” [(a)(13)]** – “Member” means both patron members and investor members. The definition recognizes a person can hold interests in a limited cooperative association either as a patron member or as an investor member. If a person holds both types of membership interests, each interest is governed by the provisions of this article and the organic rules related to the particular type of membership. *See* Section 6-112.

A person may transact business with an association without being a member if the association’s organic rules or operating methods permit it. The organic rules may provide that the non-member may have financial rights in the association (*e.g.*, rights to allocations of net profits) but not governance rights.

**“Members meeting” [(a)(15)]** – This article does not address record dates for voting at a members meeting (or for other matters, except to the extent an accounting date is used for determining allocations of profits and losses). The article does not prohibit the organic rules, nor if the organic rules are silent, does it prohibit the board of directors from establishing a record date for determining voting members for purposes of a vote under the boards general authority.

**“Organic rules” [(a)(16)]** – The definition of “organic rules” is confined to articles of organization and bylaws of a limited cooperative association. An association may have other contractual relationships providing benefits and obligations between the association and a member through a membership agreement, marketing contract, or other contractual relationship. Contracts of this type may have a material effect on the relationship of a member to the

association but they are not included in the statutory term for purposes of this article unless unique factual context otherwise requires. The board of directors may adopt policies and procedures that are not within the definition of organic rules.

**“Patron member” [(a)(18)]** – A “patron member” is a member who is entitled or required to conduct patronage with a limited cooperative association, has governance rights, and may be required to pay a fee or make an investment to become a patron member. The fees or investments do not transform the patron member to an investor member or imply a dual capacity; that status is governed by the organic rules under this article. Generally, an association must have two patron members to begin business. *See* Section 6-501.

**“Patronage” [(a)(19)]** – “Patronage” is a term of art adopted for this article from traditional cooperative principles and concepts. “Patronage” may be conducted with a limited cooperative association by non-members as well as members if permitted by the association’s organic rules.

**“Required information” [(a)(20)]** – Information required to be maintained under Section 6-114 is significant in relation to the ability for members to access information from a limited cooperative association under Section 6-505.

**“Voting group” [(a)(21)]** – Sections 6-511 and 6-517 permit patron members to be divided into geographic districts and for patron members and investor members to be divided into classes. If the members in a district or class have voting rights under the organic rules, the members in a district or class, or a combination of them, are a voting group whose voting procedures may be governed by the organic rules pursuant to Section 6-517. Similarly situated members are required to vote as a voting group where their rights are potentially affected adversely by the vote. *See e.g.*, Section 6-404.

**“Voting member” [(a)(22)]** – This article requires that every patron member be entitled to vote. The organic rules could create classes of investor members that do not have voting rights.

**“Voting power” [(a)(23)]** – “Voting power” encompasses all votes that may be cast by members as provided by this article or the organic rules on a particular matter.

### **SECTION 6-103. NATURE OF LIMITED COOPERATIVE ASSOCIATION.**

(a) A limited cooperative association organized under this [article] is an autonomous, unincorporated association of persons united to meet their mutual interests through a jointly owned enterprise primarily controlled by those persons, which permits combining:

(1) ownership, financing, and receipt of benefits by the members for whose interests the association is formed; and

(2) separate investments in the association by members who may receive returns on their investments and a share of control.

(b) The fact that a limited cooperative association does not have one or more of the characteristics described in subsection (a) does not alone prevent the association from being formed under and governed by this [article] nor does it alone provide a basis for an action against the association.

### **Comment**

Section 6-103 is descriptive of an entity that is organized in conformity with this article and, as such, there are no consequences if the limited cooperative association fails to conform to the description in this Section. Cooperative values and principles are distributed throughout the article, though some are varied as a result of permitting investor members with limited governance rights.

This section introduces cooperative values and principles in this article. The values and principles reflected elsewhere in the article are in some cases mandatory and in others matters of default unless the association “opts-out”.

Understanding the article at a fundamental level is aided by an overview of cooperative values and principles. They have been stated in different ways, *see* Prefatory Note, and different kinds of cooperatives reflect them in various combinations and diverse ways.

As a matter of general consensus cooperative values and principles include voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; cooperation among cooperatives; and, concern for community.

Section 6-103 addresses the values of voluntary membership, member economic participation, and autonomy and independence. Voluntary membership is reflected by the term “persons united” in this section and relationships that are “consensual” in Section 6-109(a). Open membership has been compromised under this article and similar existing law in order to allow (but not require) the formation of “closed” cooperatives. Closed cooperative structure is necessary where an association desires for patron members to share fully in any increased value of their equity and to provide member liquidity.

A limited cooperative association is a self-help organization controlled by its members and is a separate entity from its members under Section 6-104(a). This principle of autonomy must, however, be placed within the practical context of long-term debt, equity, and contractual relationships both in this article and in traditional cooperatives.

Section 6-1004 (“Allocations of Profits and Losses”) expressly provides for the values of



member economic participation; education, training and information; and cooperation among cooperatives. One of the key balancing points of this article concerns “democratic member control.” Sections 6-405, 6-511 through 6-514, 6-804, and 6-816(a) (as well as the other voting provisions on fundamental changes) all relate to this balance.

“Concern for community” is directly addressed in Section 6-820 which varies the law generally applicable to, for example, corporate directors, to allow the directors of a limited cooperative to consider a number of community constituencies in making decisions.

Another frequently articulated cooperative principle is “operation at cost.” This principle is frequently recognized through allocations of profits and losses among members in a traditional cooperative in a manner similar to allocations in partnerships. Section 6-1004 reflects this approach. “Operation at cost” can also be addressed through pricing of goods and services received from or provided to members in ways that financially benefit the members. This, in turn, will affect profits and losses available for allocation to members. This approach is taken in this article.

In sum, this article expressly considers important traditional cooperative values and provides reasoned departures from those values only where necessary for purposes of this article. Its intention is to encourage the use of entities recognizing cooperative principles by providing greater options for obtaining equity financing, yet is flexible enough to form a limited cooperative association which operates like a traditional cooperative.

#### **SECTION 6-104. PURPOSE AND DURATION OF LIMITED COOPERATIVE ASSOCIATION.**

(a) A limited cooperative association is an entity distinct from its members.

(b) A limited cooperative association may be organized for any lawful purpose, regardless of whether for profit [except designated prohibited purposes].

(c) Unless the articles of organization state a term for a limited cooperative association’s existence, the association has perpetual duration.

**Legislative Note:** *This article does not preclude a limited cooperative association organized under this article from pursuing any lawful purpose. If an adopting jurisdiction desires to prevent an association under this article from being used for a particular purpose, this can be accomplished as follows. First, an exception for the particular purpose can be specified in subsection (b). Second, if there is another statute in the adopting jurisdiction that governs the particular purpose and that statute by its own terms does not already apply, the other statute could be amended to ensure that no entity organized under this article may pursue the purpose identified in the other statute or that any entity organized under this article will comply with the other statute. Third, Section 6-107 may identify a particular purpose or statute with which this*

*article should be coordinated; as is done in optional Section 6-107(c).*

### **Comment**

**Subsection (a)** – This section, together with Section 6-103, identifies the “separate entity” concept of a limited cooperative association. *See* the comment to Section 6-103.

**Subsection (b)** – The phrase “any lawful purpose, regardless of for profit” means a limited cooperative association need not be formed or operated with a profit motive. Existing law in some states provides traditional cooperatives may be formed under not-for-profit cooperative statutes which reflect the cooperative value of operating at cost.

The subsection does not prevent a limited cooperative association from being organized to carry on charitable activities, but with the exception of Section 2-104(b), this article does not include any specific protective provisions pertaining to charitable purposes. Those protections must be (and typically are) found in other law, although sometimes that “other law” appears within a state’s non-profit corporation statute. *See, e.g.,* MINN. STAT. ANNOT. § 317A.811 (2006) (providing restrictions on charitable organizations that seek to “dissolve, merge, or consolidate, or to transfer all or substantially all of their assets” but imposing those restrictions only on “corporations” which are elsewhere defined as corporations incorporated under the non-profit corporation act). Of course, tax law significantly effects charities and contains strict parameters beyond the scope of this article.

Section 6-107 emphasizes that protective and other regulatory provisions outside this article remain applicable to limited cooperative associations. Those laws and regulations are not supplanted by this article or the organic rules of an association organized under this article. *See* Section 6-109.

**Subsection (c)** – In this context, the word “perpetual” states the default rule consistent with statutes governing other entities. As in many current limited liability company statutes, this article provides several methods that could be used to override perpetuity: a term specified in the articles of organization and occurrences specified in Sections 6-1202, 6-1203, 6-1205, and 1-602. In this article, “perpetuity” means that the article does not require a definite term and creates no nexus between the dissociation of a member and the dissolution of the association beyond, in most cases, the requirement that a limited cooperative association have two members. *See* Section 6-501. (The dissociation of an association’s last remaining member does threaten dissolution under the compulsory provisions of Section 6-1202(3).)

**SECTION 6-105. POWERS.** A limited cooperative association has the capacity to sue and be sued in its own name and has the power to do all things necessary or convenient to carry on its activities and affairs. An association may maintain an action against a member for harm caused to the association by the member’s violation of a duty to the association or of the organic law or organic rules.

## Comment

As is the case with all the other uniform unincorporated entity acts, this article omits as unnecessary any detailed list of specific powers.

The capacity to sue and be sued is mentioned specifically. It cannot be varied by the organic rules. *See* Section 6-109. The section affirms the right of a limited cooperative association to maintain an action against a member in the circumstances described.

The omission of any reference to non-members in connection with a limited cooperative association maintaining an action against a member does not imply that an association may not sue non-members or restrict the association from engaging in business or other transactions with non-members *See* Section 1-702 (Supplemental Principles of Law). It is intended to broaden the rights of the association rather than narrow them.

**SECTION 6-106. GOVERNING LAW.** The law of this state governs:

- (1) the internal affairs of a limited cooperative association; and
- (2) the liability of a member as member and a director as director for the debts, obligations, or other liabilities of a limited cooperative association.

## Comment

This Section may not be varied by the organic rules. *See* Section 6-109. This article is part of the law of this state. *See generally*, Section 6-109(a) (addressing the flexibility of this article).

**Paragraph (1)** – The laws of this state, including this article, govern the interpretation and enforcement of the organic rules and matters relating to relations among members as members and relations between the limited cooperative association and the members as members regardless of where the members are located. *Compare* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §302, Comment A (defining “internal affairs” with reference to a corporation as “the relations inter se of the corporation, its shareholders, directors, officers or agents”). Like any other legal concept, “internal affairs” in paragraph (1) may be indeterminate in some circumstances.

In some types of cooperatives marketing contracts are an integral part of an association’s business. Part 7 (“Marketing Contracts”) of this article, like most traditional marketing cooperative statutes, allows all or part of a marketing contract to be included in the organic rules. The placement of the terms of the marketing contract in the organic rules or in a separate agreement is not necessarily determinative of whether those terms are part of the internal affairs of the association. *See* the comments to Sections 6-601 and 6-701.

**Paragraph (2)** – This paragraph relates to Section 6-504 (the liability shield for

members) and Section 6-802 (the liability shield of directors) but does not necessarily encompass a claim for which a member or director may be liable to a third party for (i) having purported to bind a limited cooperative association to the third party; or (ii) having committed a tort against the third party while acting on the association's behalf or in the course of its business. That liability is not by status (*i.e.*, not as a member) but rather results from behavior or conduct, which is governed by agency or other law.

#### **SECTION 6-107. REQUIREMENTS OF OTHER LAWS.**

(a) This [article] does not alter or amend any law that governs the licensing and regulation of an individual or entity in carrying on a specific business or profession even if that law permits the business or profession to be conducted by a limited cooperative association, a foreign cooperative, or its members.

(b) A limited cooperative association may not conduct an activity that, under law of this state other than this [article], may be conducted only by an entity that meets specific requirements for the internal affairs of that entity unless the organic rules of the association conform to those requirements.

[(c) If an activity of a limited cooperative association is within the scope of [reference to the Uniform Common Interest Ownership act or to the Model Real Estate Cooperative act], the requirements of [reference to the Uniform Common Interest Ownership act or to the Model Real Estate Cooperative act] apply, even if there is a conflicting provision in this [article].]

**Legislative Note:** *If an adopting jurisdiction has enacted the Uniform Common Interest Ownership Act or the Model Real Estate Cooperative Act, the adopting jurisdiction should add subsection (c).*

*The phrase "limited cooperative associations" should be added by amendment to other statutes outside this article that contain lists of entities and other law should be conformed as appropriate.*

#### **Comment**

Section 6-107 may appear to be surplusage because it restates the application of known legal interpretive principles outside this article. Nonetheless it attempts to make clear that this article is limited to its terms; that it does not supersede other law, either directly or by implication, including regulatory law; and that a limited cooperative association organized under

this article is not exempt from separately qualifying as a “cooperative” under other law. Thus, it serves a similar purpose for domestic associations as does Section 1-501 for foreign cooperatives which provides that a “certificate of authority does not authorize the cooperative to exercise any power not given a limited cooperative association in this state”. To an extent, this is related to the policy that the use of the term “limited” is included in the name of the association to distinguish it from cooperatives formed under other law.

The following examples illustrate the application of this Section.

EXAMPLE: Ten construction workers desire to form a worker’s cooperative as a limited cooperative association. Organizing as a limited cooperative association will not excuse the limited cooperative from any contractor bonding requirements in other law. Further, the limited cooperative association will be required to comply with applicable wage and hour law.

EXAMPLE: Same scenario as in previous example except the jurisdiction in which the workers desire to form a limited cooperative association has a specific workers’ cooperative statute that expressly states all workers cooperatives must be organized under the workers cooperative statute. Workers cannot lawfully organize a workers cooperative under this article in that jurisdiction.

EXAMPLE: A group of consumers desires to form a limited cooperative association to conduct business as a natural foods cooperative. The association must comply with the health regulations applicable to grocery businesses as well as laws relating to distribution of natural foods.

EXAMPLE: A real estate developer desires to organize as a limited cooperative association to develop property as a “housing cooperative.” The state has a housing cooperative law that applies to all “residential common interest communities.” In turn the statute defines “residential common interest community.” If the planned project organized as a limited cooperative association meets the definition of the “residential common interest community,” all the provisions of that law apply to the developer, the project, and the limited cooperative association. If the law contains disclosure requirements the association must make the required disclosures.

The number and types of regulatory laws are too numerous to list in the text of this article and any exclusive list of laws or activities raises the risk of inadvertent omission. For example, the application for, the qualification of, and the licensing and examination of the following business professions would appear in a comprehensive statutory list: legal, medical, dental, optometry, engineers, architects, surveyors, public accountancy, opticians, psychologists, veterinary medicine, speech pathologists, audiologists, financial institutions, contractors, fumigators, pest control operators, real estate brokers and sales persons, electricians, plumbers, real estate appraisers, photographers, pharmacists, physical therapy, podiatry, barbering, nursing, social workers, embalmers and funeral directors, motor vehicle dealers, boxing contests, cable television, and degree granting institutions.

The list would include other general trade regulation and trade practice law such as trademark and trade names, trade secrets, franchise investment, business opportunity, consumer law, public accommodations, and many others.

**Subsection (a)** – This subsection is a general statement that the requirements of licensing and regulatory law apply to the conduct of activity by or through a limited cooperative association organized under it without attempting to provide a comprehensive list of specific professions, trades, or businesses.

EXAMPLE: Two real estate brokers desire to form a limited cooperative association for the sale of residential real estate on a commission basis. Nothing in this article would preclude them from organizing a limited cooperative association. Nonetheless, the form of the organization in which they conduct that activity is still subject to the law regulating the sale of residential real estate on a commission basis. Therefore if those laws do not permit the limited cooperative association as a permissible form in which to conduct business, the real estate brokers may not organize as an association to conduct their business. Moreover, organizing as a limited cooperative association, even if allowed for this purpose, will not exempt it from the application of other applicable regulation or law such as disclosure requirements or standards for the maintenance of trust funds or escrow accounts.

**Subsection (b)** – Some other laws contain requirements for the internal affairs of any organization used to conduct a specific activity or to perform a specific function. This subsection is a general statement that those requirements apply to a limited cooperative association conducting those activities or performing those functions.

EXAMPLE: Same facts as in the previous example. The state housing cooperative law is silent concerning the type of entity permitted to be a “homeowners association.” The statute does require that all members of the homeowners association must be able to vote in particular matters by a proxy and that only homeowners may be members of the association. Under these facts the homeowners association could be formed as a limited cooperative association but it would be necessary that the organic rules provide for voting by a proxy and include the membership restrictions required by the housing cooperative law.

**Subsection (c)** – This subsection recognizes that the state’s housing cooperative law contains a comprehensive and integrated regulatory scheme that extends to a substantial number of aspects of a housing cooperative. As a result, it might be argued that limited cooperative associations should not be able to be formed for that purpose. Exclusions described in terms of broad activities or purposes, however, are likely to be difficult to interpret and apply and run the risk of being either over or under exclusive. Expressly referencing a specific act mitigates these difficulties while clearly emphasizing the desired regulatory result which would probably otherwise apply because of subsections (a) and (b). This is consistent with the policy of permitting limited cooperative associations to be available for a broad range of endeavors.

## **[SECTION 6-108. RELATION TO RESTRAINT OF TRADE AND ANTITRUST**

**LAWS.** To the extent a limited cooperative association or activities conducted by the association in this state meet the material requirements for other cooperatives entitled to an exemption from or immunity under any provision of [the restraint of trade or antitrust laws of this state], the association and its activities are entitled to the exemption or immunity. This section does not create any new exemption or immunity for an association or affect any exemption or immunity provided to a cooperative organized under any other [law].]

***Legislative Note:** Some states' existing general cooperative or marketing cooperative statutes contain an exemption from state restraint of trade and antitrust laws. In the context of a marketing cooperative such an exemption is historical and may be helpful because cooperatives are united groups of producers that could be interpreted to be fixing prices.*

*This section is bracketed because some states as a matter of policy do not include an exception in their other cooperative statutes and, presumably, would not include them in this article. Moreover because this article, unlike other cooperative statutes, allows for investor members, it can be distinguished from cooperatives organized under other laws. It is appropriate, therefore, that adopting jurisdictions consider if their existing policy should be applied to limited cooperative associations.*

### **Comment**

Many state cooperative statutes, most particularly marketing cooperative statutes, contain special exemptions from state antitrust and restraint of trade laws. There is variety in the formulation of such exemptions even in marketing cooperative statutes and the variation reflects policy distinctions between states. This section reflects the settled policy of this state by reference to existing law.

## **SECTION 6-109. EFFECT OF ORGANIC RULES.**

(a) The relations between a limited cooperative association and its members are consensual. Unless required, limited, or prohibited by this [article], the organic rules may provide for any matter concerning the relations among the members of the association and between the members and the association, the activities of the association, and the conduct of its activities.

(b) The matters referred to in paragraphs (1) through [(9)] [(11)] may be varied only in the articles of organization. The articles may:

- (1) state a term of existence for the association under Section 6-104(c);
- (2) limit or eliminate the acceptance of new or additional members by the initial board of directors under Section 6-302(b);
- (3) vary the limitations on the obligations and liability of members for association obligations under Section 6-504;
- (4) require a notice of an annual members meeting to state a purpose of the meeting under Section 6-508(b);
- (5) vary the board of directors meeting quorum under Section 6-815(a);
- (6) vary the matters the board of directors may consider in making a decision under Section 6-820;
- (7) specify causes of dissolution under Section 6-1202(1);
- (8) delegate amendment of the bylaws to the board of directors pursuant to Section 6-405(f);
- (9) provide for member approval of asset dispositions under Section 6-1401; [and]
- [(10)] subject to Section 6-820, provide for the elimination or limitation of liability of a director to the association or its members for money damages pursuant to Section 6-818;
- [(11)] provide for permitting or making obligatory indemnification under Section 6-901(a); and]
- [(10)] [(12)] provide for any matters that may be contained in the organic rules, including those under subsection (c).



(c) The matters referred to in paragraphs (1) through (25) may be varied only in the organic rules. The organic rules may:

(1) require more information to be maintained under Section 6-110 or provided to members under Section 6-505(j);

(2) provide restrictions on transactions between a member and an association under Section 6-111;

(3) provide for the percentage and manner of voting on amendments to the organic rules by district, class, or voting group under Section 6-404(a);

(4) provide for the percentage vote required to amend the bylaws concerning the admission of new members under Section 6-405(e)(5);

(5) provide for terms and conditions to become a member under Section 6-502;

(6) restrict the manner of conducting members meetings under Sections 6-506(c) and 6-507(e);

(7) designate the presiding officer of members meetings under Sections 6-506(e) and 6-507(g);

(8) require a statement of purposes in the annual meeting notice under Section 6-508(b);

(9) increase quorum requirements for members meetings under Section 6-510 and board of directors meetings under Section 6-815;

(10) allocate voting power among members, including patron members and investor members, and provide for the manner of member voting and action as permitted by Sections 6-511 through 6-517;

(11) authorize investor members and expand or restrict the transferability of

members' interests to the extent provided in Sections 6-602 through 6-604;

(12) provide for enforcement of a marketing contract under Section 6-704(a);

(13) provide for qualification, election, terms, removal, filling vacancies, and member approval for compensation of directors in accordance with Sections 6-803 through 6-805, 6-807, 6-809, and 6-810;

(14) restrict the manner of conducting board meetings and taking action without a meeting under Sections 6-811 and 6-812;

(15) provide for frequency, location, notice and waivers of notice for board meetings under Sections 6-813 and 6-814;

(16) increase the percentage of votes necessary for board action under Section 6-816(b);

(17) provide for the creation of committees of the board of directors and matters related to the committees in accordance with Section 6-817;

(18) provide for officers and their appointment, designation, and authority under Section 6-822;

(19) provide for forms and values of contributions under Section 6-1002;

(20) provide for remedies for failure to make a contribution under Section 6-1003(b);

(21) provide for the allocation of profits and losses of the association, distributions, and the redemption or repurchase of distributed property other than money in accordance with Sections 6-1004 through 6-1007;

(22) specify when a member's dissociation is wrongful and the liability incurred by the dissociating member for damage to the association under Section 6-1101(b) and (c);

(23) provide the personal representative, or other legal representative of, a deceased member or a member adjudged incompetent with additional rights under Section 6-1103;

(24) increase the percentage of votes required for board of director approval of:

- (A) a resolution to dissolve under Section 6-1205(a)(1);
- (B) a proposed amendment to the organic rules under Section 6-402(a)(1);
- (C) transaction under [Article] 2 as required under Section 6-518; and
- (D) a proposed disposition of assets under Section 6-1403(1); and

(25) vary the percentage of votes required for members approval of:

- (A) a resolution to dissolve under Section 6-1205;
- (B) an amendment to the organic rules under Section 6-405;
- (C) a transaction under [Article] 2 as required under Section 6-518; and
- (D) a disposition of assets under Section 6-1404.

(d) The organic rules must address members' contributions pursuant to Section 6-1001.

**Legislative Note:** Bracketed subsections (a)(10) and (11) are illustrative. They apply only if the adopting jurisdiction selects both the state general business corporation act in Sections 6-818 and 6-901 and the act so selected provides for modification of those standards in the articles of incorporation. Thus, these provisions need to be conformed to the flexibility of choice provided by those sections.

### Comment

The article contains default rules which may be varied by the organic rules (Section 6-102(a)(11)). This section identifies specific provisions in the article that may be altered, eliminated, revised or otherwise modified by the organic rules. Subsection (b) identifies those provisions that may be modified only in the articles of organization. Subsection (c) identifies those provisions that may be modified in either the articles or the bylaws (the "organic rules"). The provisions identified in subsections (b) and (c) are substantive only to the extent they provide guidance on the interpretation of phrases like "unless otherwise provided in the organic rules." They serve the additional function of collecting references to provisions where variance from statutory default rules must be in the organic rules.

**Subsection (a)** – This article generally follows the approach of other unincorporated entity statutes. If a particular matter is not prohibited or specifically mandated by the article, a limited cooperative association may deal with the matter as part of its internal governance structure. If the article does not address a subject with a specific requirement, permission, limitation or prohibition, a limited cooperative association is not limited in its approach or activities with respect to the subject.

**Subsections (b) and (c)** – In this article, where the phrase “unless the organic rules otherwise provide” is used, that phrase signals freedom for the organic rules to vary the provision in which the phrase appears unless the provision itself contains a constraint on that freedom. In effect these provisions contain default rules. *See, e.g.*, Sections 6-602 and 6-1005.

Other techniques are used to signal that sections are not mandatory. In some sections of the article, there are specific prohibitions on how the article may be varied or on how negation of a default result, such as a default delegation of authority to the board of directors, must be made. *See, e.g.*, Sections 6-812(a) and 6-1004(d). Other provisions in the article use the phrase “may provide” to emphasize the flexibility of the article and to provide further guidance with respect to a particular subject. The phrase does not necessarily grant additional authority beyond what is already available. By way of illustration, where “may provide” is used, the organic rules may state specific rules, instructions or results or may state a procedure by which the subject matter will be decided, such as delegating authority to the board of directors. *See, e.g.*, Sections 6-515(c) and (d) and 6-1004(a).

**Subsection (d)** – This subsection is included to make it clear that contributions must be addressed in the organic rules. The subject matter of this subsection may represent a trap for the unwary. Though there are no negative legal consequences for not addressing contributions provided in this article changes in contribution requirements require super-majority member vote.

## **SECTION 6-110. REQUIRED INFORMATION.**

(a) Subject to subsection (b), a limited cooperative association shall maintain in a record available at its principal office:

(1) a list containing the name, last known street address and, if different, mailing address, and term of office of each director and officer;

(2) the initial articles of organization and all amendments to and restatements of the articles, together with a signed copy of any power of attorney under which any article, amendment, or restatement has been signed;

(3) the initial bylaws and all amendments to and restatements of the bylaws;

- (4) all filed articles of merger, interest exchange, conversion, and domestication;
- (5) all financial statements of the association for the six most recent years;
- (6) the six most recent [annual] [biennial] reports delivered by the association to the [Secretary of State];
- (7) the minutes of members meetings for the six most recent years;
- (8) evidence of all actions taken by members without a meeting for the six most recent years;
- (9) a list containing:
  - (A) the name, in alphabetical order, and last known street address and, if different, mailing address of each patron member and each investor member; and
  - (B) if the association has districts or classes of members, information from which each current member in a district or class may be identified;
- (10) the federal income tax returns, any state and local income tax returns, and any tax reports of the association for the six most recent years;
- (11) accounting records maintained by the association in the ordinary course of its operations for the six most recent years;
- (12) the minutes of directors meetings for the six most recent years;
- (13) evidence of all actions taken by directors without a meeting for the six most recent years;
- (14) the amount of money contributed and agreed to be contributed by each member;
- (15) a description and statement of the agreed value of contributions or benefits other than money made or provided and agreed to be made or provided by each member;

(16) the times at which, or events on the happening of which, any additional contribution is to be made by each member;

(17) for each member, a description and statement of the member's interest or information from which the description and statement can be derived; and

(18) all communications concerning the association made in a record to all members, or to all members in a district or class, for the six most recent years.

(b) If a limited cooperative association has existed for less than the period for which records must be maintained under subsection (a), the period records must be kept is the period of the association's existence.

(c) The organic rules may require that more information be maintained.

### **Comment**

This section defines a minimum amount of information that must be maintained by a limited cooperative association. The listed items do not specify all records that may be advisable for an association to maintain for legal or business purposes. The section does not prohibit an association from maintaining other records. The organic rules may identify other records to be maintained and specify the time period they must be maintained. The organic rules may also provide that records may be kept longer than the time specified in this section.

Although the section provides periods during which some of the listed items are to be maintained for purposes of this article, this does not define the time frame for which the items should be maintained for other purposes, *e.g.*, records for purposes of taxation. As a practical matter, business practices may require that certain records such as minutes of directors and members meetings be maintained for longer periods. The period for maintenance of records is a matter for determination by the association except for the required minimum periods. The maintenance of records may also be governed by other law, for example, immigration compliance records and record retention for discovery under rules of civil procedure for pending or threatened litigation.

This section coordinates with Section 6-505 ("Right of Member and Former Member to Information"). Section 6-505 that provides the rights of members and former members to access information required to be maintained under this section. Conditions and limitations on a member's rights to information are also contained in Section 6-505.

**Subsection (a)** – The requirement that a record of the required information be "available" at the "principal office" of the association does not mean the record must be maintained there at

all times. It is sufficient if the record can be obtained and made available at the office and, therefore, includes records maintained electronically or in other forms that may or may not be instantaneously available.

The association's principal office under the article is the principal executive office of the association or a foreign cooperative wherever located. Section 1-102(35).

The form of the record in which the information must be maintained is any form included in the definition of "record" in Section 1-102(41).

**Subsection (a)(1)** – "Officer" is not a defined term but means only individuals that have executive authority beyond the title of "officer".

**Subsections (a)(2) and (3)** – These requirements apply to superseded as well as current articles of organization and bylaws.

**Subsections (a)(8) and (13)** – These subsections do not require a limited cooperative association to make a record of consents given and votes taken although this may be required by Sections 6-516 and 6-812.

**Subsection (a)(15)** – The information required by this provision is essential for determining the rights and interests of a member generally and is especially important where a member is both a patron member and an investor member. It is also necessary because the information is referenced in Section 6-505(e) permitting a member to access the member's own information with respect to a limited cooperative association. This information may be particularly important where a member with dual capacity dissociates in one capacity but not the other.

**Subsection (a) (18)** – The emphasis in this subsection is on "all members." The subsection does not require communications to an individual member; only communications directed to all members of a limited cooperative association or to all members in a district or class must be maintained.

**Subsection (c)** – This subsection is a good example of the operation of Section 6-109(c) because requiring greater information would be the rule even without this subsection. *See* the comment to Section 6-109 ("Subsections (b) and (c)").

**SECTION 6-111. BUSINESS TRANSACTIONS OF MEMBER WITH LIMITED COOPERATIVE ASSOCIATION.** Subject to Sections 6-818 and 6-819 and except as otherwise provided in the organic rules or a specific contract relating to a transaction, a member may lend money to and transact other business with a limited cooperative association in the same manner as a person that is not a member.

### **Comment**

This section is derived from Section 112 of the ULPA (2001) (Last Amended 2013). Basically what this section means is that this article does not discriminate against a creditor of a limited cooperative association that also happens to be a member of the limited cooperative association. Other law, such as fraudulent transfer or conveyance acts, will be applicable to these creditor-member transactions. *See* Section 1-702 (Supplemental Principles of Law).

**SECTION 6-112. DUAL CAPACITY.** A person may have a patron member's interest and an investor member's interest. When such person acts as a patron member, the person is subject to this [article] and the organic rules governing patron members. When such person acts as an investor member, the person is subject to this [article] and the organic rules governing investor members.

### **Comment**

One person can be both a patron member and an investor member concurrently. Membership is governed by the provisions of this article and the organic rules for each type of membership, respectively. *See* Comment to Section 6-102(13).

**SECTION 6-113. USE OF THE TERM “COOPERATIVE” IN NAME.** Use of the term “cooperative” or its abbreviation under this [article] is not a violation of the provisions restricting the use of the term under [insert cross-reference to law of this state].

### **Comment**

Some states have provisions in their existing cooperative statutes restricting the use of the term “cooperative” to entities formed under those statutes. This subsection states that those provisions not apply to a limited cooperative association formed under this act.

**SECTION 6-114. SUBJECTS COVERED OUTSIDE [ARTICLE].** The following subjects are covered in whole or in part outside this [article]:

- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Name of entity – Part 3 of Article 1.



- (4) Registered agent of entity – Part 4 of Article 1.
- (5) Foreign entities – Part 5 of Article 1.
- (6) Administrative dissolution – Part 6 of Article 1.
- (7) Miscellaneous provisions, including supplemental principles of law and reservation of power to amend or repeal – Part 7 of Article 1.
- (8) Entity transactions generally – Part 1 of Article 2.
- (9) Merger – Part 2 of Article 2.
- (10) Interest exchange – Part 3 of Article 2.
- (11) Conversion – Part 4 of Article 2.
- (12) Domestication – Part 5 of Article 2.

### **Comment**

This section lists the principal parts of the Code that are applicable to limited cooperative associations.

### **[PART] 2**

**(Reserved)**

### **[PART] 3**

## **ORGANIZATION OF LIMITED COOPERATIVE ASSOCIATION**

### **SECTION 6-301. FORMATION OF LIMITED COOPERATIVE ASSOCIATION; ARTICLES OF ORGANIZATION.**

- (a) One or more persons may act as organizers to form a limited cooperative association by delivering to the [Secretary of State] for filing articles of organization.
- (b) The articles of organization must state:
  - (1) the name of the limited cooperative association, which must comply with Sections 1-301 and 1-302(e);

- (2) the purposes for which the association is formed;
- (3) the street and mailing addresses in this state of the initial registered agent;
- (4) the street and mailing addresses of the initial principal office;
- (5) the name and street and mailing addresses of each organizer; and
- (6) the term for which the association is to exist if other than perpetual.

(c) Subject to Section 6-109, articles of organization may contain any other provisions in addition to those required by subsection (a).

(d) A limited cooperative association is formed after articles of organization that substantially comply with subsection (a) are delivered to the [Secretary of State], are filed, and become effective under Section 1-203.

### **Comment**

**Subsection (a)** – The requirements for filing documents with the filing office are set forth in Part 2 of Article 1. *See also* Sections 1-104 (Delivery of Record) and 6-407 (Amendment or Restatement of Articles of Organization).

The definition of “organizer” in Section 6-102(17) requires an organizer to be an individual.

This article permits the organizing of limited cooperative associations without members at the time of organization. Section 6-501, however, requires the existence of at least two patron members before a limited cooperative association may begin business (unless the sole member is a cooperative). It may seem somewhat paradoxical that an unincorporated entity may exist, even if largely for filing convenience, without members. Some limited liability company statutes, however, provide for such “shelf” organizations.

Historically, cooperative statutes required multiple organizers who were to be members. Some statutes for specific types of cooperatives required permission by designated administrative agencies to form a cooperative. This article requires neither.

A limited cooperative association is a unique unincorporated association. This article borrows terminology and concepts from partnership, limited liability company, corporate, and traditional cooperative laws but an association organized under this article, despite some similarities, is none of those.

A limited cooperative association is both a creature of statute and contract like limited

partnerships, limited liability companies, and some traditional cooperatives. Therefore, unlike in limited partnerships, for example, articles of organization have more significance in the internal governance of an association than does a certificate of limited partnership under limited partnership law.

This section governs how a limited cooperative association comes into existence. An association is formed only if (i) articles of organization are prepared, signed and delivered to the specified public official for filing, (ii) the public official files the articles, (iii) the articles are in substantial compliance with this section, and (iv) the articles become effective under Section 1-203. To commence business an association must have patron members. *See* Section 6-501.

Despite its foundational importance, the articles of organization of a limited cooperative association are not required to contain significant amounts of information. Bylaws must also contain certain provisions that are fundamental to the organizational structure of a limited cooperative association if those matters are not contained in the articles or which override specific default rules hereunder. *See* Sections 6-109, 6-303(a), and 6-405(e). The bylaws of an association play a more powerful role than is typical in corporate law. Together the articles and bylaws are similar to the operating agreement of a limited liability company or the partnership agreement of a partnership. The relationship between the articles and bylaws of limited cooperative associations, therefore, places great weight on any planning decision to delegate authority to the board of directors to amend the bylaws.

The bylaws are, however, subject to the articles. *See* Section 6-303(a). Some matters must be addressed, if at all, in the articles to effectively vary the default rules of this article. *See* Section 6-109(b).

**Subsection (b)(2)** – For “the purposes for which the association is formed,” the articles of organization may state “any lawful purpose.” *See* Section 6-104(b).

**Subsection (b)(3)** – Part 4 of Article 1 contains provisions on registered agents.

**Subsection (b)(5)** – The principal office of a limited cooperative association is its principal executive office. *See* Section 1-201(35).

## **SECTION 6-302. ORGANIZATION OF LIMITED COOPERATIVE ASSOCIATION.**

(a) After a limited cooperative association is formed:

(1) if initial directors are named in the articles of organization, the initial directors shall hold an organizational meeting to adopt initial bylaws and carry on any other business necessary or proper to complete the organization of the association; or

(2) if initial directors are not named in the articles of organization, the organizers shall designate the initial directors and call a meeting of the initial directors to adopt initial bylaws and carry on any other business necessary or proper to complete the organization of the association.

(b) Unless the articles of organization otherwise provide, the initial directors may cause the limited cooperative association to accept members, including those necessary for the association to begin business.

(c) Initial directors need not be members.

(d) An initial director serves until a successor is elected and qualified at a members meeting or the director is removed, resigns, is adjudged incompetent, or dies.

### **Comment**

The articles of organization of a limited cooperative association are not required to list initial directors. This section addresses how initial directors are designated if they are not named in the articles and the steps to be taken by the initial directors at a first meeting of the directors.

**Subsection (a)** – This subsection contemplates adoption of initial bylaws by the initial directors. There are circumstances, however, under which bylaws might not be required such as where all provisions required to be in the bylaws or articles of organization are in the articles of organization. *See* Section 6-303(a).

**Subsection (b)** – This subsection permits the initial board of directors to admit new members. If initial members are identified in the articles of organization, the initial board may admit additional members. If the articles of organization provide requirements for membership qualification, the initial board of directors' admission of members must comply with those requirements.

**Subsection (c)** – To facilitate the organizing process, the initial directors do not need to be members of the association. *See also* Section 6-803.

### **SECTION 6-303. BYLAWS.**

(a) Bylaws must be in a record and, if not stated in the articles of organization, must include:

(1) a statement of the capital structure of the limited cooperative association, including:

(A) the classes or other types of members' interests and relative rights, preferences, and restrictions granted to or imposed upon each class or other type of member's interest; and

(B) the rights to share in profits or distributions of the association;

(2) a statement of the method for admission of members;

(3) a statement designating voting and other governance rights, including which members have voting power and any restriction on voting power;

(4) a statement that a member's interest is transferable if it is to be transferable and a statement of the conditions upon which it may be transferred;

(5) a statement concerning the manner in which profits and losses are allocated and distributions are made among patron members and, if investor members are authorized, the manner in which profits and losses are allocated and how distributions are made among investor members and between patron members and investor members;

(6) a statement concerning:

(A) whether persons that are not members but conduct business with the association may be permitted to share in allocations of profits and losses and receive distributions; and

(B) the manner in which profits and losses are allocated and distributions are made with respect to those persons; and

(7) a statement of the number and terms of directors or the method by which the number and terms are determined.

(b) Subject to Section 6-109(c) and the articles of organization, bylaws may contain any other provision for managing and regulating the affairs of the association.

(c) In addition to amendments permitted under [Part] 4, the initial board of directors may amend the bylaws by a majority vote of the directors at any time before the admission of members.

### **Comment**

The initial directors adopt the original bylaws. Section 6-302(a)(1).

The article does not provide a penalty and does not work a dissolution of a limited cooperative association or prevent it from being duly organized solely because it fails to adopt bylaws. Without bylaws much of the relationship between the limited cooperative association and its members will be covered by the article's default rules. The article does not, however, provide default rules for all the fundamental governing provisions listed in this section.

This article provides default rules for many items that can be covered in bylaws and permits the bylaws to vary many of those default rules. This article does not, however, address or provide for all matters that are permitted in an association's bylaws. *See* Section 6-109(c) and Section 6-303(b). Best practices might dictate that bylaws contain comprehensive provisions for the governance and financial structure of the association.

Bylaws have played a particularly central role in traditional cooperatives. Traditional cooperative statutes sometimes place power in the members to determine specific matters in the bylaws, such as the allocations of the profits or savings of the association. In practice bylaws have been a source for the cooperative principle of democratic control by members. *See* comment to Section 6-103. Membership qualification and eligibility frequently appear in the bylaws. In the agricultural marketing cooperative, even the marketing contract sometimes appears in the bylaws. Under this article, members are specifically required to address and vote on various matters unless the bylaws, or the articles of organization, otherwise provide.

Bylaws of traditional cooperatives have generally been considered to be part of the contract between the cooperatives and its members. *See* the comment to Section 6-102(3).

**Subsection (a)** – This subsection states the minimum requirements for bylaws of a limited cooperative association if those required provisions are not contained in the articles of organization. It draws upon the statutory requirements for bylaws of traditional cooperatives. The primary focus of the required provisions is on governance and financial rights.

Oral bylaws are not permitted by this article, however not all policies or procedures adopted by the board of directors pursuant to Section 6-801(b) need be contained in the bylaws. *Compare* Section 6-303(b) *with* Section 6-801(b).

**Subsection (a)(1)** – This subsection, together with Section 6-1001, requires the organic rules (articles of organization and bylaws –See Section 6-102 (16) to set forth the financial rights and obligations between the members and the limited cooperative association. The items contained in subsection (a)(1)(A) broadly include both financial benefits and burdens. Therefore, for example, provisions for additional capital contribution requirements must be made in the organic rules under Section 6-1001.

**SECTION 6-304. SIGNING OF RECORDS TO BE DELIVERED FOR FILING TO SECRETARY OF STATE.** A record delivered to the [Secretary of State] for filing

pursuant to this [Code] must be signed as follows:

(1) A limited cooperative association’s initial articles of organization must be signed by at least one person acting as an organizer.

(2) A statement of withdrawal under Section 6-206 must be signed as provided in that section.

(3) Except as otherwise provided in paragraph (4), a record signed by an existing association must be signed by an officer.

(4) A record filed on behalf of a dissolved association must be signed by a person winding up activities under Section 6-1206(b) or a person appointed under Section 6-1206(c) to wind up those activities.

(5) Any other record delivered on behalf of a person to the [Secretary of State] for filing must be signed by that person.

### **Comment**

As provided in Section 1-102(44), “sign” includes any manual, facsimile, conformed, or electronic signature.

From the perspective of the filing office, it is not necessary that a record delivered for filing on behalf of a limited cooperative association be filed by a member, officer or director. The bylaws can impose such a requirement as an *inter se* matter, but the requirement would not affect this provision.

The filing office will not check whether a person who purports to be authorized to sign a

record on behalf of a limited cooperative association actually has that authority, even if a statement of authority pertaining to the matter is in effect. The filing office's duties are ministerial and the assessment of a record delivered for filing is limited to determining if the record contains the information required by the Code and is accompanied by the required filing fee.

#### **[PART] 4**

### **AMENDMENT OF ORGANIC RULES OF LIMITED COOPERATIVE ASSOCIATION**

#### **SECTION 6-401. AUTHORITY TO AMEND ORGANIC RULES.**

(a) A limited cooperative association may amend its organic rules under this [article] for any lawful purpose. In addition, the initial board of directors may amend the bylaws of an association under Section 6-303.

(b) Unless the organic rules otherwise provide, a member does not have a vested property right resulting from any provision in the organic rules, including a provision relating to the management, control, capital structure, distribution, entitlement, purpose, or duration of the limited cooperative association.

#### **Comment**

This section is important because it introduces the manner and method of amending the organic rules (Section 6-102(16)) and provides background concerning the unique relationship and distinction between the articles of organization and bylaws of a limited cooperative association. *See* Sections 6-109 and 6-405(e). It is important because it contains a clear statement of authority to amend the organic rules.

All entities, whether they are incorporated or unincorporated, contain provisions for amending their internal governing rules. In many unincorporated entities, the default rule is unanimous consent. Under corporate statutes, a percentage vote which is less than unanimous is permitted. Corporate law has, and some original limited liability company law had, two levels of internal rules, such as articles of incorporation and bylaws. The articles are the highest authority within the organization and are a public filing. Under this article, most items may be contained in the articles or the bylaws. If certain items are contained in the bylaws, they are subject to a different vote for amendment than other provisions in the bylaws. *See* the comment to Section 6-405.

The default rule for all bylaw amendments require member voting. These provisions are consistent with the nature of the limited cooperative association and underscore its unique management structure with centralized management, but democratic control. The organic rules



may provide for greater voting percentages than the default rules, including unanimity. The article provides mechanisms in this part and elsewhere which balance and protect the interests of patron members and investor members when investor members are introduced into the association. *See, e.g.*, Sections 6-405 (“Approval of Amendment”), 6-1004 (“Allocations of Profits and Losses”), and 6-1203 (“Judicial Dissolution”).

**Subsection (a)** – This subsection provides authority for amending the organic rules of a limited cooperative association. An amendment to either the articles or bylaws can add, change or delete provisions.

**Subsection (b)** – Without this subsection, it is possible that all amendments would require unanimity based on contract principles because the contractual nature of an association might give rise to vested property rights. The subject of this section also appears in corporate law for slightly different historical reasons. Much of the common law for traditional cooperatives has arisen under a corporate structure and, therefore, may be helpful here. This subsection does not directly address contracts between an association and its members or between members that are independent from the organic rules.

## **SECTION 6-402. NOTICE AND ACTION ON AMENDMENT OF ORGANIC RULES.**

(a) Except as provided in Sections 6-401(a) and 6-405(f), the organic rules of a limited cooperative association may be amended only at a members meeting. An amendment may be proposed by either:

(1) a majority of the board of directors, or a greater percentage if required by the organic rules; or

(2) one or more petitions signed by at least 10 percent of the patron members or at least 10 percent of the investor members.

(b) The board of directors shall call a members meeting to consider an amendment proposed pursuant to subsection (a). The meeting must be held not later than 90 days following the proposal of the amendment by the board or receipt of a petition. The board must mail or otherwise transmit or deliver in a record to each member:

(1) the proposed amendment, or a summary of the proposed amendment and a

statement of the manner in which a copy of the amendment in a record may be reasonably obtained by a member;

(2) a recommendation that the members approve the amendment, or if the board determines that because of conflict of interest or other special circumstances it should not make a favorable recommendation, the basis for that determination;

(3) a statement of any condition of the board's submission of the amendment to the members; and

(4) notice of the meeting at which the proposed amendment will be considered, which must be given in the same manner as notice for a special meeting of members.

### **Comment**

This section is mandatory and establishes the two ways that an amendment to the organic rules may be proposed. There are two exceptions to the rules provided in this section with respect to amendment of the bylaws. They are: (1) amendments by the initial directors permitted by Sections 6-401(a) and 6-305; and (2) that the articles may delegate authority to the board to adopt and amend most bylaws under Section 6-405(f).

An amendment to either the articles of organization or the bylaws may be proposed either by the board of directors or by petitions from members. This section provides how a meeting of members will be called and notice of the meeting is to be given for voting on the amendment.

This same procedure is utilized not only for amendments but also for other fundamental changes such as mergers.

### **SECTION 6-403. METHOD OF VOTING ON AMENDMENT OF ORGANIC RULES.**

(a) A substantive change to a proposed amendment of the organic rules may not be made at the members meeting at which a vote on the amendment occurs.

(b) A nonsubstantive change to a proposed amendment of the organic rules may be made at the members meeting at which the vote on the amendment occurs and need not be separately voted upon by the board of directors.

(c) A vote to adopt a nonsubstantive change to a proposed amendment to the organic rules must be by the same percentage of votes required to pass a proposed amendment.

### **Comment**

No substantive amendment to a proposed amendment to the organic rules may be made at a meeting of members where the proposed amendment is considered. What constitutes a “substantive” amendment is left to the particular facts and circumstances related to the proposed amendment. A nonsubstantive change certainly includes matters of spelling and punctuation that do not affect the meaning of the proposed amendment. Substantive amendments include changes that modify the meaning or effect of the proposed amendment.

### **SECTION 6-404. VOTING BY DISTRICT, CLASS, OR VOTING GROUP.**

(a) This section applies if the organic rules provide for voting by district or class, or if there is one or more identifiable voting groups that a proposed amendment to the organic rules would affect differently from other members with respect to matters identified in Section 6-405(e)(1) through (5). Approval of the amendment requires the same percentage of votes of the members of that district, class, or voting group required in Sections 6-405 and 6-514.

(b) If a proposed amendment to the organic rules would affect members in two or more districts or classes entitled to vote separately under subsection (a) in the same or a substantially similar way, the districts or classes affected must vote as a single voting group unless the organic rules otherwise provide for separate voting.

### **Comment**

Section 6-405 provides the fundamental voting structure for the members in a limited cooperative association. This structure is repeated throughout the article although the percentage votes are different in various areas. The rules of that section apply whether there are only patron members of an association or a combination of patron members and investor members voting together as the entire membership. This section provides an alternative voting structure if the organic rules provide for members to be divided into districts or classes as authorized in Section 6-517. Where the members are to vote on the amendments to the organic rules by district or class, the rules of Section 6-405 apply in determining whether a proposed amendment is passed in each district or class.

The same alternative structure applies to other identifiable voting groups that would be

affected differently from other members with respect to the items listed in Section 6-405(e)(1) through (5). “Voting group” is a defined term. *See* Section 6-102(21). The concept of voting group is protective. It gives a group of similarly situated members who share a specific burden under a fundamental change a right to vote separately in order to protect their interests. Voting groups are not provided in the organic rules. Rather only districts and classes are provided for in the organic rules. Voting groups for purposes of voting on a proposed amendment to the organic rules would be determined based upon the scope of the amendment and the members it would affect.

This article does not attempt to provide a comprehensive default system for the use of districts or classes. The use of districts or classes provides a great deal of flexibility to the article and permits the drafting of blocking power in a district or class under Section 6-405 (“Approval of Amendment”). It leaves the crafting of rules governing the use of districts or classes to the organic rules.

Limited cooperative associations should carefully craft provisions about districts and classes if they decide to establish them in their organic rules.

**Subsection (b)** – This subsection is a default rule for a limited cooperative association that has districts or classes, but does not address whether the votes in the classes or districts will be counted separately or together. The default rule reflects the overall cooperative principle of democratic control within the entire membership of a cooperative. The default rule provides that members in districts or classes that would be affected in a substantially similar way by a proposed amendment are counted together (and not separately by district or class) unless the organic rules otherwise provide.

#### **SECTION 6-405. APPROVAL OF AMENDMENT.**

(a) Subject to Section 6-404 and subsections (c) and (d), an amendment to the articles of organization must be approved by:

(1) at least two-thirds of the voting power of members present at a members meeting called under Section 6-402; and

(2) if the limited cooperative association has investor members, at least a majority of the votes cast by patron members, unless the organic rules require a greater percentage vote by patron members.

(b) Subject to Section 6-404 and subsections (c), (d), (e) and (f), an amendment to the bylaws must be approved by:

(1) at least a majority vote of the voting power of all members present at a members meeting called under Section 6-402, unless the organic rules require a greater percentage; and

(2) if a limited cooperative association has investor members, a majority of the votes cast by patron members, unless the organic rules require a larger affirmative vote by patron members.

(c) The organic rules may require that the percentage of votes under subsection (a)(1) or (b)(1) be:

(1) a different percentage that is not less than a majority of members voting at the meeting;

(2) measured against the voting power of all members; or

(3) a combination of paragraphs (1) and (2).

(d) Consent in a record by a member must be delivered to a limited cooperative association before delivery of an amendment to the articles of organization or restated articles of organization for filing pursuant to Section 6-407, if as a result of the amendment the member will have:

(1) personal liability for an obligation of the association; or

(2) an obligation or liability for an additional contribution.

(e) The vote required to amend bylaws must satisfy the requirements of subsection (a) if the proposed amendment modifies:

(1) the equity capital structure of the limited cooperative association, including the rights of the association's members to share in profits or distributions, or the relative rights, preferences, and restrictions granted to or imposed upon one or more districts, classes, or voting

groups of similarly situated members;

(2) the transferability of a member's interest;

(3) the manner or method of allocation of profits or losses among members;

(4) the quorum for a meeting and the rights of voting and governance; or

(5) unless otherwise provided in the organic rules, the terms for admission of new members.

(f) Except for the matters described in subsection (e), the articles of organization may delegate amendment of all or a part of the bylaws to the board of directors without requiring member approval.

(g) If the articles of organization delegate amendment of bylaws to the board of directors, the board shall provide a description of any amendment of the bylaws made by the board to the members in a record not later than 30 days after the amendment, but the description may be provided at the next annual members meeting if the meeting is held within the 30-day period.

### **Comment**

Voting structure is one of the key balancing points between patron members and investor members necessary to fulfill the purposes of the article. The voting structure in this section is also contained in correlative voting provisions concerning dissolution (Section 6-1205), merger, interest exchange, conversion, and domestication transactions (Section 6-518), and disposition of assets (Section 6-1604). Another important balancing provision is Section 6-514(1) that requires the majority of voting power be held by patron members.

Existing traditional cooperative statutes provide a rather remarkable range of voting options. For example, within limitations, there can be voting or nonvoting preferred shareholders who are not necessarily required to be members. Nonetheless, this article permits investor members and because of the existence of investor members the article provides a rather detailed allocation of voting power between investor members and patron members.

The articles of organization may be amended under subsection (a); and, generally, the bylaws may be amended under subsection (b). Specified items under subsection (e) may appear in either the articles or bylaws. Those items may be amended only in the same manner as the amendment of the articles. Amendments affecting a member's liability require the consent of that member under subsection (d). As a general matter, the articles may provide that the bylaws

can be amended by the board of directors. *But see* subsection (e).

**Subsection (a)** – The default vote to amend the articles of organization is two-thirds of the voting power present at the meeting.

In a limited cooperative association which permits investor members, however, the subsection requires a bifurcated approach to better protect the decisional power of patron members relative to investor members. First, it requires a two-thirds vote of all members present (patron members and investor members). Second, the votes of patron members are counted. A simple majority of patron members present and voting is required to adopt the amendment.

This bifurcated voting procedure assures patron members substantial decisional authority. Indeed requiring a majority of the patron members to vote for an amendment gives the patron members absolute blocking power on amendments.

EXAMPLE: Assume a limited cooperative association under which 34 votes are in patron members and 33 votes are in investor members and all members are present and voting. The total vote required to pass the amendment is two-thirds of the voting power of members present. Thus, the first voting prong requires at least 45 (two-thirds) votes of the total cast to be for the amendment. The second prong requires at least a majority of the 34 patron member votes to be for the amendment. Thus, at least 18 of the patron member votes must be cast for the amendment. If only 17 patron members voted for the amendment it would fail under the second prong even if all of the investor members voted for the amendment.

The bifurcated voting structure also provides investor members significant voting influence. The two-thirds majority under subsection (a)(1) would not be reached in the Example even if all the patron member votes were cast for the amendment unless a sufficient number of investor members vote to achieve the required two-thirds. In addition, using the flexibility afforded under Section 6-404, blocking power could be provided to investor members by establishing strict class voting for them in the organic rules. The same could be done for patron members.

**Subsection (c)** – The vote required to amend the organic rules may be varied by the organic rules but only within the parameters of this subsection.

**Subsection (d)** – If a member will have personal liability as a result of an amendment, the member must consent in a record to the amendment.

**Subsection (e)** – The five matters listed in subsection (e) require the same vote as necessary to amend the articles of organization whether or not the matters are contained in the articles or the bylaws.

**Subsection (g)** – If bylaw amendments are delegated to the board of directors, a description of an amendment adopted by the board must be provided to the members in accordance with this subsection.

**SECTION 6-406. RESTATED ARTICLES OF ORGANIZATION.** A limited cooperative association, by the affirmative vote of a majority of the board of directors taken at a meeting for which the purpose is stated in the notice of the meeting, may adopt restated articles of organization that contain the original articles as previously amended. Restated articles may contain amendments if the restated articles are adopted in the same manner and with the same vote as required for amendments to the articles under Section 6-405(a). Upon filing, restated articles supersede the existing articles and all amendments.

**Comment**

This section permits the board of directors to restate the articles of organization. A restatement of the articles is helpful after several amendments have been made over time. The board of directors, however, is not permitted to adopt any amendments to the articles when it restates them. If the restatement is to include amendments to the articles, the amendments must be adopted in the manner provided in this part. If a restatement includes amendments, the entire restated articles may be adopted pursuant to this article, but care should be exercised to comply with the notice requirements for amendments. *See* Section 6-402. Filing of restated articles is governed by Section 6-407.

**SECTION 6-407. AMENDMENT OR RESTATEMENT OF ARTICLES OF ORGANIZATION; FILING.**

(a) To amend its articles of organization, a limited cooperative association must deliver to the [Secretary of State] for filing an amendment of the articles, or restated articles of organization or articles of merger, interest exchange, conversion, or domestication pursuant to [Article] 2, which contain one or more amendments of the articles of organization, stating:

- (1) the name of the association;
- (2) the date of filing of the association's initial articles; and
- (3) the text of the amendment.

(b) Before the beginning of the initial meeting of the board of directors, an organizer who knows that information in the filed articles of organization was inaccurate when the articles were



filed or has become inaccurate due to changed circumstances shall promptly:

(1) cause the articles to be amended; or

(2) if appropriate, deliver an amendment to the [Secretary of State] for filing pursuant to Section 1-104(b).

(c) To restate its articles of organization, a limited cooperative association must deliver to the [Secretary of State] for filing a restatement designated as such in its heading.

(d) Upon filing, an amendment of the articles of organization or other record containing an amendment of the articles which has been properly adopted by the members is effective as provided in Section 1-203.

### **Comment**

If a restatement of the articles of organization contains amendments, it must be filed. If a restatement does not contain amendments, this section permits it to be filed. Amendments to the articles may also be included in statements of merger, interest exchange, conversion, and domestication that are filed. *See* Sections 2-205(b)(5), 2-305(b)(5), 2-405(b)(5), and 2-505(b)(5).

## **[PART] 5**

### **MEMBERS**

**SECTION 6-501. MEMBERS.** To begin business, a limited cooperative association must have at least [two] patron members unless the sole member is a cooperative.

***Legislative Note:*** The “two” in brackets means an adopting jurisdiction may increase the number of required patron members required for a limited cooperative association to begin business. It does not mean the number should be reduced unless the association is to be a wholly-owned subsidiary of a cooperative.

### **Comment**

One person may organize a limited cooperative association under Section 6-301 but this section adds an additional requirement that the association have at least two *patron* members to begin business unless the sole member is a cooperative. More than one member is required consistent with the general meaning of “cooperation.” The requirement of multiple members to begin business is, thus, somewhat analogous to partnership law that requires two members to

form a partnership. *See* Section 3-202 (a). *See also* the comment to Section 6-301. The reason a cooperative is allowed to be a sole member is because its “organic” law will provide the necessary “cooperation” among members.

A limited cooperative association has some flexibility in determining its number of members. A membership interest could be held in cotenancies such as tenancy in common or may be community property in community property jurisdictions. The organic rules may provide that co-owners will be treated as one person or will be treated individually as separate persons subject to the law governing those relationships. The organic rules may also address other ownership arrangements. For example, the organic rules of traditional agricultural marketing cooperatives sometimes contain provisions concerning cooperative memberships in the context of landlord-tenant relationships for agricultural land.

#### **SECTION 6-502. BECOMING MEMBER.**

(a) If a limited cooperative association is to have only one cooperative member upon formation, the cooperative becomes a member as agreed by that cooperative and the organizer of the association. That cooperative and the organizer may be, but need not be, different persons. If different, the organizer acts on behalf of the initial cooperative member.

(b) If a limited cooperative association is to have more than one member upon formation, those persons become members as agreed by the persons before the formation of the association. The organizer acts on behalf of the persons in forming the association and may be, but need not be, one of the persons.

(c) After formation of a limited cooperative association, a person becomes a member:

- (1) as provided in the organic rules;
- (2) as the result of a transaction effective under [Article] 2;
- (3) with the affirmative vote or consent of all the members; or
- (4) as provided in Section 6-1202(3).

#### **Comment**

This section combines concepts from traditional cooperatives, limited liability companies and partnerships in determining how persons become members. Traditional cooperatives usually provide for the qualifications and the process for admitting members in their bylaws. Limited

liability companies and partnerships usually provide for these matters in their operating agreements or partnership agreements, respectively, and frequently require member consent for admission as a member or partner in the entity.

Section 6-603 addresses transfers of membership interests, the limitations on transfers, and whether a transferee may become a member as a result of transfer.

Initial members may be (i) named in the articles of organization, (ii) admitted by the board of directors pursuant to Section 6-302(b), or (iii) admitted in a manner provided in the organic rules. Once initial members are admitted, additional members may be admitted pursuant to the organic rules or by unanimous consent of the members. The unanimous consent of all members is an exception to changing membership requirements through a change of the organic rules. *See* Section 6-405(e)(5) (with respect to the terms for admission of members in the bylaws).

The method for admitting new members is a mandatory provision for the organic rules under Section 6-303(a)(2) because admission of members is a central feature of a limited cooperative association. The provision deserves care in drafting. Nonetheless, Section 6-502(3) provides a “fail safe” mechanism if a membership provision is not contained in the organic rules.

**Subsection (c)(2)** – This subsection recognizes that memberships may be continued or new memberships may be created in a merger, interest exchange, conversion, or domestication transaction involving a limited cooperative association under Article 2.

### **SECTION 6-503. NO AGENCY POWER OF MEMBER AS MEMBER.**

(a) A member is not an agent of a limited cooperative association solely by reason of being a member.

(b) A person’s status as a member does not prevent or restrict law other than this [article] from imposing liability on a limited cooperative association because of the person’s conduct.

### **Comment**

This section confirms a member is not an agent for a limited cooperative association simply by being a member. This is similar to a limited partner in a limited partnership, shareholder in a corporation, and members under traditional cooperative law. It serves the same function as similar statements in limited liability company laws. One of its purposes is to reject any implication of “statutory apparent authority” in members by reason of their membership. The section does not prohibit an association from specifically appointing a member to act as an agent of the association, for example, by an act of the board of directors, with power to bind the association under the law of agency as otherwise applicable.

## **SECTION 6-504. LIABILITY OF MEMBERS AND DIRECTORS.**

(a) A debt, obligation, or other liability of a limited cooperative association is solely the debt, obligation, or other liability of the association. A member or director is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the association solely by reason of being or acting as a member or director of the association. This subsection applies regardless of the dissolution of the association.

(b) The failure of a limited cooperative association to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on any member or director for a debt, obligation, or other liability of the association.

### **Comment**

This section shields members from debts, obligations, and liabilities of a limited cooperative association unless the articles of organization provide otherwise. The shield may not be removed in bylaws. This section does not apply to claims seeking to hold a member directly liable on account of the member's own conduct.

**EXAMPLE:** A member personally guarantees a debt of a limited cooperative association. This section does not govern the member's liability as a guarantor.

**EXAMPLE:** A member purports to bind a limited cooperative association while lacking any agency law power to do so. The association is not bound, but the member is liable for having breached the "warranty of authority" (an agency law doctrine). This section does not apply. The liability is not *for* an obligation of the association, but rather is the member's direct liability resulting because the association is *not* indebted, obligated or otherwise liable. *See* RESTATEMENT (THIRD) OF AGENCY § 6.10 (2006).

This section does not eliminate a member's liability for required contributions to capital of a limited cooperative association under the organic rules or contribution agreements. Sections 6-1001 through 6-1003. It does not eliminate a member's liability for improper distributions. Section 6-1008. Liability for those obligations pertains to a person's status as a member but is not for an obligation of the association.

This section has no application to directors whose liability is addressed in Sections 6-802 and 6-818 through 6-820.

This article does not address the equitable doctrine of "piercing the veil" which is well-established with respect to corporations. Because certain formalities are required in the

operation of a limited cooperative association organized under this article, corporate law regarding “piercing the corporate veil” (including the factor of “disregard of corporate formalities”) could properly be applied to associations organized under this article under some circumstances even though they are unincorporated associations. *See* the comment to Section 5-304 (b) (limited liability companies). Of course, disregard of formalities is but one factor of the multifactor analysis applied in cases of equitable piercing. Finally, some provision of regulatory law outside this article may impose liability on members and this section does not affect the operation of those regulations. *See* Section 6-107.

#### **SECTION 6-505. RIGHT OF MEMBERS AND DISSOCIATED MEMBERS TO INFORMATION.**

(a) On reasonable notice, a member may inspect and copy during regular business hours, at the principal office or a reasonable location specified by the limited cooperative association, required information listed in Sections 6-110(a)(1) through (8). A member need not have any particular purpose for seeking the information. The association is not required to provide the same information listed in Section 6-110(a)(1) through (8) to the same member more than once during a six-month period.

(b) On reasonable notice, a member may inspect and copy during regular business hours, at the principal office or a reasonable location specified by the limited cooperative association, required information listed in Section 6-110(a)(9), (10), (12), (13), (16), and (18), if:

(1) the member seeks the information in good faith and for a proper purpose reasonably related to the member’s interest;

(2) the demand includes a description with reasonable particularity of the information sought and the purpose for seeking the information;

(3) the information sought is directly connected to the member’s purpose; and

(4) the demand is reasonable.

(c) Not later than 10 business days after receipt of a demand pursuant to subsection (b), a limited cooperative association shall provide, in a record, the following information to the

member that made the demand:

(1) if the association agrees to provide the demanded information:

(A) what information the association will provide in response to the demand; and

(B) a reasonable time and place at which the association will provide the information; or

(2) if the association declines to provide some or all of the demanded information, the association's reasons for declining.

(d) On 10 days' demand made in a record received by a limited cooperative association, a dissociated member may have access to information to which the person was entitled while a member if the information pertains to the period during which the person was a member, the person seeks the information in good faith, and the person satisfies the requirements imposed on a member by subsection (b)(2). The association shall respond to a demand made pursuant to this subsection in the manner provided in subsection (b)(3).

(e) Not later than 10 business days after receipt by a limited cooperative association of a demand made by a member in a record, but not more often than once in a six-month period, the association shall deliver to the member a record stating the information with respect to the member required by Section 6-110(a)(17).

(f) In addition to any restriction or condition stated in its organic rules, a limited cooperative association, as a matter within the ordinary course of its activities and affairs, may impose reasonable restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient. In a dispute concerning the reasonableness of a

restriction under this subsection, the association has the burden of proving reasonableness.

(g) A limited cooperative association may charge a person that makes a demand under this section reasonable costs of copying, limited to the costs of labor and material.

(h) A member or dissociated member may exercise rights under this section through an agent or, in the case of an individual under legal disability, a legal representative. Any restriction or condition imposed by the organic rules or under subsection (g) applies both to the agent or legal representative and the member or dissociated member.

(i) The rights stated in this section do not extend to a person as transferee.

(j) The organic rules may require a limited cooperative association to provide more information than required by this section and may establish conditions and procedures for providing the information.

### **Comment**

This section provides to members of a limited cooperative association rights of inspection of records of the association that must be maintained by it under Section 6-110, but the section does not require an association to maintain any records that are not specifically required to be maintained under Section 6-110. These rights may not be reduced by the organic rules although subsection (f) does permit an association to impose reasonable restrictions on the use of information obtained by a member under this section.

Cooperative associations present a conundrum with respect to information about the association. Cooperatives are owned and controlled by their members. Members need information for that purpose. Most cooperatives are, however, representative democracies governed by a board of directors or similar body elected by the members. This may reduce the need for information on the part of members and permit a cooperative to withhold confidential information from the members. The “proper purpose” provision of subsection (b) allows an evaluation of the need for the information demanded by the member making the demand to be measured against the needs of the association. If there is a change in information obtained by a member under this section, the changed information is new information for purposes of this section. The section anticipates that both a member and the limited cooperative association will act in good faith with respect to the rights and obligations of each under this section.

There is a burden on a member seeking records if the member is not located in the jurisdiction in which the association’s principal office (Section 1-102(35)) is located and is, therefore, required to travel. This burden is reduced by the member being entitled to engage an

attorney or agent in the jurisdiction where the principal office is located in order to access the records under Section 6-505(h). Nothing in this article prevents the association from making records available at locations in addition to the principal office or electronically.

Records listed in subsections 6-110(a)(11), (14) and (15) regarding accounting records and contributions are not covered by the inspection rights of this subsection because of concerns over confidentiality and privacy.

**Subsection (a)** – The subsection permits a member to request, inspect and copy records specified in Section 6-110(a)(1) through (8) that are records that should be generally available and relate to the organization, general financial condition and membership actions of the association. No particular purpose is required for the inspection and copying of these records.

**Subsection (b)** – The subsection permits a member to request, inspect and copy records specified in Section 6-110(a)(9), (10), (12), (13), (16) and (18) that may be records more likely to contain confidential information or information that may be more difficult to understand or harder for an association to produce than the records referenced in subsection (a). To obtain access to these records a member must act in good faith and state a “proper purpose” for seeking the records that must be directly connected to the member’s purpose. “Proper purpose” is a well-recognized term. This subsection closely follows corporate provisions. *See* MBCA § 16.02.

The six-month time period in subsection (a) and “proper purpose” under subsection (b) serve an analogous function to the phrase, “except to the extent the demand or information demanded is unreasonable or otherwise improper under the circumstances” in Section 5-410(a)(2)(B).

**Subsection (c)** – If a limited cooperative association refuses to produce information demanded by a member, it must state why it has refused the request.

**Subsection (d)** – A person dissociated as a member may obtain any of the information referenced in subsections (a) or (b) but in either case must follow the procedures for a member seeking to obtain information under subsection (b). The right to inspect and copy records under this section does not extend to a transferee of a member who has not been admitted as a member in the limited cooperative association. *See* subsection (i). If a member dies or is adjudged incompetent Section 6-1103 applies.

**Subsection (e)** – A member may obtain information regarding the member’s own interest in the limited cooperative association but the member may not obtain information about any other member except the names and addresses of other members under subsection (b).

**Subsection (f)** – The subsection permits a limited cooperative association to include nondisclosure restrictions on the use of information obtained by a member under the section. Some of the information to which a member may have access under this section could contain confidential information of the association. The association has the right to reasonably restrict the uses to which the information may be put by the member. The restriction could be in contractual form and a violation of the contract could result in damages or a right to injunctive



relief in favor of the association.

#### **SECTION 6-506. ANNUAL MEETING OF MEMBERS.**

(a) Members shall meet annually at a time provided in the organic rules or set by the board of directors not inconsistent with the organic rules.

(b) An annual members meeting may be held inside or outside this state at the place stated in the organic rules or selected by the board of directors not inconsistent with the organic rules.

(c) Unless the organic rules otherwise provide, members may attend or conduct an annual members meeting through any means of communication if all members attending the meeting can communicate with each other during the meeting.

(d) The board of directors shall report, or cause to be reported, at the association's annual members meeting the association's business and financial condition as of the close of the most recent fiscal year.

(e) Unless the organic rules otherwise provide, the board of directors shall designate the presiding officer of the association's annual members meeting.

(f) Failure to hold an annual members meeting does not affect the validity of any action by the limited cooperative association.

#### **Comment**

Section 6-506(a) requires every limited cooperative association to hold an annual meeting of members each year. Rather than having an annual meeting, the members may take action by written consent under Section 6-516. Unlike corporate statutes, this section does not specifically require an election of directors to the board of directors at the annual meeting, but this is implied from Section 6-805(a) that provides a director's term expires at the annual meeting following the director's election or appointment unless the organic rules otherwise provide. The purpose of an annual meeting is not limited and provides an appropriate forum for a member to raise any relevant question about the association's operations unless inconsistent with notices of annual meetings where fundamental changes such as amendments to the limited cooperative association's organic rules are to be considered. *See* Sections 6-402, 6-508(b).

If an annual meeting is not held, directors' terms are extended under Section 6-805(c) until a successor is elected or appointed and qualified.

The requirement of Section 6-506(a) that an annual meeting be held is phrased in mandatory terms to ensure that every member entitled to participate in the meeting has an opportunity to do so. There is no specific provision in this article that governs the procedure for applying to a court for intercession if an annual meeting is not held but under appropriate circumstances a direct or derivative action could be brought for this purpose. Section 6-506(f) provides that failure to hold the annual meeting does not affect the validity of any action taken by the association.

The organic rules or the board of directors may fix the time and place for annual meetings. This gives the limited cooperative association the flexibility to meet at various times and various places depending on convenience and circumstances. Where authority is granted to the board to fix the time and place of the annual meeting, the authority must be exercised in good faith. *See Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971) (relating to corporations). Failure to have annual meetings may also be evidence of oppression for purposes of Section 6-1203(2)(B).

The default rule in subsection (c) provides great flexibility by allowing conduct of meetings and member attendance through means of modern communication (*e.g.*, telephone and the internet) while protecting the deliberative function of the meeting. The use of the words "attend" and "conduct" encompass the ability to vote and, therefore, voting under subsection (c) is not "voting by other means" for purposes of Section 6-515(d). *See also* Section 6-507 (e) (similar flexibility for special meetings of members).

#### **SECTION 6-507. SPECIAL MEETING OF MEMBERS.**

(a) A special meeting of members may be called only:

(1) as provided in the organic rules;

(2) by a majority vote of the board of directors on a proposal stating the purpose of the meeting;

(3) by demand in a record signed by members holding at least 20 percent of the voting power of the persons in any district or class entitled to vote on the matter that is the purpose of the meeting stated in the demand; or

(4) by demand in a record signed by members holding at least 10 percent of the total voting power of all the persons entitled to vote on the matter that is the purpose of the

meeting stated in the demand.

(b) A demand under subsection (a)(3) or (4) must be submitted to the officer of the limited cooperative association charged with keeping its records.

(c) Any voting member may withdraw its demand under subsection (a)(3) or (4) before receipt by the limited cooperative association of demands sufficient to require a special meeting of members.

(d) A special meeting of members may be held inside or outside this state at the place stated in the organic rules or selected by the board of directors not inconsistent with the organic rules.

(e) Unless the organic rules otherwise provide, members may attend or conduct a special meeting of members through the use of any means of communication if all members attending the meeting can communicate with each other during the meeting.

(f) Only business within the purpose or purposes stated in the notice of a special meeting of members may be conducted at the meeting.

(g) Unless the organic rules otherwise provide, the presiding officer of a special meeting of members shall be designated by the board of directors.

### **Comment**

This section provides the means for calling and holding special members meetings of the limited cooperative association. Any meeting of members other than an annual meeting is a special meeting. The primary difference between an annual meeting and a special meeting under this article is that any issue relevant to the association may be discussed at an annual meeting subject only to special notice requirements for certain matters under this article, for example, voting on amendments to the organic rules, sales of assets, and Article 2 transactions. Only issues provided in the call and notice of a special meeting may be discussed at a special meeting. *See* Section 6-508(c). If an annual meeting is not held, members could demand that a special meeting be held to consider specific items that would ordinarily be considered at an annual meeting.

Democratic control by members is a cooperative principle. Inherent in this principle is

the members' right to voice opinions and the board of director's ability to receive advice and direction from members at a deliberative meeting. Therefore this section provides several ways by which a special meeting may be called and the organic rules may provide other ways to call special meetings or state circumstances under which special meetings are required.

Members may suggest a place for a special meeting, but the ultimate authority for determining the place is the organic rules or the board of directors under Subsection (d). The article does not specifically state who sets the time and date of a special meeting. Generally the board of directors acting for the limited cooperative association would set the time and date under its management authority in Section 6-801 and the notice provisions of Section 6-508(a).

If demands stating different purposes for a special meeting are received by a limited cooperative association, the board of directors has reasonable discretion to combine or otherwise coordinate the demands into one meeting.

#### **SECTION 6-508. NOTICE OF MEMBERS MEETING.**

(a) A limited cooperative association shall notify each member of the time, date, and place of a members meeting [at least 15 and not more than 60] days before the meeting.

(b) Unless the articles of organization otherwise provide, notice of an annual members meeting need not include any purpose of the meeting.

(c) Notice of a special meeting of members must include each purpose of the meeting as contained in the demand under Section 6-507(a)(3) or (4) or as voted upon by the board of directors under Section 6-507(a)(2).

(d) Notice of a members meeting must be given in a record unless oral notice is reasonable under the circumstances.

#### **Comment**

This article requires that notice of meetings be given to all members of a limited cooperative association whether they are entitled to vote at the meeting or not. This seems more consistent with cooperative principles than corporate statutes under which, generally, only shareholders who are entitled to vote at a meeting are entitled to notice. *See* MBCA § 7.05(a).

This article does not contain a provision that relieves a limited cooperative association from giving notice to a member if mailings to the member have been returned as undeliverable over a period of time as is found in MBCA § 16.06 and a number of state corporate statutes.

**Subsection (d)** – This subsection permits oral instead of written notice if oral notice of a members meeting is “reasonable under the circumstances.” This recognizes there may be situations when oral notice is appropriate, but it is likely this would be an exception rather than a rule. Reliance on oral notice, however, may create evidentiary issues if a dispute concerning notice arises. If membership would be small enough that oral notice might be appropriate, the members might consider taking action by consent under Section 6-516.

#### **SECTION 6-509. WAIVER OF MEMBERS MEETING NOTICE.**

(a) A member may waive notice of a members meeting before, during, or after the meeting.

(b) A member’s participation in a members meeting is a waiver of notice of that meeting unless the member objects to the meeting at the beginning of the meeting or promptly upon the member’s arrival at the meeting and does not thereafter vote for or assent to action taken at the meeting.

#### **Comment**

Patron members are entitled to vote under Section 6-511. The organic rules may provide for voting or nonvoting investor members under Section 6-513. Section 6-508 requires notice of members meetings be given to all members, including members who are not entitled to vote at the meeting, including an investor member not entitled to vote at the meeting.

**Subsection (b)** – This article requires objections to be made at the beginning of the meeting or promptly after the member’s arrival at the meeting if the member does not wish attendance at the meeting to constitute waiver of notice of a meeting.

**SECTION 6-510. QUORUM OF MEMBERS.** Unless the organic rules otherwise require a greater number of members or percentage of the voting power, the voting member or members present at a members meeting constitute a quorum.

#### **Comment**

This section states a default rule. Absent a provision in the organic rules to the contrary, one person with a voting interest in a limited cooperative association who is in attendance at a duly called meeting would constitute a quorum for the meeting, the meeting could proceed, and actions taken at the meeting could be valid if the votes cast by that member meet the voting requirements in, *e.g.* Section 6-405.

With the interaction of Sections 6-509 and 6-510, a member who attends a meeting for the sole purpose of objecting to the meeting would nevertheless be present for purposes of a quorum under Section 6-510. Section 6-509 relates solely to a waiver of notice, not to presence at a meeting, for purposes of a quorum.

**SECTION 6-511. VOTING BY PATRON MEMBERS.** Except as provided by Section 6-512(a), each patron member has one vote. The organic rules may allocate voting power among patron members as provided in Section 6-512(a).

### **Comment**

In following cooperative principles of ownership by patrons and democratic control cooperative statutes have, historically, limited voting power of any one member to one vote. The “one member, one vote” principle, for example, is a requirement in a number of federal statutes in order for an entity to be a cooperative for the purposes of the federal statute or to be operating on a “cooperative basis.” Many of those federal statutes, however, provide an additional or alternative requirement based on the cooperative principle of a limited return on investment by capping the percentage return that may be paid on member investments in their cooperative. *See, e.g.,* 12 U.S.C.A. § 1141(j)(a) (definition of “cooperative association” for Agricultural Marketing Act), 12 U.S.C.A. § 3015(a) (definition of “eligible cooperative” for National Consumer Cooperative Bank), 15 U.S.C.A. § 521 (definition of fishing association). In recent years, revisions to some traditional state cooperative statutes have permitted percentage voting by members although in some cases with a limitation. For example, the Colorado Cooperative Act permits voting by patronage or patronage equity in the cooperative, but all members must have at least one vote and no member may have more than two and one-half percent of the total votes of the members of the cooperative. COL. REV. STAT. § 7-56-305(3) (2006). The Ohio Cooperative Law and the Oregon Cooperative Corporation Act permit voting based on patronage. OHIO REV. CODE § 1729.17 (2004); OR. REV. STAT. § 62.265 (2003).

Section 6-513 governs voting by investor members.

### **SECTION 6-512. ALLOCATION OF VOTING POWER OF PATRON MEMBER.**

(a) The organic rules may allocate voting power among patron members on the basis of one or a combination of the following:

- (1) one member, one vote;
- (2) use or patronage;
- (3) equity; or
- (4) if a patron member is a cooperative, the number of its patron members.

(b) The organic rules may provide for the allocation of patron member voting power by districts or class, or any combination thereof.

### **Comment**

If the strict “one member, one vote” principle in subsection (a)(1) is not followed, the article permits the use of three other methods: a member’s use or patronage of the limited cooperative association, a member’s equity in the association, or if the member of the association is itself a cooperative by the number of patron members in the member cooperative. The association may combine two, three, or all four methods in establishing the voting power among patron members but no patron member may be deprived of a vote. *See* Section 6-511.

**Subsection (a)** – This article permits the organic rules to provide for more than one vote per member in a limited cooperative association; but, in the absence of other provisions in the organic rules, defaults to one member one vote. Section 6-512(a) provides the means through which the organic rules may allocate voting power among the patron members.

**Subsection (a)(2)** – Use of patronage of the limited cooperative association can be measured in a variety of ways. For example, it can be based on a dollar volume of business conducted by a patron member with the association.

EXAMPLE: A member sells and delivers wheat to the association. The member is paid \$60,000 for the wheat sold and delivered. Over a one year period, the association paid \$2,000,000 for all the wheat it purchased from all of its members. The association’s organic rules base voting power on patronage measured by the purchase price paid to each member for wheat purchased from each member during the year. The member that was paid \$60,000 would be entitled to 3% of the voting power of all of the voting members in the association.

If the association in this example had ten members, and each had only one vote, each member would have 10% of the voting power. If voting in this example is based on patronage percentages, the fact that the member did not have ten percent of the voting power does not violate Section 6-511 because the member is entitled to vote the member’s percentage of total member patronage as determined under the organic rules of the association.

If voting is allocated based on patronage, each patron member conducting patronage with the association will be eligible to vote, even though the percentage weight of that vote may be a smaller percentage proportion than represented by one vote. A complicating feature in this article is that in no event, consistent with traditional cooperative principles, may any patron member be deprived of voting under Section 6-511. Thus, for example, a patron member, so long as it is a member, must be allocated some vote even though it did not conduct patronage during the relevant measuring period.

It would then be possible for the organic rules to provide each patron member with one

vote and then allocate an additional number of votes fixed in the organic rules based solely on proportional patronage conducted with the association. The number of votes fixed in the organic rules could be less than, equal to, or far greater than the number of votes allocated based on membership alone.

Other types of patronage measurement include the quantity of business a member conducts with the association measured in units, weight or other methods of measuring quantities such as hours worked in a worker owned association.

**Subsection (a)(3)** – The organic rules could base voting on a percentage of equity in the limited cooperative association or on each dollar of equity in the association. The equity could be paid in capital or retained allocations in the capital accounts of the members that have not been distributed, or a combination of both.

EXAMPLE: A member has \$1,000 of paid in capital in an association that has a total of \$20,000 in paid in capital from all voting members. In addition, the member has \$15,000 of retained allocations in the member's capital account that have not been distributed. All of the members together have \$100,000 of retained allocations in their capital accounts collectively.

The organic rules of the association could provide that voting power will be based on paid in capital. The member would have 1/20, or 5%, of the total voting power in the association.

The organic rules could provide that voting power will be based on retained allocations. The member would have 15/100, or 15%, of the total voting power.

The organic rules could provide that voting power will be based on total equity in the association, a combination of paid in capital and retained allocations. The member would have a total of \$16,000 in equity (\$1,000 of paid in capital plus \$15,000 of retained allocations). Total equities of the association as a whole would be \$120,000 (\$20,000 of paid in equity plus \$100,000 of retained allocations). The member would have 16/120, or 13.3%, of the total voting power.

*CAVEAT: Voting based on equity may cause unintended consequences for other regulation and governmental programs.*

**Subsection (a)(4)** – The paragraph does not refer to a limited cooperative association itself but rather to a cooperative that is a patron member of the association. In that case, the organic rules could provide that in counting the total voting power in the association the number of members of the cooperative member could be counted among the voting members.

EXAMPLE: An association has 20 individual members and a cooperative entity as a member that itself has 15 members. The organic rules could provide for adding all the individual members of the association and the 20 members of the cooperative together for a total of 35 votes of which 15 would be cast by the cooperative member.



Paragraph (4) is not the exclusive way that votes may be allocated to a cooperative that is a member but is in addition to the other alternatives.

**Subsection (b)** – Cooperatives that have drawn members from large geographic areas have frequently divided the members into geographic districts for purposes of the election of directors or voting generally on matters affecting the cooperative. Because the voting power in traditional cooperatives has usually, although not exclusively, been confined to one class of voting membership or stock, there has been little need for classifying members by class of membership or stock for voting purposes.

This article permits more complex membership structures than are usually seen in traditional cooperatives. This subsection authorizes the association to divide patron members into districts, classes of membership, or combinations of districts and classes.

**SECTION 6-513. VOTING BY INVESTOR MEMBERS.** If the organic rules provide for investor members, each investor member has one vote, unless the organic rules otherwise provide. The organic rules may provide for the allocation of investor member voting power by class, classes, or any combination of classes.

#### **Comment**

This article does not require a limited cooperative association to have investor members.

If there are to be investor members the organic rules must provide for them. If they do not do so, all of the members must be patron members by default. *See* Section 6-502(a). If the organic rules provide for investor members, they may provide for any means of allocating voting power among them including the use of classes and combinations of classes. If the organic rules do not provide another means of allocating voting power, each investor member will have one vote following the cooperative “one person, one vote” principle. *See* the comment to Section 6-511. However, unlike patron member voting under Section 6-511, this section permits the organic rules to provide for nonvoting investor members. No matter of the quantum of votes a member votes, the voting provisions of an association must meet the requirements of Section 6-514.

**SECTION 6-514. VOTING REQUIREMENTS FOR MEMBERS.** If a limited cooperative association has both patron and investor members, the following rules apply:

(1) the total voting power of all patron members may not be less than a majority of the entire voting power entitled to vote.

(2) action on any matter is approved only upon the affirmative vote of at least a majority

of:

(A) all members voting at the meeting unless more than a majority is required by [Part] 4, 12, or 14, [Article] 2, or the organic rules; and

(B) votes cast by patron members unless the organic rules require a larger affirmative vote by patron members.

(3) The organic rules may provide for the percentage of the affirmative votes that must be cast by investor members to approve the matter.

### **Comment**

This article seeks to balance financial and governance rights between patron members and investor members where a limited cooperative association has both types of members. In doing so, this article does not follow the similar statutes in Minnesota, Wisconsin, Tennessee and Iowa that were catalysts in the development of this article. This article establishes a floor for patron member voting power below which the organic rules may not go. The organic rules may provide for greater voting power for patron members than required in this section.

**Paragraph (1)** – At least a majority of the voting power in an association must be in the patron members if the association has both patron and investor members.

**Paragraph (2)** – If there are investor members this section mandates that two tests must be met for members to take action: (1) a majority of all members voting must be in the affirmative; and, (2) a majority of patron members voting must be in the affirmative. The two test approach is used for voting by members throughout the article. The organic rules may require a larger affirmative vote for all members voting or may increase the affirmative vote required by patron members. By mandating patron member votes to be counted separately, this article gives the patron members blocking power in all votes but does not necessarily give them the ability to dictate affirmative action.

Voluntary dissolution, amendments to the organic rules, Article 2 transactions and certain dispositions of assets have special minimum voting requirements under Sections 6-405, 6-518, 6-1205, and 6-1404.

**EXAMPLE:** A limited cooperative association has 30 members of which 20 are patron members and 10 are investor members all of whom attend and vote at a meeting of members. The bylaws provide for voting on a “one member, one vote” basis. The association has a majority of the total voting power in patron members. On a particular proposition, 12 of the patron members vote “yes” and eight vote “no.” Four investor members vote “yes” and six vote “no.” A majority of all members (16 of 30) voted “yes” and a majority of the patron members (12 of 20) voted “yes.” The proposition passes.

EXAMPLE: In the preceding example, eight of the patron members vote “yes” and 12 vote “no.” All of the investor members vote “yes.” Clearly a majority of all the members (18 of 30) voted “yes” but the proposition does not pass because a majority of the patron members did not vote “yes.”

EXAMPLE: In the first example, 18 patron members vote “yes” and two vote “no.” All of the investor members vote “no.” The proposition passes because a majority of the members (18 of 30) voted “yes” and a majority of the patron members (18 of 20) voted “yes” even though the proposition received no votes from the investor members. *But see* the comment to paragraph (3).

**Paragraph (3)** – In addition to the requirement for separately counting patron member votes, the organic rules may provide for a percentage of affirmative votes of the investor members necessary for a matter to be approved. That percentage does not necessarily need to be a majority and, unlike patron member voting percentage under paragraph (2), may be below a majority. A separate affirmative vote by investor members as permitted by this paragraph may result in giving investor members blocking power. This paragraph is for emphasis because it would be allowed under the general flexibility of this article if the article were silent. *See* Section 6-109.

## **SECTION 6-515. MANNER OF VOTING.**

(a) Unless the organic rules otherwise provide, voting by a proxy at a members meeting is prohibited. This subsection does not prohibit delegate voting based on district or class.

(b) If voting by a proxy is permitted, a patron member may appoint only another patron member as a proxy and, if investor members are permitted, an investor member may appoint only another investor member as a proxy.

(c) The organic rules may provide for the manner of and provisions governing the appointment of a proxy.

(d) The organic rules may provide for voting on any question by ballot delivered by mail or voting by other means on questions that are subject to vote by members.

### **Comment**

**Subsection (a)** – Many traditional cooperatives have not permitted voting by a proxy at membership meetings because of a belief that voting by a proxy is inconsistent with cooperative principles. In some other types of cooperatives, such as housing cooperatives, proxies are viewed as an essential protection of members’ democratic control. This article permits the

organic rules to provide for voting by a proxy. If the organic rules do not expressly permit voting by a proxy, voting by a proxy is not permitted.

The word “proxy” is often used ambiguously, sometimes referring to the grant of authority to vote, sometimes to the document granting the proxy, and sometimes to the person to whom the authority is granted. This article uses the term “proxy” to mean the person to whom authority to vote is granted.

The appointment of a proxy is, at base, the appointment of an agent and is governed by agency law and principles except that subsection (c) permits the organic rules to provide the manner of and provisions governing appointment of a proxy. The organic rules are entitled to provide how an appointment is to be made and proven, the duration of an appointment, whether an appointment may be irrevocable, and any other matter relating to a proxy that is not prohibited by this article.

**Subsection (b)** – If voting by a proxy is permitted, patron members may only authorize other patron members; and, investor members may only authorize other investor members to be their proxy. If a member is both a patron member and an investor member, the member must authorize only another patron member to vote for the member as a patron member, and the member may only authorize other investor members to vote for the member as an investor member. This could be accomplished by appointing another member that is both a patron member and investor member.

**Subsection (d)** – The subsection gives broad power for the organic rules to provide for membership voting to be conducted in ways other than by being in attendance at a meeting or by authorizing a vote to be cast by a proxy. The power can be extended to all or less than all matters brought before the members at a meeting. The power can be utilized to prohibit other means of voting. Secret ballots could be required. Voting by mail could be authorized.

For purposes of subsection (d), attendance and voting pursuant to Sections 6-506(c) and 6-507(e) are not “voting by other means” because the member is present. *See* the comments to Sections 6-506(c) and 6-507(e).

An association may desire to study whether it is wise or a best practice to authorize both voting by mail or other means and by a proxy at the same time. If voting by mail or other means is permitted, votes may be cast without the benefit of discussion provided by attendance at a meeting. Although a member authorizing a proxy to vote for the member would not have that benefit, at least the proxy could have that advantage if the proxy had discretion in how to vote. On the other hand, if mail or other means are not permitted, less than a representative vote may be obtained.

## **SECTION 6-516. ACTION WITHOUT A MEETING.**

(a) Unless the organic rules require that action be taken only at a members meeting, any action that may be taken by the members may be taken without a meeting if each member

entitled to vote on the action consents in a record to the action.

(b) Consent under subsection (a) may be withdrawn by a member in a record at any time before the limited cooperative association receives a consent from each member entitled to vote.

(c) Consent to any action may specify the effective date or time of the action.

### **Comment**

Most state business corporation statutes allow for less than unanimous consent in writing for action by shareholders and the consents are generally effective if signed and delivered by the number of shareholders necessary to pass a matter if it were voted on at a meeting. Unincorporated law rarely, if ever, requires meetings but does contemplate written consents. *See e.g.*, Section 5-407(d) (limited liability companies). This article retains the historical and more prevalent requirement that written consent to action without a meeting must be unanimous. The unanimity requirement provides that each member has the ability to force a meeting for purposes of voting and discussion of the matter to be voted upon. This is consistent with the deliberative function of meetings and cooperative principles.

### **SECTION 6-517. DISTRICTS AND DELEGATES; CLASSES OF MEMBERS.**

(a) The organic rules may provide for the formation of geographic districts of patron members and:

(1) for the conduct of patron member meetings by districts and the election of directors at the meetings; or

(2) that districts may elect district delegates to represent and vote for the district at members meetings.

(b) A delegate elected under subsection (a)(2) has one vote unless voting power is otherwise allocated by the organic rules.

(c) The organic rules may provide for the establishment of classes of members, for the preferences, rights, and limitations of the classes, and:

(1) for the conduct of members meetings by classes and the election of directors at the meetings; or

(2) that classes may elect class delegates to represent and vote for the class in members meetings.

(d) A delegate elected under subsection (c)(2) has one vote unless voting power is otherwise allocated by the organic rules.

### **Comment**

This section is the specific authorization for a limited cooperative association to divide patron members into geographic districts and all members into classes. It must do so, if at all, in its organic rules. The preferences, rights, and limitations applicable to any class authorized may be provided in the organic rules not inconsistent with this article. The organic rules may provide for members to hold meetings by district or class, the election of directors from districts or classes, and the authority of members in districts or classes to elect delegates to annual or special membership meetings. Delegates to membership meetings have only one vote unless the organic rules provide for different allocation of voting from districts pursuant to Section 6-512(a) or different aggregate or representative voting under Sections 6-511 through 6-513.

Section 6-404 addresses voting by district, class or other voting groups with respect to proposed amendments to the organic rules.

**Subsections (a) and (b)** – The geographic locations of patron members in a limited cooperative association may cause them to reflect different perspectives with respect to the association. For this reason, many traditional cooperatives, especially in agriculture, have permitted the division of members into geographic districts within which the members can address localized concerns, have representatives or delegates represent those interests in association wide meetings, and otherwise benefit from more localized structures within larger organizations. These subsections permit the organic rules to provide for formation of geographic districts of patron members, the conduct of district meetings, the election of directors from districts, and provides a default rule for voting by a delegate elected by a district to represent the district in a full membership meeting. The subsections do not provide details for the structure or operation of a district leaving that to the organic rules and, under its general management authority, the board of directors.

Investor members may not be divided into districts under this article because the geographic location of investor members is unlikely to affect their perspectives with respect to the association in the same way or with the significance that geographic location could affect the relationships between patron members and the association.

**Subsections (c) and (d)** – The concept of “class” is a familiar one in the context of business corporation law where shares with identical or different preferences, limitations and rights including voting, may be issued. *See, e.g.,* MBCA § 6.01. Although the term “class” is used less frequently in unincorporated law the agreement that governs the relationship between the members frequently provides great variation in preferences, limitations, and rights among

and between members. This article expressly authorizes that the organic rules may provide classes of membership. An example of the use of a class would be to have two classes of investor members each of which elects one member of the board of directors. Of course, any such structure would also need to comply with Section 6-804.

Similar to other provisions, the authorization emphasizes the flexibility inherent in this article and contemplates that the board of directors could be delegated the authority of establishing classes by the organic rules in a way that would emulate a “series” of shares in corporate law.

#### **SECTION 6-518. APPROVAL OF TRANSACTION UNDER [ARTICLE] 2.**

(a) For a limited cooperative association to approve a plan for a transaction under [Article] 2, the plan must be approved by a majority of the board of directors, or a greater vote if required by the organic rules, and the board shall call a members meeting to consider the plan, hold the meeting not later than 90 days after approval of the plan by the board, and mail or otherwise transmit or deliver in a record to each member:

(1) the plan, or a summary of the plan and a statement of the manner in which a copy of the plan in a record reasonably may be obtained by a member;

(2) a recommendation that the members approve the plan, or if the board determines that because of a conflict of interest or other circumstances it should not make a favorable recommendation, the basis for that determination;

(3) a statement of any condition of the board’s submission of the plan to the members; and

(4) notice of the meeting at which the plan will be considered, which must be given in the same manner as notice of a special meeting of members.

(b) Subject to subsections (c) and (d), a plan must be approved by:

(1) at least two-thirds of the voting power of members present at a members meeting called under subsection (a); and

(2) if the limited cooperative association has investor members, at least a majority of the votes cast by patron members, unless the organic rules require a greater percentage vote by patron members.

(c) The organic rules may provide that the required vote under subsection (b)(1) be:

(1) a different fraction that is not less than a majority of members voting at the meeting;

(2) measured against the voting power of all members; or

(3) a combination of paragraphs (1) and (2).

(d) The vote required under subsections (b) and (c) to approve a plan may not be less than the vote required for the members of the limited cooperative association to amend the articles of organization.

(e) A member's consent in a record to a plan must be delivered to the limited cooperative association before delivery to the [Secretary of State] for filing of articles of merger, interest exchange, conversion, or domestication if, as a result of the merger, interest exchange, conversion, or domestication, the member will have interest holder liability for debts, obligations, or other liabilities that are incurred after the transaction becomes effective.

(f) The voting requirements for districts, classes, or voting groups under Section 6-404 apply to approval of a transaction under [Article] 2.

### **Comment**

Article 2 authorizes mergers, interest exchange, conversion, and domestication transactions involving limited cooperative associations. This section, which was added to this article in the Harmonization project, consolidates in one section the voting requirements for approval of these transactions.

**Subsection (e)** – This provision deals with the situation where an interest holder (defined in Section 2-102(11) of an entity that is a party to an Article 2 transaction will have vicarious liability for the liabilities of the surviving entity that are incurred after the Article 2 transaction is



effective. *See also* Sections 2-206(c), 2-306(c), 2-406(c), and 2-506(c).

## **[PART] 6**

### **MEMBER'S INTEREST IN LIMITED COOPERATIVE ASSOCIATION**

**SECTION 6-601. MEMBER'S INTEREST.** A member's interest:

(1) is personal property;

(2) consists of:

(A) governance rights;

(B) financial rights; and

(C) the right or obligation, if any, to do business with the limited cooperative association; and

(3) may be in certificated or uncertificated form.

### **Comment**

This article has its genesis in cooperative principles and laws. Its structure combines elements of cooperative law, limited liability company law, and aspects of general and limited partnerships and corporate laws. The entity that may be formed under this article is intended to be an unincorporated entity for state law purposes. With the flexibility of organizational structure and rights and obligations within an unincorporated entity structure, the relationships between the limited cooperative association and its members (and to some extent among the members themselves) have strong contractual underpinnings. This is consistent with cooperative common law where the courts have found the relationships between a cooperative and its members to be based on contract. In those cases, the articles of incorporation and bylaws of a cooperative, and sometimes additional contracts, are components of a contract even when the cooperative is organized under a corporate form of cooperative statute. The determination of the terms of the contract is made on a case-by-case basis and the cases are well-known. *See, e.g., State ex rel. Boldt v. St. Cloud Milk Producers' Association*, 200 Minn. 1, 273 N.W. 603 (Minn. 1937); *Tennessee Cotton Growers' Association v. Hanson*, 2 Tenn. App. 118 (1926); *Boyle v. Pasco Growers' Ass'n, Inc.*, 170 Wash. 516 17 P.2d (1932); *New England Trust Co. v. Abbott*, 162 Mass. 148, 38 N.E. 432 (1894).

The contractual interpretive gloss is a unique feature of cooperatives. This article envisions its interpretation will be consistent with general cooperative law and reflect approaches similar to other unincorporated law.

Nonetheless, this article provides for the fundamental governance rights and financial

rights within a limited cooperative association and between the association and its members as well as the governance and financial relationships among all the members. The article permits the organic rules of an association to vary, with certain limitations (for example, Section 6-514 that requires certain voting power for patron members), many of the rules provided by this article function as default rules so that the governance and financial relationships within the association can be designed to fit the objectives and needs of the association and its members. *See* Section 6-109.

**Paragraph (1)** – Like ULLCA (2006) (Last Amended 2013) and ULPA (2001) (Last Amended 2013), a member’s interest in a limited cooperative association is personal property. Section 6-603(a) deals with transferability and the results of transfers or attempted transfers, either voluntary or involuntary.

**Paragraph (2)** – The paragraph delineates in summary form the three basic rights of a member’s interest in a limited cooperative association. Detailed provisions with respect to governance rights and financial rights are contained in other parts of the article.

**Paragraph (2)(C)** – One reason for the existence of cooperatives is for patron members to engage in business with the cooperative as a form of self-help. This subparagraph expressly recognizes the right or obligation of a member to engage in business with the cooperative as a component of the member’s interest in the association. The right or obligation is typically evidenced by a marketing or use contract, a membership agreement, or a combination of the two. In addition, portions of those contracts or agreements are sometimes contained in the organic rules. Marketing or similar contracts are usually interpreted the same way as third-party contracts. The placement of provisions that would otherwise be interpreted as a third party contract in either a membership agreement or the organic rules may affect whether those provisions are interpreted solely as a matter of third party contract. Such a determination will depend on all the facts and circumstances of the particular scenario.

A membership agreement should not be confused with a control agreement (for example, the typical shareholders’ agreement in business corporation planning).

This article does not provide details of the rights or obligations of a member to do business with the limited cooperative association leaving maximum flexibility for development of them to the organic rules and separate contract. For example in an agricultural limited cooperative association, membership may be required for an agricultural producer to be entitled to deliver production to the association for processing. In an association where workers are the patron members, membership in the association may be required to be an employee of the association. Typically, but again depending on the facts and circumstances, neither of these requirements would constitute financial or governance rights but, nonetheless, would be an integral part of the membership in the association.

Some traditional cooperatives provide in their organic rules and operating policies that simply engaging in business with the cooperative constitutes an application for membership in the cooperative or automatically constitutes a person as a member of the cooperative. For example, rural telephone cooperatives almost always provide that a request for service also

constitutes an application for membership and, in some cases, require a person to be a member to obtain telephone service. This article does not prohibit this type of provision in the organic rules.

Traditional cooperatives may engage in business with persons who are not members of the cooperative unless prohibited by the organic rules. Traditionally cooperatives have referred to those persons as “non-member patrons.” This article does not prevent a limited cooperative association from engaging in business or other activities with non-members. These arrangements are not addressed in this article. They are governed by general contract law. If an association engages in business or other activities with non-members, the organic rules may authorize the non-members to share in profits of the association but this would be done through a contract. Nothing in this article prohibits an association from engaging in business with “non-member patrons.” The organic rules of an association could address “non-member patrons” as well.

**Paragraph (3)** – A limited cooperative association formed under this article is not required to issue membership certificates, but it may do so. If it does so, it is required to note restrictions on transfer of membership interests on the certificate under Section 6-603(d)(2).

## **SECTION 6-602. PATRON AND INVESTOR MEMBERS’ INTERESTS.**

(a) Unless the organic rules establish investor members’ interests, a member’s interest is a patron member’s interest.

(b) Unless the organic rules otherwise provide, if a limited cooperative association has investor members, while a person is a member of the association, the person:

(1) if admitted as a patron member, remains a patron member;

(2) if admitted as an investor member, remains an investor member; and

(3) if admitted as a patron member and investor member remains a patron and

investor member if not dissociated in one of the capacities.

### **Comment**

**Subsection (a)** – A limited cooperative association may have both patron members and investor members. Investor members are not permitted unless the organic rules provide for them.

**Subsection (b)** – If a limited cooperative association has investor members, persons who become a member as either a patron member or as an investor member will remain that type of member so long as the person remains a member of the association. A person may hold memberships in both capacities. *See* Section 6-112. The organic rules could provide that a

patron member is converted to an investor member upon the occurrence of specified events, such as ceasing to qualify as a patron member under the organic rules. If a person holds memberships in both capacities, the member could dissociate in one capacity but not in the other or, subject to this article and the organic rules of the association, could transfer one type of membership interest but not the other.

### **SECTION 6-603. TRANSFERABILITY OF MEMBER'S INTEREST.**

(a) The provisions of this [article] relating to the transferability of a member's interest are subject to [reference to Uniform Commercial Code].

(b) Unless the organic rules otherwise provide, a member's interest other than financial rights is not transferable.

(c) Unless a transfer is restricted or prohibited by the organic rules, a member may transfer its financial rights in the limited cooperative association.

(d) The terms of any restriction on transferability of financial rights must be:

- (1) set forth in the organic rules and the member records of the association; and
- (2) conspicuously noted on any certificates evidencing a member's interest.

(e) A transferee of a member's financial rights, to the extent the rights are transferred, has the right to share in the allocation of profits or losses and to receive the distributions to the member transferring the interest to the same extent as the transferring member.

(f) A transferee of a member's financial rights does not become a member upon transfer of the rights unless the transferee is admitted as a member by the limited cooperative association.

(g) A limited cooperative association need not give effect to a transfer under this section until the association has notice of the transfer.

(h) A transfer of a member's financial rights in violation of a restriction on transfer contained in the organic rules is ineffective if the intended transferee has notice of the restriction at the time of transfer.

## Comment

**Generally** – Unincorporated entity law restricts transferability of interests because of the personal and contractual nature of the entities. Members choose to form unincorporated entities in reliance on their knowledge of, and comfort with, the persons with whom they will be associated. The governing law generally distinguishes between the governance (or management) rights of members and their financial rights. *See, e.g.*, Sections 5-501 (transferable interest in a limited liability company is personal property); 5-502(a)(3)(A) (transfer does not entitle transferee to participate in management or conduct of limited liability company's activities); 5-502(a)(3)(B) (transferee has right to receive distributions from limited liability company to which transferor would otherwise be entitled).

This article draws the same basic distinction. Thus, subsections (b) and (c) provide the default rule that only financial rights may be transferred, and subsection (f) states that a transferee of financial rights does not thereby become a member. Subsection (e) provides that a transferee of financial rights receives only the right to share in the allocation of profits and losses and the right to receive the distributions to which the transferring member would otherwise have been entitled. A member who transfers financial rights retains governance rights. *See* the comment to Section 6-102(8).

Governance rights are a statutory component of a member's interest, which is itself defined in Section 6-601(1) as personal property. The differentiation between financial rights and governance rights under this article, and the exclusion of management rights from transferable interests under other unincorporated entity acts, rests in part on the fact that governance rights are as close to contracts for unique personal services as they are to purely commercial transactions or even the servicing and maintenance agreements attendant to the purchase of other property. This is especially true in a small, closely held entity.

In secured transactions involving a member's interest in a limited cooperative association as collateral, Uniform Commercial Code Sections 9-406 and 9-408 must be consulted to determine whether any restrictions on the transferability of the member's interest are effective with respect to the secured party.

**Subsection (b)** – If there are restrictions on transfers of interests in a limited cooperative association, except for financial rights, the interests are not transferable unless permitted by the organic rules, the association's membership records, and on certificates of interest if the association issues certificates. An association does not need to issue certificates. *See* Section 6-601(3).

**Subsection (c)** – To be effective, a restriction or prohibition on the transfer of financial rights in a limited cooperative association must be set forth in the organic rules. The default rule that financial rights are transferable is based on laws governing other unincorporated entities, where such rights are considered to be personal property that is not subject to transfer restrictions except to the extent a restriction is set forth in the entity's organic document.

**Subsection (e)** – If a transferee is entitled under this article and the organic rules to

receive transfer of financial rights from a member of a limited cooperative association, the transferee is entitled to share in allocations of profit and loss and distributions of the association. This does not mean a transferee would have a greater right than the transferor. If it is a requirement that a patron member transact patronage with an association to participate in allocations of profit and loss, a transferee of financial rights from that member would not be permitted to receive a share of allocations of profit and loss if the member did not transact patronage with the association during the period for which the allocations are determined.

**Subsection (f)** – A transferee of the financial rights of a member of a limited cooperative association does not automatically become a member of the association because of the transfer. For a transferee to become a member (with all the rights of a member including governance rights) requires an act of the association to admit the transferee as a member of the association. *See* Section 6-502 (c). A mere transfer of financial rights does not alone dissociate the transferor member. *See* Section 6-1101. Therefore, under the default rules, the transferor retains all other rights including the right to vote as a member. If the transferor is dissociated pursuant to Section 6-1101, the voting rights associated with the membership vanish. The organic rules could vary this result, however, by admitting the transferee as a member. If the organic rules admit the transferee, they should address the case of a transfer to a transferee who is an existing member; especially if the association uses the one member - one vote manner of voting.

**Subsection (g)** – This subsection recognizes an administrative necessity by relieving a limited cooperative association of any obligation with respect to a transfer of a membership interest in the association, or any portion of an interest, if the association has no knowledge or notice of the transfer or attempted transfer. As in other parts of this article, what constitutes effective “notice” in this section is left to other law. Provisions dealing with “notice” could also be written in the organic rules.

**Subsection (h)** – A transfer of all or a portion of a member’s interest in violation of a restriction on transfer is not effective against a person who had knowledge of the restriction. Conversely, if a transferee had no notice of the restriction, the transfer is effective.

#### **SECTION 6-604. SECURITY INTEREST AND SET-OFF.**

(a) A member or transferee may create an enforceable security interest in its financial rights in a limited cooperative association.

(b) Unless the organic rules otherwise provide, a member may not create an enforceable security interest in the member’s governance rights in a limited cooperative association.

(c) The organic rules may provide that a limited cooperative association has a security interest in the financial rights of a member to secure payment of any indebtedness or other obligation of the member to the association. A security interest provided for in the organic rules

is enforceable under, and governed by, [reference to Article 9 of the Uniform Commercial Code].

(d) Unless the organic rules otherwise provide, a member may not compel the limited cooperative association to offset financial rights against any indebtedness or obligation owed to the association.

### **Comment**

This section succinctly addresses recurring security interest issues that arise concerning members' interest and that are common to both cooperative and unincorporated entities. Under subsections (a) and (b) a member may create an enforceable security interest in its financial rights but, unless the organic rules provide otherwise, may not create an enforceable security interest in governance rights. The word "enforceable" is significant here and ties into the relationship between the provisions of this article relating to transferability and those of UCC Sections 9-406 and 9-408.

**Subsection (c)** – This subsection permits the organic rules of a limited cooperative association to create an enforceable UCC Article 9 security interest in the financial rights of a member to secure the indebtedness or the performance of obligations of a member to the association with the organic rules themselves constituting the security agreement. In other words, the organic rules will have the same legal effect as a UCC Article 9 security agreement authenticated by the debtor (member) and describing the collateral as the member's financial rights. If the organic rules provide for such a security interest, issues of perfection, priority, and the manner of enforcement are governed by the relevant provisions of the UCC.

The creation of the security interest in the organic rules is consistent with the mutual self-help purpose of a cooperative which recognizes all members are inter-reliant. That is, a default by one member of an obligation to the cooperative can affect all members.

The usefulness of the ability of a cooperative to protect itself, and thus all of its members, in the event of a failure of one member to meet its obligations to the cooperative can arise in many contexts. If members in a supply cooperative fail to pay for goods received from the cooperative, the failure damages all other members by reducing the receipts of the cooperative used to cover its expenses in providing services to its members. Some agricultural cooperatives pay for commodities received by them through "net proceeds contracts" where the purchase price is determined by the total amounts received for the commodities by the cooperative less the cooperative's expenses during a marketing period. Many of these cooperatives make advances towards the purchase price during the marketing period. If at the end of the marketing period, it is discovered the cooperative has overpaid its members, the security interest (although unperfected) can assist the cooperative in recovering the overpayments for the equitable treatment and benefit of all the members. This subsection constitutes a balancing of the interests of the member and creditors of the member, on one hand, and the association and its other

members and creditors on the other. It reflects one of the unique features of cooperatives: those who own them are both their primary customers and sources of capital. This feature is present in limited cooperative associations even though it is arguably diluted by the possible existence of non-patron investor members.

**Subsection (d)** – Under the default rule of this subsection, no member of a limited cooperative association may require the association to offset amounts due to the member from the association against amounts due to the association from the member. An association may, however, offset against amounts due a member in accordance with other law.

#### **SECTION 6-605. CHARGING ORDER.**

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the financial rights of the judgment debtor for the unsatisfied amount of the judgment. Except as otherwise provided in subsection (f), a charging order constitutes a lien on the judgment debtor's financial rights and requires the limited cooperative association to pay over to the person to which the charging order was issued any distribution that otherwise would be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the financial rights. Except as otherwise provided in subsection (f), the purchaser at the foreclosure sale obtains only the financial rights that are subject to the charging order, does not thereby become a member, and is subject to Section 6-603.

(d) At any time before foreclosure under subsection (c), the member or transferee whose



financial rights are subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), the limited cooperative association or one or more members whose financial rights are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order. Unless the organic rules otherwise provide, the association may act under this subsection only with the consent of all members whose financial rights are not subject to the charging order.

(f) If a court forecloses a charging order lien against the sole member of a limited cooperative association:

- (1) the court shall confirm the sale;
- (2) the purchaser at the sale obtains the member's entire interest, not only the member's financial rights;
- (3) the purchaser thereby becomes a member; and
- (4) the person whose interest was subject to the foreclosed charging order is dissociated as a member.

(g) This [article] does not deprive any member or transferee of the benefit of any exemption law applicable to the member's or transferee's financial rights.

(h) This section provides the exclusive remedy by which a person seeking in the capacity of judgment creditor to enforce a judgment against a member or transferee may satisfy the judgment from the judgment debtor's financial rights.

## Comment

This section balances the needs of a judgment creditor of a member or transferee with the needs of the limited cooperative association and its members. The section achieves that balance by allowing the judgment creditor of a member to collect on the judgment from distributions with respect to financial rights of the judgment debtor in the association while prohibiting interference in the management and activities of the association by the judgment creditor or a court. If the organic rules permit the entire interest of a member in an association to be transferred, this section only permits a charging order to reach the member's or transferee's financial rights (defined in Section 6-102(8)). *See also* Section 6-603 ("Transferability of Member's Interest"). It does not permit a charging order to reach governance rights except in the circumstance described in subsection (f),

Under this section, the judgment creditor of a member or transferee is entitled to a charging order against the relevant financial rights. While the order is in effect, it entitles the judgment creditor to whatever distributions (defined in Section 6-102(7)) would otherwise be due to the member or transferee whose interest is subject to the order. However, the judgment creditor has no voice in determining the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited cooperative association.

"Distributions" may be made in a variety of ways under Section 6-1005 including the distribution of property. The charging order would apply to those distributions, but this would not compel the association to accelerate the time at which the property would be distributed or converted to money by the association in its ordinary course of operations.

This section may not be varied by the organic rules.

**Subsection (a)** – The phrase "judgment debtor" encompasses both members and transferees. As a matter of civil procedure and due process, an application for a charging order must be served both on the limited cooperative association and the member or transferee whose financial rights are to be charged. The order itself must be served on the limited cooperative association. Whether the order must also be served on the judgment debtor is a matter for other law.

**Subsection (b)** – Paragraph (2) refers to "other orders" rather than "additional orders". Therefore, given appropriate circumstances, a court may invoke either paragraph (1) or (2), or both.

**Subsection (b)(1)** – The receiver contemplated here is not a receiver for the limited cooperative association, but rather a receiver for the distributions. The principal advantage provided by this paragraph is a probable expanded right to information. However, that right goes no further than "the extent necessary to effectuate the collections of distributions pursuant to a charging order".

**Subsection (b)(2)** – This paragraph must be understood in the context of the balance

described in the general comment to this section. In particular, the court's power to make orders "that the circumstances of the case may require" is limited to "giv[ing] effect to the charging order."

**EXAMPLE:** A judgment creditor with a charging order believes that the limited cooperative association should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the association to restrict re-investment. Subsection (b)(2) does not authorize the court to grant the motion.

**EXAMPLE:** A judgment creditor with a judgment for \$10,000 against a member obtains a charging order against the member's financial rights. Having been properly served with the order, the limited cooperative association nonetheless fails to comply and makes a \$3,000 distribution to the member. The court has the power to order the association to pay \$3,000 to the judgment creditor to "give effect to the charging order."

Under subsection (b)(2), the court also has the power to decide whether a particular payment is a distribution, because that decision determines whether the payment is part of the financial rights subject to the charging order. To the extent a payment is not a distribution, it may not be part of the financial rights and, if not, would not be subject to a charging order. In that connection, Section 6-1007(a) excludes "reasonable compensation" from being a distribution.

**EXAMPLE:** A member of ABC LCA has for several years received distributions from the limited cooperative association. However, when a judgment creditor of A obtains a charging order against A's transferable interest, the limited cooperative association ceases to make distributions to A and instead provides a salary to A equivalent to A's former distributions. Under subsection (b)(2), a court might deem this salary a disguised distribution. (In any event, however, the salary will be subject to garnishment.)

This article has no specific rules for determining the fate or effect of a charging order when the limited cooperative association undergoes a merger, interest exchange, conversion, or domestication under Article 2.

**Subsections (c)-(f)** – These subsections set forth the procedure and effect of a foreclosure action on the charging order. As is pointed out in subsection(c), except as provided in subsection(f) (see below), the purchaser at a foreclosure sale only obtains the financial rights that are subject to the charging order.

The phrase "that distributions under the charging order will not pay the judgment debt within a reasonable period of time" comes from case law. *See, e.g., Nigri v. Lotz*, 453 S.E.2d 780, 783 (Ga. Ct. App. 1995).

**Subsection (e)** – The definition of "distribution" in Section 6-102(7) is broad enough to include payments in redemption of a membership interest in a limited cooperative association under Section 6-1006 making those payments a part of a member's financial rights. A charging order could reach distributions to redeem the interest. The procedure provided in ULLCA

(2006) (Last Amended 2013) and followed in this article is appropriate for limited cooperative associations.

At the same time, when possible, buying the judgment remains superior to the mechanism provided by this subsection, because this subsection requires full satisfaction of the underlying judgment, while the limited cooperative association or the other members might be able to buy the judgment for less than face value. On the other hand, this subsection operates without need for the judgment creditor's consent, so it remains a valuable protection in the event a judgment creditor seeks to do mischief to the association.

A unanimous vote of members is required for an association to pay a member's judgment creditor under this subsection unless otherwise provided in the organic rules.

**Subsection (f)** – The charging order remedy – and more particularly, the exclusiveness of the remedy – protect the “pick your partner” principle in this and other uniform unincorporated entity acts as well as in traditional cooperative statutes. *See* Sections 6-502 (“Becoming a Member”) and 6-603(f) (a transferee of a member's financial rights does not become a member upon transfer of those rights unless the transferee is admitted as a member of the limited cooperative association). That principle is inapposite when a limited cooperative association has only one member. The exclusivity of the charging order was never intended to protect a judgment debtor, but rather only to protect the interests of the judgment debtor's co-owners.

Put another way, the charging order was never intended as an “asset protection” device for judgments. *See Olmstead v. F.T.C.*, 44 So. 3d 76, 83 (Fla. 2010) and *Inre Aalbright*, 391 B.R. 538, 540 (Bankr. D. Colo. 2003), both of which involved single member limited liability companies. Accordingly, when a charging order against the sole member of a limited cooperative association is foreclosed, the member's entire interest is sold and the buyer replaces the judgment debtor as the sole member.

This subsection was added to this article during the Harmonization project. It is parallel to Section 503(g) of ULLCA (2006) (Last Amended 2013). These are the only two unincorporated entity acts that have single member authorization. For example, a partnership must, by definition, have two or more partners.

**Subsection (g)** – This subsection preserves otherwise applicable exemptions but does not create any. *See. In Re Foos*, 405 B.R. 604, 609 (Bankr. N.D. 2009).

**Subsection (h)** – This subsection does not override Article 9 of the Uniform Commercial Code, which may provide different remedies for a secured creditor acting in that capacity. A secured creditor with a judgment might decide to proceed under UCC Article 9 alone, under this Section alone, or under both UCC Article 9 and this section. In the last-mentioned circumstance, the constraints of this section would apply to the charging order but not to the UCC Article 9 remedies. The effect of Section 6-604 with respect to the creation of security interests in membership interests in a limited cooperative association needs to be considered in connection with UCC Article 9 security interests and related remedies if a creditor seeks a security interest in a membership interest in an association in which the creditor's debtor is a member.

See the comments to Section 5-503 (limited liability companies) for additional background information on the history and use of the charging order remedy in unincorporated entities.

## **[PART] 7**

### **MARKETING CONTRACTS**

#### **Preliminary Comment**

Agricultural cooperatives that market or process members' agricultural commodities have benefitted from special statutory marketing contract provisions that are unique to agricultural cooperatives under many traditional cooperative statutes. These statutes authorize the cooperative to enter into agricultural marketing contracts that specifically authorize sums for, or methods to establish, liquidated damages for a breach of the contract by a member selling and delivering or consigning commodities to the cooperative. In the early 1900s, absent these statutory authorizations, marketing contracts were held to be void as against public policy. The damages provided in the contracts were treated as unenforceable penalties. *E.g.*, *Burns v. Wray Farmers' Grain Co.*, 65 Colo. 425, 176 P. 487 (1918) (agreement void); *Rifle Potato Growers' Coop. Ass'n v. Smith*, 78 Colo. 171, 240 P. 937 (1925) (agreement upheld and is not invalid because it permits injunctive relief or specific performance); *Mountain States Beet Growers' Mkt. Ass'n v. Monroe*, 84 Colo. 300, 269 P. 886 (1928) (discuss history of marketing contracts). Section 6-704 contains but a vestige of these statutory provisions addressing the enforcement of remedies that may be in the contract.

This article broadens the application of marketing contracts from solely for agricultural commodities to the sale of products processed from any type of product, commodity, or goods furnished by a member; and, to commodities, products, and goods of any kind that are marketed through the association. Oregon, for example, has provided for a similar breadth in its traditional cooperative statute. OR. REV. STAT. § 62.355 (2003).

This part has no application to contracts for the purchase of any item by a limited cooperative association for its members in the role of a purchasing entity for the members or to contracts between an association and its members under which members of the association market their services to others. Likewise, it does not have any application to any other type of contractual relationship between the association and a member other than a marketing contract. It neither authorizes nor prevents the enforcement of remedies, including liquidated damages and injunctive relief, under other types of contracts. Those contracts are governed under the general law of contracts and other law.

"Goods" is used in the definitional sense of the Uniform Commercial Code (Section 2-105 (1)) but is supplemented by "products" and "commodities" to emphasize the breadth of authorization for an association's use of marketing contracts governed by this part.

Marketing contract provisions are sometimes distributed across a number of agreements or documents and do not necessarily appear within the four corners of a single instrument. *See*

the comment to Section 6-601(2)(C); *cf.* JAMES R. BAARDA, STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES, AGRICULTURAL COOPERATIVES SERVICE, UNITED STATES DEPARTMENT OF AGRICULTURE, Info. Rep. 30, § 14.04.12, p. 102 (1982). Provisions are sometimes placed in the organic rules, even though this can create difficulties if the provisions require amendment. Provisions are also sometimes placed in separate membership agreements.

Whether rights and obligations under a marketing contract are subject to assignment may be addressed in the organic rules or the terms of the contract itself as supplemented by the law of contracts. In the absence of express provisions concerning assignment in the organic rules or the contract itself, general contract law will govern. The contract or the provisions governing membership, wherever located, frequently require a person to be a member of a cooperative as a prerequisite to entering into a marketing contract. Such provisions may affect the assignability of a marketing contract.

If a limited cooperative association is not prevented by its organic rules from engaging in business with persons who are not members, frequently called “non-member patrons,” the association may enter into marketing contracts with the non-member patrons. *See* the comment to Section 6-601(2)(C). Those contracts are authorized by Section 6-701(1) and could contain provisions authorized by this part including the remedies provided in Section 6-704. If, however, provisions of the marketing contract are contained in the organic rules and those provisions are amended by an amendment to the organic rules, the amendments to the organic rules might not be binding on a non-member patron in the absence of the non-member patron’s specific consent.

The provisions of this article regarding marketing contracts do not affect the application of statutes, such as the Packers and Stockyards Act, 7 U.S.C.A. § 181 *et seq.*, that provide protections for payments to agricultural producers who deliver their livestock or commodities to a buyer or processor. *See* Sections 6-107 (Requirements of Other Laws) and 1-702 (Supplemental Principles of Law).

This part has no effect on contracts, other than marketing contracts.

**SECTION 6-701. AUTHORITY.** In this [part], “marketing contract” means a contract between a limited cooperative association and another person, which need not be a patron member:

(1) requiring the other person to sell, or deliver for sale or marketing on the person’s behalf, a specified part of the person’s products, commodities, or goods exclusively to or through the association or any facilities furnished by the association; or

(2) authorizing the association to act for the person in any manner with respect to the

products, commodities, or goods.

### **Comment**

**Paragraph (1)** – A marketing contract may cover a portion or all of a member’s products, commodities, or goods. It need not be a total output contract to be subject to this part.

**Paragraph (2)** – This paragraph permits a limited cooperative association to be a buyer, a sales agent, a consignee, or act in any other capacity in connection with marketing products, commodities, or goods under a marketing contract.

## **SECTION 6-702. MARKETING CONTRACTS.**

(a) If a marketing contract provides for the sale of products, commodities, or goods to a limited cooperative association, the sale transfers title to the association upon delivery or at any other specific time expressly provided by the contract.

(b) A marketing contract may:

(1) authorize a limited cooperative association to create an enforceable security interest in the products, commodities, or goods delivered; and

(2) allow the association to sell the products, commodities, or goods delivered and pay the sales price on a pooled or other basis after deducting selling costs, processing costs, overhead, expenses, and other charges.

(c) Some or all of the provisions of a marketing contract between a patron member and a limited cooperative association may be contained in the organic rules.

### **Comment**

**Subsection (a)** – This subsection addresses the question of when title passes to products, commodities, or goods delivered and sold to a limited cooperative association under a marketing contract. The question often has no clear answer under other law if the contract does not provide one. This subsection provides the date of delivery as a default rule but recognizes the contract may provide a different time.

**Subsection (b)(1)** – This subsection recognizes that it may be necessary for business reasons for a limited cooperative association to borrow money to carry on its operations, including for purposes of making payments to its member patron suppliers, before it has sold the

products, commodities, or goods delivered to it under the contract. A marketing contract may permit the association to grant a security interest in the products, commodities, or goods delivered to it even if title has not passed to the association. Perfection, priority and other matters related to the security interest are governed by other law such as Article 9 of the Uniform Commercial Code.

**Subsection (b)(2)** – This subsection permits a marketing contract to provide one of a variety of ways to determine the price or amount to be paid for products, commodities, or goods delivered to the association. It expressly includes pooling of products, commodities, or goods from all or several producers for marketing, sale, and payment based on the results of marketing the entire pool. This article does not provide default rules. The marketing contract must provide those terms.

**SECTION 6-703. DURATION OF MARKETING CONTRACT.** The initial duration of a marketing contract may not exceed 10 years, but the contract may be self-renewing for additional periods not exceeding five years each. Unless the contract provides for another manner or time for termination, either party may terminate the contract by giving notice in a record at least 90 days before the end of the current term.

#### **Comment**

This section limits the primary term of a marketing contract to a maximum of 10 years which is in accord with similar provisions concerning marketing contracts in traditional cooperative statutes.

#### **SECTION 6-704. REMEDIES FOR BREACH OF CONTRACT.**

(a) Damages to be paid to a limited cooperative association for breach or anticipatory repudiation of a marketing contract may be liquidated, but only at an amount or under a formula that is reasonable in light of the actual or anticipated harm caused by the breach or repudiation. A provision that so provides is not a penalty.

(b) Upon a breach of a marketing contract, whether by anticipatory repudiation or otherwise, a limited cooperative association may seek:

- (1) an injunction to prevent further breach; and
- (2) specific performance.



(c) The remedies in this section are in addition to any other remedies available to an association under law other than this [article].

### **Comment**

**Subsections (a) and (b)** – Many traditional cooperative statutes addressing marketing contracts in agriculture have detailed provisions regarding the enforcement and remedies. This section identifies three primary remedies which a marketing contract may provide and authorizes their enforcement as provided in the contract. The remedies are expressed somewhat differently in this article as compared to their expression in many traditional cooperative statutes that include similar provisions.

## **[PART] 8**

### **DIRECTORS AND OFFICERS**

#### **Preliminary Comment**

This article draws its substance from limited liability company and partnership concepts and limited cooperative associations formed under it are unincorporated entities under state law. *See* Section 6-103. Traditional cooperatives, however, use a board of director management structure similar to corporate law (whether for-profit or not-for-profit). Therefore, this part dealing with boards of directors draws primarily from traditional cooperative and for-profit corporation statutes. This article requires an elected board of directors for general governance of a limited cooperative association. *See* Section 6-801. Although not statutorily required by limited liability company law, some LLCs choose to organize their internal management to provide for a board management structure. Members have a more participatory role in cooperatives than in typical business corporations and any analogy to corporate management, therefore, is by its nature somewhat limited. Nonetheless, some of the meeting and notice provisions borrow heavily from corporate law because that content is where those provisions have the longest history and experience. This part does not generally contain the level of detail that is present in business corporation law leaving many of the details to be developed by the parties in the organic rules in a manner similar to other unincorporated or alternative entities like limited liability companies.

A substantial number of the provisions of this part, as in other parts, may be modified by the organic rules, but in the absence of modification, the part provides sufficient default rules that a board of directors can be elected and function.

#### **SECTION 6-801. BOARD OF DIRECTORS.**

(a) A limited cooperative association must have a board of directors of at least three individuals, unless the association has fewer than three members. If the association has fewer

than three members, the number of directors may not be fewer than the number of members.

(b) The affairs of a limited cooperative association must be managed by, or under the direction of, the board of directors. The board may adopt policies and procedures that do not conflict with the organic rules or this [article].

(c) An individual is not an agent for a limited cooperative association solely by being a director.

### **Comment**

**Subsection (a)** – This subsection is similar to Section 62.280(2) of the Oregon Cooperative Corporation Act. The subsection does not limit the number of directors to the number of members where there are fewer than three members but it does require there be at least the number of directors equal to the number of members in that case. The flexibility to deviate below three directors when there are fewer than three members allows an industry practice of having wholly-owned cooperative subsidiaries of a cooperative. It seems *unnecessary* as a matter of law to require three directors if there are only one or two members. Section 6-803(c)(1) permits an association to have one director who is a non-member if so provided in the organic rules if there is at least one director that is a member. Section 6-801(a) provides the members great, but not unfettered, flexibility in organizing their board governance structure.

**Subsection (b)** – This article follows statutes for most entities which have a governing body or other individuals authorized by statute or the entity's organic rules to manage or provide for the direction of the entity. This is consistent with a representative democracy approach followed in most traditional cooperative statutes and by most cooperatives. The general management authority of the board of directors is mandatory.

**Subsection (c)** – Simply being a director does not make the director an agent nor does it confer agency authority on a person to act on behalf of a limited cooperative association. The association could delegate agency authority to a director in the same manner as it delegates agency authority to other persons. *See* Section 6-503.

### **SECTION 6-802. NO LIABILITY AS DIRECTOR FOR LIMITED**

**COOPERATIVE ASSOCIATION'S OBLIGATIONS.** A debt, obligation, or other liability of a limited cooperative association is solely that of the association and is not a debt, obligation, or other liability of a director solely by reason of being a director. An individual is not personally liable, directly or indirectly, for an obligation of an association solely by reason of

being a director.

### **Comment**

This section is “new” to the law of cooperatives as a codified statement and is arguably necessary because limited cooperative associations are unincorporated entities and distinguishes directors under this article with general partners of limited partnerships to whom they may be compared. It does not change the result under existing traditional cooperative law. The liability shield for directors is not different in-kind from the shield for members under Section 6-504. *See* the comment to Section 6-504. It does not shield the director from liability on account of the director’s own conduct, for improper distributions under Section 6-1008(a), or for a breach of the duties under Sections 6-818 or 6-819.

### **SECTION 6-803. QUALIFICATIONS OF DIRECTORS.**

(a) Unless the organic rules otherwise provide, and subject to subsection (c), each director of a limited cooperative association must be an individual who is a member of the association or an individual who is designated by a member that is not an individual for purposes of qualifying and serving as a director. Initial directors need not be members.

(b) Unless the organic rules otherwise provide, a director may be an officer or employee of the limited cooperative association.

(c) If the organic rules provide for nonmember directors, the number of nonmember directors may not exceed:

- (1) one, if there are two through four directors;
- (2) two, if there are five through eight directors; or
- (3) one-third of the total number of directors if there are at least nine directors.

(d) The organic rules may provide qualifications for directors in addition to those in this section.

### **Comment**

This section follows traditional cooperative approaches for the qualifications of directors in that, generally the directors must be individuals and must be a member of the limited cooperative association or a designee of a member that is not an individual even though a limited

number of non-members may be directors.

The director qualification requirements of this article limiting the number of nonmember directors, as in cooperatives generally, may conflict with the concept of an “independent board.” The conflict may be important in specific regulatory contexts. *See* the comment to subsection (c).

This section needs to be coordinated with Section 6-804 in practical application.

**Subsection (b)** – An officer or employee of the association may be a director, but would be required to be a member, a designee of a member that is not an individual, or a non-member director if non-member directors are authorized by the organic rules within the limitations of subsection (c), and meet any other qualifications for eligibility to be a director established in the organic rules under subsection (d).

**Subsection (c)** – In keeping with traditional cooperative governance structures which require directors to be members, the directors must be predominantly members or designees of members who are not individuals. This is a traditional cooperative policy that is different from corporate policy and against the general thrust of federal securities laws for publicly traded corporations. Traditional cooperative policy requires the governance of the cooperative to be in the hands of the members who are its owners and users and who provide the primary financial support of the cooperative. This article follows that policy but provides some flexibility in recognition of the possibility of having investor members in a limited cooperative association and in recognition of the potential usefulness of having a limited number of nonmember directors to provide outside advice and counsel in the affairs of the association.

**Subsection (d)** – Consistent with Section 6-109, the organic rules may provide additional qualifications for eligibility to be a director. Those qualifications may not conflict with the requirements of this section.

## **SECTION 6-804. ELECTION OF DIRECTORS AND COMPOSITION OF BOARD.**

(a) Unless the organic rules require a greater number:

(1) the number of directors that must be patron members may not be fewer than:

(A) one, if there are two or three directors;

(B) two, if there are four or five directors;

(C) three, if there are six through eight directors; or

(D) one-third of the directors if there are at least nine directors; and

(2) a majority of the board of directors must be elected exclusively by patron members.

(b) Unless the organic rules otherwise provide, if a limited cooperative association has investor members, the directors who are not elected exclusively by patron members are elected by the investor members.

(c) Subject to subsection (a), the organic rules may provide for the election of all or a specified number of directors by one or more districts or classes of members.

(d) Subject to subsection (a), the organic rules may provide for the nomination or election of directors by districts or classes, directly or by district delegates.

(e) If a class of members consists of a single member, the organic rules may provide for the member to appoint a director or directors.

(f) Unless the organic rules otherwise provide, cumulative voting for directors is prohibited.

(g) Except as otherwise provided by the organic rules, subsection (e), or Sections 6-302, 6-516, 6-517, and 6-809, member directors must be elected at an annual members meeting.

### **Comment**

This section reflects one of the major policy decisions in this article concerning the cooperative principle of “user control” and the flexibility for an equity structure that includes “non-user” investor members. It resolves the matter by bifurcating the issue as follows: (1) director qualification requirements assuring a significant percentage of the board will be composed of patron members; and (2) requiring a majority of the board will be elected by patron members.

**EXAMPLE:** Assume a limited cooperative association has 20 members (14 patron members, six investor members), six directors, and one vote for each member. Under the default rules, (1) two of the directors (one-third of the total number) must be patron members by whomever elected, and (2) only the patron members elect four (a majority) of the directors. The investor members may elect the other two directors.

This article’s resolution of composition assures patron members have significant

“control” over choosing board members. The extent of patron member “control,” however, hinges on the terms of the organic rules and the interplay between the qualification, nomination and election provisions in them. This article does not address the nomination process. The protection of patron member control by the default and mandatory rules, however, is neither perfect nor designed to be complete and does not guarantee that patron members will always be able to dictate results.

**Subsection (a)(1)** – This subsection provides for the minimum number of directors who must be patron members. The organic rules may require that there be a greater number of directors who are patron members.

**Subsection (a)(2)** – In addition to the requirements of subsection (a)(1), the majority of the directors must be elected by the patron members, whether the directors are patron members, investor members, designees of members who are not individuals, or nonmembers. *See* Section 6-803.

**Subsection (b)** – Although a majority of the directors must be elected by patron members, this subsection permits a limited cooperative association through its organic rules to have great flexibility in the manner of electing the remaining directors.

**Subsection (c)** – Subject to the requirements of subsection (a) regarding the number of directors who must be patron members, the organic rules may provide for some or all of the directors of a limited cooperative association to be elected by districts or classes of members that may be established pursuant to Section 6-517. An association could have some directors elected by districts or classes and some elected at large. In the context of this article, the term “classes” of members is broader than the distinction between patron members and investor members. Election by classes, in particular, can significantly vary the results of elections when compared to the results under the default rules.

**Subsection (d)** – If provided by the organic rules, directors may be nominated or elected directly by members in districts or classes without a vote of the entire membership or the districts or classes may elect delegates to nominate or vote for directors at the annual meeting of a cooperative association without nominations from, or votes by, the entire membership. Of course, under the general flexibility of this article the organic rules may provide for other methods of nomination.

**Subsection (e)** – If a class of members consists of only one member, for example where there is only one investor member, the single member of the class may appoint a director rather than requiring the director to stand for election if such an appointment process is provided by the organic rules.

**Subsection (f)** – Cumulative voting for directors is not permitted in most traditional cooperatives. This subsection permits the organic rules to provide for cumulative voting. Corporate statutes typically no longer define “cumulative voting.” This subsection follows that approach. Best practices would provide a definition in the organic rules if cumulative voting is to be permitted. The organic rules should fully cover how cumulative voting is intended to apply

because of its complexity where classes or districts may exist.

**Subsection (g)** – This subsection provides a default rule that directors are elected at an annual meeting of the members. It may be varied by the organic rules within parameters. Other exceptions to this default rule reference other provisions of this article that apply in the context of specific circumstances. They are the appointment or naming of the initial board of directors (Section 6-302(a)), by action taken without a meeting (Section 6-516) and filling a vacancy on the board (Section 6-809). The other exceptions to the default rule stated in this subsection occur when the organic rules (1) provide for districts and classes (Section 6-517) including single member classes (subsection (e)), or (2) provide for nonmember directors (Section 6-803(c)). The method or manner of selecting directors under the last two exceptions is left to the organic rules because the exceptions themselves are creatures of the organic rules.

#### **SECTION 6-805. TERM OF DIRECTOR.**

(a) Unless the organic rules otherwise provide, and subject to subsections (c) and (d) and Section 6-302(d), the term of a director expires at the annual members meeting following the director's election or appointment. The term of a director may not exceed three years.

(b) Unless the organic rules otherwise provide, a director may be reelected.

(c) Except as otherwise provided in subsection (d), a director continues to serve until a successor director is elected or appointed and qualifies or the director is removed, resigns, is adjudged incompetent, or dies.

(d) Unless the organic rules otherwise provide, a director does not serve the remainder of the director's term if the director ceases to qualify to be a director.

#### **Comment**

This section coordinates with Section 6-809 relating to filling a vacancy on the board of directors of a limited cooperative association.

**Subsection (a)** – This subsection provides for one-year terms for directors but the organic rules may provide for longer terms not to exceed three years. Exceptions to the term are provided for initial directors whose terms are governed by Section 6-302(d), for holdover directors under subsection (c), and for directors who cease to qualify to be a director under subsection (d).

Requiring reelection at least every three years is conceptually important because this article, like cooperatives generally, contemplates meaningful participation by members coupled

with centralized management control by the board of directors. This is true in any event, but especially if the board may amend the bylaws.

Nothing in this article prohibits staggered terms for directors and it expressly provides that the organic rules may establish terms longer than one year which are necessary for staggered terms. *See* Section 6-109(a).

**Subsection (b)** – This subsection permits directors to serve unlimited numbers of terms but the organic rules could obviously provide term limitations for directors. *See* Section 1-109(c)(13).

**Subsection (c)** – This subsection provides for “holdover” directors so that director positions do not automatically become vacant at the expiration of their terms. Rather, the same directors continue in office until successors qualify for office. This allows the board of directors to act continuously and without interruption even if an election is not held or the members are deadlocked and unable to elect directors. *See generally* Section 6-1203 (“Judicial Dissolution”).

**SECTION 6-806. RESIGNATION OF DIRECTOR.** A director may resign at any time by giving notice in a record to the limited cooperative association. Unless the notice states a later effective date, a resignation is effective when the notice is received by the association.

#### **Comment**

The resignation of a director is effective when a notice in a record is received by a limited cooperative association unless the notice provides a later effective date. If the notice provides a later effective date, since the person giving the notice is still a member of the board, the person may participate in all decisions until the specified date. The participation of the resigning director in the decision of the successor may be particularly important where political balances within the board may be affected by the resignation. Relatedly, Section 6-809 places limitations on the persons who may be appointed as replacements with respect to classes who elected the resigning director.

**SECTION 6-807. REMOVAL OF DIRECTOR.** Unless the organic rules otherwise provide, the following rules apply:

(1) Members may remove a director with or without cause.

(2) A member or members holding at least 10 percent of the total voting power entitled to be voted in the election of a director may demand removal of the director by one or more signed petitions submitted to the officer of the limited cooperative association charged with keeping its



records.

(3) Upon receipt of a petition for removal of a director, an officer of the association or the board of directors shall:

(A) call a special meeting of members to be held not later than 90 days after receipt of the petition by the association; and

(B) mail or otherwise transmit or deliver in a record to the members entitled to vote on the removal, and to the director to be removed, notice of the meeting which complies with Section 6-508.

(4) A director is removed if the votes in favor of removal are equal to or greater than the votes required to elect the director.

### **Comment**

All provisions of this section may be varied by the organic rules providing maximum latitude for a limited cooperative association to fashion the standard, manner and procedure for removal of directors. This article does not provide for removal of a director by the board of directors but this could be provided in the organic rules. *See* Section 6-109(c)(13). The board may suspend a director, however, under Section 6-808. In the absence of variation of the article's provisions by the organic rules, this section provides the rules regarding the removal of directors.

**Paragraph (1)** – This section reflects the policy that the members are the owners of a limited cooperative association and should be entitled to change the directors if they desire to do so. It is consistent with the notion of member control. This differs from corporate common law that a director may only be removed “for cause” such as fraud, criminal conduct, gross abuse of office or similar conduct.

**Paragraph (2)** – The process of removing a director by the members is commenced by a demand made in a signed record (essentially a petition process) by members holding 10 percent of the *total* voting power of the membership group who could vote on the election of the director. The record must be delivered to the officer of the limited cooperative association who is charged with keeping its records.

The organic rules may provide that a director may only be removed for cause. “Cause” can be defined in the organic rules.

**Paragraph (3)** – Once the signed record of the demand is received by the limited

cooperative association, an officer or the board of directors must call a special members meeting that is to be held within 90 days and provide proper notice to the members of the meeting stating that the removal will be considered at the meeting.

**Paragraph (4)** – The vote on the removal of a director by the members must be the same as the vote that would be necessary to have elected the director. This means, consistently with subsection (2): a director elected solely by patron members can be removed only by patron members; a director elected solely by investor members can be removed only by investor members; directors elected by a district or class can be removed only by members of that district or class. If cumulative voting is permitted by the organic rules, cumulative voting would be applicable in a removal vote. *See* comment to MBCA § 8.08 (describing how cumulative voting operates in connection with a vote on removal).

#### **SECTION 6-808. SUSPENSION OF DIRECTOR BY BOARD.**

(a) A board of directors may suspend a director if, considering the director's course of conduct and the inadequacy of other available remedies, immediate suspension is necessary for the best interests of the association and the director is engaging, or has engaged, in:

- (1) fraudulent conduct with respect to the association or its members;
- (2) gross abuse of the position of director;
- (3) intentional or reckless infliction of harm on the association; or
- (4) any other behavior, act, or omission as provided by the organic rules.

(b) A suspension under subsection (a) is effective for 30 days unless the board of directors calls and gives notice of a special meeting of members for removal of the director before the end of the 30-day period in which case the suspension is effective until adjournment of the meeting or the director is removed.

#### **Comment**

Although the board of directors may not remove a director, it may suspend a director for 30 days for cause as defined in subsection (a). Within the 30 day period the board may call and give notice of a special meeting of members to consider removing the suspended director in the same manner as if the board received a demand for removal from members under Section 6-807. In that case, the suspension continues until the removal is determined at the members meeting. If members do not vote to remove the director, the director continues in office.

## **SECTION 6-809. VACANCY ON BOARD.**

(a) Unless the organic rules otherwise provide, a vacancy on the board of directors must be filled:

(1) within a reasonable time by majority vote of the remaining directors until the next annual members meeting or a special meeting of members called to fill the vacancy; and

(2) for the unexpired term by members at the next annual members meeting or a special meeting of members called to fill the vacancy.

(b) Unless the organic rules otherwise provide, if a vacating director was elected or appointed by a class of members or a district:

(1) the new director must be of that class or district; and

(2) the selection of the director for the unexpired term must be conducted in the same manner as would the selection for that position without a vacancy.

(c) If a member appointed a vacating director, the organic rules may provide for that member to appoint a director to fill the vacancy.

### **Comment**

**Subsection (a)** – This subsection provides that the remaining directors (without regard to quorum requirements) are to fill a vacancy on the board within a reasonable time. The replacement director is to serve until the next annual members meeting or until a special meeting is called by the remaining directors to fill the vacancy. If the term of the director whose position is vacant would have extended beyond the next annual meeting of members, the members are to vote on a person to fill the vacancy until the end of the term. The special members meeting could be the same meeting at which members were asked to vote on the removal of a director if the appropriate notice was given.

**Subsection (b)** – This subsection provides that if a voting group of members is entitled to elect a director, only that voting group is entitled to fill a vacant office which was held by a director elected by that voting group. This section is part of the consistent treatment of directors elected by a voting group of members. *See* Section 6-804(c) and (d).

**Subsection (c)** – This subsection permits the organic rules to provide that a member, who alone constitutes a class of members entitled to appoint a director under Section 6-804(e), may

appoint a director to replace a director previously appointed by the member if that director's position becomes vacant. Unless the organic rules provide for this, the vacancy would be filled in the same manner as other vacancies under subsections (a) and (b).

**SECTION 6-810. REMUNERATION OF DIRECTORS.** Unless the organic rules otherwise provide, the board of directors may set the remuneration of directors and of nondirector committee members appointed under Section 6-817(a).

#### **Comment**

Although this article permits the organic rules to provide other means for establishing the compensation of directors, the default rule is for the board of directors to fix the remuneration of directors and nondirector committee members appointed by the board pursuant to subsection 6-817(a).

#### **SECTION 6-811. MEETINGS.**

(a) A board of directors shall meet at least annually and may hold meetings inside or outside this state.

(b) Unless the organic rules otherwise provide, a board of directors may permit directors to attend or conduct board meetings through the use of any means of communication, if all directors attending the meeting can communicate with each other during the meeting.

#### **Comment**

This section provides maximum flexibility for directors meetings requiring only that the directors meet at least once a year.

In the traditions of many types of cooperatives, non-director members of the cooperative are permitted to observe board meetings. These traditions may have emerged from the member governance concepts in cooperatives especially those in the non-profit sector or where cooperatives operate within a regulatory sphere which makes them quasi-public entities. This article does not address this matter. Best practices may suggest this matter be addressed in the organic rules. This article implicitly allows the board to close its meetings. In some areas, such as employment law, legal requirements and best business practices may make it advisable or necessary to close meetings of the directors.

#### **SECTION 6-812. ACTION WITHOUT MEETING.**

(a) Unless prohibited by the organic rules, any action that may be taken by a board of

directors may be taken without a meeting if each director consents in a record to the action.

(b) Consent under subsection (a) may be withdrawn by a director in a record at any time before the limited cooperative association receives consent from all directors.

(c) A record of consent for any action under subsection (a) may specify the effective date or time of the action.

### **Comment**

Formal board meetings are not the most efficient manner in which to take board action. Often board action is not controversial but needs to be memorialized in a record of unanimous consent. For example, where a limited cooperative association is a wholly-owned subsidiary of another cooperative entity and there is only one director of the association, a record of action by the sole director is an efficient and practical way to make a record of the action. Consent may be given in one or more records as defined in Section 1-102(41), which includes the use of electronic media.

A director who believes discussion or further consideration is necessary or helpful may force a meeting by withholding consent.

### **SECTION 6-813. MEETINGS AND NOTICE.**

(a) Unless the organic rules otherwise provide, a board of directors may establish a time, date, and place for regular board meetings, and notice of the time, date, place, or purpose of those meetings is not required.

(b) Unless the organic rules otherwise provide, notice of the time, date, and place of a special meeting of a board of directors must be given to all directors at least three days before the meeting, the notice must contain a statement of the purpose of the meeting, and the meeting is limited to the matters contained in the statement.

### **Comment**

Regular meetings of the board of directors may be held at designated times without further notice of time, date, place or purpose. Special meetings require three days' notice and must state the time, date, place and purpose. At special meetings, only the matters specified in the notice may be subject to action at the meeting. The latter differs from typical provisions in business corporation law. This article does not require the notice of a special meeting to be in

writing.

Best practices might suggest that at least some reminder of a regular meeting and a proposed agenda be given to directors prior to the meeting. This article does not require a notice because (a) any additional requirements may subvert certainty of action taken at regular meetings, and (b) it conforms to the purpose of this article to provide a flexible entity to meet the unique needs of different groups that may organize under the article.

The organic rules may provide for different requirements regarding notices of meetings.

#### **SECTION 6-814. WAIVER OF NOTICE OF MEETING.**

(a) Unless the organic rules otherwise provide, a director may waive any required notice of a meeting of the board of directors in a record before, during, or after the meeting.

(b) Unless the organic rules otherwise provide, a director's participation in a meeting is a waiver of notice of that meeting unless:

(1) the director objects to the meeting at the beginning of the meeting or promptly upon the director's arrival at the meeting and does not thereafter vote in favor of or otherwise assent to the action taken at the meeting; or

(2) the director promptly objects upon the introduction of any matter for which notice under Section 6-813 has not been given and does not thereafter vote in favor of or otherwise assent to the action taken on the matter.

#### **Comment**

**Subsection (a)** – This subsection follows modern corporate practice in viewing notice as a technical requirement with waivers being favored at the level of the board of directors. Generally, subsection (a) applies where a director desires to waive notice so that action taken will be valid.

**Subsection (b)** – This subsection addresses the effect of a director's attendance at a meeting as related to waiver of notice. The subsection governs circumstances clearly distinguishable from voluntary waivers under subsection (a). Absent modification by the organic rules, this subsection requires a director to object to the holding of a meeting for lack of notice at the beginning of the meeting or upon the director's arrival. If there is no objection to the notice of a meeting, but a matter is presented at a meeting that was not included in the notice, a director may object at the time the matter is presented.

A director who stays during a meeting to which the director has objected is not presumed to have waived notice of the meeting unless the director votes for or assents to action taken at the meeting in which case the director would be considered to have waived objection to the meeting for lack of notice.

#### **SECTION 6-815. QUORUM.**

(a) Unless the articles of organization provide for a greater number, a majority of the total number of directors specified by the organic rules constitutes a quorum for a meeting of the directors.

(b) If a quorum of the board of directors is present at the beginning of a meeting, any action taken by the directors present is valid even if withdrawal of directors originally present results in the number of directors being fewer than the number required for a quorum.

(c) A director present at a meeting but objecting to notice under Section 6-814(b)(1) or (2) does not count toward a quorum.

#### **Comment**

**Subsection (a)** – The default rule under this article, which may be varied by the organic rules, requires the number of directors to be fixed either in the organic rules or by a resolution of the board within parameters established by the organic rules. Thus, this subsection establishes a quorum as a majority of the fixed number of directors. If a higher number is to be required for a quorum, it must be provided in the articles of organization and not in the bylaws.

**Subsection (b)** – This subsection permits a meeting to continue once a quorum is established even if a sufficient number of directors leave the meeting to reduce the number in attendance to less than a quorum. This means no director may block the board from acting simply by leaving the meeting.

**Subsection (c)** – For purposes of establishing a quorum, a director who is present but only to object to the meeting because of lack of notice is not counted in determining the presence of a quorum.

#### **SECTION 6-816. VOTING.**

(a) Each director shall have one vote for purposes of decisions made by the board of directors.

(b) Unless the organic rules otherwise provide, the affirmative vote of a majority of directors present at a meeting is required for action by the board of directors.

### **Comment**

A limited cooperative association may not provide for any director to have more, or less, than one vote in connection with action by the board of directors. A majority of directors present may take action as a board, but the organic rules may establish a different voting standard, including unanimity, on some or all matters that come before the board.

### **SECTION 6-817. COMMITTEES.**

(a) Unless the organic rules otherwise provide, a board of directors may create one or more committees and appoint one or more individuals to serve on a committee.

(b) Unless the organic rules otherwise provide, an individual appointed to serve on a committee of a limited cooperative association need not be a director or member.

(c) An individual who is not a director and is serving on a committee has the same rights, duties, and obligations as a director serving on the committee.

(d) Unless the organic rules otherwise provide each committee of a limited cooperative association may exercise the powers delegated to it by the board of directors, but a committee may not:

(1) approve allocations or distributions except according to a formula or method prescribed by the board of directors;

(2) approve or propose to members action requiring approval of members; or

(3) fill vacancies on the board of directors or any of its committees.

### **Comment**

Many types of committees have become common in organizations, *e.g.*, executive committees, audit committees, litigation committees, legislative committees, membership committees. Those committees, however, are subject to the oversight responsibility of the board.

This section provides substantial flexibility in the board of directors to establish



committees. The flexibility may be expanded or contracted by the organic rules. This article does not provide for creation of committees to which the board may delegate its power by any means other than by board action or in the organic rules.

**Subsection (a)** – Under this subsection a committee can consist of only one individual. This can facilitate rapid decision making when circumstances require it.

**Subsections (b) and (c)** – The directors may appoint persons who are not directors or members of the limited cooperative association to a committee, but if persons are appointed who are not directors, they have all the rights, duties, and obligations of a director appointed to serve on a committee. This is broader than, for example, MBCA Section 8.25 which authorizes the board of directors of a corporation to create committees that consist only of board members. This article provides for the board to have greater flexibility in the creation of committees to which the board may delegate its power. It does not limit other ways in which a committee may be created and its members designated. *But see* the comment to Section 6-901 (indemnification and insurance considerations). In any event, however, the board has oversight responsibility. Those willing to serve on such committees need to be aware of their statutory obligations. Consulting arrangements, may in many circumstances, be an alternative to the official delegation of board authority.

**Subsection (d)** – The board of directors can delegate substantial powers to a committee but may not do so with respect to the three subjects listed in paragraphs (1), (2) or (3).

**SECTION 6-818. STANDARDS OF CONDUCT AND LIABILITY.** Except as otherwise provided in Section 6-820:

(1) the discharge of the duties of a director or member of a committee of the board of directors is governed by the law applicable to directors of entities organized under [reference to this state’s cooperative corporation act or the general business corporation act]; and

(2) the liability of a director or member of a committee of the board of directors is governed by the law applicable to directors of entities organized under [insert reference to this state’s cooperative corporation act or to the general business corporation act].

**Legislative Note:** *Adopting jurisdictions should choose only one of the bracketed alternative statutes to govern what has traditionally been called the “fiduciary duties” of directors. While the listed laws are generally similar in most jurisdictions, they do not contain the same formulation either between the laws in a given jurisdiction or between laws governing even the same type of entity among various jurisdictions. Thus the choice of the bracketed law, including any power to modify the law as referenced in optional Sections 6-109(b)(10) and (11), has policy implications for limited cooperative associations organized under this article.*

*Adopting jurisdictions should carefully coordinate the choices under this section and Sections 6-819 and 6-901.*

### **Comment**

The approach taken to Sections 6-818 and 6-819 recognizes that (1) states take fundamentally different approaches to the duties of managers or governors within unincorporated organizations of the same kind; (2) there is variety among the states in their approach to duties within corporate statutes; and (3) there is variety among the states in their approach in cooperative laws. The existing cooperative statutes appear to most closely follow corporate duty formulations.

This article establishes a limited cooperative association as an unincorporated entity. Although an unincorporated entity, the board of directors of a limited cooperative association under this article functions more analogously to a corporate board than to the typical managers in a manager-managed limited liability company or general partners in a limited partnership. Nonetheless, the duties in almost all entities use the same labels of care and loyalty. Thus adopting corporate standards in this article, while unusual for unincorporated entities (but not cooperatives), is unusual only to a matter of degree even apart from the distinctive features of the standards.

If a statute to which reference is made in this article permits the equivalent of its organic rules to vary the standards of conduct and liability of directors, drafters of the organic rules of a limited cooperative association should take care to provide for the levels of conduct and potential liability to be imposed on directors consistent with those statutory provisions. *See the Legislative Note to this section.*

### **SECTION 6-819. CONFLICT OF INTEREST.**

(a) The law applicable to conflicts of interest between a director of an entity organized under [reference to this state's cooperative corporation act or the general business corporation act] governs conflicts of interest between a limited cooperative association and a director or member of a committee of the board of directors.

(b) A director does not have a conflict of interest under this [Code] or the organic rules solely because the director's conduct relating to the duties of the director may further the director's own interest.

***Legislative Note:*** *See the Legislative Note to Section 6-818.*

## Comment

*See the comment to Section 6-818.*

**Subsection (b)** – This subsection recognizes that the members of a cooperative entity, including a limited cooperative association, both own and patronize the cooperative and that directors are commonly required to be members of the cooperative. Thus there will be technical conflicts of interest even where a director properly performs a director's functions because the director may receive contractual benefits shared by other members. This subsection makes it clear that a director will not be held to have a conflict of interest simply by performing the required duties of a director even if the director is benefitted as a member.

**SECTION 6-820. OTHER CONSIDERATIONS OF DIRECTORS.** Unless the articles of organization otherwise provide, in considering the best interests of a limited cooperative association, a director of the association in discharging the duties of director, in conjunction with considering the long and short term interest of the association and its patron members, may consider:

- (1) the interest of employees, customers, and suppliers of the association;
- (2) the interest of the community in which the association operates; and
- (3) other cooperative principles and values that may be applied in the context of the decision.

## Comment

In keeping with traditional cooperative values and principles, *e.g.*, community interests, interests of persons related to the cooperative, and other appropriate cooperative principles such as education regarding cooperative organizations, this section clearly permits the board of directors of a limited cooperative association to consider matters which may be improper for consideration in connection with other entities. The additional factors identified in this section modify the statutes referenced in Sections 6-818 and 6-819 in application. Such application will be highly contextual.

**SECTION 6-821. RIGHT OF DIRECTOR OR COMMITTEE MEMBER TO INFORMATION.** A director or a member of a committee appointed under Section 6-817 may obtain, inspect, and copy all information regarding the state of activities and financial condition

of the limited cooperative association and other information regarding the activities of the association if the information is reasonably related to the performance of the director's duties as director or the committee member's duties as a member of the committee. Information obtained in accordance with this section may not be used in any manner that would violate any duty of or to the association.

### **Comment**

This section gives a director or a member of a committee created and appointed by the board of directors a right to access to all information regarding a limited cooperative association that is necessary for the individual to perform the functions of a director or a member of a committee. A director's or committee member's use of the information is, however, limited to its use in performing the functions for which the information was obtained and not in any way that would violate the individual's duty to the association or any duty of the association to others.

### **SECTION 6-822. APPOINTMENT AND AUTHORITY OF OFFICERS.**

(a) A limited cooperative association has the officers:

(1) provided in the organic rules; or

(2) established by the board of directors in a manner not inconsistent with the organic rules.

(b) The organic rules may designate or, if the rules do not designate, the board of directors shall designate, one of the association's officers for preparing all records required by Section 6-110 and for the authentication of records.

(c) Unless the organic rules otherwise provide, the board of directors shall appoint the officers of the limited cooperative association.

(d) Officers of a limited cooperative association shall perform the duties the organic rules prescribe or as authorized by the board of directors not in a manner inconsistent with the organic rules.

(e) The election or appointment of an officer of a limited cooperative association does not

of itself create a contract between the association and the officer.

(f) Unless the organic rules otherwise provide, an individual may simultaneously hold more than one office in a limited cooperative association.

### **Comment**

This section provides substantial flexibility for a limited cooperative association to structure its internal affairs with respect to officers. Only an officer to prepare and maintain records required by Section 6-110 and to authenticate records is required. Practically, most limited cooperative associations will need additional officers. The offices may be established through the organic rules or by the board of directors in a manner not inconsistent with the organic rules. The duties, authority and obligations of officers are to be provided in the organic rules and by the board of directors in accordance with the organic rules. If the organic rules are silent the board has broad authority. This article contemplates the board will appoint officers but this can be modified by the organic rules. *See* Section 6-109 (c)(18).

### **SECTION 6-823. RESIGNATION AND REMOVAL OF OFFICERS.**

(a) The board of directors may remove an officer at any time with or without cause.

(b) An officer of a limited cooperative association may resign at any time by giving notice in a record to the association. Unless the notice specifies a later time, the resignation is effective when the notice is given.

### **Comment**

If an officer is removed or resigns, this in and of itself will have no effect on contractual rights of an officer under an employment or other contract with the association which will govern the rights and obligations of the officer and the association following the removal or resignation. *See* Section 6-822(e).

This article contains no provision directly addressing the standard of conduct of officers. This is, at the least, not unusual in the world of general cooperative statutes. This article leaves much of the law governing officers to contract and agency principles.

There is a distinction between the power to remove an officer and the right to do so. This section is intended to give complete discretion to the board of directors to remove officers (the power). The exercise of that power, however, may lead to a damage claim by the officer if, for example, the officer has a separate employment contract. The exercise of the power could also violate other law (*e.g.*, Title VII of the Civil Rights Act).

**Subsection (a)** – Authority for removal of an officer resides in the board of directors

under its general management authority and is necessary in order to match board liability with board authority. *See* Section 6-801(b). Removal need not be for cause.

**Subsection (b)** – Subsection (b) follows current corporate law permitting an officer to resign immediately or through a resignation that becomes effective at a later date. Notice of the resignation must be given to the limited cooperative association. This subsection does not require any action by the association with respect to a resignation.

## **[PART] 9**

### **INDEMNIFICATION**

***Legislative Note:** See the Legislative Note to Section 6-818. Adopting jurisdictions should coordinate the selection of the bracketed references with the selections made in conjunction with Sections 6-818 and 6-819. As with standards of conduct and liability and conflicts of interest, the matter of indemnification of directors and officers of an entity can be among the most complex and important in a statute governing an entity. Because most, if not all, adopting jurisdictions will have addressed this issue in statutes relating to corporations or in other cooperative statutes, an adopting jurisdiction should consistently reference one of the bracketed statutes to provide a workable and comprehensive policy with respect to indemnification and the right of a limited cooperative association to provide insurance.*

#### **SECTION 6-901. INDEMNIFICATION AND ADVANCEMENT OF EXPENSES; INSURANCE.**

(a) Indemnification and advancement of expenses of an individual who has incurred liability or is a party, or is threatened to be made a party, to litigation because of the performance of a duty to, or activity on behalf of, a limited cooperative association is governed by [reference to this state’s cooperative corporation act or this state’s general business corporation act].

(b) A limited cooperative association may purchase and maintain insurance on behalf of any individual against liability asserted against or incurred by the individual to the same extent and subject to the same conditions as provided by [reference to this state’s cooperative corporation act or this state’s general business corporation act].

#### **Comment**

This section takes the same approach to indemnification and related insurance as Sections 6-818 and 6-819 take to “Standards of Conduct and Liability” and “Conflict of Interest.” The

identity of the individuals referred to in this section is limited to those identified in the referenced statutes as being entitled to indemnification or the benefit of insurance under those statutes.

The referenced statutes govern the ability and the extent of that ability to expand or limit indemnification for specified actions and standards for indemnification and the provision of insurance by a limited cooperative association. If the referenced statute requires such matters to be addressed in the articles or bylaws those requirements apply to an association under this article.

The association should consider the scope of sections referenced in this section and Sections 6-818 and 6-819 in anticipation of appointing non-directors to committees under Section 6-817.

## **[PART] 10**

### **CONTRIBUTIONS, ALLOCATIONS, AND DISTRIBUTIONS**

#### **Preliminary Comment**

The development and management of the capital structure and handling of profits and losses in a cooperative entity help to define the uniqueness of the cooperative. There are strong similarities in these areas, however, between cooperatives and other types of entities. This part contains the provisions relating to contributions (Sections 6-1001 through 6-1003), allocations (Section 6-1004), distributions (Sections 6-1005, 6-1007 and 6-1008) and redemptions of capital (Section 6-1006).

The contribution and distribution provisions in this part address issues that are dealt with in ways similar across many entities but with recognition of cooperative principles peculiarly applicable to limited cooperative associations organized under this article. While redemptions are treated in this article as a kind of distribution in a manner similar, for example, to state partnership law, this part reflects the slightly different business role and function of redemption plays under traditional cooperative law where it functions rather like a nonguaranteed buy-out for dissociating members.

The manner in which profits and losses are allocated among members is a defining element of a cooperative. Allocations are central to this article and limited cooperative associations organized under it. For this reason, Section 6-1004 is a pivotal provision. The addition of investor members to limited cooperative associations made possible by this article requires a more detailed definition of what it means to be a “cooperative” than is necessary under other kinds of cooperative statutes and this part, particularly Section 6-1004, serves that definitional and regulatory purpose. Thus Section 6-1004 contains more detail than is frequently found in the statutes under which other types of entities are organized. Emphatically, however, this part governs allocations for state law purposes only. Financial reporting and income taxation are clearly beyond the scope of this article.

This part reflects cooperative principles related to “operation at cost” and ownership of

profits based on the use of the cooperative by its members. *See* the comment to Section 6-1004. Partnership based accounting mechanisms provide an appropriate and efficient means to achieve a cooperative result and are the basis of that section.

**SECTION 6-1001. MEMBERS' CONTRIBUTIONS.** The organic rules must establish the amount, manner, or method of determining any contribution requirements for members or must authorize the board of directors to establish the amount, manner, or other method of determining any contribution requirements for members.

#### **Comment**

This section requires the organic rules to contain provisions governing contribution requirements for new members and additional capital contributions from existing members. *See also* Section 6-109(d). It allows the organic rules to provide for a structure like that of limited partnerships where “capital call” provisions are often part of the partnership agreement but which may, by terms of the provision, be subject to rather broad authority in the general partner.

An amendment of the organic rules pursuant to Section 6-405 is necessary to require existing members to contribute additional capital if the organic rules are silent regarding additional contributions by members. Under that section consent in a record by each member that the amendment proposes to require to make additional contributions is necessary. The consent requirement, therefore, is consistent with the merger, interest exchange, conversion, and domestication provisions in Article 2. *See* Section 6-518.

The limited cooperative association also has information requirements concerning contributions. *See* Section 6-110(a)(14).

It is certainly permissible, given the flexibility of this article, for the organic rules to provide for pre-emptive rights for existing members or to fashion other anti-dilution provisions but no such matters are addressed by this article. Further, tailored redemption and buy-sell agreements are appropriately addressed in planning under this article. *See also* Section 6-1006.

#### **SECTION 6-1002. CONTRIBUTION AND VALUATION.**

(a) Unless the organic rules otherwise provide, the contributions of a member to a limited cooperative association may consist of property transferred to, services performed for, or another benefit provided to the association or an agreement to transfer property to, perform services for, or provide another benefit to the association.

(b) The receipt and acceptance of contributions and the valuation of contributions must



be reflected in a limited cooperative association's records.

(c) Unless the organic rules otherwise provide, the board of directors shall determine the value of a member's contributions received or to be received and the determination by the board of directors of valuation is conclusive for purposes of determining whether the member's contribution obligation has been met.

**Legislative Note:** *The type of property that is permitted to be contributed to organizations and entities is sometimes, though increasingly rarely, the subject of state constitutions. Adopting jurisdictions should review their constitutions for the existence of inconsistent provisions and revise this section accordingly.*

### **Comment**

**Subsection (a)** – This subsection is derived from Section 5-402 (limited liability companies) and provides wide latitude for the form of contribution.

**Subsection (c)** – The board of directors, subject to modification by the organic rules, has the authority and obligation to determine the value of a member's contribution and reflects the central role performed by the board of directors under traditional cooperative statutes. Valuation of different forms of contributions raises the specter of unfairness or abuse if, for example, services are valued optimistically. A modicum of protection from such abuse is provided by director standards of conduct and liability under Section 6-818 and by provisions related to conflicts of interest under Section 6-819. As a result this article's approach differs from Section 402(c) (limited partnerships) and Section 5-403(c) (limited liability companies) in that it does not give creditors who have granted credit to a member without notice or knowledge of a compromise an express direct right to enforce the contribution obligation of a member. Any such rights, by design, are left to the common law.

### **SECTION 6-1003. CONTRIBUTION AGREEMENTS.**

(a) Except as otherwise provided in the agreement, the following rules apply to an agreement made by a person before formation of a limited cooperative association to make a contribution to the association:

(1) The agreement is irrevocable for six months after the agreement is signed by the person unless all parties to the agreement consent to the revocation.

(2) If a person does not make a required contribution:

(A) the person is obligated, at the option of the association, once formed, to contribute money equal to the value of that part of the contribution that has not been made, and the obligation may be enforced as a debt to the association; or

(B) the association, once formed, may rescind the agreement if the debt remains unpaid more than 20 days after the association demands payment from the person, and upon rescission the person has no further rights or obligations with respect to the association.

(b) Unless the organic rules or an agreement to make a contribution other than money to a limited cooperative association otherwise provide, if a person does not make a required contribution to an association, the person or the person's estate is obligated, at the option of the association, to contribute money equal to the value of the part of the contribution which has not been made.

### **Comment**

Pre-formation agreements to contribute to a limited cooperative association are addressed in subsection (a). It states default terms variable by the terms of the agreement itself.

Post-formation agreements are addressed in subsection (b) and are subject to the terms of the agreement and the applicable provisions of the organic rules. *See also* Section 6-1001.

Section 6-110(a)(14) and (15) require the association to maintain a record of the amount of money or value of contributions other than money agreed to be contributed by each member.

### **SECTION 6-1004. ALLOCATIONS OF PROFITS AND LOSSES.**

(a) The organic rules may provide for allocating profits of a limited cooperative association among members, among persons that are not members but conduct business with the association, to an unallocated account, or to any combination thereof. Unless the organic rules otherwise provide, losses of the association must be allocated in the same proportion as profits.

(b) Unless the organic rules otherwise provide, all profits and losses of a limited cooperative association must be allocated to patron members.

(c) If a limited cooperative association has investor members, the organic rules may not reduce the allocation to patron members to less than 50 percent of profits. For purposes of this subsection, the following rules apply:

(1) amounts paid or due on contracts for the delivery to the association by patron members of products, goods, or services are not considered amounts allocated to patron members.

(2) amounts paid, due, or allocated to investor members as a stated fixed return on equity are not considered amounts allocated to investor members.

(d) Unless prohibited by the organic rules, in determining the profits for allocation under subsections (a), (b), and (c), the board of directors may first deduct and set aside a part of the profits to create or accumulate:

(1) an unallocated capital reserve; and

(2) reasonable unallocated reserves for specific purposes, including expansion and replacement of capital assets; education, training, cooperative development; creation and distribution of information concerning principles of cooperation; and community responsibility.

(e) Subject to subsections (b) and (f) and the organic rules, the board of directors shall allocate the amount remaining after any deduction or setting aside of profits for unallocated reserves under subsection (d):

(1) to patron members in the ratio of each member's patronage to the total patronage of all patron members during the period for which allocations are to be made; and

(2) to investor members, if any, in the ratio of each investor member's contributions to the total contributions of all investor members.

(f) For purposes of allocation of profits and losses or specific items of profits or losses of

a limited cooperative association to members, the organic rules may establish allocation units or methods based on separate classes of members or, for patron members, on class, function, division, district, department, allocation units, pooling arrangements, members' contributions, or other equitable methods.

### Comment

The first part of this comment explains the importance of this section and places it within the context of this article and cooperative law. It identifies the policy behind the section. The second part of the comment briefly explains the mechanical operation of the section and then discusses each subsection.

**Generally** – Allocation of profits and losses is typically not a matter of detailed statutory treatment in general unincorporated or general corporate statutes. The modern trend of organizational law is to expressly govern distributions but not detail the manner or method of the internal allocation of profits and losses between and among the owners. Rather, allocations are left to organic rules, for example, the operating agreement in limited liability companies. Moreover, accounting conventions for financial accounting or reporting, and state and federal income tax law for purposes of taxation will, in any event, apply largely independent of any state law allocation provisions. For example unallocated reserves will raise federal income taxation for unincorporated entities but are contemplated by the law of taxation in the context of cooperatives.

For general business entities there seems to be little purpose for intervention in allocations by a state organizational statute. Indeed, general business corporation law has abandoned much of the corporate legal capital machinery required by older corporate statutes. One of the primary purposes of that machinery was creditor protection. A leading treatise observed, concerning changes in that machinery, "It is conceivable, even, that the proposed changes may lead some persons for the first time to examine the degree of protection afforded to creditors by the present legal capital system and discover that it is a Swiss Cheese made up mainly of holes ... ." BAYLESS MANNING AND JAMES J. HANKS, *LEGAL CAPITAL*, 194 (3<sup>rd</sup> ed. 1990).

It is for good reason, therefore, that there is a trend away from including statutory provisions concerning allocations of profit and loss. Nonetheless, regulatory law sometimes uses balance sheet accounting for regulatory purposes, for example, in the regulation of financial institutions. There are, however, good reasons for including such provisions in cooperative law. *See generally* the Preliminary Comment to Part 10.

*One reason* "allocations" are important in cooperative law is as an analogue to regulatory law. Allocation of profit and loss to members is a key component to determine whether an entity is operating in accordance with a "cooperative plan" which is a term used in some traditional cooperative statutes or on a "cooperative basis" which is a term of art for defining "cooperative"

for some purposes of federal income taxation. This article takes the approach that the mere use of terms of art from other substantive bodies of law is too ambiguous for purposes of defining a limited cooperative association for state law purposes. And that such importation represents a trap to the unwary, and would inhibit the use of this article that contemplates voting investor members.

*A second reason*, related to the first, is both historical and a matter of cooperative principles. One of the fundamental principles of cooperative organizations is that they operate “at cost.” This is a different concept from operating “for profit” or “not for profit.” This principle has caused much confusion for persons dealing with cooperatives, including regulators, who seek to compartmentalize cooperatives as either “for profit” or “not for profit” entities. Cooperatives are unique in having a principle that, in operation, results in a cooperative having “no profit” and “no loss” at the end of an annual accounting period. Business methods have been developed to reach the “at cost” result while at the same time providing necessary capital to the cooperative.

Profits are usually allocated among members (and in some cooperatives among non-member patrons) through some method that returns annual profits to the members on the books of the cooperative, in cash payments, or a combination of both. Traditional midwestern agricultural cooperatives have usually used patronage dividends (called by various names such as “patronage allocations” and “allocations of net margins”) as the means to allocate net profits at the end of an accounting year among the members. This approach is similar to the allocation of profits among partners in a partnership or among members in a limited liability company. It is derived in a cooperative, however, from a different philosophical basis.

Another method utilized by certain marketing cooperatives is a “per unit retain” under which the cooperative withholds a portion of the purchase price to be paid to a member for goods or commodities marketed by or through the cooperative as a capital contribution to the cooperative.

Traditional cooperatives may permit assessments of members if there is a loss at the end of an annual accounting period. Among other techniques, losses may also be charged against reserves or surplus accounts or be carried over to be offset against future profits. The method of allocation of losses is usually the same as allocations of profits. This is reflected in Section 6-1004, notably Section 6-1004(a).

Although more detailed with respect to allocations than statutes governing other entities, this article does not address any *particular allocation* method to be used by an association. Section 6-1004 does not prohibit any method to be authorized in the organic rules. While based on partnership accounting, Section 6-1004 overlays partnership accounting with allocation methods based on patronage for patron members developed in traditional cooperatives. *See* Section 6-1004(e)(1). The organic rules can authorize methods of allocation and, further, can designate the Board of Directors to apply the methods. *See also* Section 6-817(d)(1).

Investor members are not patron members. *But see* Section 6-112 (“Dual Capacity”). The organic rules may provide methods unburdened by patronage considerations for allocating

net profits and losses among investor members.

*A third reason* this article provides rather detailed allocation provisions is because “profit” is a key concept in Section 6-1004(c) which tests and constrains the division of profits between patrons and investor members under this article. Here Section 6-1004 operates in a regulatory manner.

**Section 6-1004** – Section 6-1004 addresses the allocation of profit and loss among members of a limited cooperative association. As an important policy matter, it establishes that patron members must be allocated at least 50 percent of the profit of the association as determined under customary accounting procedures and as augmented, amplified, and defined by this section.

Section 6-1004 is a part of state organizational law governing limited cooperative associations. Accounting standards, tax law, and exceptions and qualifications found in other state and federal laws and regulations independently apply to associations governed by this article. These other laws and regulations may require careful drafting of organic rules to take advantage of, or comply with, those laws. This section has no application to distributions. Distributions are governed by Sections 6-1005 through 6-1008.

The distinct concepts of “profit” and “allocation” animate the operation of this section. Simply stated, Section 6-1004 provides a framework that in application results in a number of dollars representing profit (or loss) of the association being allocated to the members of the limited cooperative association to provide some assurance that patron members receive “their share” of profit.

The basic mechanical operation of the section is:

- take the profit of the association (subsection (a)), as determined in accordance with the accounting method of the association, and deduct amounts placed in reserves (subsection (d));
- apportion it between groups entitled to receive an allocation of profit and loss (subsections (a), (b) and (c)); and
- allocate the apportioned amounts within the groups’ members (subsections (e) and (f)).

**Subsection (a)** – The organic rules may provide that profit and loss be allocated only among members (patron members and investor members), and others who utilize the cooperative but are not members, to an unallocated account (such as a reserve), or in some combination of the foregoing.

Losses are to be allocated in the same manner as profits unless the organic rules establish a different means for allocating losses.

Some traditional cooperatives permit the cooperative to engage in business with non-

members and permit those non-members (sometimes called “participating patrons” or “non-member patrons”) to share in allocations of profit and loss. Allocations to non-members who do business with the association create complexities and may affect matters outside this article such as financial reporting and taxation.

**Subsection (b)** – The general default rule under Section 6-1004 is that profit and loss are to be allocated among patron members. Therefore if there are investor members to whom profit is to be allocated, the organic rules must provide for making those allocations.

**Subsection (c)** – While Section 6-1004 provides significant flexibility in how allocations of profit are to be determined, this subsection places parameters on those allocations. It is central to this article. Patron members must be allocated at least 50 percent of profit that is allocated in accordance with this section. A larger percentage, but not a lower one, could be provided by the organic rules.

The provisions in this subsection are mandatory and may not be varied by the organic rules for purposes of measuring the minimum 50 percent allocation to patron members. The determination of the percentage required to be allocated to patron members is a difficult policy decision *for an association*. On one hand, the percentage goes to the heart of what it means to be a cooperative in which the patron members are to share in any profit of the entity resulting from their use and the “investment” of their allocated retained earnings. On the other hand, one of the purposes of this article is to encourage greater equity capital formation by allowing investor members to receive a return on their capital investments in the association. To that end, this article seeks to provide enough flexibility to allow financial participation by investor members while protecting the economic interests of patron members.

Subsections (c)(1) and (2) modify “profits” for purposes of applying the 50 percent minimum standard to be allocated to patrons. They contain mandatory rules regarding the treatment of amounts paid to patron members for products, goods or services delivered to a limited cooperative association for marketing; and, for specifically identified categories of amounts paid, due or allocated to investor members on the equity (capital) account established for them in the association. These amounts are not treated as allocations to the recipients *for purposes of determining whether the patron members have been allocated 50 percent of profit* (or a higher amount provided in the organic rules).

**EXAMPLE:** A limited cooperative association has investor members and allocates 50 percent of the profits to them under its organic rules. It contracts to purchase 500 units of goods from its patron members for \$10 for each unit. The association resells the goods for a total of \$11,000. The only expense for the association is the total price paid to its patron members. It has revenues of \$11,000 (resale). Its expense is \$5000 (500 units at \$10 per unit). Therefore, its “profit” is \$6,000. (\$11,000 minus \$5,000). Under its 50 percent allocation rule the patron members are allocated \$3,000 profit and the investor members are allocated \$3,000 profit. Under subsection (c)(1), the \$5,000 paid as a purchase price to patron members for the goods is not counted as an allocation to the patron members *for purposes of the 50 percent test* because it is characterized at the association level as cost of goods sold (an expense).

EXAMPLE: Same facts as in the previous Example except the investor members receive a stated fixed return on their contributions (equity). The stated fixed return is 10 percent of the value of their contributions and their total contributions are \$12,000. Therefore, they are paid \$1,200 as a return on contributions. The profit from the above Example is \$6,000 and remains \$6,000 in this Example because a stated fixed return on equity contributions is not an expense under general accounting practices. As a result, as in the previous Example, the patron members would be allocated \$3,000 profit (and also receive the price paid for their goods) and the investor members would be allocated \$3,000 profit. Under subsection (c)(2), the \$1,200 paid to investor members for the stated fixed return on contributions is not treated as an allocation to the investor members for purposes of the 50 percent test. Note that money allocated is not the same as money paid-out. While seemingly complex this difference is present and material in the drafting and planning of unincorporated “deals”. That is, the source of the \$1,200 paid to the investor members is “cash” not profit.

There is a relevant, but subtle, distinction between the *probable* accounting treatment of the two Examples. In the first Example, the purchase price for the goods paid to the patron members represents an expense in determining profit which is the starting point in applying the 50 percent test under subsection (c). In the second Example, the stated fixed return paid to investor members on their equity capital (contributions) is not an expense in determining profit under general accounting practices. Although the distinction is worth noting, it does not directly affect the mechanical operation of subsection (c).

In traditional cooperatives various ways exist to compensate members for products, goods or services. For example, cooperatives may pay a market or otherwise fixed price for the products, goods or services. There are, however, a variety of other arrangements under which products, goods or services may be sold through the cooperative. These other arrangements include several commonly used, but vastly different, methods for determining the amount to be paid to the patron member. Some of these methods are net proceeds contracts, agency contracts, and marketing pool arrangements. In some of them a proportionate part of the total gross amount received by the cooperative from its sale of the products, goods and services after deducting the operating costs of the cooperative is paid to the member. Under these circumstances, the “price” for the products, goods and services marketed through the cooperative by the member is the amount received by the member. Any of these approaches may be provided by contract but the method used will greatly affect the allocation calculations under this section.

EXAMPLE: Same facts as in the first Example except the arrangement between the patron member and the association is different. It is a net proceeds contract under which the revenues from resale (\$11,000) less the association’s expenses are paid to the patron members as the price of the goods. Just as in the first example there are no expenses other than the purchase price of the goods. Therefore, the purchase price is \$11,000 (\$11,000 revenues minus \$0 other association expenses). There is no profit to be allocated to the members.

**Subsection (d)** – In determining the amount of profit to be allocated, a limited



cooperative association's board of directors may first set aside a portion of profit for reserves of the types specified in subsections (d)(1) and (2). The portion set aside under subsection (d) is subtracted from the association's profit to determine the "profit" to be allocated.

The phrase "unless the organic rules prohibit" is used to make clear that, if the organic rules are silent, the board of directors may set aside a portion of the profit for reserves in determining "profit" as the term is used in the rest of the section. Over time it is conceivable that these reserves could be the source of funds to pay investor members a fixed stated return on their contributions.

**Subsection (e)** – Once the provisions of subsections (c) and (d) have been applied in determining profit or loss of a limited cooperative association, profit or loss is first apportioned between patron members as a categorical group and investor members as a categorical group as provided in the organic rules pursuant to subsection (b). Then the apportioned amounts are further allocated to the members in each group. The default method for patron member allocation is based on patronage (subsection (e)(1)). The default method for investor member allocation is based on contributions (subsection (e)(2)). Of course, the organic rules may change the default rules provided in this section. *See also* subsections (a), (b), and (f).

**Subsection (f)** – Subsection (f) is intended to provide the association great latitude in the ways it may establish allocated profit and loss among patron members.

## **SECTION 6-1005. DISTRIBUTIONS.**

(a) Unless the organic rules otherwise provide and subject to Section 6-1007, the board of directors may authorize, and the limited cooperative association may make, distributions to members.

(b) Unless the organic rules otherwise provide, distributions to members may be made in any form, including money, capital credits, allocated patronage equities, revolving fund certificates, and the limited cooperative association's own or other securities.

### **Comment**

**Subsection (a)** – This subsection is consistent with unincorporated entity law in that members are not entitled to distributions. It is also consistent with cooperative and corporate law where dividends or other distributions are at the discretion of the board of directors. In the context of the law of other business organizations, distributions under this section might be termed "interim distributions" to distinguish them from distributions under Section 6-1208 (Distributions of Assets in Winding Up).

"Interim" distributions to members are related to the allocation provisions in Section 6-

1004 but not determined by them and the calculations and limitations in Section 6-1004 do not apply directly to distributions.

The reference to Section 6-1007 is because Section 6-1007 limits distributions under certain circumstances based on the financial position of the association.

**Subsection (b)** – Cooperative statutes typically contain this or a similar provision consistent with cooperative business practices. This subsection contains terms that are common in the context of cooperatives but which are not defined for purposes of this article. They are used for purposes of illustrating the variety of forms of distributions and as a common point of reference between this article and other cooperative statutes.

**SECTION 6-1006. REDEMPTION OR REPURCHASE.** Property distributed to a member by a limited cooperative association, other than money, may be redeemed or repurchased as provided in the organic rules but a redemption or repurchase may not be made without authorization by the board of directors. The board may withhold authorization for any reason in its sole discretion. A redemption or repurchase is treated as a distribution for purposes of Section 6-1007.

### **Comment**

This section coordinates “redemption” as used practically in traditional cooperatives with the operation of unincorporated entities. This section, together with Section 6-1005(b), addresses features that are ubiquitous in cooperative businesses. “Redemption” has a special role in cooperatives and is one way, if not the only way, members receive their share of accumulated capital when “retiring” or terminating their membership. In the business policy of some types of traditional marketing cooperatives “redemption” serves as a kind of functional equivalent to buy-out rights of a dissociated partner in general partnerships. *See* Section 3-701. The legal rules in the two situations are, however, markedly different and the similarity is in function only. A Department of Agriculture publication stated:

Although equity accumulation is one of the biggest challenges facing cooperatives, each year many associations redeem part of their patronage-based capital. Equity redemption frequently focuses on the oldest allocations in the cooperative. Redeeming the oldest equities, particularly those of persons no longer patronizing the cooperative, implements the cooperative principle that financing should come from persons currently benefitting from the cooperative’s services.

DONALD A. FREDERICK, INCOME TAX TREATMENT OF COOPERATIVES, DISTRIBUTIONS, RETAINS,

REDEMPTIONS AND PATRONS' TAXATION, Info. Rep. 44, Part 3, p. 4 (2005).

This article affords flexibility for planning different “buy-out” and “redemption” arrangements. One disadvantage of using traditional cooperatives is that members infrequently receive a portion of the increase of value of the entity due in part to their “investment” and use of the entity. This was one of the important financial reasons for the advent of “new generation” cooperatives which were frequently “closed-end.” *See* Prefatory Note to Uniform Limited Cooperative Association Act (2007). It is also an important reason for the flexibility afforded under this article which allows the organic rules to provide for a plethora of plans and arrangements including the reflection of appreciated value.

Redemption or repurchase must be in the discretion of the board of directors because of its duty to manage the association. *See* Section 6-801(b). The necessity of this authority is illustrated, for example, in the application of Section 6-1007.

#### **SECTION 6-1007. LIMITATIONS ON DISTRIBUTIONS.**

(a) In this section, “distribution” does not include reasonable compensation for present or past services or other payments made in the ordinary course of business for commodities or goods or under a bona fide retirement or other bona fide benefits program.

(b) A limited cooperative association may not make a distribution, including a distribution under Section 6-1208, if after the distribution:

(1) the association would not be able to pay its debts as they become due in the ordinary course of the association’s activities and affairs; or

(2) the association’s total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the association were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of members whose preferential rights are superior to the rights of persons receiving the distribution.

(c) A limited cooperative association may base a determination that a distribution is not prohibited under subsection (b) on:

(1) financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances; or

(2) a fair valuation or other method that is reasonable under the circumstances.

(d) Except as otherwise provided in subsection (e), the effect of a distribution allowed under subsection (b) is measured:

(1) in the case of a distribution by purchase, redemption, or other acquisition of financial rights in the limited cooperative association, as of the earlier of:

(A) the date money or other property is transferred or debt is incurred by the association; or

(B) the date the person entitled to the distribution ceases to own the financial rights being acquired by the association in return for the distribution;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs not later than 120 days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(e) A limited cooperative association's indebtedness incurred by reason of a distribution made in accordance with this section is at parity with the association's indebtedness to its general, unsecured creditors except to the extent subordinated by agreement.

(f) A limited cooperative association's indebtedness, including indebtedness issued as a distribution, is not a liability for purposes of subsection (b) if the terms of the indebtedness provide that payment of principal and interest is made only if and to the extent that payment of a distribution could then be made under this section. If the indebtedness is issued as a distribution,

each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is made.

(g) In measuring the effect of a distribution under Section 6-1208, the liabilities of a dissolved limited cooperative association do not include any claim that has been disposed of under Section 6-1209, 6-1210, or 6-1211.

### **Comment**

Both this section and Section 6-1008 were derived essentially from the Model Business Corporation Act § 6.40. Both this sections are necessary and appropriate because a limited cooperative association provides its members and directors a corporate-like liability shield.

**Subsection (a)** – Whether compensation and payments made under a retirement or benefits program to a member are considered “distributions” has been the subject of litigation in cases involving unincorporated business entities. Subsection (a), added to this article as part of the Harmonization project, codifies the majority rule that these payments are not distributions.

**Subsection (b)** – This subsection provides two tests of insolvency, which are disjunctive. A distribution violates this section if, after the distribution, the limited cooperative association fails either of the tests. The subsection applies to both interim and liquidating distributions.

**Subsection (c)(2)** – This alternative valuation provision is likely to be both useful and fair when a limited cooperative association has appreciated assets but for accounting purposes these assets are valued at book value less depreciation.

**Subsection (e)** – This exception is directly derived from Section 5-405(e) (limited liability companies). It emphasizes that protection from the operation of this section extends to some contracts between members and the association. It applies only for purposes of this section.

*See* the comments to Section 5-405 for additional information on how the limitations in this section are applied.

### **SECTION 6-1008. LIABILITY FOR IMPROPER DISTRIBUTIONS; LIMITATION OF ACTION.**

(a) If a director of a limited cooperative association consents to a distribution made in violation of Section 6-1007 and in consenting to the distribution fails to comply with Section 6-818, the director is personally liable to the association for the amount of the distribution that

exceeds the amount that could have been distributed without the violation of Section 6-1007.

(b) A person that receives a distribution knowing that the distribution violated Section 6-1007 is personally liable to the limited cooperative association but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 6-1007.

(c) A director against whom an action is commenced because the director is liable under subsection (a) may:

(1) implead any other director that is liable under subsection (a) and seek to enforce a right of contribution from the director; and

(2) implead any person that received a distribution in violation of subsection (b) and seek to enforce a right of contribution from the person in the amount the person received in violation of subsection (b).

(d) An action under this section is barred unless commenced not later than two years after the distribution.

### **Comment**

This section, and Section 6-1007, are derived from MBCA § 6.40. They are mandatory and may not be changed by the organic rules. In substance and effect these sections protect the interests of creditors of the limited cooperative association.

There are two types of liability in this section: Subsection (a) imposes liability on the directors who approve an improper distribution; and subsection (b) imposes liability on the members who receive the improper distribution.

**Subsection (a)** – This subsection refers both to Section 6-1007 which includes in its subsection (c)(2) a standard of ordinary care (“reasonable in the circumstances”), and to Section 6-818 and Section 6-819 (concerning standards of conduct and liability of directors). Section 6-818 adopts the standards of other law in this state by reference.

A limited cooperative association’s failure to meet the standard of Section 6-1007(b) cannot by itself cause a director to be liable under Section 6-1008(a). *Both* of the following would have to occur before a failure to satisfy Section 6-1007(b) could occasion personal

liability for a director under Section 6-1008(a):

- (1) the association “base[s] a determination that a distribution is not prohibited ... on financial statements prepared on the basis of accounting practices and principles that are [not] reasonable in the circumstances or on a valuation [that is not fair] or other method that is [not] reasonable in the circumstances”[Section 6-1007(c)].

*and*

- (2) the director’s decision to rely on the improper methodology in consenting to the distribution constitutes a breach of the standard imported into [this article] by Section 6-818 or Section 6-819.

**[SECTION 6-1009. RELATION TO STATE SECURITIES LAW.** A patron member’s interest in a limited cooperative association has the same exemption as provided for substantially similar interests in cooperatives under [reference to appropriate provision of this state’s laws].]

***Legislative Note:** Section 6-1009 is bracketed because it represents a unique policy decision that concerns both limited cooperative associations and state securities law. If the adopting jurisdiction has a securities exemption for general cooperatives located in cooperative statutes, it should determine whether the jurisdiction is best served by including limited cooperative associations within the existing exemption by referencing the statutory provision here. If the adopting jurisdiction’s free standing securities law has a specific exemption or definitional exclusion for cooperatives this optional section need not be included but the adopting jurisdiction might consider whether limited cooperative associations should be treated similarly by that statutory provision.*

### **Comment**

There is a great variation among the states concerning exemptions for cooperatives from state securities laws and this article does not attempt to change the settled policy of any state. Section 6-1009 is further limited, however, to apply the law of this state to patron member interests because those interests are most similar to membership interests in traditional cooperatives. Securities exemptions may be particularly important where the limited cooperative association distributes interests which might be deemed to be securities in lieu of money on a regular basis. *See, e.g.,* Section 6-1005(b). Federal securities law will, obviously, apply independently of this article and any securities law exemptions, if any, available under federal law must be obtained in accordance with that law.

**[SECTION 6-1010. ALTERNATIVE DISTRIBUTION OF UNCLAIMED PROPERTY, DISTRIBUTIONS, REDEMPTIONS, OR PAYMENTS.** A limited cooperative association may distribute unclaimed property, distributions, redemptions, or payments under [reference to the appropriate provision in the law governing cooperatives not formed under this [article] in this state].]

***Legislative Note:** The general cooperative law of some, but not all, states contains a provision unique to cooperatives concerning the disposition of unclaimed property. Some of these provisions allow unclaimed property to revert to the cooperative if, after reasonable search, the member cannot be found; others may allow the cooperative to donate unclaimed property to a charity. See, e.g., OREGON REV. STAT. § 62.425 (2003). In states having such a provision the legislature should consider as a matter of policy whether the same provision should be applicable to limited cooperative associations. This is the appropriate referencing the provision contained in other law of the adopting jurisdiction and thereby place in this article for incorporating it by reference. If the referenced statute in a given state requires the cooperative's articles or bylaws to authorize the use of the statutory provision, the authorization requirement should be added in the appropriate subsection of Section 6-109.*

#### **Comment**

This section is intended to provide an exception to this state's general unclaimed property statute.

The probable reasons that some state traditional cooperative statutes contain unique provisions concerning unclaimed property is two-fold. First, many cooperatives have revolving membership and, in the regular course of business, have occasional small sales that are patronage; for example, a consumer food cooperative. In these cases it can be reasonably anticipated that there will be numerous accounts with small balances that will not be claimed. Second, cooperative principles and values emphasize community and operation on a cost basis. While operation at cost is not synonymous with either not-for-profit or charity, it may be appropriate to distinguish cooperatives from general for-profit entities for purposes of treatment of unclaimed property.

#### **[PART] 11**

#### **DISSOCIATION**

##### **SECTION 6-1101. MEMBER'S DISSOCIATION.**

- (a) A person has the power to dissociate as a member at any time.
- (b) Unless the organic rules otherwise provide, a member's dissociation from a limited



cooperative association is wrongful only if:

(1) it is in breach of an express provision of the organic rules; or

(2) it occurs before the termination of the limited cooperative association and:

(A) the person is expelled as a member under subsection (d)(3) or (4); or

(B) in the case of a person that is not an individual, trust other than a business trust, or estate, the person is expelled or otherwise dissociated as a member because it dissolved or terminated in bad faith.

(c) Unless the organic rules otherwise provide, a person that wrongfully dissociates as a member is liable to the limited cooperative association and to the other members for damages caused by the dissociation. The liability is in addition to any other debt, obligation, or liability of the person to the association.

(d) A member is dissociated as a member when:

(1) the limited cooperative association receives notice in a record of the member's express will to dissociate as a member, or if the member specifies in the notice an effective date later than the date the association received notice, on that later date;

(2) an event stated in the organic rules as causing the person's dissociation occurs;

(3) the person's entire interest is transferred in a foreclosure sale under Section 6-605(f);

(4) the person is expelled as a member under the organic rules;

(5) the person is expelled as a member by the board of directors if:

(A) it is unlawful to carry on the limited cooperative association's activities and affairs with the person as a member;

(B) there has been a transfer of all the member's financial rights in the

association, other than:

(i) a transfer for security purposes; or

(ii) a charging order in effect under Section 6-605 which has not been foreclosed;

(C) the person is an unincorporated entity that has been dissolved and its activities and affairs are being wound up; or

(D) the person is a corporation or cooperative and:

(i) the person filed a certificate of dissolution or the equivalent, or the jurisdiction of formation revoked the person's charter or right to conduct business;

(ii) the association sends a notice to the person that it will be expelled as a member for a reason described in clause (i); and

(iii) not later than 90 days after the notice was sent under clause (ii), the person did not revoke its certificate of dissolution or the equivalent, or the jurisdiction of formation did not reinstate the person's charter or right to conduct business; or

(E) the member is an individual and is adjudged incompetent;

(6) in the case of an individual, the individual dies;

(7) in the case of a member that is a testamentary or inter vivos trust or is acting as a member by virtue of being a trustee of a trust, the trust's entire financial rights in the limited cooperative association are distributed;

(8) in the case of a person that is an estate or is acting as a member by virtue of being a personal representative of an estate, the estate's entire financial interest in the association is distributed;

(9) in the case of a person that is not an individual, partnership, limited liability

company, cooperative, corporation, trust, or estate, the existence of the person terminates; or

(10) the association's participation in a transaction under [Article] 2 that causes the person to cease to be a member.

### **Comment**

This article follows current unincorporated law terminology in using “dissociation” as the term used to mean a person ceasing to be affiliated with an organization as a member or partner.

This section, together with Sections 6-1102 and 6-1103, addresses a member's dissociation from a limited cooperative association. Many provisions of these subsections may be varied by the organic rules. Drafters of organic rules should consider the different dynamics in associations with many members versus those with a small number of members and recognize those differences in the organic rules. For example, associations with few members may need to be designed with more restrictions on dissociation than would be appropriate for associations with many members. This article does not provide different rules for associations with a large number of members versus associations with a small number but the organic rules could be drafted to be appropriate under the circumstances. This is consistent with ULLCA (2006) (Last Amended 2013) and ULPA (2001) (Last Amended 2013) where dissociation of members or partners is treated generally without regard to the numbers of members in the entity. Consideration should also be given to the dichotomy between patron members and investor members where investor members are authorized.

After a person has been dissociated as a member, the rights of the person as a member cease, but debts, obligations, or liabilities of the person to the association that arose prior to the dissociation continue and are enforceable as debts, obligations, or liabilities of the person to the association without regard to membership status. *See* Section 6-1102 (b). A person who is both a patron member and an investor member could be dissociated in one capacity but not the other. *See* Section 6-112.

As in other provisions of this article, what constitutes proper notice in connection with a dissociation is governed by other law.

**Subsection (a)** – This subsection recognizes the power of a person to dissociate as a member of a limited cooperative association. The “power” to dissociate is different from the “right” to dissociate. While a member may have the power to dissociate from an association, the dissociation may be “wrongful” as a violation of the organic rules because, for example, a specific prohibition on the right to dissociate, or for other reasons described in subsection (b). A prohibition against dissociation in the organic rules cannot stop a member from dissociating from the association (the power to dissociate) but, on the other hand, the dissociation could be a clear violation of the rules (there being no right to dissociate).

The organic rules may not eliminate the power to dissociate.

**Subsection (b)** – This subsection provides a limited number of situations when a dissociation is wrongful. The situations could be expanded or contracted by the organic rules.

**Subsection (c)** – This confirms that a wrongful dissociation may result in the dissociating member being liable to the limited cooperative association if the dissociation causes harm to the association. The amount of damages would need to be proven. These damages are in addition to any other obligation the member owes to the association.

**Subsection (d)** – This subsection details the various means through which different types of members are dissociated from a limited cooperative association, whether voluntarily or involuntarily.

**Subsection (d)(5)** – None of the events described in paragraphs (A) through (E) of this subsection cause a dissociation of a member without action of the board of directors to expel the member. Stated another way, these events do not cause an automatic dissociation of the member.

**Subsection (d)(5)(E)** – A member who has been adjudged incompetent may be dissociated by the board of directors. This could be addressed in the organic rules. Section 6-1103 provides for the representative of an expelled incompetent member to have certain rights which are less than the rights of the personal representative settling the estate of a deceased member. Being adjudged incompetent, however, does not automatically dissociate the member. If the member is not expelled they would continue to have the rights of a member.

**Subsection (d)(6)** – An individual is dissociated upon death under this provision. The decedent's estate has the powers conferred by Section 6-1103. An estate that is carrying on business could become a member by admission.

EXAMPLE: An individual farmer who was a member of the limited cooperative association dies. The decedent's estate anticipates farming for three years before the estate closes. The estate could become a member of the association pursuant to the organic rules of the association for admission of a member.

**Subsection (d)(10)** – A plan of merger, interest exchange, conversion, or domestication under Article 2 could provide for dissociation of members in a limited cooperative association.

## **SECTION 6-1102. EFFECT OF DISSOCIATION.**

(a) When 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 cooperative association's activities and affairs terminates; and

(2) subject to Section 6-1103 and [Article] 2, any financial rights owned by the

person in the person's capacity as a member immediately before dissociation are owned by the person as a transferee.

(b) A person's dissociation as a member does not of itself discharge the person from any debt, obligation, or other liability to the limited cooperative association or the other members which the person incurred while a member.

### **Comment**

**Subsection (a)** – In general, when a person dissociates as a member, the person's rights as a member disappear and, subject to Section 6-112 (Dual Capacity), the person's status degrades to that of a mere transferee of financial rights. However, Section 6-1103, provides some special rights when dissociation is caused by an individual's death or a member has been adjudged incompetent.

### **SECTION 6-1103. POWER OF LEGAL REPRESENTATIVE OF DECEASED**

**MEMBER.** If a member dies, the deceased member's legal representative may exercise for the purposes of settling the estate, the rights the deceased member had under Section 6-505.

### **Comment**

The estate of a deceased member and those claiming through the estate are transferees, and as such they have very limited rights to information. This section provides temporary additional information rights to the legal representative of the estate.

## **[PART] 12**

### **DISSOLUTION**

**SECTION 6-1201. DISSOLUTION AND WINDING UP.** A limited cooperative association is dissolved only as provided in this [part] and upon dissolution winds up in accordance with this [part].

### **Comment**

There are only three basic ways in which a limited cooperative association is dissolved: non-judicially, judicially and administratively. In subsequent sections this article identifies these

ways in detail and provides how each of the three ways is applied.

After dissolution, no matter how the dissolution occurred, Sections 6-1206 through 6-1213 govern the winding up process including the handling of claims and final distributions. In that regard, Section 6-1010, an optional provision, may provide an alternative to the general unclaimed property statute of this State.

Sections 6-1212 and 6-1213 provide for voluntary filings that may prove helpful to the limited cooperative association under certain circumstances.

**SECTION 6-1202. NONJUDICIAL DISSOLUTION.** Except as otherwise provided in Sections 6-1203 and 1-603, a limited cooperative association is dissolved and its activities must be wound up:

- (1) upon the occurrence of an event or at a time specified in the articles of organization;
- (2) upon the action of the association's organizers, board of directors, or members under Section 6-1204 or 6-1205; or
- (3) 90 days after the dissociation of a member, which results in the association having one patron member and no other members, unless the association:
  - (A) has a sole member that is a cooperative; or
  - (B) not later than the end of the 90-day period, admits at least one member in accordance with the organic rules and has at least two members, at least one of which is a patron member.

### **Comment**

The exception for Sections 6-1203 relating to judicial dissolution and 1-603 relating to administrative dissolution is to make it clear those sections provide the only other ways that a limited cooperative association may be dissolved.

**Paragraph (1)** – The articles of organization may, but are not required to, state events or times when a limited cooperative association is dissolved. To be effective, the provision must be in the articles of organization (not in the bylaws). For example, the articles could provide for dissolution to be required if the association has only five remaining members. This does not contradict the provision in paragraph (3) because it would provide a higher standard. The articles could also provide for a term of years for the association consistent with Section 6-

301(b)(6). That provision requires the term be stated in the articles if the association is not to have perpetual existence.

**Paragraph (3)** – This paragraph and Section 6-501 (requiring at least two members for a limited cooperative association to commence business unless the sole member is a cooperative) together state a requirement that there be at least two members except where an association is wholly-owned by a cooperative.

**SECTION 6-1203. JUDICIAL DISSOLUTION.** The [appropriate court] may dissolve a limited cooperative association or order any action that under the circumstances is appropriate and equitable:

(1) in a proceeding initiated by the [Attorney General], if:

(A) the association obtained its articles of organization through fraud; or

(B) the association has continued to exceed or abuse the authority conferred upon it by law; or

(2) in a proceeding initiated by a member, if:

(A) the directors are deadlocked in the management of the association's affairs, the members are unable to break the deadlock, and irreparable injury to the association is occurring or is threatened because of the deadlock;

(B) the directors or those in control of the association have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

(C) the members are deadlocked in voting power and have failed to elect successors to directors whose terms have expired for two consecutive periods during which annual members meetings were held or were to be held; or

(D) the assets of the association are being misapplied or wasted.

### **Comment**

Section 6-1203 permits a court to fashion remedies other than dissolution if an application to dissolve is made to the court. Illustratively, a court could refuse to dissolve a

limited cooperative association and instead appoint provisional directors or force a buy-out of membership interests. This follows what appears to be a trend in both statutory and case law of corporations. The language expressly providing for such remedies is “or order any action that under the circumstances is appropriate and equitable.” This provision is not subject to change by the organic rules.

Neither a creditor of a limited cooperative association nor a transferee may initiate an action to dissolve a limited cooperative association. In the case of a creditor with a claim or judgment against the association, the creditor’s remedies are left to other law, such as bankruptcy or fraudulent transfer law. Flatly, a transferee may not seek dissolution. This is consistent with other unincorporated entity law.

**Paragraph (1)** – A proceeding may be initiated by the attorney general to dissolve a limited cooperative association only if its articles of organization were obtained through fraud or the association continues to exceed or abuse its legal authority. “Continued” in this context implies that the behavior is temporal in nature and has not ceased. It is somewhat similar to “acting” as used in paragraph (2)(B).

A policy reason for the attorney general having authority to bring an action to dissolve the limited cooperative association is rooted in the history of cooperatives as a unique type of entity formed for the mutual benefit of its members and in recognition that some cooperatives receive special statutory treatment under particular laws. Traditional cooperative laws typically contain a similar provision.

**Paragraph (2)** – A member may seek dissolution of a limited cooperative association if the member can demonstrate one of the four conditions stated as grounds for a court to dissolve the association. The burden of proof is on the member who initiates the proceeding.

**Paragraphs (2)(A)-(D)** – The language in these paragraphs is similar to that commonly found in corporate law (*see* MBCA § 14.30) and invites the courts to apply the deadlock and “oppression” doctrines from closely-held corporation law to limited cooperative associations as they have begun to do in the context of limited liability companies. *See* the comment to Section 5-701(a)(4)(C) (limited liability company oppression remedy). These subsections permit inquiry into the management and operations of a limited cooperative association within the stated parameters of the litigation if dissolution is sought by a member.

**SECTION 6-1204. VOLUNTARY DISSOLUTION BEFORE COMMENCEMENT OF ACTIVITY.** A majority of the organizers or initial directors of a limited cooperative association that has not yet begun business activity or the conduct of its affairs may dissolve the association.



## **Comment**

This section reflects the practical reality that the organizers or initial directors need to be able to dissolve a limited cooperative association before it begins business. Corporate law recognizes that both organizers and the initial board of directors owe duties to the entity.

### **SECTION 6-1205. VOLUNTARY DISSOLUTION BY THE BOARD AND MEMBERS.**

(a) Except as otherwise provided in Section 6-1204, for a limited cooperative association to voluntarily dissolve:

(1) a resolution to dissolve must be approved by a majority vote of the board of directors unless a greater percentage is required by the organic rules;

(2) the board of directors must call a members meeting to consider the resolution, to be held not later than 90 days after adoption of the resolution; and

(3) the board of directors must mail or otherwise transmit or deliver to each member in a record that complies with Section 6-508:

(A) the resolution required by paragraph (1);

(B) a recommendation that the members vote in favor of the resolution or, if the board determines that because of conflict of interest or other special circumstances it should not make a favorable recommendation, the basis of that determination; and

(C) notice of the members meeting, which must be given in the same manner as notice of a special meeting of members.

(b) Subject to subsection (c), a resolution to dissolve must be approved by:

(1) at least two-thirds of the voting power of members present at a members meeting called under subsection (a)(2); and

(2) if the limited cooperative association has investor members, at least a majority

of the votes cast by patron members, unless the organic rules require a greater percentage.

(c) The organic rules may require that the percentage of votes under subsection (b)(1) is:

(1) a different percentage that is not less than a majority of members voting at the meeting; or

(2) measured against the voting power of all members; or

(3) a combination of paragraphs (1) and (2).

### **Comment**

**Subsections (a) and (b)** – These subsections follow the notice, action, and voting procedures in other parts of this article for amendments to the organic rules, Article 2 transactions, and disposition of assets. *See* Sections 6-402, 6-405, 6-518, and 6-1402 through 6-1404.

**Subsection (c)** – The articles of organization or the bylaws may provide for a voting percentage to approve dissolution that ranges from a majority of the voting power of the members present at a meeting of the members to unanimity of all members. If there are investor members, at least one-half of the votes cast by patron members must be affirmative unless the organic rules require a larger percentage. *See* Section 6-514.

### **SECTION 6-1206. WINDING UP.**

(a) A dissolved limited cooperative association shall wind up its activities and affairs, and except as provided in Section 6-1207, the association continues after dissolution only for the purpose of winding up.

(b) In winding up its activities and affairs, the board of directors:

(1) shall discharge the association's debts, obligations, or other liabilities, settle and close the association's activities, and marshal and distribute the assets of the association; and

(2) may:

(A) deliver to the [Secretary of State] for filing a statement of dissolution stating the name of the association and that the association is dissolved;

(B) preserve the association's activities, affairs and property as a going

concern for a reasonable time;

(C) prosecute and defend actions and proceedings, whether civil, criminal, or administrative;

(D) transfer the association's property;

(E) settle disputes by mediation or arbitration;

(F) deliver to the [Secretary of State] for filing a statement of termination stating the name of the company and that the company is terminated; and

(G) perform other acts necessary or appropriate to the winding up.

(c) After dissolution and upon application of a limited cooperative association, a member, or a holder of financial rights, [the appropriate court] may order judicial supervision of the winding up of the association, including the appointment of a person to wind up the association's activities, if:

(1) after a reasonable time, the association has not wound up its activities; or

(2) the applicant establishes other good cause.

(d) If a person is appointed pursuant to subsection (c) to wind up the activities of a limited cooperative association, the association shall promptly deliver to the [Secretary of State] for filing an amendment to the articles of organization to reflect the appointment.

### **Comment**

Sections 6-1206 through 6-1213 govern the process of winding-up including the handling of claims and final distributions no matter how the dissolution occurred. Sections 1-601 through 1-604 govern administrative dissolution. *See also* Section 6-1010 ("Alternative Distribution of Unclaimed Property, Distributions, Redemptions or Payments").

Sections 6-1212 and 6-1213 permit a limited cooperative association to deliver for filing a statement of dissolution and a statement of termination. The purpose of the filings is to provide public notice relevant to the post-dissolution activities of the association.

**Subsection (a)** – Dissolution changes the scope of activities in which a limited

cooperative association may engage. Following dissolution, the association may only engage in activities consistent with winding up its affairs.

**Subsection (b)** – The subsection places the primary obligations in the winding up process on the board of directors consistent with its general management authority under this article. Despite the limitation on the scope of business of a limited cooperative association following dissolution, this subsection provides broad authority in the board of directors to undertake activities in connection with winding up the affairs of the association. The subsection is expansive to enable the board of directors to conduct the winding up process. The board has authority to designate agents and others to conduct winding up activities. Whether the agent has the authority to bind the association in any given transaction during the winding-up process is a matter of agency law.

The board of directors is given broad authority to take necessary action to wind-up its affairs under subsection (b)(6). For example, if any of the limited cooperative's assets are insubstantial in value and cannot be readily converted to cash, those assets may be abandoned or donated to a charitable organization without violating the obligations of the person conducting the winding up of the association. *See* Subsection (b)(2)(G).

**Subsection (c)** – If the board of directors of a limited cooperative association fails to carry out its obligations under subsection (b), either the association, a member or a holder of financial rights (a transferee) may apply to a court for supervision of the winding up process. This subsection is a safety net for members and holders of financial rights if winding up is unreasonably delayed or other good cause for judicial supervision can be shown.

**Subsection (d)** – This subsection requires an amendment to the articles of organization to be delivered to the Secretary of State for filing only when a person is appointed by a court to wind up the association's activities. This requirement is not applicable if the board of directors manages the winding up.

## **SECTION 6-1207. RESCINDING DISSOLUTION.**

(a) A limited cooperative association may rescind its dissolution, unless a statement of termination applicable to the association is effective, [the appropriate court] has entered an order under Section 6-1203 dissolving the association, or the [Secretary of State] has dissolved the association under Section 1-602.

(b) Rescinding dissolution under this section requires:

- (1) the affirmative vote or consent of each member;
- (2) if a statement of dissolution applicable to the limited cooperative association

has been filed by the [Secretary of State] but has not become effective, the delivery to the [Secretary of State] for filing of a statement of withdrawal applicable to the statement of dissolution; and

(3) if a statement of dissolution applicable to the limited cooperative association is effective, the delivery to the [Secretary of State] for filing of a statement of rescission stating the name of the association and that dissolution has been rescinded under this section.

(c) If a limited cooperative association rescinds its dissolution:

(1) the association resumes carrying on its activities and affairs as if dissolution had never occurred;

(2) subject to paragraph (3), and any liability incurred by the association after the dissolution and before the rescission is effective is determined as if dissolution had never occurred; and

(3) the rights of a third party arising out of conduct in reliance on the dissolution before the third party knew or had notice of the rescission may not be adversely affected.

### **Comment**

The Harmonization project added this section, which is based on UPA (1997) (Last Amended 2013) § 802(b)(1) permitting the partners to “waive the right to have the partnership’s business wound up and the partnership terminated” after which “the partnership resumes carrying on its business as if dissolution had never occurred”).

**Subsection (a)** – The first exclusion results inevitably from the effect of a statement of termination – *i.e.*, the limited cooperative association ceases to exist. A “dead” entity lacks both the capacity and power to bring itself back from the dead.

The second and third exclusions pertain to dissolutions effected by outsiders – *i.e.*, the court and the filing office.

**Subsections (b)(1)** – The requirement of unanimous consent protects any vested rights or reliance by members. However, the organic rules may vary this provision.

**Subsection (c)(3)** – This paragraph protects third parties. *E.g.*, *Neurobehavioral*

*Associates, P.A. v. Cypress Creek Hosp., Inc.*, 995 S.W.2d 326, 331 (Tex. App. 1999) (“If the Hospital had the right to terminate the Agreement when it did because the Association was then dissolved, then even though the Association can revoke articles of dissolution and have that relate back to the date of dissolution, it would be grossly unfair to let the Association assert its ex post facto change as a defense. Surely the Association would be estopped from doing so, having created the very conditions that gave the Hospital the correct impression that it was then dissolved.”). The rule is subject to constructive notice by filing. *See* Section 6-1212.

## **SECTION 6-1208. DISTRIBUTION OF ASSETS IN WINDING UP.**

(a) In winding up its activities and affairs, the limited cooperative association shall apply its assets to discharge its obligations to creditors, including members that are creditors. The association shall apply any remaining assets to pay in money the net amount distributable to members in accordance with their right to distributions under subsection (b).

(b) Unless the organic rules otherwise provide, in this subsection “financial interests” means the amounts recorded in the names of members in the records of a limited cooperative association at the time a distribution is made, including amounts paid to become a member, amounts allocated but not distributed to members, and amounts of distributions authorized but not yet paid to members. Unless the organic rules otherwise provide, each member is entitled to a distribution from the association of any remaining assets in the proportion of the member’s financial interests to the total financial interests of the members after all other obligations are satisfied.

### **Comment**

**Subsection (a)** – This subsection follows a traditional approach to the distribution of assets in winding up an entity. It leaves priorities among creditors to other law, such as the Uniform Commercial Code and real property mortgage law.

**Subsection (b)** – This subsection provides for a distribution to all members of assets available for distribution to members after all other obligations of the limited cooperative association are satisfied. The distribution is based on a proportional comparison of the financial interests of the members. “Financial interests” is a specially defined term for purposes of the subsection.

In some cooperatives, such as rural electric associations, other law or custom may provide for a “look back” period of a designated amount of time to determine members entitled to receive a distribution in the winding up process. This could be addressed in the organic rules. If members or holders of financial rights cannot be located, Section 6-1010 (“Alternative Distributions of Unclaimed Property, Distributions, Redemptions or Payments”) of this article and other law governing unclaimed property apply.

The organic rules may establish rules to determine the financial interests and manage the distributions under this section but only as a matter of the internal relationship between and among the members and the entity. The existence of nonmember patrons that may have what appears to be equity accounts may raise difficult interpretive issues that turn on the unique facts under the circumstances.

## **SECTION 6-1209. KNOWN CLAIMS AGAINST DISSOLVED LIMITED COOPERATIVE ASSOCIATION.**

(a) Except as otherwise provided in subsection (d), a dissolved limited cooperative association may give notice of a known claim under subsection (b), which has the effect provided in subsection (c).

(b) A dissolved limited cooperative association in a record may notify its known claimants of the dissolution. The notice must:

- (1) specify the information required to be included in a claim;
- (2) state that a claim must be in writing and provide a mailing address to which the claim is to be sent;
- (3) state the deadline for receipt of a claim, which may not be less than 120 days after the date the notice is received by the claimant; and
- (4) state that the claim will be barred if not received by the deadline.

(c) A claim against a dissolved limited cooperative association is barred if the requirements of subsection (b) are met, and:

- (1) the claim is not received by the specified deadline; or
- (2) if the claim is timely received but rejected by the association:

(A) the association causes the claimant to receive a notice in a record stating that the claim is rejected and will be barred unless the claimant commences an action against the association to enforce the claim not later than 90 days after the claimant receives the notice; and

(B) the claimant does not commence the required action not later than 90 days after the claimant receives the notice.

(d) This section does not apply to a claim based on an event occurring after the date of dissolution or a liability that on that date is contingent.

### **Comment**

Sections 6-1209 through 6-1211 provide rules under which a dissolved limited cooperative association may achieve finality with regard to creditor claims.

This section, which is derived almost verbatim from MBCA § 14.02, provides a means for a dissolved limited cooperative association to address known claims against it and to bar those claims if the claimant does not act in a timely manner or meet other requirements for making a claim to the association. The section also provides the procedures to be followed by a claimant in seeking to enforce a claim against a dissolved association.

## **SECTION 6-1210. OTHER CLAIMS AGAINST DISSOLVED LIMITED COOPERATIVE ASSOCIATION.**

(a) A dissolved limited cooperative association may publish notice of its dissolution and request persons having claims against the association to present them in accordance with the notice.

(b) A notice authorized under subsection (a) must:

(1) be published at least once in a newspaper of general circulation in the [county] in this state in which the dissolved limited cooperative association's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the



association's registered agent is or was last located;

(2) describe the information required to be contained in a claim, state that the claim must be in writing, and provide a mailing address to which the claim is to be sent; and

(3) state that a claim against the association is barred unless an action to enforce the claim is commenced not later than three years after publication of the notice.

(c) If a dissolved limited cooperative association publishes a notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences an action to enforce the claim against the association not later than three years after the publication date of the notice:

(1) a claimant that did not receive notice in a record under Section 6-1209;

(2) a claimant whose claim was timely sent to the company but not acted on; and

(3) a claimant whose claim is contingent at, or based on an event occurring after, the effective date of dissolution.

(d) A claim not barred under this section or Section 6-1209 may be enforced:

(1) against a dissolved limited cooperative association, to the extent of its undistributed assets; and

(2) except as provided in Section 6-1211, if the assets of the association have been distributed after dissolution, against a member or holder of financial rights to the extent of that person's proportionate share of the claim or the assets distributed to the person after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution.

### **Comment**

This section, which is derived almost verbatim from MBCA § 14.07, provides a means for a dissolved limited cooperative association to address unknown claims against it and to bar

those specific types of claims. Those claims are barred three years after completion of publication by the association of a notice to submit claims if a claim is not presented to the association within that period.

**Subsection (c)** – This subsection identifies the specific types of claims which may be barred under this Section. They include known claimants who did not receive notice under Section 6-1210. They also include claimants with contingent claims and claimants whose claims are based on an event occurring after the date of dissolution.

**Subsection (d)(2)** – Liability under this paragraph would extend to anyone who has received distributions as a member or as a holder of financial rights (transferee, assignee) and under a charging order attaching to financial rights. This paragraph contains no “knowledge” element.

#### **SECTION 6-1211. COURT PROCEEDINGS.**

(a) A dissolved limited cooperative association that has published a notice under Section 6-1210 may file an application with [the appropriate court] in the [county] where the association’s principal office is located or, if the principal office is not located in this state, where the office of its registered agent is or was last located, for a determination of the amount and form of security to be provided for payment of claims that are reasonably expected to arise after the date of dissolution based on facts known to the association and:

(1) at the time of the application:

(A) are contingent; or

(B) have not been made known to the association; or

(2) are based on an event occurring after the date of dissolution.

(b) Security is not required for a claim that is or is reasonably anticipated to be barred under Section 6-1210.

(c) Not later than 10 days after filing an application under subsection (a), the dissolved limited cooperative association shall give notice of the proceeding to each claimant holding a contingent claim known to the association.

(d) In a proceeding under this section, the court may appoint a guardian ad litem to represent all claimants whose identities are unknown. The reasonable fees and expenses of the guardian, including all reasonable expert witness fees, must be paid by the dissolved limited cooperative association.

(e) A dissolved limited cooperative association that provides security in the amount and form ordered by the court under subsection (a) satisfies the association's obligations with respect to claims that are contingent, have not been made known to the association, or are based on an event occurring after the effective date of dissolution. Such claims may not be enforced against a member or holder of financial rights on account of assets received in liquidation.

### **Comment**

This section is similar to MBCA § 14.08. It provides a procedure under which a dissolved limited cooperative association that has followed the procedures under Section 6-1210 to seek judicial assistance for providing security for contingent and unknown claims and claims based on events occurring after dissolution. Its purpose is to provide greater certainty for distributions made in liquidation. If satisfactory security is provided, the association can confidently distribute the remaining assets. Subsection (d) provides protection to the recipients of the distributions from recovery by claimants of the association.

It is expected a court would use its discretion and deny the protections of Section 6-1210 to a dissolved association where it is determined that the association is dissolving for purposes of avoiding anticipated claims of future tort claimants. *See, e.g.,* Uniform Fraudulent Transfer Act.

### **SECTION 6-1212. STATEMENT OF DISSOLUTION.**

(a) A limited cooperative association that has dissolved or is about to dissolve may deliver to the [Secretary of State] for filing a statement of dissolution that states:

- (1) the name of the association;
- (2) the date the association dissolved or will dissolve; and
- (3) any other information the association considers relevant.

(b) A person has notice of a limited cooperative association's dissolution on the later of:

- (1) 90 days after a statement of dissolution is filed; or
- (2) the effective date stated in the statement of dissolution.

### **Comment**

This section provides for the voluntary filing of a statement of dissolution with the filing office. The effect of filing the statement is to give notice that a limited cooperative association has dissolved or will soon dissolve and is winding up. It provides constructive notice of dissolution under subsection (b). If a person is appointed by a court to wind up the activities of a dissolved association under Section 6-1206(c), an amendment to the articles of organization reflecting the appointment must be filed with the filing office under Section 6-1206(d).

### **SECTION 6-1213. STATEMENT OF TERMINATION.**

(a) A dissolved limited cooperative association that has completed winding up may deliver to the [Secretary of State] for filing a statement of termination that states:

- (1) the name of the association;
- (2) the date of filing of its initial articles of organization; and
- (3) that the association is terminated.

(b) The filing of a statement of termination does not itself terminate the limited cooperative association.

### **Comment**

This section provides for the voluntary filing of a statement of termination with the filing office. The effect of filing the statement is to give notice that a limited cooperative association has terminated its existence. As with the statement of dissolution under Section 6-1212, the effect of this notice is left to other law, including the law of agency.

Filing of a notice of termination does not eliminate the obligations of the association and those handling its winding up to complete the winding up of the association's affairs and distributing its assets as required by this article.

If a statement of dissolution or a statement of termination is not filed, and no further annual reports are filed with the filing office, the filing office will eventually administratively dissolve the limited cooperative association under Section 1-602.

## [PART] 13

### ACTIONS BY MEMBERS

#### SECTION 6-1301. DIRECT ACTION BY MEMBER.

(a) Subject to subsection (b), a member may maintain a direct action against another member, director, or the limited cooperative association to enforce the member's rights and protect the member's interests, including rights and interests under the organic rules or this [Code] or arising independently of the membership relationship.

(b) 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 cooperative association.

#### Comment

This section was added as part of the Harmonization project. ULLCA (2006) (Last Amended 2013) and ULPA (2001) (Last Amended 2013) have similar provisions. *See* Sections 5-801 and 4-801. The distinction between direct and derivative actions (Sections 6-1302 through 6-1307) has been an issue that has frequently been litigated in the past.

**Subsection (a)** – A member's rights under this subsection are subject to the rule of standing stated in subsection (b). The phrase “otherwise protect the member's interests” pertains to remedies and creates no additional causes of action.

The last phrase of this subsection (“or arising independently ...”) does not create any new rights, obligations, or remedies, and is included merely to emphasize that a person's membership in a limited cooperative association does not preclude the person from enforcing rights existing “independently of the membership relationship” – *e.g.*, as a creditor.

**Subsection (b)** – This subsection codifies the rule of standing that predominates in law of limited liability companies as well as corporations. *See, e.g., Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004); *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969).

The distinction between direct and derivative claims protects the limited cooperative association's organic rules. If any member can sue directly over any management issue, the mere threat of suit can interfere with the members' agreed-upon arrangements. Although in ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract, within a limited cooperative association different circumstances typically

exist. A member does not have a direct claim against a director or another member merely because the director or other member has breached the operating agreement. Likewise a member's violation of this article does not automatically create a direct claim for every other member. To have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the limited cooperative association.

EXAMPLE: Through grossly negligent conduct, in violation of Section 818, the directors of a limited cooperative association reduce the net assets of a limited cooperative association by 50%, which in turns decreases the value of Member A's investment by \$3,000,000. Member A has no standing to bring a direct claim. Member A's damage is merely derivative of the damage first suffered by the limited cooperative association. The member may, however, bring a derivative claim. Sections 6-1302 through 6-1307.

EXAMPLE: Same facts, except in addition to violating Section 6-818, the directors' conduct breaches an express provision of the organic rules to which Member A is a signatory. The analysis and the result are the same.

EXAMPLE: The organic rules of a limited cooperative association define "distributable cash" and requires the association to periodically distribute that cash among all members. The association's directors fail to distribute the cash. Each member has a direct claim against the directors and the association.

The reference to "threatened injury" is to encompass potential claims for preventative relief, such as a TRO or preliminary injunction.

Section 6-1203(2) gives a member the right to bring a direct action for dissolution against a limited cooperative association in circumstances involving deadlock, oppression and waste. This dissolution action is in addition to and independent of the direct action under this section.

**SECTION 6-1302. DERIVATIVE ACTION.** A member may maintain a derivative action to enforce a right of a limited cooperative association if:

(1) the member first makes a demand on the directors requesting that they cause the association to bring an action to enforce the right and the directors do not bring the action within a reasonable time; or

(2) a demand under paragraph (1) would be futile.

### **Comment**

**Paragraph (1)** – The demand requirement recognizes that, presumptively at least, the

decision to cause a limited liability company to bring suit is a business decision, to be made by those who manage the business. Deborah A. DeMott, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE (Westlaw DB SDALP, retrieved November 4, 2012) § 5.9 (Demand on directors—Rationales for demand).

**Paragraph (2)** – Some jurisdictions have a “universal demand” requirement, but the approach stated here is by far the majority one. *Id.* § 5.12.

**SECTION 6-1303. PROPER PLAINTIFF.** A derivative action to enforce a right of a limited cooperative association may be maintained only by a person that is a member at the time the action is commenced and:

- (1) was a member when the conduct giving rise to the action occurred; or
- (2) whose status as a member devolved on the person by operation of law or pursuant to the terms of the organic rules from a person that was a member at the time of the conduct.

#### **Comment**

The rule stated here is conventional in both the law of unincorporated entities and corporate law. Dissociated members and other transferees have no standing to bring a derivative action.

**Paragraph (2)** – This paragraph will be inapposite if the limited cooperative association has only two members, one of whom is the derivative plaintiff. In that limited circumstance, the plaintiff’s death would cause the derivative action to abate.

This article takes no position on whether:

- the death of member abates a direct claim against the limited cooperative association or a fellow member; and
- bringing a direct claim precludes a person from being a proper plaintiff for a derivative claim.

As to the latter issue, see *e.g. Cordts-Auth v. Crunk, LLC*, 815 F. Supp. 2d 778, 793-94 (S.D.N.Y. 2011) (discussing the potential conflict of interest) *aff’d*, 479 F. App’x 375 (2d Cir. 2012).

**SECTION 6-1304. PLEADING.** In a derivative action to enforce a right of a limited cooperative association, the complaint must state with particularity:

- (1) the date and content of plaintiff’s demand and the response to the demand by the directors; or

(2) why demand should be excused as futile.

#### **Comment**

This section parallels Section 6-1302. The pleading requirement first appeared in a uniform act in 1976. *See* ULPA (1976/1985) § 1003.

#### **SECTION 6-1305. APPROVAL FOR DISCONTINUANCE OR SETTLEMENT.**

A derivative action on behalf of a limited cooperative association may not be voluntarily dismissed or settled without the court's approval.

#### **Comment**

Discontinuance or settlement of a derivative action must be approved by the court. This acts as a prophylactic against strike suits where a member-plaintiff brings an action with the primary objective to obtain a private settlement.

The section does not address whether a court must provide notice to any members who might be affected by discontinuance of a derivative suit or a settlement. The court has discretion to determine what information should be provided to others in its judicial administration of the suit.

#### **SECTION 6-1306. PROCEEDS AND EXPENSES.**

(a) Except as otherwise provided in subsection (b):

(1) any proceeds or other benefits of a derivative action, whether by judgment, compromise, or settlement, belong to the limited cooperative association and not to the plaintiff; and

(2) if the plaintiff receives any proceeds, the plaintiff shall remit them immediately to the association.

(b) If a derivative action is successful in whole or in part, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees and costs, from the recovery of the limited cooperative association.

#### **Comment**



**Subsection (a)** – The proceeds recovered in a derivative action belong to the limited cooperative association, not the members who brought the action. In a derivative action the plaintiffs are suing on behalf of the association. In contrast, any recovery in a direct action (Section 6-1301) belongs to the member or members who brought the action.

#### **SECTION 6-1307. SPECIAL LITIGATION COMMITTEE.**

(a) If a limited cooperative association is named as or made a party in a derivative proceeding, the association may appoint a special litigation committee to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests of the company. If the association appoints a special litigation committee, on motion by the committee made in the name of the association, except for good cause shown, the court shall stay discovery for the time reasonably necessary to permit the committee to make its investigation.

This subsection does not prevent the court from:

- (1) enforcing a person's right to information under Section 6-505; or
- (2) granting extraordinary relief in the form of a temporary restraining order or preliminary injunction.

(b) A special litigation committee must be composed of one or more disinterested and independent individuals, who may be members.

(c) A special litigation committee may be appointed:

- (1) by a majority of the directors not named as parties in the proceeding; or
- (2) if all directors are named as parties in the proceeding, by a majority of the directors named as defendants.

(d) After appropriate investigation, a special litigation committee may determine that it is in the best interests of the limited cooperative association that the proceeding:

- (1) continue under the control of the plaintiff;
- (2) continue under the control of the committee;

(3) be settled on terms approved by the committee; or

(4) be dismissed.

(e) After making a determination under subsection (d), a special litigation committee shall file with the court a statement of its determination and its report supporting its determination and shall serve each party with a copy of the determination and report. The court shall determine whether the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof. If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court shall enforce the determination of the committee. Otherwise, the court shall dissolve the stay of discovery entered under subsection (a) and allow the action to continue under the control of the plaintiff.

### Comment

Although special litigation committees are best known in the corporate field, they are no more inherently corporate than derivative litigation or the notion that an organization is a person distinct from its owners. An “SLC” can serve as an ADR mechanism, help protect an agreed upon arrangement from strike suits, protect the interests of members who are neither plaintiffs nor defendants (if any), and bring the benefits of a specially tailored business judgment to any judicial decision.

This section’s approach corresponds to established law in most jurisdictions, modified to fit the typical governance structures of a limited cooperative association. Use of an SLC is optional.

**Subsection (a)(1)** – Section 6-505 pertains to information rights. On the availability of Section 6-505 remedies pending the SLC’s investigation, *compare Kaufman v. Computer Assoc. Int’l, Inc.*, No. Civ.A. 699-N, 2005 WL 3470589 at \*1 (Del.Ch. Dec. 21, 2005, as revised) (presenting “the question of whether to stay a books and records action under 8 Del. C. § 220 at the request of a special litigation committee when a derivative action encompassing substantially the same allegations of wrongdoing filed by different plaintiffs is pending in another jurisdiction,” concluding “[f]or reasons that have much to do with the light burden imposed by the plaintiff’s demand in this case ... that the special litigation committee’s motion to stay the books and records action should be denied”).

**Subsection (e)** – The standard stated for judicial review of the SLC determination follows *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920 (N.Y. 1979) rather than *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), because the latter’s reference to a court’s business judgment has generally not been followed in other states. In essence, an SLC is intended to function as a surrogate decision-maker, allowing the limited liability company to make what is fundamentally a business decision. If a court determines that “the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof,” it makes no sense to substitute the court’s legal judgment for the business judgment of the SLC.

*Houle v. Low*, 407 Mass. 810, 822, 556 N.E.2d 51, 58 (Mass. 1990) contains an excellent explanation of the court’s role in reviewing an SLC decision:

The value of a special litigation committee is coextensive with the extent to which that committee truly exercises business judgment. In order to ensure that special litigation committees do act for the [entity]’s best interest, a good deal of judicial oversight is necessary in each case. At the same time, however, courts must be careful not to usurp the committee’s valuable role in exercising business judgment. ... . [A] special litigation committee must be independent, unbiased, and act in good faith. Moreover, such a committee must conduct a thorough and careful analysis regarding the plaintiff’s derivative suit ... . The burden of proving that these procedural requirements have been met must rest, in all fairness, on the party capable of making that proof--the [entity].

For an extensive discussion of how a court should approach the question of independence, see *Einhorn v. Culea*, 612 N.W.2d 78, 91 (Wis. 2000).

## **[PART] 14**

### **DISPOSITION OF ASSETS**

#### **SECTION 6-1401. DISPOSITION OF ASSETS NOT REQUIRING MEMBER**

**APPROVAL.** Unless the articles of organization otherwise provide, member approval under Section 6-1402 is not required for a limited cooperative association to:

- (1) sell, lease, exchange, license, or otherwise dispose of all or any part of the assets of the association in the usual and regular course of business; or
- (2) mortgage, pledge, dedicate to the repayment of indebtedness, or encumber in any way all or any part of the assets of the association whether or not in the usual and regular course of

business.

### **Comment**

This section and article do not have express counterparts in ULLCA (2006) (Last Amended 2013), ULPA (2001) (Last Amended 2013), or UPA (1997) (Last Amended 2013), though in application those acts provide for similar heightened voting as matter of default in the context of a disposition of assets. For example, Section 3-401(j) provides that a majority of general partners may decide matters arising “in the ordinary course of business” while an “act outside the ordinary course of business ... and an amendment to the partnership agreement may be undertaken only with the consent of all the partners.” This article similarly requires, unless the articles otherwise provide, the same voting standard and mechanism for dispositions of assets as for amending the articles of organization if the disposition is outside the usual and regular course of business. *See* Section 6-1402.

This section allows a limited cooperative association the flexibility to deal with its assets as required by modern business practices. No member approval is required for asset dispositions if they occur in the usual and regular course of business.

**EXAMPLE:** A limited cooperative association of artisans purchases wares from its artisan members. It is organized in such a way that the artisans’ ship wares from their personal studios located in twenty different states to a temporary market location in a different city every three months. The association leases market space in each city for one week and sells substantially all of the inventory of wares shipped to that location. The only other assets the association has are a small leased home office, leased telecommunication equipment and two personal computers. The sale of all the association’s inventory of wares is in the usual and regular course of business and this article does not require member approval for its disposition even though the sale of the inventory represents substantially all of the assets of the association.

### **SECTION 6-1402. MEMBER APPROVAL OF OTHER DISPOSITION OF**

**ASSETS.** A sale, lease, exchange, license, or other disposition of assets of a limited cooperative association, other than a disposition described in Section 6-1401, requires approval of the association’s members under Sections 6-1403 and 6-1404 if the disposition leaves the association without significant continuing business activity.

### **Comment**

The test in determining whether member approval is necessary for the disposition of assets is not alone a matter of the nominal value of the assets to be disposed or the relative percentage of the value of assets disposed to the value of the assets owned by the limited cooperative association. This section, together with Section 6-1401, focuses the inquiry on

whether the disposition is in the regular or usual course of business of the association and how the disposition affects the association's existence, purpose, and continued activity.

A primary reason for requiring member approval for the disposition of assets outside the usual and regular course of business is because such a sale may be used as a transactional substitute or a piece of a transactional substitute for a merger or conversion.

**SECTION 6-1403. NOTICE AND ACTION BY BOARD OF DIRECTORS ON  
DISPOSITION OF ASSETS REQUIRING MEMBER APPROVAL.** For a limited

cooperative association to dispose of assets under Section 6-1402:

(1) a majority of the board of directors, or a greater percentage if required by the organic rules, must approve the proposed disposition; and

(2) the board of directors must call a members meeting to consider the proposed disposition, hold the meeting not later than 90 days after approval of the proposed disposition by the board, and mail or otherwise transmit or deliver in a record to each member:

(A) the terms of the proposed disposition;

(B) a recommendation that the members approve the disposition, or if the board determines that because of conflict of interest or other special circumstances it should not make a favorable recommendation, the basis for that determination;

(C) a statement of any condition of the board's submission of the proposed disposition to the members; and

(D) notice of the meeting at which the proposed disposition will be considered, which must be given in the same manner as notice of a special meeting of members.

**Comment**

This section and Section 6-1404 set forth the approval procedure by the directors and members of sales of assets that must be approved by the members under Section 6-1402

#### **SECTION 6-1404. MEMBER ACTION ON DISPOSITION OF ASSETS.**

(a) Subject to subsection (b), a disposition of assets under Section 6-1402 must be approved by:

(1) at least two-thirds of the voting power of members present at a members meeting called under Section 6-1403(2); and

(2) if the limited cooperative association has investor members, at least a majority of the votes cast by patron members, unless the organic rules require a greater percentage vote by patron members.

(b) The organic rules may require that the percentage of votes under subsection (a)(1) is:

(1) a different percentage that is not less than a majority of members voting at the meeting;

(2) measured against the voting power of all members; or

(3) a combination of paragraphs (1) and (2).

(c) Subject to any contractual obligations, after a disposition of assets is approved and at any time before the consummation of the disposition, a limited cooperative association may approve an amendment to the contract for disposition or the resolution authorizing the disposition or approve abandonment of the disposition:

(1) as provided in the contract or the resolution; and

(2) except as prohibited by the resolution, with the same affirmative vote of the board of directors and of the members as was required to approve the disposition.

(d) The voting requirements for districts, classes, or voting groups under Section 6-404 apply to approval of a disposition of assets under this [part].

### **Comment**

Action on the proposed disposition of assets by members is coordinated with the voting on amendments to the articles of association and on Article 2 transactions. *See* Section 6-405 and 6-518.

## **ARTICLE 7**

### **UNINCORPORATED NONPROFIT ASSOCIATIONS**

**SECTION 7-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Unincorporated Nonprofit Associations.

### **Comment**

This article replaces a state's current statutes governing unincorporated nonprofit associations whether or not those statutes are based on the Uniform Unincorporated Nonprofit Association Act.

### **SECTION 7-102. DEFINITIONS.**

(a) In this [article]:

(1) "Established practices" means the practices used by an unincorporated nonprofit association without material change during the most recent five years of its existence, or if it has existed for less than five years, during its entire existence.

(2) "Governing principles" means the agreements, whether oral, in a record, or implied from its established practices, or in any combination thereof, which govern the purpose or operation of an unincorporated nonprofit association and the rights and obligations of its members and managers. The term includes any amendment or restatement of the agreements constituting the governing principles.

(3) "Manager" means a person that is responsible, alone or in concert with others, for the management of an unincorporated nonprofit association.

(4) "Member" means a person that, under the governing principles, may

participate in the selection of persons authorized to manage the affairs of the unincorporated nonprofit association or in the development of the policies and activities of the association.

(5) “Unincorporated nonprofit association” means an unincorporated organization consisting of [two] or more members joined under an agreement that is oral, in a record, or implied from conduct, for one or more common, nonprofit purposes. The term does not include:

(A) a trust;

(B) a marriage, domestic partnership, common law domestic relationship, civil union, or other domestic living arrangement;

(C) an organization formed under any other statute that governs the organization and operation of unincorporated associations;

(D) a joint tenancy, tenancy in common, or tenancy by the entireties even if the co-owners share use of the property for a nonprofit purpose; or

(E) a relationship under an agreement in a record that expressly provides that the relationship between the parties does not create an unincorporated nonprofit association.

(b) The following definitions outside this [article] apply to this [article]:

(1) “Person” – Section 1-102(34).

(2) “Property” – Section 1-102(38).

(3) “Record” – Section 1-102(41).

(4) “Registered agent” – Section 1-102(42).

(5) “Sign” – Section 1-102(44).

(6) “State” – Section 1-102(45).

(7) “Transfer” – Section 1-102(47).

(c) The following subjects are covered in whole or in part outside this [article]:



- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Registered agent of entity – Part 4 of Article 1.
- (4) Miscellaneous provisions, including supplemental principles of law and reservation of power to amend or repeal – Part 7 of Article 1.
- (5) Entity transactions generally – Part 1 of Article 2.
- (6) Merger – Part 2 of Article 2.
- (7) Interest exchange – Part 3 of Article 2.
- (8) Conversion – Part 4 of Article 2.
- (9) Domestication – Part 5 of Article 2.

### **Comment**

**Subsection (a)** – This subsection contains definitions for terms used throughout this article.

**“Established practices” [(a)(1)]** – The “established practices” are essentially equivalent to the commercial law concepts of course of performance and course of dealing. *See* UCC §1-303. Many nonprofit associations operate on a very informal basis. Often there are no written procedures or bylaws – or what writings they have are very incomplete. Nevertheless, over time they develop and follow various practices. These practices, if followed consistently for at least five years (or during the entire existence of the nonprofit association if it has been in existence less than five years), become established practices and therefore can qualify as part of the nonprofit associations “governing principles.” An example would be an unincorporated church that has no written bylaws covering the issue of notice of meetings that for the past five years has printed notice of the annual meeting of its members in the church bulletin for the three weeks preceding the annual meeting. This established practice would be part of the church’s governing principles and if followed in the sixth and subsequent years would be determinative of whether reasonable notice of an annual meeting had been given.

**“Governing principles” [(a)(2)]** – The “governing principles are the equivalent of the articles of incorporation, bylaws and other documents, and established practices that govern the internal affairs of a nonprofit association, sometimes referred to as an entity’s private organic rules. *See* Model Entity Transactions Act (2007) (Last Amended 2013) § 102(33). The “governing principles” of a nonprofit association do not have to be in a written form. This is consistent with partnership law, the for-profit equivalent of a nonprofit association. *See* Sections 3-102(7) (general partnerships); 4-102(9) (limited partnerships); 5-102(9) (limited liability companies). Where there is no clear oral agreement or record, the governing principles would

come from the nonprofit association's established practices (subsection (1)).

**“Manager” [(a)(3)]** – A person is a “manager” of a nonprofit association if the person fits the definition even if that person's designation might usually be associated with another type of organization. Many nonprofit associations refer to members of their governing boards as “directors” or “trustees.” These designations do not disqualify the organization from being a nonprofit association even though the term “director” is commonly associated with corporations and the term “trustee” is commonly associated with trusts. A manager may, but need not be, a member of the nonprofit association (*see* Section 7-121(2); and may, and, in fact in most cases will be, an individual, but various types of entities can also be managers of a nonprofit association (*see* Section 1-102(34)—definition of person).

**“Member” [(a)(4)]** – The definition of “member” may reach somewhat beyond decisions of some courts. Either participation in the selection of the management or in the development of policies and activities of the nonprofit association is enough. Both are not required. This broad definition of member ensures that the insulation from liability is provided in all cases in which the common law might have imposed liability on a person simply because the person was a member.

Persons who do not have the right to select a nonprofit association's manager or to approve its governing policies are not members of the nonprofit association for purposes of this article even though the nonprofit association may call or refer to them as members. A fund-raising device commonly used by many nonprofit organizations is a membership drive. In most cases the contributors are not members for purposes of this article. They are not authorized to “participate in the selection of persons authorized to manage the affairs of the unincorporated nonprofit association or in the development of policies and activities of the association.” Simply because an association calls a person a member does not make the person a member under this article.

The role of a member in the affairs of a nonprofit association is described as “may participate in the selection” instead of “may select or elect” the governing board and officers and “may participate . . . in the development of policies and activities” instead of “may determine” policies and activities. This accommodates this article to a great variation in practices and organizational structures. For example, some nonprofit associations permit the president or chair to name some members of the governing board, such as by naming the chairs of principal committees who are designated *ex officio* members of the governing board. Similarly, the role in determination of policy is described in general terms. “Persons authorized to manage the affairs of the association” is used in the definition instead of president, executive director, officer, member of governing board, and the like. Given the wide variety of organizational structures of nonprofit associations to which this article applies and the informality of many of them, the more generic term is more appropriate.

**“Unincorporated nonprofit association” [(a)(5)]** – An organization cannot be a nonprofit association if it is organized as a corporation or is a for-profit unincorporated entity, e.g., a partnership. On the other hand, not every form of unincorporated nonprofit organization should automatically become a nonprofit association and therefore be able to have limited

liability and the other benefits of this statute. That is the reason for the language excluding trusts, domestic living arrangements including marriages and domestic partnerships, and agreements merely to hold title to property as co-owners. The laws governing the rights of creditors, trustees, and beneficiaries of trusts are well developed and therefore the legal principles in this article are unnecessary. Domestic relations law provides property rights for adults co-habiting together after a legal marriage or in a long-term unmarried status such as what is frequently referred to as a “common law marriage” or in domestic partnership and civil union statutes. Living together in any of these domestic living arrangements can probably qualify as an association having a nonprofit purpose, but for public policy reasons these arrangements should not be able to qualify as a nonprofit association and therefore avoid individual liability for taxes and other liabilities. For similar reasons, mere co-ownership of property, even if for nonprofit purposes, should not automatically result in the applicability of this article. An enacting jurisdiction can choose to expand or reduce the number of types of exclusions consistent with the concept that a nonprofit association is a default form of organization for unincorporated nonprofit entities.

“Agreement” rather than “contract” is the appropriate term because the legal requirements for an agreement are less stringent and less formal than for a contract. For example, mutual consent must be present in both but the contractual concept of consideration is not necessary for an agreement. The agreement to form a nonprofit association can be in a “record” (*see* Section 1-102(41)), or oral, or implied from conduct (*e.g.*, course of performance or course of dealing). The agreement to form a nonprofit association becomes part of the nonprofit association’s overall “governing principles.” “Implied from conduct” rather than “implied from its established practices” (*see* subsection (a)(2)) is used as the standard because the agreement to form a nonprofit association precedes or is contemporaneous with its existence, and established practices can only exist after the nonprofit association is in existence.

Although it is always preferable to have written agreements, most existing nonprofit associations are quite informal and have few, if any, writings setting forth the agreements governing the purpose and operation of the organization. Moreover, most nonprofit associations are formed and operate without independent legal advice. Imposing a statute of frauds or similar writing requirement would, therefore, have the effect of excluding most existing nonprofit associations from being able to qualify under this article. The enacting jurisdiction’s general rules governing the proof and effect of oral agreements and the priority of written provisions over subsequent inconsistent oral provisions apply to nonprofit association governing principles. *See* section 7-103.

Although the agreement to form a nonprofit association can be quite informal and sketchy, there must be some tangible, objective data such as the use of the organization’s name in communications to its members or third parties, or the existence of a bank account or of a mailing (or internet) address in the name of the nonprofit association or similar “conduct” indicating that, in fact, there is an actual agreement.

An express provision in a record stating that the parties to a contract do not intend to create an unincorporated nonprofit association, on the other hand, would negate any conclusion that there was an agreement to have a nonprofit association. *See* subsection (a)(5)(E). An

example is a contractual relationship between two nonprofit organizations where the parties do not want the contract to be subject to this article. An express provision in a record to that effect in the contract should be upheld.

The members must be joined together for a common purpose. Several states provide that they be “joined together for a *stated* common purpose” (emphasis added). Because of the informality of many ad hoc associations, it is prudent not to impose the requirement that the common purpose be “stated.” Very probably, it is the small, informal, ad hoc associations and those third parties affected by them that most need this article.

The best reference point for what constitutes a nonprofit purpose is probably the enacting state’s Nonprofit Corporation Act. The nonprofit purpose requirement carries with it the implicit understanding that the purpose is not a criminal activity and is otherwise lawful. Each enacting jurisdiction needs to determine whether these limitations need to be set forth explicitly in this article.

The two–person requirement for forming a nonprofit association is quite minimal, assuming the standard broad definition of person (Section 1-102(34)) incorporated into this article. At least two persons are required because that is the minimum number necessary to have an agreement under general legal principles. If one person wants to create a nonprofit organization, it is possible to do so by means of a trust, a nonprofit corporation, or in many states, a single member limited liability company. A few states currently require more than two members at the time of formation. New Jersey, for example, requires seven or more.

Nonprofit corporation statutes typically allow a nonprofit corporation to be formed by one or more incorporators but to operate without members and therefore to be governed by a self-perpetuating board of directors. *See Model Nonprofit Corporation Act-Third Edition (2008) §§ 2.02(4), 6.01.* A nonprofit association, however, must always have at least two members. The definition of a nonprofit association states that it is an organization “consisting of [two] or more members....”

This article applies to all nonprofit associations, whether they are classified as religious, public benefit, or mutual benefit, or whether they are classified as tax-exempt under the laws of the enacting jurisdiction. Therefore, this article will cover unincorporated philanthropic, educational, scientific, social and literary clubs, unions, trade associations, political organizations, such as political parties, churches, hospitals, neighborhood and property owner associations, and sports organizations such as Little League baseball teams. If the enacting jurisdiction decides to exempt one or more types of nonprofit associations from this article, it needs to draft specific provisions listing the exemptions.

**Subsection (b)** – This subsection contains a list of definitions in Article 1 that are applicable to nonprofit associations.

**Subsection (c)** – This subsection lists the other parts of the Code that are applicable to nonprofit associations.

### **SECTION 7-103. RELATION TO OTHER LAW.**

(a) A statute governing a specific type of unincorporated nonprofit association prevails over an inconsistent provision in this [article], to the extent of the inconsistency.

(b) This [article] supplements the law of this state that applies to nonprofit associations operating in this state. If a conflict exists, that law applies.

(c) Unless displaced by particular provisions of this [article], the principles of law and equity supplement this [article].

***Legislative Note:** A thorough review of all these other laws should be conducted to be sure they do not need to be amended in order to continue to apply to nonprofit associations after this article is effective. If amendments to these other laws are necessary, they should be included as trailing amendments in the legislation containing this article.*

#### **Comment**

**Subsection (a)** – Many jurisdictions have existing statutes governing particular types of nonprofit associations, *e.g.*, churches. Subsection (a) establishes the rule that in the event of an inconsistency between this article and the statute governing a specific type of nonprofit association, the latter will control. Under generally accepted statutory interpretation principles, there is a strong presumption against inconsistency, *i.e.*, the presumption is that the provisions of the two statutes are not inconsistent.

**Subsection (b)** – Most jurisdictions have statutory provisions giving the chief legal officer of the jurisdiction oversight supervisory powers over nonprofit organizations, including the power to enjoin or prohibit various activities. Most jurisdictions also have statutes that require registration, permits, or advance notice to engage in certain activities, *e.g.*, fundraising from the public, and the filing of reports, *e.g.*, assumed name filings, tax forms, and the like. All of these existing and future statutes, rules, and regulations are applicable to nonprofit associations. Whether specific provisions stating this principle need to be included in this article depends on the enacting jurisdiction's statutory drafting conventions.

**Subsection (c)** – Examples of other laws that apply to nonprofit associations are general principles of contracts, agency, fraud, estoppel, the priority of written provisions of an agreement over prior inconsistent oral provisions, civil and criminal procedural rules, and rules for enforcing judgments,

Drafting conventions as to whether these general principles of law should be set forth in separate provisions in an act like this vary greatly. Uniform acts, as a general rule, do not have provisions other than what is stated in subsection (c).

## **SECTION 7-104. GOVERNING LAW.**

(a) Except as otherwise provided in subsection (b), the law of this state governs the operation in this state of an unincorporated nonprofit association formed or operating in this state.

(b) Unless the governing principles specify a different jurisdiction, the law of the jurisdiction in which an unincorporated nonprofit association has its main place of activities governs the internal affairs of the association.

### **Comment**

This article applies to pre-existing nonprofit associations formed in the enacting state, as well as to all nonprofit associations formed in the state after the effective date of this article. *See* Section 1-708. This is a standard approach in statutes governing organizational entities. Exempting various types of existing organizations from the new law is not a desirable practice. Because the existing laws governing nonprofit associations are, for the most part, incomplete and this article may change some of the common understanding of what the law is, an enacting jurisdiction whose standard rule is to have a new statute effective when signed or at the beginning of the next fiscal year after signing may want to have a delayed effective date of 6 or 12 months to provide time to educate the affected organizations and their advisors about the changes.

This article's applicability to nonprofit associations formed in other jurisdictions that are operating in this state is necessary because in all other types of entities the internal affairs rules of the jurisdiction of the entity's formation (*e.g.*, the governance rules and duties and responsibilities of the owners and managers to each other and the entity) control; but it is difficult to determine the jurisdiction of a nonprofit association's formation since it does not, in most jurisdictions, file any public document upon its formation. Some mechanism for choosing the internal affairs jurisdiction is therefore necessary. The default rule in this article is the jurisdiction in which the nonprofit association has its main place of activities. A nonprofit association can, however, designate the internal affairs jurisdiction in its governing principles, subject to applicable conflicts of laws substantial contact rules. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971).

The term "main place of activities" is not defined but should not be difficult to determine in most cases. Most nonprofit associations are quite informal and probably do not have what are commonly thought of as "executive offices" (*cf.* UCC § 9-103(3)(d)—a debtor's "chief executive office", an undefined term, determines the proper place to file a financing statement) or even a "principal office" (*cf.* Section 3-104(2) – default rule is the state where a general partnership has its principal office governs its internal affairs). In any case, most nonprofit associations conduct operations in only one state and a nonprofit association that has operations in more than one state

can designate the state that will govern its internal affairs so it will be a rare case when it will be necessary to determine which of two or more states' laws govern a nonprofit association's internal affairs.

Since the laws governing nonprofit associations in the enacting jurisdiction govern nonprofit associations formed in other jurisdictions that are conducting activities (except for internal affairs issues in the enacting jurisdiction), a foreign-formed nonprofit association could not conduct activities in the enacting jurisdiction that a nonprofit association formed in this jurisdiction could not conduct, even if the activity were legal in the foreign jurisdiction in which the nonprofit association was formed or has its main place of activities.

#### **SECTION 7-105. ENTITY; PERPETUAL EXISTENCE; POWERS.**

(a) An unincorporated nonprofit association is an entity distinct from its members and managers.

(b) An unincorporated nonprofit association has perpetual duration unless the governing principles specify otherwise.

(c) An unincorporated nonprofit association has the same powers as an individual to do all things necessary or convenient to carry on its purposes.

(d) An unincorporated nonprofit association may engage in profit-making activities but profits from any activities must be used or set aside for the association's nonprofit purposes.

#### **Comment**

**Subsection (a)** – The separate legal status of a nonprofit association is a fundamental concept that undergirds all the principles that allow a nonprofit association to hold and dispose of property in its own name and to sue and be sued in its own name and that insulate the assets of the members from claims against the nonprofit association. This is a reversal of traditional common law principles that treat partnerships and other unincorporated entities under an aggregate theory.

**Subsection (b)** – Providing for perpetual existence of a nonprofit association is one of the key aspects of its separate entity status. Under the traditional common law aggregate theory, a nonprofit association's existence would end with any change in the membership and if the nonprofit association continued in operation it was deemed to be a new nonprofit association.

The members can agree to a limited term and a nonprofit association can, of course, terminate by being dissolved and winding up. *See* Sections 7-127 and 7-128.

**Subsection (c)** – This is a standard general powers clause. *See e.g.*, Section 5-109 (limited liability companies).

**Subsection (d)** – Many existing unincorporated nonprofit organizations engage in activities that are intended to produce a profit, *e.g.*, a bingo parlor operated by a church where the profits are used to buy food for a homeless shelter. This type of profit-making endeavor should not disqualify the organization from being a nonprofit association if it otherwise qualifies. A for-profit activity might endanger the tax-exempt status of the organization or may generate taxable income, but these are separate issues and should not affect the organizational status of a nonprofit association or the rights and liabilities of its members and managers.

The fact that some or all of the members receive some direct or indirect benefit from a nonprofit association's profit-making activities will not disqualify an unincorporated nonprofit organization from being a nonprofit association under this article so long as the benefit is in furtherance of the nonprofit association's nonprofit purposes. The distribution of any profits to the members for the members' own use, *e.g.*, a dividend distribution to members, would, however, disqualify the organization from being a nonprofit association because the distribution is not made in furtherance of the nonprofit association's nonprofit purposes. *See* Section 7-125. The organization would be a general partnership, the default organizational form for a for-profit organization. An unincorporated investment club that distributes its profits to its members, for example, would be a general partnership and not a nonprofit association even though its stated purpose is to educate its members about investments.

## **SECTION 7-106. OWNERSHIP AND TRANSFER OF PROPERTY.**

(a) An unincorporated nonprofit association may acquire, hold, or transfer in its name an interest in property.

(b) An unincorporated nonprofit association may be a beneficiary of a trust or contract, a legatee, or a devisee.

### **Comment**

**Subsection (a)** – Subsection (a) is based on Section 3-102(8) of the Uniform Common Interest Ownership Act. It reverses the common law rule. Inasmuch as an unincorporated nonprofit association was not a legal entity at common law, it could not acquire, hold, or convey real or personal property. Harold J. Ford, *Unincorporated Non-Profit Associations*, 1-45 (Oxford Univ. Press (1959)); Warburton, *The Holding of Property by Unincorporated Associations*, *Conveyancer* 318 (September-October 1985).

This strict common law rule has been modified in various ways in most jurisdictions by courts and statutes. For example, courts have held that a gift by will or inter vivos transfer of real property to a nonprofit association is not effective to vest title in the nonprofit association but is effective to vest title in the officers of the association to hold as trustees for the members



of the association. *Matter of Anderson's Estate*, 571 P. 2d 880 (Okla. App. 1977).

A New York statute specifies that a grant by will of real or personal property to an unincorporated association is effective if within three years after probate of the will the association incorporates. McKinney's N.Y. Estates, Powers, & Trust Law, § 3-1.3 (1981).

As is the case with many of the problems created by the view that an unincorporated association is not an entity, the statutory solutions are often partial – limited to special circumstances and associations. Subsection (a) solves this problem for all nonprofit associations, for all kinds of transactions, and for both real and personal property.

Section 7-130 deals with attempted transfers of real and personal property to a nonprofit association that were made before the effective date of this article where under the current law title did not vest in the nonprofit association.

**Subsection (b)** – Subsection (b) is a necessary corollary of subsection (a) and, thus, it may be unnecessary. However, several states currently have statutes which expressly provide that an unincorporated, nonprofit association may be a legatee, devisee, or beneficiary. *See*, for example, Md. Estates & Trusts Code Ann. § 4-301 (1991). Therefore, it is desirable to continue this as an express rule. Subsection (b) applies to both trusts and contracts. Not all existing state statutes apply expressly to both.

#### **SECTION 7-107. STATEMENT OF AUTHORITY AS TO REAL PROPERTY.**

(a) In this section, “statement of authority” means a statement authorizing a person to transfer an interest in real property held in the name of an unincorporated nonprofit association.

(b) An interest in real property held in the name of an unincorporated nonprofit association may be transferred by a person authorized to do so in a statement of authority [filed] [recorded] by the association in the office in the [county] in which a transfer of the property would be [filed] [recorded].

(c) A statement of authority must state:

- (1) the name of the unincorporated nonprofit association;
- (2) the address in this state, including the street address, if any, of the association or, if the association does not have an address in this state, its out-of-state address;
- (3) that the association is an unincorporated nonprofit association; and

(4) the name, title, or position of a person authorized to transfer an interest in real property held in the name of the association.

(d) A statement of authority must be executed in the same manner as [a deed] [an affidavit] by a person other than the person authorized in the statement to transfer the interest.

(e) A filing officer may collect a fee for [filing] [recording] a statement of authority in the amount authorized for [filing] [recording] a transfer of real property.

(f) A record amending, revoking, or canceling a statement of authority or stating that the statement is unauthorized or erroneous must meet the requirements for executing and [filing] [recording] an original statement.

(g) Unless canceled earlier, a [filed] [recorded] statement of authority and its most recent amendment expire [five] years after the date of the most recent [filing] [recording].

(h) If the record title to real property is in the name of an unincorporated nonprofit association and the statement of authority is [filed] [recorded] in the office of the [county] in which a transfer of the property would be [filed] [recorded], the authority of the person named under subsection (c)(4) is conclusive in favor of a person that gives value without notice that the person lacks authority.

### **Comment**

This section is based on Section 3-303 (general partnerships).

A statement of authority need not be filed to conclude an acquisition of or to hold real property. It is concerned only with the sale, lease, encumbrance, and other transfer of an estate or interest in real property. For this, it should, but need not, be filed. The filing, however, provides important documentation. As a general rule a statement of authority will only be filed at the time of a conveyance of an interest in real estate as a means of establishing in the title records who has authority to execute a deed or other instrument conveying an interest in real estate.

Inasmuch as the statement relates to the authority of a person to act for the association in transferring real property, subsection (b) requires that the statement be filed or recorded in the

office where a transfer of the real property would be filed or recorded. This is usually the county in which the real estate is situated. This is where a title search concerning the real estate would be conducted. Section 3-303 also provides for central filing, such as with the Secretary of State, but its statement of partnership authority concerns authority of partners generally, not just with respect to real estate.

“Filed” and “recorded” are bracketed to direct an enacting state to choose. In most jurisdictions “recorded” will be the appropriate choice.

**Subsection (c)(2)** – Subsection (c)(2) may present a problem for small, ad-hoc nonprofit associations. They may have no fixed office address. They may meet in the homes of their leaders. However, if they distribute literature or file petitions they are likely to have a mailing address of some kind, *e.g.*, the mailing address of a member or manager.

**Subsection (c)(3)** – Subsection (c)(3) informs those relying on the statement of the precise character of the organization. Knowing that the organization is an unincorporated nonprofit association may cause the person dealing with the organization to act differently.

**Subsection (c)(4)** – Subsection (c)(4) permits the statement to identify as the person who can act for the association someone who holds a particular office, such as president. This designation relieves the association from the need to make additional filings on each change of officers. Under local title standards and practices, the transferee and filing or recording office are likely to require a certificate of incumbency if the statement designates the holder of an office.

**Subsection (d)** – Subsection (d) is designed to reduce the risk of fraud and to reflect law and practice applicable to other organizations. It requires someone other than the person authorized to deal with the real property to execute the statement of authority on behalf of the nonprofit association. Whether the formalities of execution must conform to those of a deed or an affidavit is left for each state to determine.

**Subsection (g)** – Subsection (g) makes a statement inoperative five years after its most recent recording or filing. A new statement of authority can be filed before or after the expiration of the five year limitation.

**Subsection (h)** – The purpose of subsection (h) is to protect good faith purchasers for value without notice who rely on the statement, including those who acquire a security interest in the real property. If the required signatures on the statement, deed, or both are forgeries, the effect of them is not governed by Section 7-107(h). Instead, Section 7-103 applies and would invoke the other law of the state. In many states the deed would be a nullity. *See Boyer, Hovenkamp, and Kurtz, THE LAW OF PROPERTY, An Introductory Survey* (West Pub. Co. 4th ed. 1991).

## **SECTION 7-108. LIABILITY.**

(a) A debt, obligation, or other liability of an unincorporated nonprofit association is solely the debt, obligation, or other liability of the association. 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 association solely by reason of being or acting as a member or manager. This subsection applies regardless of the dissolution of the association.

(b) A person's status as a member or manager does not prevent or restrict law other than this [article] from imposing liability on the person or the association because of the person's conduct.

(c) The failure of an unincorporated nonprofit association to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager of the association for a debt, obligation, or other liability of the association.

### **Comment**

The effect of Section 7-108 is to provide members and managers of a nonprofit association with the same protection against vicarious liability for the debts and obligations of the nonprofit association and tort liability imposed on the nonprofit association as the members and managers of a nonprofit corporation would have under the enacting jurisdiction's laws. These principles, taken together, constitute what is known as the limited liability doctrine under which a member or manager is personally liable for his or her own tortious conduct under all circumstances and is personally liable for contract liabilities incurred on behalf of the nonprofit association if the member or manager guarantees or otherwise assumes personal liability for the contract or fails to disclose that he or she is acting as the agent for the nonprofit association. A member or manager is not otherwise personally liable for the tort or contract liabilities imposed upon the nonprofit association. A creditor with a judgment against the nonprofit association must seek to satisfy the judgment out of the nonprofit association's assets but cannot levy execution against the assets of a member or manager.

The one exception is the alter ego doctrine (also known as the veil piercing doctrine). Courts have pierced the corporate veil of nonprofit corporations. *See Comment, Piercing the Nonprofit Corporate Veil*, 66 Marq. L. Rev. 134 (1984); *Macaluso v. Jenkins*, 95 Ill.App.3d 461, 420 N.E.2d 251 (1981) (President of nonprofit corporation who commingled funds of the

nonprofit corporation with funds of a corporation he controlled held personally liable for unpaid debts of the nonprofit corporation under the veil piercing doctrine). In that connection, disregard for corporate formalities is often cited as a key factor in corporate veil piercing cases. That factor is inappropriate with respect to nonprofit associations because informality of organization and operation is both common and desired. This concept is encapsulated in subsection (c). The fact that members of nonprofit corporations for the most part do not have an expectation of financial gain, as compared to shareholders of a for-profit corporation, should mean that there will be fewer types of cases than those involving for-profit corporations where the veil piercing doctrine will be held to be applicable to nonprofit corporations. The same criteria that are applied to pierce the veil of nonprofit corporations should be applied in nonprofit association veil piercing cases.

If the alter ego doctrine is found to be applicable, the separate entity status of a nonprofit association would be disregarded and the assets of the nonprofit association and its members and managers would be aggregated and subject to a nonprofit association creditor's claims in the same manner that a judgment creditor collects a judgment against the assets of a general partner in a general partnership.

In recent years all states have enacted laws providing unpaid officers, board members, and other volunteers some protection from liability for their own negligence (but generally not for conduct that is determined to constitute gross negligence or willful or reckless misconduct). The statutes vary greatly as to who is covered, for what conduct protection is given, and the conditions imposed for the freedom from liability. Some apply only to nonprofit corporations. *State Liability Laws for Charitable Organizations and Volunteers* (Nonprofit Risk Management & Insurance Institute, 1990); *Developments, Nonprofit Corporations*, 105 Harv. L. Rev. 1578, 1685-1696 (1992). This means that members and volunteers involved with unincorporated nonprofit associations do not obtain protection under those state statutes. Others may cover the managers of nonprofit associations but only if the nonprofit association qualifies as a tax-exempt entity under federal or state law. See N.Y. Not For Profit Corporation Law §§ 720-a and 721 (federal income tax); Minn. Stat. Ann. § 317A.257 (state income tax). Some states have statutes that premise the insulation of liability upon the organizations having specified amounts of liability insurance.

In 1997 Congress enacted the Volunteer Protection Act, 42 U.S.C. §§ 14501-14505. This statute, which preempts state laws to the extent of any inconsistency with the Volunteer Protection Act except to the extent the state law provides additional protections from liability, insulates directors, officers, trustees, and direct service volunteers of nonprofit organizations who receive no compensation (other than reasonable reimbursement of expenses) from liability for harm that "was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious or flagrant indifference to the rights or safety of the individual harmed by the volunteer." 42 U.S.C. § 14503(a)(3). Damages caused by operation of "a motor vehicle, vessel, aircraft, or other vehicle" for which a license or insurance is required to be maintained, are not covered. 42 U.S.C. § 14503(4).

The interplay between the Federal Volunteer Protection Act and the existing state statutes that provide liability protection to volunteers of nonprofit associations is a complex matter and

must be determined on a state-by-state basis. *See* subsection (b).

Finally, the liability of the managers of a nonprofit association for breach of the duties of due care, good faith, and loyalty to the nonprofit association and the ability of the governing principles of a nonprofit association to limit or eliminate this liability as far as monetary damages are concerned is a separate subject which is dealt with in Section 7-122.

“Solely” as used in Section 7-108 is intended to make it clear that a member or manager is not vicariously liable for the liabilities of the nonprofit association or the liabilities of another member or manager merely because of that person’s status as a member or manager. A member or manager may, however, have personal liability as a result of his or her own actions. A member or manager will be personally liable, for example, for his or her own tortious acts, or for breach of a contract binding on the nonprofit association which the member or manager is a party to or has guaranteed. This personal liability is imposed by other law (*see* Section 7-108(b) and Section 7-103(c)) and not because of his or her status as a member or manager.

#### **SECTION 7-109. ASSERTION AND DEFENSE OF CLAIMS.**

(a) An unincorporated nonprofit association may sue or be sued in its own name.

(b) A member or manager may assert a claim the member or manager has against the unincorporated nonprofit association. An association may assert a claim it has against a member or manager.

#### **Comment**

**Subsection (a)** – Under traditional common law doctrine, a nonprofit association was considered to be an aggregate of members and therefore it could not sue or be sued in its own name. Only the members could sue or be sued and some state court cases held that all of the members had to be named plaintiffs in a suit brought on behalf of the nonprofit association and that all the members had to be named and served with the summons and complaint in a suit against a nonprofit association. Most states have enacted statutes in recent years granting a nonprofit association entity status for the purpose of suits by and against the nonprofit association. Section 7-109 follows the modern rule and is consistent with the concept built into this article that a nonprofit association is a separate entity for many more purposes than existed under traditional common law principles.

This section is intended to apply to all types of judicial, administrative, and governmental proceedings and all types of alternative dispute resolution proceedings such as arbitration and mediation. An enacting state may want to modify this section to make it clear that this is the case if that is not clear under its current civil procedure law.

The enacting state’s general civil procedure law will be applicable to nonprofit associations. *See* Section 7-103(c). These statutes and court rules will deal with issues such as

standing of a nonprofit association to sue on behalf of its members, joinder, counterclaims, and the like. Most will also cover issues such as pleadings, service of pleadings, and venue. That is why Sections 7-111 and 7-113 are bracketed and should not be enacted in a state if the existing statutes and court rules are sufficient. Sections 7-109, 7-110, and 7-112 should be enacted as part of this article, however, because there is a body of inconsistent case law or gaps in the existing statutes or rules on the issues dealt with in these sections.

**Subsection (b)** – Subsection (b) is another aspect of a nonprofit association under this article being a separate legal entity. Under the common law aggregate theory, since a nonprofit association was not an entity separate from its members, a member could not assert a claim against the nonprofit association since there is technically no legal entity, and the member would be both a claimant and the defendant and personally liable for any judgment obtained in the action. For the same reason, a nonprofit association could not assert a claim against a member (*e.g.*, for unpaid dues) because the nonprofit association technically does not exist. This subsection only allows a member to assert that member’s claim against the nonprofit association. It does not authorize a member to file a derivative action. The enacting jurisdiction’s civil procedure law may, however, authorize derivative actions.

**SECTION 7-110. EFFECT OF JUDGMENT OR ORDER.** A judgment or order against an unincorporated nonprofit association is not by itself a judgment or order against a member or manager.

### **Comment**

This section is consistent with RESTATEMENT (SECOND) OF JUDGMENTS, § 61(2), which provides: “If under applicable law an unincorporated association is treated as a jural entity distinct from its members, a judgment for or against the association has the same effects with respect to the association and its members as a judgment for or against a corporation . . . .”

Section 7-110 applies not only to judgments but also to orders, such as an award rendered in arbitration or an injunction.

This section reverses the common law rule. Under the common law’s aggregate view of an unincorporated association, members, as co-principals, were individually liable for obligations of the association.

That a judgment against a nonprofit association is not also a judgment against one authorized to manage the affairs of the nonprofit association recognizes fully the entity status of a nonprofit association. An obvious corollary of this section is that a judgment against a nonprofit association may not be satisfied against a member unless there is also a judgment against the member. The one exception to this rule would be an injunction issued against a nonprofit association. Federal Rule of Civil Procedure 65(d) provides that every injunction and restraining order is binding not only on the named parties but also on “the parties’ officers, agents, servants, employees, and attorneys . . . who receive actual notice of it by personal notice

or otherwise.”

**[SECTION 7-111. SERVICE OF PROCESS.** In an action or proceeding against an unincorporated nonprofit association, process may be served on an agent authorized by appointment to receive service of process, on a manager of the association, or in any other manner authorized by the law of this state.]

#### **Comment**

Some states have expressly addressed service of process on a nonprofit association in court rules or by statute. Those states may wish to continue their rules and so should not adopt this section. For this reason this section is bracketed.

By rule or statute all jurisdictions have extensive law on service of process. The real question for nonprofit associations is which set of these rules should apply. This article treats a nonprofit association as a legal entity. Thus, the rules applicable to another legal entity, a corporation, seem most appropriate.

“Manager” is a defined term. See Section 7-102(3). Service on a member of a nonprofit association (also a defined term – see Section 7-102(4)) would not be effective under this section unless the member was also a manager of the nonprofit association.

**SECTION 7-112. ACTION OR PROCEEDING NOT ABATED BY CHANGE.** An action or proceeding against an unincorporated nonprofit association does not abate merely because of a change in its members or managers.

#### **Comment**

This provision reverses the common law rule of partnerships, which courts often extended to unincorporated nonprofit associations. Uniform Partnership Act (1914) §§ 29 and 31(4). This article’s entity approach requires this change to the old common law rule. *See* Uniform Partnership Act (1997) (Last Amended 2013) §§ 603(a), 701, and 801.

**[SECTION 7-113. VENUE.** Unless otherwise provided by law other than this [article], venue of an action against an unincorporated nonprofit association brought in this state is determined under the statutes applicable to an action brought in this state against a corporation.]



### Comment

This section is bracketed because many states have already satisfactorily solved this issue. A criterion used by all states for fixing venue is the county of residence of the defendant. If an aggregate view of a nonprofit association were taken, the association is resident in any county in which a member resides. *See* Wright, Miller, & Cooper, 15 FEDERAL PROCEDURE & PRACTICE 3812 (1986). Conforming to the entity view of an association, Section 7-113 rejects the common law view. Many states have by statute modified the common law rule. Illinois, for example, provides that “a voluntary unincorporated association sued in its own name is a resident of any county in which it has an office or if on due inquiry no office can be found, in which any officer resides.” Ill. Code Civ. Prac. § 2-102(c). In many cases, however, a nonprofit association will not have an office or an officer in the state.

Most states specify as many as eight additional grounds for venue, including the county in which the real estate that is the subject of the suit is situated and the county in which the act causing, in whole or in part, the personal injury or other tort occurred. None of these additional criteria present a special problem with respect to an unincorporated nonprofit association.

**SECTION 7-114. MEMBER NOT AGENT.** A member is not an agent of the association solely by reason of being a member.

### Comment

The purpose of this section is to make it clear that a person’s status as a member does not by itself make that person an agent of the nonprofit association. This is contrary to partnership law where the general partners are considered to be general agents of the partnership and can bind the partnership for acts in the ordinary course of business. Agency and the power to bind in a nonprofit association are determined under the enacting state’s agency law. *See* Section 7-103(c). Under agency law the managers of a nonprofit association would in most cases be considered as having apparent authority to bind the nonprofit association for acts in the ordinary course of the nonprofit association’s business. Therefore a member who is also a manager would be considered to be an agent of the nonprofit association but this is because that person is a manager as well as a member of the nonprofit association, and therefore the agency authority is not “solely by reason of being a member.” Under agency law, a member might have actual authority to bind the nonprofit association or might have apparent authority to bind the nonprofit association because of the member’s established course of dealing with third parties or under an estoppel theory. Again, the member’s agency authority to bind is not solely because of the member’s status as a member.

A nonprofit association might be directly or vicariously liable for actions of a member under general law other than agency law. For example, under the doctrine of respondeat superior, a nonprofit association might be liable for the tortious conduct of a member who is found to be acting as a servant of the nonprofit association at the time of the tortious conduct or for negligently supervising a member who is acting on behalf of the nonprofit association. *See* Section 7-108.

## **SECTION 7-115. APPROVAL BY MEMBERS.**

(a) Except as otherwise provided in the governing principles, an unincorporated nonprofit association must have the approval of its members to:

- (1) admit, suspend, dismiss, or expel a member;
- (2) select or dismiss a manager;
- (3) adopt, amend, or repeal the governing principles;
- (4) sell, lease, exchange, or otherwise dispose of all, or substantially all, of the association's property, with or without the association's goodwill, outside the ordinary course of its activities;
- (5) dissolve under Section 7-127(a)(2) or merge under Section 7-129;
- (6) approve a transaction under [Article] 2;
- (7) undertake any other act outside the ordinary course of the association's activities; or
- (8) determine the policy and purposes of the association.

(b) An unincorporated nonprofit association must have the approval of the members to do any other act or exercise a right that the governing principles require to be approved by members.

### **Comment**

Sections 7-115 through 7-126 deal with governance issues and are often referred to as internal affairs rules. They establish the rules governing the relation of the members and managers to each other and to the nonprofit association. Many but not all of these provisions are default rules that can be varied by the nonprofit association's governing principles. Liability to third parties is covered by other provisions of this article. *See* Section 7-108. The internal affairs rules in Sections 7-115 through 7-126 apply to nonprofit associations formed in the enacting state. The internal rules of nonprofit associations formed in other jurisdictions are determined under Section 7-104(b).

## **SECTION 7-116. MEMBER MEETINGS; PROCEDURAL REQUIREMENTS.**

(a) Unless the governing principles provide otherwise:

(1) approval of a matter by the members requires the affirmative vote of at least a majority of the votes cast at a meeting of members; and

(2) each member is entitled to one vote on each matter that is submitted for approval by the members.

(b) The governing principles may provide for the:

(1) calling, location, and timing of member meetings;

(2) notice and quorum requirements for member meetings;

(3) conduct of member meetings;

(4) taking of action by the members by consent without a meeting or casting ballots; and

(5) participation by members in a member meeting by telephone or other means of electronic communication.

(c) If the governing principles do not provide for a matter described in subsection (b), customary usages and principles of parliamentary law and procedure apply.

### **Comment**

**Subsection (a)** – The principles set forth in subsection (a) – members vote on a per capita basis, notice of meetings and majority vote for approval actions – are all default rules. They apply unless there are different rules in the nonprofit association’s governing principles. Thus, if a nonprofit association’s bylaws specified that only some members have voting rights, then only those so designated would have voting rights. Similarly, if the bylaws specified that all members are entitled to vote on specific actions (*e.g.*, election of a board of directors), but a subset of members is the approving authority for all other matters, the bylaws would trump the default rules. In addition, bylaw provisions that provided for a higher (or lower) voting percentage rather than the majority vote required by the statutory default rule would control.

An enacting state may decide to require supermajority voting (*e.g.*, two-thirds majority) for transactions that are not in the ordinary course of business such as dissolution, merger, or

amendment of the nonprofit association's governing principles. The default voting requirements for similar transactions under the enacting jurisdiction's nonprofit corporation law might be an appropriate model for structuring the voting requirements for a nonprofit association. Because it is often quite difficult to locate and to get a majority of all members together for voting purposes in a nonprofit association, the requirement of a supermajority vote for any issue may not be appropriate.

There is one limitation on the authority to modify member approval rights. A nonprofit association must always have at least two members. *See* Section 7-102(5). Therefore, the governing principles cannot specify that a nonprofit association have one or no members.

**Subsection (b)** – Subsection (b) contains a non-exclusive list of member meeting procedural requirements that can be included in a nonprofit association's governing principles. A nonprofit association will undoubtedly have some kind of notice and quorum requirements and meeting procedures in its governing principles, which include its established practices. If it does not have any such requirements (*e.g.*, it is newly formed and is holding its initial meeting), it can create them at that meeting, using as a reference customary usages and principles of parliamentary law and procedures (*see* subsection (c)), and these requirements, even if oral, become over time the nonprofit association's established practices and therefore part of the nonprofit association's governing principles. If the appropriate notice has been given and a quorum is present, the member meeting would be properly called and convened under subsection (a)(1).

## **SECTION 7-117. DUTIES OF MEMBER.**

(a) A member does not have any fiduciary duty to an unincorporated nonprofit association or to another member solely by reason of being a member.

(b) A member shall discharge the duties to the unincorporated nonprofit association and the other members and exercise any rights under this [article] consistent with the governing principles and the contractual obligation of good faith and fair dealing.

### **Comment**

**Subsection (a)** – Members of a nonprofit association, like members of a limited liability company in a manager managed LLC (*see* Section 5-409(i)(6)) and limited partners in a limited partnership (*see* Section 4-305(b)), do not have fiduciary duties (generally defined as a duty of loyalty and good faith) to the nonprofit association or the other members by virtue of their status as members. A member who undertakes managerial duties, however, would have the fiduciary duties of a manager (*see* Section 7-122).

**Subsection (b)** – While they have no fiduciary duties, members do have the obligation stated in subsection (b) to discharge any duties and any rights they exercise pursuant to this

article or pursuant to the nonprofit association's governing principles consistent with the obligation of good faith and fair dealing. A member cannot, for example, disclose confidential information obtained from the nonprofit association to third parties. The obligation of good faith and fair dealing is not strictly speaking a fiduciary duty but rather is a duty that is derived from the consensual or contract nature of a nonprofit association. *See* RESTATEMENT (SECOND) OF CONTRACTS (1981) § 205. The duty of good faith and fair dealing of a member in a nonprofit association cannot be altered or varied. In this respect, it differs from the similar rule in partnerships and limited liability companies. *See* Sections 3-105(c)(6) and 3-409(d) (general partnerships) and 5-105(c)(6) and 5-409(d) (limited liability companies).

#### **SECTION 7-118. ADMISSION, SUSPENSION, DISMISSAL, OR EXPULSION OF MEMBERS.**

(a) A person becomes a member and may be suspended, dismissed, or expelled in accordance with the governing principles of the unincorporated nonprofit association. If there are no applicable governing principles, a person may become a member or be suspended, dismissed, or expelled from an association only by a vote of its members. A person may not be admitted as a member without the person's consent.

(b) Unless the governing principles provide otherwise, the suspension, dismissal, or expulsion of a member does not relieve the member from any unpaid capital contribution, dues, assessments, fees, or other obligation incurred or commitment made by the member before the suspension, dismissal, or expulsion.

#### **Comment**

Section 7-118 sets forth the default rules for admission, suspension, dismissal, or expulsion of members as a majority vote of members. If the nonprofit association's governing principles provide otherwise, the governing principles would be applicable.

Subsection (b) makes it clear that suspension, dismissal, or expulsion do not relieve a member of any obligations it owes the nonprofit association.

#### **SECTION 7-119. MEMBER'S RESIGNATION.**

(a) A member may resign as a member in accordance with the governing principles. In the absence of applicable governing principles, a member may resign at any time.

(b) Unless the governing principles provide otherwise, resignation of a member does not relieve the member from any unpaid capital contribution, dues, assessments, fees, or other obligation incurred or commitment made by the member before resignation.

#### **Comment**

Preventing a member from voluntarily withdrawing from a nonprofit association would be unconstitutional and void on public policy grounds. A nonprofit association should, however, be able to impose reasonable restrictions on withdrawal, for example, requiring 30 days' advance notice. Moreover, as subsection (b) states, a member who resigns remains liable for obligations and commitments made before the resignation.

**SECTION 7-120. MEMBERSHIP INTEREST NOT TRANSFERABLE.** Except as otherwise provided in the governing principles, a member's interest or any right under the governing principles is not transferable.

#### **Comment**

This is a basic common sense rule. A member of a church that is a nonprofit association, for example, should not be able to transfer his or her membership to a third party. There may be situations where a nonprofit association might be willing to allow transfers. In those situations, the transfer could be made in accordance with the nonprofit association's governing principles. Condominium homeowners association bylaws, for example, frequently authorize automatic transfer of membership in the association upon transfer of title in the condominium.

**SECTION 7-121. SELECTION OF MANAGERS; MANAGEMENT RIGHTS OF MANAGERS.** Except as otherwise provided in this [article] or the governing principles:

- (1) only the members may select a manager or managers;
- (2) a manager may be a member or a nonmember;
- (3) if a manager is not selected, all members are managers;
- (4) each manager has equal rights in the management and conduct of the activities of the unincorporated nonprofit association;
- (5) all matters relating to the association's activities are decided by its managers except for matters reserved for approval by members in Section 7-115; and

(6) a difference among managers is decided by a majority of the managers.

### **Comment**

“Manager” is a defined term. See Section 7-102(3).

The default rule is all members are managers. In nonprofit associations such as churches with large numbers of members, this default rule will rarely be applicable because the governing principles will in most situations provide a selection process for managers.

Paragraphs (4) (each manager has equal management rights), (5) (managers manage the nonprofit association’s activities), and (6) (differences among the managers are resolved by majority vote) are consistent with the rights of general partners in a partnership and the managers of a limited liability company. See Section 3-401 (general partnerships) and 5-407 (limited liability companies).

The rules in this section are default rules that can be varied by a nonprofit association’s governing principles. The intent is to allow maximum flexibility. The nonprofit association’s governing principles can provide for any type of managerial structure the nonprofit association wants to have. Choices range from a traditional board of directors or board of trustees, to third parties who manage the nonprofit association under a contract. The managerial responsibilities can be split between the various managers (*e.g.*, one manager in charge of finances, another in charge of programs). Members who are also managers will have a dual status and their duties and liabilities will be based on the capacity in which they are acting at the time an action (or omission) takes place.

### **SECTION 7-122. DUTIES OF MANAGERS.**

(a) A manager owes to the unincorporated nonprofit association and to its members the duties of loyalty and care.

(b) A manager shall manage the unincorporated nonprofit association in good faith, in a manner the manager reasonably believes to be in the best interests of the association, and with such care, including reasonable inquiry, as a prudent person would reasonably exercise in a similar position and under similar circumstances. A manager may rely in good faith on any opinion, report, statement, or other information provided by another person that the manager reasonably believes is a competent and reliable source for the information.

(c) After full disclosure of all material facts, a specific act or transaction that would

otherwise violate the fiduciary duty of loyalty by a manager may be authorized or ratified by a majority of the members that are not interested directly or indirectly in the act or transaction.

(d) A manager that makes a business judgment in good faith satisfies the duties specified in subsection (a) if the manager:

(1) is not interested, directly or indirectly, in the subject of the business judgment and is otherwise able to exercise independent judgment;

(2) is informed with respect to the subject of the business judgment to the extent the manager reasonably believes to be appropriate under the circumstances; and

(3) believes that the business judgment is in the best interests of the unincorporated nonprofit association and in accordance with its purposes.

(e) The governing principles in a record may limit or eliminate the liability of a manager to the unincorporated nonprofit association or its members for damages for any action taken, or for failure to take any action, as a manager, except liability for:

(1) the amount of financial benefit improperly received by a manager;

(2) an intentional infliction of harm on the association or one or more of its members;

(3) an intentional violation of criminal law;

(4) breach of the fiduciary duty of loyalty; or

(5) improper distributions.

### **Comment**

This section deals with what are generally referred to as fiduciary duties. Only individuals exercising managerial authority in a nonprofit association have fiduciary duties. This is consistent with U.S. business entity laws. See, e.g., Section 5-409 (limited liability companies) and Model Business Corporation Act §§ 8.30 and 8.31. Thus, members of a nonprofit association do not have any fiduciary duties to the other members or to the managers or to the nonprofit association, unless the member is also a manager. See Section 7-117. In this



event that member, in his or her capacity as a manager, would have the fiduciary duties that the other managers of the nonprofit association have.

The fundamental fiduciary duty is loyalty. The duty of care is often, but not always, characterized as a fiduciary duty. Compare Section 3-404(a) with Section 3-409(a)-(c). Good faith is sometimes characterized as a fiduciary duty but with respect to unincorporated business entities is designated as a contract based obligation. *See, e.g.*, Section 5-409(d) (limited liability companies).

**Subsection (b)** – Subsection (b) describes how a manager exercises care and good faith in making decisions. Subsection (d) describes what is known as the business judgment rule, which in effect is a defense to a breach of care claim.

**Subsection (c)** – Under subsection (c) a potential breach of loyalty claim (*e.g.*, conflict of interest transaction or appropriation of something that falls within what is commonly called the “corporate opportunity” or “enterprise opportunity” doctrine or engaging in competing activities) can be avoided by advance approval or ratification after full disclosure of the facts. Note also that under subsection (d)(1) having a conflict of interest precludes the application of the business judgment rule.

**Subsection (e)** – Subsection (e) states that the governing principles of a nonprofit association can limit or eliminate the monetary liability of a manager who is found to have breached a fiduciary duty except for the five exceptions listed in the subsection. Even if the manager is exempt from monetary damages, he or she could still be bound by an injunction or other equitable remedy granted by a court. This limitation, unlike most governing principles, must be in a record, which means that it must be in some kind of writing.

This section only deals with the liability of a nonprofit association manager to the nonprofit association and its members. Liability of a manager to third parties is dealt with in other sections of this article. *See* Section 7-108 and the comment to Section 7-108 dealing with limitations on liability to third parties under state and federal volunteer protection acts.

## **SECTION 7-123. PROCEDURAL REQUIREMENTS FOR MANAGER MEETINGS.**

(a) The governing principles may provide for the:

- (1) calling, location, and timing of manager meetings;
- (2) notice and quorum requirements for manager meetings;
- (3) conduct of manager meetings;
- (4) taking of action by the managers by consent without a meeting; and

(5) participation by managers in a manager meeting by telephone or other means of electronic communication.

(b) If the governing principles do not provide for a matter described in subsection (a), customary usages and principles of parliamentary law and procedure apply.

### **Comment**

Subsection (a) – Subsection (a) contains a non-exclusive list of manager meeting procedural requirements that can be included in the governing principles of a nonprofit association. A nonprofit association will undoubtedly have some kind of notice and meeting procedures in its governing principles which include its established practices. If a nonprofit association does not have any such requirements (e.g., it is newly formed and is holding its initial meeting), it can create them at that meeting using as references customary usages and principles of parliamentary law and procedures (see subsection (b). and those requirements, even if oral, become the established practices and therefore part of the nonprofit association's governing principles.

The use of proxies in manager meetings will be determined by other applicable law. *See* Section 7-103(c). As a general rule, directors or other persons performing managerial responsibilities may, consistent with a nonprofit association's governing principles, delegate one or more duties to another person, but they are not authorized to give another person a proxy to vote on a matter.

### **SECTION 7-124. RIGHT OF MEMBER OR MANAGER TO INFORMATION.**

(a) On reasonable notice, a member or manager of an unincorporated nonprofit association may inspect and copy during the association's regular operating hours, at a reasonable location specified by the association, any record maintained by the association regarding its activities, financial condition, and other circumstances, to the extent the information is material to the member's or manager's rights and duties under the governing principles.

(b) An unincorporated nonprofit association may impose reasonable restrictions on access to and use of information to be furnished under this section, including designating the information confidential and imposing obligations of nondisclosure and safeguarding on the recipient.

(c) An unincorporated nonprofit association may charge a person that makes a demand under this section reasonable copying costs, limited to the costs of labor and materials.

(d) A former member or manager is entitled to information to which the member or manager was entitled while a member or manager if the information pertains to the period during which the person was a member or manager, the former member or manager seeks the information in good faith, and the former member or manager satisfies subsections (a) through (c).

### **Comment**

This article does not require a nonprofit association to keep any books and records, but if it does have them, they must be made available to the members and managers pursuant to this section. The term books and records is intended to cover all types and forms of data, including electronic data. An enacting jurisdiction may want to include a definition of books and records in this article if there is any uncertainty about what is included in this term in the state's existing laws.

## **SECTION 7-125. DISTRIBUTIONS PROHIBITED; COMPENSATION AND OTHER PERMITTED PAYMENTS.**

(a) Except as otherwise provided in subsection (b), an unincorporated nonprofit association may not pay dividends or make distributions to a member or manager.

(b) An unincorporated nonprofit association may:

(1) pay reasonable compensation or reimburse reasonable expenses to a member or manager for services rendered;

(2) confer benefits on a member or manager in conformity with its nonprofit purposes;

(3) repurchase a membership and repay a capital contribution made by a member to the extent authorized by its governing principles; or

(4) make distributions of property to members upon winding up and termination

to the extent permitted by Section 7-128.

### **Comment**

A distribution by a nonprofit association to members in violation of this section would disqualify it from continuing to be a nonprofit association. See Section 7-102(5).

The permitted distributions authorized by subsection (b) are derived from Sections 6.40 and 6.41 of the Model Nonprofit Corporation Act-Third Edition (2008).

An action to recover improper distributions could be brought by the nonprofit association or by a member as a derivative action, if authorized by state law. The Attorney General may also have authority under state law to bring a disgorgement action.

### **SECTION 7-126. REIMBURSEMENT; INDEMNIFICATION; ADVANCEMENT; AND INSURANCE.**

(a) Except as otherwise provided in the governing principles, an unincorporated nonprofit association shall reimburse a member or manager for authorized expenses reasonably incurred in the course of the member's or manager's activities on behalf of the association.

(b) An unincorporated nonprofit association may indemnify a member or manager for any debt, obligation, or other liability incurred in the course of the member's or manager's activities on behalf of the association if the person seeking indemnification has complied with Sections 7-117 and 7-122. Governing principles in a record may broaden or limit indemnification.

(c) If a person is made or threatened to be made a party in an action or proceeding based on that person's activities on behalf of an unincorporated nonprofit association and the person makes a request in a record to the association, a majority of the disinterested managers may approve in a record advance payment, or reimbursement, by the association, of all or a part of the reasonable expenses, including attorney's fees and costs, incurred by the person before the final disposition of the proceeding. To be entitled to an advance payment or reimbursement, the

person must state in a record that the person has a good faith belief that the criteria for indemnification in subsection (b) have been satisfied and that the person will repay the amounts advanced or reimbursed if the criteria for payment have not been satisfied. The governing principles in a record may broaden or limit the advance payments or reimbursements.

(d) An unincorporated nonprofit association may purchase and maintain insurance on behalf of a member or manager against liability asserted against or incurred by the member or manager in that capacity or arising from that status, whether or not the association has authority under this [article] to reimburse, indemnify, or advance expenses to the member or manager against the liability.

(e) The rights of reimbursement, indemnification, and advancement of expenses under this section apply to a former member or manager for an activity undertaken on behalf of the unincorporated nonprofit association while a member or manager.

### **Comment**

The rights to reimbursement of expenses (subsection (a)), indemnification (subsection (b)) and advancement of litigation expenses and attorneys' fees (subsection (c)) in business entity statutes vary greatly from jurisdiction to jurisdiction. The rights of reimbursement of expenses and indemnification in subsections (a) and (b) are similar to those found in other business entity statutes. See Section 3-401 (general partnerships and Model Nonprofit Corporation Act §§ 8.50-8.58. Many existing state business entity statutes only allow reimbursement of litigation expenses after the conclusion of the litigation and a finding of nonliability. Given the fact that most members and managers of nonprofit associations are unpaid volunteers, the advancement of litigation expenses on a discretionary basis authorized by subsection (c) seems appropriate.

The right to reimbursement under subsection (a) is mandatory, unless the governing principles otherwise provide. The right to indemnification under subsection (b) is discretionary; however, a nonprofit association in a record (*i.e.*, a writing of some kind, *see* Section 1-102(41)), can broaden (*e.g.*, make the right mandatory) or limit (*e.g.*, impose conditions beyond compliance with Sections 7-117 and 7-122) the right to indemnification. Advancement of litigation expenses under subsection (c) is also discretionary but in addition the request for an advancement, the commitment to repay the amounts advanced if the criteria for payment have not been satisfied, and the approval of an advancement must be in a record. As is the case with indemnification under subsection (b) the governing principles of the nonprofit association in a

record may broaden or further limit the advancement right. The discretionary nature of both the rights of indemnification and advancement and the record requirements for these rights are appropriate as default rules in order to focus attention on the importance of these decisions. After all many nonprofit associations have very limited financial resources and the first priority for their resources is to fulfill their nonprofit purposes.

Directors and officers insurance and errors and omissions insurance for managers of nonprofit associations is expensive but because of potential liability, directors and other managers of nonprofit associations are increasingly demanding that it be maintained on their behalf. Subsection (d) makes it clear that the purchase of such insurance is authorized.

Both current and former members and managers are eligible for these rights of reimbursement, indemnification, and advancement of expenses.

## **SECTION 7-127. DISSOLUTION.**

(a) An unincorporated nonprofit association may be dissolved as follows:

(1) if the governing principles provide a time or method for dissolution, at that time or by that method;

(2) if the governing principles do not provide a time or method for dissolution, upon approval by the members;

(3) if no member can be located and the association's operations have been discontinued for at least three years, by the managers or, if the association has no current manager, by its last manager;

(4) by court order; or

(5) under law other than this [article].

(b) After dissolution, an unincorporated nonprofit association continues in existence until its activities have been wound up and it is terminated pursuant to Section 7-128.

### **Comment**

The vote required for dissolution under subsection (a)(2) would be a majority vote of the members and under subsection (a)(3) would be a majority of the managers, unless the governing principles require a higher vote. See Sections 7-115(5) and 7-121(6).

As a general rule, a court order dissolving a nonprofit association would be appropriate if subsection (a)(1)-(3) are inapplicable. It should also be appropriate if it is impossible or impracticable to continue the nonprofit association, for example because of a deadlock or in other circumstances where the doctrine of cy pres is deemed to be applicable.

A nonprofit association that is totally inactive and has no assets is *de facto* dissolved, even though it is not *de jure* dissolved. Formal dissolution (and winding up and termination under Section 7-128) is only necessary if the nonprofit association has assets.

**SECTION 7-128. WINDING UP AND TERMINATION.** Winding up and termination of an unincorporated nonprofit association must proceed in accordance with the following rules:

- (1) All known debts and liabilities must be paid or adequately provided for.
- (2) Any property subject to a condition requiring return to the person designated by the donor must be transferred to that person.
- (3) Any property subject to a trust must be distributed in accordance with the trust agreement.
- (4) Any remaining property must be distributed as follows:
  - (A) as required by law other than this [article] that requires assets of an association to be distributed to another person with similar nonprofit purposes;
  - (B) in accordance with the association's governing principles or in the absence of applicable governing principles, to the members of the association per capita or as the members direct; or
  - (C) if neither subparagraph (A) nor (B) applies, under [cite the unclaimed property law in this state].

### **Comment**

This section sets out the rules for distribution of a nonprofit association's assets after its affairs have been wound up. It is derived from the California Unincorporated Nonprofit Association statute. See Calif. Corp. Code § 18410.

The state's statutes of limitations will determine when an action by a creditor to recover any assets distributed by a nonprofit association upon liquidation will be barred. Many business organization statutes, however, have provisions that shorten the normal statutes of limitations for known and unknown creditor claims when the organization is liquidated. See Sections 5-704 and 5-705 (limited liability companies) and Model Business Corporation Act, §§ 14.06 and 14.07.

#### **SECTION 7-129. APPOINTMENT OF REGISTERED AGENT.**

(a) An unincorporated nonprofit association may deliver to the [Secretary of State] for filing a statement appointing an agent authorized to receive service of process.

(b) A statement appointing a registered agent must state:

(1) the name of the unincorporated nonprofit association; and

(2) the name and street and mailing addresses in this state of the registered agent.

(c) A statement appointing a registered agent must be signed by a person authorized to manage the affairs of the unincorporated nonprofit association. The signing of the statement is an affirmation of fact that the person is authorized to manage the affairs of the unincorporated nonprofit association and that the agent has consented to serve.

(d) An amendment to or cancellation of a statement appointing a registered agent must meet the requirements for signing an original statement. An agent may resign by delivering a resignation to the office of the [Secretary of State] for filing and giving notice to the unincorporated nonprofit association at the address most recently supplied to the agent by the association.

(e) The [Secretary of State] may collect a fee for filing a statement appointing a registered agent, an amendment, a cancellation, or a resignation in the amount charged for filing similar documents.

(f) A statement appointing a registered agent takes effect on filing by the [Secretary of State] and is effective for five years after the date of filing unless canceled or terminated earlier.



(g) A statement appointing a registered agent may not be rejected for filing because the name of the unincorporated nonprofit association signing the statement is not distinguishable on the records of the [Secretary of State] from the name of another entity appearing in those records. The filing of such a statement does not make the name of the association signing the statement unavailable for use by another entity.

(h) The only duty under this [article] of a registered agent is to forward to the unincorporated nonprofit association at the address most recently supplied to the agent by the association any process, notice, or demand pertaining to the association which is served on or received by the agent.

### **Comment**

This section authorizes but does not require, a nonprofit association to file a statement appointing a registered agent. *Compare* Section 1-402 (domestic filing entities, domestic limited liability partnerships and registered foreign entities “shall” designate and maintain a registered agent in this state). It is, of course, not the equivalent of filing articles of incorporation. However, some nonprofit associations may find it prudent to file. Filing may assure that the nonprofit association’s management gets prompt notice of any lawsuit filed against it. Also, depending upon the jurisdiction’s other laws, filing gives some public notice of the nonprofit association’s existence and its address.

Subsection (g) has two purposes: (1) it prohibits the filing office (the Secretary of State is the filing office in most states) from refusing to file a registered agent statement by a nonprofit association on the grounds that the name of the nonprofit association conflicts with the name of another entity that has filed formation documents with the filing office; and (2) the filing of the statement by the nonprofit association does not prohibit another entity formed after the nonprofit association has filed from using the same name as the nonprofit association. Both derive from the non-mandatory nature of the appointment of a registered agent by a nonprofit association. The name of entities that are required to file formation documents with the filing office must be distinguishable on the records of the filing office from the name of other mandatory filing entities.

### **[SECTION 7-130. TRANSITION CONCERNING REAL AND PERSONAL PROPERTY.]**

(a) If, before [the effective date of this [article]], an interest in property was by terms of a

transfer purportedly transferred to an unincorporated nonprofit association but under the law of this state the interest did not vest in the association, or in one or more persons on behalf of the association under subsection (b), on [the effective date of this [article]] the interest vests in the association, unless the parties to the transfer have treated the transfer as ineffective.

(b) If, before [the effective date of this [article]], an interest in property was by terms of a transfer purportedly transferred to an unincorporated nonprofit association but the interest was vested in one or more persons to hold the interest for members of the association, on or after [the effective date of this [article]] the persons, or their successors in interest, may transfer the interest to the association in its name, or the association may require that the interest be transferred to it in its name.]

**Legislative Note:** *This is an optional section and it may not be necessary to adopt it (or any one of the subsections) in a particular state. The initial common law rule was that a purported transfer of property to an unincorporated nonprofit association totally failed as the association was not a legal entity. If a state currently has that rule, it should adopt subsection (a). If, on the other hand, its rule is that title does not pass to the association in its name but passes instead to a fiduciary, such as its officers, to hold the property for the benefit of the members, a state should adopt subsection (b).*

*If a state has by statute made transfers effective to some classes of nonprofit associations but not all, it should probably adopt both subsections (a) and (b). On the other hand, if a state has made all transfers to all unincorporated nonprofit associations effective, it does not need Section 7-130.*

### Comment

Section 7-130 brings to fruition the parties' expectations that previous law frustrated. Inasmuch as the common law did not consider a nonprofit association to be a legal entity, it could not acquire property. A gift of real or personal property thus failed. Reference to the transfer as "purportedly" made identifies the document of transfer as one not effective under the law. Subsection (a) gives effect to the gift. However, if parties were informed about the common law they may have treated the gift as ineffective. In that case, the final clause of subsection (a) provides that the gift does not become effective when this article takes effect. The unless clause would apply, for example, if the residual beneficiaries of the donor's will, knowing that the devise of Blackacre to the nonprofit association was ineffective under the law, continued to use Blackacre as their summer home with the approval and acquiescence of members and representatives of the nonprofit association.

**Subsection (a)** – Section 7-130 is not a retroactive rule. It applies to the facts existing when this article takes effect (*see* Section 1-708). At that time subsection (a) applies to a purported transfer of property that under the law of the jurisdiction could not be given effect at the time it was made. The first alternative belatedly makes it effective – when this article takes effect and not when made. The practical result is that when the purported transfer is effective, the transfer is subject to interests in the property that came into being in the interim. The nonprofit association’s interest is subject, for example, to a tax or judgment lien that became effective in the interim. An intervening transfer by the initial transferor may simply be evidence that the “parties had treated the transfer as ineffective.” If so, the purported transfer does not vest ownership in the nonprofit association.

**Subsection (b)** – Some courts gave effect to a gift of property to a nonprofit association by determining that the gift lodged title in someone, often officers of the association, to hold the property in trust for the benefit of the nonprofit association’s members. Subsection (b) addresses this situation. When this article takes effect it authorizes the fiduciary to transfer the property to the nonprofit association. If the fiduciary is unwilling or reluctant, the nonprofit association may require the fiduciary to transfer the property to the nonprofit association. In either case, the nonprofit association will get a deed transferring the property to it which, in the case of real property, the nonprofit association may record.

Jurisdictions that have a statute like New York’s concerning grants of property by will have a problem that needs special attention. The New York statute provides that a grant by will of real or personal property to an unincorporated association is effective only if the association incorporates within three years after probate of the will. McKinney’s N.Y. Estates, Powers & Trust Law § 3-1.3 (1991). The grants by will that need attention are those that have not become effective by incorporation of the association and have not become ineffective by the running of the three year period. These grants seem entitled to the benefits of Section 7-130. If so, some modification of Section 7-130 may be required.

## **ARTICLE 8**

### **STATUTORY TRUST ENTITIES**

#### **[PART] 1**

#### **GENERAL PROVISIONS**

**SECTION 8-101. SHORT TITLE.** This [article] may be cited as the Uniform Business Organizations Code – Statutory Trust Entities.

#### **Comment**

Because this article provides for the creation of a statutory trust as a form of business organization, it might seem that “Uniform Statutory Trust Act,” “Uniform Statutory Business Trust Act,” or “Uniform Business Trust Act” would be a better short title. However, after

consultation with experts in the structured finance, bankruptcy, mutual fund, and estate planning industries, the drafting committee rejected those and other such titles in favor of “Uniform Statutory Trust Entity Act.”

The drafting committee for the Uniform Statutory Trust Entity Act (2009) (“drafting committee”) included the word “Entity” in this article’s title for two reasons. First, the creature of this article is indeed an entity (*see* Section 8-302). It has the power to sue and be sued, own property, and transact in its own name (*see* Sections 8-307 and 8-308). A common-law trust, by contrast, is not a juridical entity, but rather a fiduciary relationship in which the trustee holds the trust property in a fiduciary capacity. *See* RESTATEMENT (THIRD) OF TRUSTS § 2 (2003). Second, the word “Entity” in the title differentiates this article from the Uniform Trust Code, which is a codification of the common law of trusts. *See* Uniform Trust Code Prefatory Note (2000) (Last Amended 2010).

The drafting committee had three reasons for eschewing the phrase “business trust.” First, under this article a statutory trust need not have a business or commercial purpose. On the contrary, Section 8-303 confirms that a statutory trust may have any lawful purpose other than a predominantly donative purpose.

Second, the drafting committee sought to avoid any implication regarding whether a statutory trust would qualify as a “business trust” under federal bankruptcy law. Under the bankruptcy code, the definition of a “debtor” eligible for bankruptcy includes a “person,” 11 U.S.C. § 101(13) (2014), the definition of “person” includes a “corporation,” *id.* § 101(41), and the definition of “corporation” includes a “business trust.” *Id.* § 101(9)(v). Bankruptcy eligibility is an important issue for trusts that are used as special purpose entities in structured finance transactions, a principal use of the modern statutory trust. Such trusts are often designed to be “bankruptcy remote.” As in the leading case of *In re Secured Equipment Trust of Eastern Air Lines, Inc.*, 38 F.3d 86 (2d Cir. 1994), in certain configurations trusts used in securitization transactions have been held not to be “business trusts” under the bankruptcy code.

Third, the drafting committee was influenced by the preference for “statutory trust” over “business trust” in the Delaware Statutory Trust Act. In 2002, Delaware recast the “Delaware Business Trust Act” as the “Delaware Statutory Trust Act,” replacing nearly every reference to “business trust” with “statutory trust.” *See* 73 Del. Laws 329 (2002). To conform with prevailing usage under the Delaware Statutory Trust Act, the entity that arises under this article is called a “statutory trust,” not a “statutory trust entity” (*see* Section 8-102(a)(9)).

## **SECTION 8-102. DEFINITIONS.**

(a) In this [article]:

(1) “Beneficial owner” means the owner of a beneficial interest in a statutory trust.

(2) “Certificate of trust” means the certificate required by Section 8-201. The

term includes the certificate as amended or restated.

(3) “Common-law trust” means a fiduciary relationship with respect to property arising from a manifestation of intent to create that relationship and subjecting the person that holds title to the property to duties to deal with the property for the benefit of charity or for one or more persons, at least one of which is not the sole trustee, whether the purpose of the trust is donative or commercial. The term includes the type of trust known at common law as a “business trust”, “Massachusetts trust”, or “Massachusetts business trust”.

(4) “Contribution”, except in the phrase “right of contribution”, means property or a benefit described in Section 8-604 which is provided by a person to a statutory trust to become a beneficial owner or in the person’s capacity as a beneficial owner.

(5) “Distribution” means a transfer of money or other property from a statutory trust on account of a beneficial interest. The term includes a redemption or other purchase by a statutory trust of a beneficial interest.

(6) “Governing instrument” means the trust instrument and certificate of trust.

(7) “Related party”, with respect to a party that is a trustee, officer, employee, manager, or beneficial owner, means:

(A) the spouse of the party;

(B) a child, parent, sibling, grandchild, or grandparent of the party, or the spouse of one of them;

(C) an individual having the same residence as the party;

(D) a trust or estate of which a related party described in subparagraph (A), (B), or (C) is a substantial beneficiary;

(E) a trust, estate, legally incapacitated individual, conservatee, or minor

for which the party is a fiduciary; or

(F) a person that directly or indirectly controls, is controlled by, or is under common control with, the party.

(8) “Series trust” means a statutory trust that has one or more series created under Section 8-401.

(9) “Statutory trust” means an entity formed under this [article] or that becomes subject to this [article] under Section 8-108.

(10) “Trust” includes a common-law trust, statutory trust, and foreign statutory trust.

(11) “Trust instrument” means a record other than the certificate of trust which provides for the governance of the affairs of a statutory trust and the conduct of its activities and affairs. The term includes a trust agreement, a declaration of trust, and bylaws.

(12) “Trustee” means a person designated, appointed, or elected as a trustee of a statutory trust in accordance with the governing instrument or applicable law.

(b) The following definitions outside this [article] apply to this [article]:

(1) “Foreign” – Section 1-102(14).

(2) “Jurisdiction” – Section 1-102(21).

(3) “Jurisdiction of formation” – Section 1-102(22).

(4) “Principal office” – Section 1-102(35).

(5) “Property” – Section 1-102(38).

(6) “Receipt” – Section 1-102(40).

(7) “Record” – Section 1-102(41).

(8) “Registered agent” – Section 1-102(42).

(9) “Sign” – Section 1-102(44).

(10) “State” – Section 1-102(45).

(11) “Transfer” – Section 1-102(47).

(c) The definition of “person” in 1-102(34) applies in this [article], except that the term does not include a common-law trust.

### **Comment**

Subsection (a) – This subsection contains definitions for terms used throughout this article. The principal source used by the drafting committee in fashioning definitions unique to the statutory trust form was Delaware Statutory Trust Act § 3801 (2009).

**Subsections (a)(2), (a)(6), and (a)(11)** define “certificate of trust,” “governing instrument,” and “trust instrument” respectively. A certificate of trust is the record that under Section 8-201 must be delivered to a public official for filing to form a statutory trust. A trust instrument is the transaction document that provides for the governance of the statutory trust. Unlike a certificate of trust, a trust instrument need not be made part of the public record, and typically it is not. Together, the certificate of trust and the trust instrument compose the governing instrument. The terms “governing instrument” and “trust instrument” are in the singular to conform with prevailing usage even though there may be more than one document that qualifies as a trust instrument. Section 8-103(c) makes authorization of multiple instruments explicit. Conflicts between the certificate of trust and another trust instrument are resolved under Section 8-201(e).

**Subsections (a)(3), (a)(9), and (a)(10)** define “common-law trust,” “statutory trust,” and “trust” respectively. In accordance with RESTATEMENT (THIRD) OF TRUSTS § 2 (2003), the term “common-law trust” is defined as a fiduciary relationship with respect to property, except that under this article the term expressly includes a common-law business trust. Thus, any trust that arises under the common law, whether the trust’s purpose is donative, commercial, or otherwise, is a “common-law trust” for purposes of this article. A “statutory trust” is the entity formed under this article. The term “trust” includes a common-law trust, statutory trust, and foreign statutory trust.

**Subsection (a)(7)** defines the term “related party,” which is used in Sections 8-507 and 8-607 concerning certain interested transactions. In using but not defining the term “substantial” in Paragraph (7), the drafting committee contemplated that a totality of the circumstances test would apply. Section 8-512 defines the term “independent trustee” with respect to a statutory trust that is an investment company under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 et seq. (2014).

**Subsection (a)(8)** defines the term “series trust” as a statutory trust that has one or more series under Section 8-401. The series concept is explained in the comments in Part 4.

**Subsection (a)(12)** defines “trustee” as a person designated as such in accordance with the governing instrument or applicable law. For further discussion see the comment to Section 8-501.

**Subsection (b)** – This subsection contains a list of definitions in Article 1 that are applicable to statutory trusts.

**Subsection (c)** – This subsection defines “person” in a manner that deviates from the other unincorporated entity acts. *See* Section 1-102(34). Under this article, the term includes a “statutory trust” but not a “common-law trust,” differentiating among kinds of trusts. Under the structure of this article, consistent with the definitions in Subsections (a)(3), (a)(9), and (a)(10), a statutory trust is a juridical person that may sue or be sued and hold property in the name of the trust, whereas a common-law trust is a fiduciary relationship with respect to property. In a common-law trust, the trustee sues, is sued, and holds property in the name of the trustee in the trustee’s fiduciary capacity.

### **SECTION 8-103. GOVERNING INSTRUMENT.**

(a) Except as otherwise provided in Section 8-104, the governing instrument governs:

(1) the management, affairs, and conduct of the activities and affairs of a statutory trust; and

(2) the rights, interests, duties, obligations, and powers of, and the relations among, the trustees, a person designated under subsection (e)(8) or (9), the beneficial owners, and the statutory trust.

(b) To the extent the governing instrument does not otherwise provide for a matter described in subsection (a), this [article] governs the matter.

(c) The governing instrument may include one or more instruments, agreements, declarations, bylaws, or other records and refer to or incorporate any record.

(d) The governing instrument may be amended with the approval of all the beneficial owners.

(e) Subject to Section 8-104, without limiting the terms that may be included in a governing instrument, the governing instrument may:



(1) provide the means by which beneficial ownership is determined and evidenced;

(2) limit a beneficial owner's right to transfer its beneficial interest;

(3) provide for one or more series under [Part] 4;

(4) to the extent that voting rights are granted under the governing instrument, include terms relating to:

(A) notice of the date, time, place, or purpose of any meeting at which any matter is to be voted on;

(B) waiver of notice;

(C) action by consent without a meeting;

(D) establishment of record dates;

(E) quorum requirements;

(F) voting:

(i) in person;

(ii) by proxy;

(iii) by any form of communication that creates a record, telephone, or video conference; or

(iv) in any other manner; or

(G) any other matter with respect to the exercise of the right to vote;

(5) subject to Section 8-404, provide for the creation of one or more classes of trustees, beneficial owners, or beneficial interests having separate rights, powers, or duties;

(6) subject to Section 8-404, provide for any action to be taken without the vote or approval of any particular trustee or beneficial owner, or classes of trustees, beneficial owners, or

beneficial interests, including:

(A) amendment of the governing instrument;

(B) merger, interest exchange, conversion, or domestication;

(C) appointment of trustees;

(D) sale, lease, exchange, transfer, pledge, or other disposition of all or any part of the property of the statutory trust or the property of any series thereof; and

(E) dissolution of the statutory trust;

(7) provide for the creation of a statutory trust, including the creation of a statutory trust to which all or any part of the property, liabilities, profits, or losses of a statutory trust may be transferred or exchanged, and for the conversion of beneficial interests in a statutory trust, or series thereof, into beneficial interests in the new statutory trust or series thereof;

(8) provide for the appointment, election, or engagement of agents or independent contractors of the statutory trust or delegates of the trustees, or agents, officers, employees, managers, committees, or other persons that may manage the activities and affairs of the statutory trust, designate their titles, and specify their rights, powers, and duties;

(9) provide rights to any person, including a person that is not a party to the governing instrument;

(10) subject to paragraph (11), specify the manner in which the governing instrument may be amended, including, unless waived by all persons for whose benefit the condition or requirement was intended:

(A) a condition that a person that is not a party to the instrument must approve the amendment for it to be effective; and

(B) a requirement that the governing instrument may be amended only as

provided in the governing instrument or as otherwise permitted by law;

(11) provide that a person may comply with paragraph (10) by a representative authorized by the person orally, in a record, or by conduct;

(12) provide that a person becomes a beneficial owner, acquires a beneficial interest, and is bound by the governing instrument if the person complies with the conditions for becoming a beneficial owner set forth in the governing instrument, such as payment to the statutory trust or to a previous beneficial owner;

(13) provide that the statutory trust or the trustees, acting for the statutory trust, hold beneficial ownership of any income earned on securities held by the statutory trust that are issued by any business entity formed, organized, or existing under the laws of any jurisdiction;

(14) provide for the establishment of record dates;

(15) grant to, or withhold from, a trustee or beneficial owner, or class of trustees or beneficial owners, the right to vote, separately or with any or all other trustees or beneficial owners, or class of trustees or beneficial owners, on any matter; and

(16) alter the prohibition in Section 8-615(a)(2) so that the prohibition requires only that the statutory trust's total assets not be less than the sum of its total liabilities.

### **Comment**

The principal source used by the drafting committee in fashioning this section was Delaware Statutory Trust Act § 3806 (2009).

**Default Rules.** Subsections (a) and (b) emphasize that this article primarily states default rules. Nearly all of the article's provisions may be overridden by the terms of the governing instrument, which is defined in Section 8-102(a)(6) as the trust instrument (*see* Section 8-102(a)(11)) plus the certificate of trust (*see* Section 8-201)), leaving the article to apply only if the governing instrument does not include an applicable provision. The exceptions—that is, the provisions of this article that are mandatory and not subject to override by the governing instrument—are scheduled in Section 8-104.

**Governing Instrument.** Subsection (c) confirms that the governing instrument may

span more than one document.

**Amending the Governing Instrument.** Subsection (d) states as a default rule that the governing instrument may be amended with the approval of all the beneficial owners. This rule applies only if the governing instrument does not make an alternative provision for amendment. Subsection (d) thus provides a fallback mechanism for amending the governing instrument, overriding the stricter common-law rules of trust modification that would otherwise apply pursuant to Section 8-105. Consistent with prevailing practice, the drafting committee assumed that in most instances the governing instrument will provide for amendment by means other than unanimous consent of the beneficial owners, a possibility that is expressly contemplated by subsection (e)(6)(A) and (e)(10). Unless the governing instrument provides otherwise, the default rule of unanimity stated in subsection (d) with respect to amending the governing instrument prevails over the general rule of majority vote stated in Section 8-603(1).

**Illustrative Statement of Permissive Terms.** The purpose of subsection (e) is to collect various permissive rules regarding the scope of the governing instrument in a single provision. Most are based on provisions that are scattered throughout the Delaware Statutory Trust Act. Additional permissive rules on remedies for a beneficial owner's breach are collected in Section 8-604(e).

The list of permissive rules stated in subsection (e) is meant to be illustrative and not to limit the generality of subsection (a). The drafting committee concluded that the demand of third parties and transactional planners to see language expressly authorizing a specific term justified inclusion of a detailed list. Statutory confirmation reduces transaction costs by avoiding doubt about the permissibility of a provision in the governing instrument or a proposed transaction (*compare* Uniform Trust Code (2000) (Last Amended 2010) § 816).

**SECTION 8-104. MANDATORY RULES.** The governing instrument may not:

- (1) vary any requirement, procedure, or other provision of this [article] pertaining to:
  - (A) registered agents; or
  - (B) the [Secretary of State], including provisions pertaining to records authorized or required to be delivered to the [Secretary of State] for filing under this [article];
  - (C) the application of this [article] to existing relationships under Section 8-108 or the reservation of power to amend or repeal under Section 1-701;
- (2) vary the law applicable under Sections 8-301 and 1-501;
- (3) negate the exclusion of a predominantly donative purpose under Section 8-303(b);
- (4) vary the provisions pertaining to the duration of a statutory trust under Section 8-

306(a);

(5) vary the capacity of a statutory trust under Section 8-308 to sue and be sued in its own name;

(6) vary the provisions pertaining to series trusts in Sections 8-401, 8-402(b), 8-402(c), 8-403, 8-404, and 8-405(c);

(7) vary the standards of conduct for trustees under Section 8-505, but the governing instrument may prescribe the standards by which good faith, best interests of the statutory trust, and care that a person in a similar position would reasonably believe appropriate under similar circumstances are determined, if the standards are not manifestly unreasonable;

(8) vary the obligation of a trustee or other person under Section 8-506 to act reasonably if the trustee or other person is not to be liable for relying on a term of the governing instrument, a record of the statutory trust, or an opinion, report, or statement of another person, but the governing instrument may prescribe the standards for assessing whether the reliance was reasonable, if the standards are not manifestly unreasonable;

(9) restrict the right of a trustee to information under Section 8-508, but the governing instrument may prescribe the standards for assessing whether information is reasonably related to the trustee's discharge of the trustee's duties as trustee, if the standards are not manifestly unreasonable;

(10) vary the prohibition under Section 8-509 of indemnification, advancement of expenses, or exoneration for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law;

(11) vary the obligation of a trustee under Section 8-510(c) not to follow a direction that is manifestly contrary to the terms of the governing instrument or would constitute a serious

breach of fiduciary duty by the trustee;

(12) vary the provisions pertaining to the transfer of a beneficial interest and the power of a court under Section 8-602(a), (c), and (d);

(13) restrict the right of a beneficial owner to information under Section 8-608, but the governing instrument may prescribe the standards for assessing whether information is reasonably related to the beneficial owner's interest, if the standards are not manifestly unreasonable;

(14) restrict the right of a beneficial owner to bring an action under Section 8-609 or 8-610, but the governing instrument may subject the right to additional standards and restrictions, including a requirement that beneficial owners owning a specified amount or type of beneficial interest, including in a series trust an interest in the series, join in bringing the action, if the additional standards and restrictions are not manifestly unreasonable;

(15) vary the rules under Section 8-613, if a statutory trust appoints a special litigation committee;

(16) vary the right of a beneficial owner under Section 2-203(a)(2), 2-303(a)(2), 2-403(a)(2), or 2-503(a)(2) to approve a merger, interest exchange, conversion, or domestication;

(17) vary the required contents of a plan of merger under Section 2-202(a), plan of interest exchange under Section 2-302(a), a plan of conversion under Section 2-402(a), or a plan of domestication under Section 2-502(a); or

(18) vary [Part] 7;

(19) vary [Part] 7 of [Article] 1; or

(20) restrict the rights under this [article] of a person other than a trustee, person designated under Section 8-103(e)(8) and (9), or beneficial owner.

## Comment

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009), Uniform Trust Code (2000) (Last Amended 2010) § 105, Section 5-105 (limited liability companies), and Section 4-105 (limited partnerships).

**Mandatory Rules.** This section schedules the provisions of this article that are not subject to override in the governing instrument. The provisions included in this schedule are the only rules that have mandatory application to a statutory trust.

Most of the provisions scheduled in this section concern public filing and notice requirements, the rights of nonparties, choice of law, or permissible purposes for a statutory trust (paragraphs (1)-(6), (12), and (18)-(20)). Two of the provisions, paragraphs (16) and (17), concern certain procedural safeguards in a merger, interest exchange, conversion, or domestication.

**Internal Affairs.** With three exceptions, all the provisions of this article concerning the powers and duties of a trustee, relations among trustees, and the rights and interests of a beneficial owner may be overridden or at least modified by the terms of the governing instrument.

The first exception is the mandatory prohibition of indemnification, advancement of expenses, or exoneration for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law in paragraph (10). A comparable rule, albeit expressed in a different verbal formulation, exists in the common law of trusts, *see, e.g.*, Uniform Trust Code (2000) (Last Amended 2010) § 1008; RESTATEMENT (THIRD) OF TRUSTS § 96 (2012), and applies to a statutory trust under Delaware law. *See* Delaware Statutory Trust Act § 3806(e) (2009) (providing that the “governing instrument may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a trustee ... ; provided, that a governing instrument may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing”). Limitations on permissible exoneration are also familiar corporate and alternative entity law. *See, e.g.*, Delaware General Corporation Law § 102(b)(7) (2009); Delaware Limited Liability Company Act § 18-1101(c), (e) (2009). As harmonized, the formulation used in this article is the same as in Sections 3-105 (general partnerships), 4-105 (limited partnerships), and 5-105 (limited liability companies).

The second exception is paragraph (11), which makes mandatory the invalidity under Section 8-510(c) of a direction to a trustee or other person that is manifestly contrary to the terms of the governing instrument or that would constitute a serious breach of fiduciary duty. The reference to serious breach of fiduciary duty is meant to exclude an inconsequential, immaterial, or technical breach that does not harm the trust or a beneficial owner. For some purposes, trust law distinguishes between serious and other breaches of trust. *See, e.g.*, Uniform Trust Code (2000) (Last Amended 2010) § 706(b)(1). However, the effect of paragraph (11) is limited by paragraph (7), which allows the governing instrument to modify the trustee’s fiduciary standards of conduct under Section 8-505 if the modification is not manifestly unreasonable.

The third exception is paragraph (15), which makes mandatory the rules under Section 8-613 for the use of a special litigation committee in derivative litigation. However, as recognized by paragraph (15), a statutory trust need not make use of such a committee. Accordingly, what paragraph (15) requires is that, if a statutory trust appoints a special litigation committee, the committee be subject to the rules of Section 8-613.

**“Manifestly Unreasonable.”** Paragraphs (7)-(9) and (13)-(14) allow the governing instrument to modify the provisions of this article pertaining to the trustee’s fiduciary obligation; the nonliability of a person for reasonable reliance on the governing instrument, records of the statutory trust, or the opinions of experts; the right of a trustee to information; the right of a beneficial owner to information; and the right of a beneficial owner to bring an action. However, any such modification must not be “manifestly unreasonable.” In opting for a “manifestly unreasonable” standard instead of Delaware’s “good faith and fair dealing” formulation, *see* Delaware Statutory Trust Act § 3806(c) and (e) (2009), the drafting committee took notice of the use of the term “manifestly unreasonable” in Sections 3-105, 4-105, and 5-105, and intended a similar meaning here. *See also* Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the “Manifestly Unreasonable” Standard*, 41 *Tulsa L. Rev.* 411 (2006).

**Relationship to Mandatory Rules in the Common Law of Trusts and the Uniform Trust Code.** Section 8-105 provides that the law of this state pertaining to common-law trusts supplements this article. However, that section also provides that the governing instrument may override or modify the application to the statutory trust of any rule pertaining to common-law trusts. Accordingly, in a jurisdiction that has also enacted the Uniform Trust Code, the UTC will apply to a statutory trust only to the extent that the UTC’s provisions are not displaced by this article or the governing instrument. No provision of the UTC, including the rules stated in Uniform Trust Code (2000) (Last Amended 2010) § 105 that are mandatory with respect to a common-law trust, is mandatory with respect to a statutory trust. Likewise, any common-law rule that is mandatory with respect to a common-law trust may nonetheless be overridden with respect to a statutory trust by the governing instrument of the statutory trust. The governing instrument of a statutory trust may override or modify any rule of trust law other than those scheduled in this section.

Public policy limits on donative transfers and testamentary freedom underpin various mandatory rules applicable to a common-law trust. *See* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 *Nw. U. L. Rev.* 1105 (2004). To prevent evasion of those limits by use of a statutory trust, Section 8-303(b) provides that a statutory trust may not have “a predominantly donative purpose.” For further discussion of the relationship between this article, the common law, and the Uniform Trust Code, see the comments to Sections 8-105 and 8-303.

**Registered Investment Companies.** The Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 et seq. (2014), supersedes this article with respect to a statutory trust that registers as an investment company. For such a trust, the 1940 Act imposes additional mandatory rules, for example those noted in the comments to Sections 1-302(f) (name of statutory trust); 8-503 (action by trustees); 8-507 (interested transactions); 8-509 (indemnification, advancement, and exoneration); and 8-511 (delegation by trustee). The 1940



Act may also apply to a statutory trust, superseding this article, if the trust meets the definition of an investment company under the 1940 Act but is otherwise exempt from registration.

**SECTION 8-105. APPLICABILITY OF TRUST LAW.** The law of this state pertaining to common-law trusts supplements this [article]. However, the governing instrument may supersede or modify application to the statutory trust of any law of this state pertaining to common-law trusts.

### **Comment**

**Trust Law Supplements This Article.** This section provides that the law pertaining to common-law trusts supplements this article and the terms of the governing instrument. In looking to trust law to supplement this article and the governing instrument, the drafting committee followed Delaware Statutory Trust Act § 3809 (2009), which likewise looks to trust law.

**No Mandatory Rules Other Than Those Scheduled in Section 8-104.** This section confirms that, except for the mandatory rules scheduled in Section 8-104, the governing instrument may override any rule pertaining to common-law trusts that would otherwise be applicable to a statutory trust under this section.

**Relationship to the Uniform Trust Code.** In a jurisdiction that has enacted the Uniform Trust Code, the effect of this section is to make the UTC applicable to a statutory trust, but only to the extent that the UTC's provisions — including the mandatory rules scheduled in Uniform Trust Code (2000) (Last Amended 2010) § 105 — are not displaced by this article or by the statutory trust's governing instrument. For further discussion, see the comment to Section 8-104.

**Remedies.** Under this section, the law of remedies for breach of trust applies to a statutory trust unless the governing instrument provides otherwise. On remedies in trust law, see Uniform Trust Code (2000) (Last Amended 2010) §§ 1001-1003; RESTATEMENT (THIRD) OF TRUSTS §§ 99-102 (2012); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 4 SCOTT AND ASCHER ON TRUSTS § 24.9 (5th ed. 2007). However, if a breach of trust injures the trust rather than a beneficial owner directly, such remedies are properly sought in a derivative suit rather than in a direct suit by the beneficial owner, as a statutory trust is itself an entity. Sections 8-609 through 8-614 govern actions by a beneficial owner.

**SECTION 8-106. RULE OF CONSTRUCTION.** The presumption that a civil statute in derogation of the common law is construed strictly does not apply to this [article].

### **Comment**

This section directs courts not to apply to this article the canon of construction that statutes in derogation of the common law are to be strictly construed. The drafting committee

included this provision because many of this article's provisions are designed specifically to override one or more common-law trust principles that would otherwise be applicable to a statutory trust under Section 8-105. Such provisions deliberately derogate the common law of trusts and should be interpreted in accordance with that purpose.

**SECTION 8-107. CONSTRUCTIVE NOTICE.** A person that is not a beneficial owner is deemed to have notice of a statutory trust's merger, interest exchange, conversion, or domestication 90 days after articles of merger, interest exchange, conversion, or domestication under [Article] 2 become effective.

### **Comment**

Unlike the other unincorporated business entity acts, this article does not include a section defining the terms "knowledge" and "notice." This section provides for constructive notice of an Article 2 transaction (merger, interest exchange, conversion, and domestication). These are the only transactions for which constructive notice by third parties is an issue in this article. *Cf.* Section 5-103(d)(2)(C) (limited liability companies).

### **SECTION 8-108. APPLICATION TO EXISTING RELATIONSHIPS.**

(a) This [article] does not limit, prohibit, or invalidate the existence, acts, or obligations of any common-law trust created or doing business in this state before, on, or after [the effective date of this [article]]. The law of this state other than this [article] pertaining to trusts applies to common-law trusts.

(b) A common-law trust created under the law of this state before, on, or after [the effective date of this [article]] which does not have a predominantly donative purpose may elect to become a statutory trust under this [article] by filing a certificate of trust under Section 8-201.

[(c) A trust created pursuant to a statute of this state that was required by that statute to file a certificate of trust with [the Secretary of State] before [the effective date of this [article]] may elect to be governed by the provisions of this [article] by filing an amendment to its certificate of trust under Section 8-202.]

[(d) On [two years after the effective date of this [article]], this [article] governs the

organization and internal affairs of a trust created pursuant to a statute of this state that was required by that statute to file a certificate of trust with the [Secretary of State] before [the effective date of this [article]].]

### **Comment**

This article governs all domestic statutory trusts formed on or after the article's effective date. The effective date of this article will be effective date of the Code (Section 1-708) unless the bill enacting this article specifies a different effective date. For pre-existing statutory trusts, this section establishes an optional "elect-in" period and a mandatory, all-inclusive date of two years following the effective date. Beginning on the all-inclusive date, each pre-existing statutory trust that has not previously elected in becomes subject to this article — including the schedule of mandatory rules in Section 8-104 — by operation of law.

Subsections (a) and (b) confirm that this article does not govern a common-law trust unless the trust forms a statutory trust by filing a certificate of trust under Section 8-201. However, consistent with Section 8-303, subsection (b) permits only a common-law trust that does not have a predominantly donative purpose to become a statutory trust.

The drafting committee contemplated that some enacting jurisdictions might modify this section—particularly subsections (c) and (d), which are bracketed to signal that uniformity is not expected—to address other transition problems arising from differences between this article and prior law. For example, an enacting jurisdiction might choose to allow trusts formed under a prior statute to remain governed by the prior statute for longer than the two years suggested in subsection (d).

This section pertains only to domestic statutory trusts. There are no comparable transition provisions for a foreign statutory trust. Thus, once this Code is effective, it applies immediately to all foreign statutory trusts, whether formed before or after this article's effective date.

Under Section 8-104(1)(C), the governing instrument may not override this section.

**SECTION 8-109. SUBJECTS COVERED OUTSIDE [ARTICLE].** The following subjects are covered in whole or in part outside this [article]:

- (1) Delivery of record – Section 1-104.
- (2) Filing with [Secretary of State] – Part 2 of Article 1.
- (3) Name of entity – Part 3 of Article 1.
- (4) Registered agent of entity – Part 4 of Article 1.

- (5) Foreign entities – Part 5 of Article 1.
- (6) Administrative dissolution – Part 6 of Article 1.
- (7) Miscellaneous provisions, including supplemental principles of law and reservation of power to amend or repeal – Part 7 of Article 1.
- (8) Entity transactions generally – Part 1 of Article 2.
- (9) Merger – Part 2 of Article 2.
- (10) Interest exchange – Part 3 of Article 2.
- (11) Conversion – Part 4 of Article 2.
- (12) Domestication – Part 5 of Article 2.

### **Comment**

This section lists the other principal parts of the Code that are applicable to statutory trusts.

## **[PART] 2**

### **FORMATION; CERTIFICATE OF TRUST AND OTHER FILINGS**

#### **SECTION 8-201. FORMATION OF STATUTORY TRUST; CERTIFICATE OF TRUST.**

(a) To form a statutory trust, a person must deliver a certificate of trust to the [Secretary of State] for filing.

(b) A certificate of trust must state:

- (1) the name of the statutory trust, which must comply with Section 1-302(f);
- (2) the street and mailing addresses of the trust's principal office;
- (3) the name and street and mailing addresses in this state of the trust's registered agent; and
- (4) if the trust may have one or more series, a statement to that effect.

(c) A certificate of trust may contain any term in addition to those required by subsection (b), but may not vary or otherwise affect the provisions specified in Section 8-104 in a manner inconsistent with that section.

(d) A statutory trust is formed when the certificate of trust becomes effective.

(e) A filed certificate of trust, a filed statement of cancellation or change, or filed articles under [Article] 2 prevail over inconsistent terms of a trust instrument.

### **Comment**

Unlike a common-law trust, a statutory trust is a creature of statute. A statutory trust comes into existence only if (1) a certificate of trust is prepared and delivered to the specified public official for filing, and (2) the public official files the certificate (*see* Section 1-206). Filing rules are typical of limited liability entities. Such rules serve a notice function, alerting interested parties to the creation and existence of a new juridical entity with limited liability. The certificate of trust also identifies the statutory trust's agent for service of process and, in connection with Section 8-401, puts third parties on notice if the statutory trust might segregate its property and associated liabilities by creating one or more series.

Although formed by a public filing, a statutory trust is also a creature of contract. As such, it will be possible, though improper, for the trust instrument to be inconsistent with the certificate of trust or other public filings relating to the statutory trust. Subsection (e) provides that the public filing controls in such circumstances.

Under Section 8-104(1), the governing instrument may not override this section.

**Subsection (b)** – In addition to the name meeting the requirements of Section 1-302(f), the name of a statutory trust must also meet the “distinguishable on the records” test and other requirements of Section 1-301. See also Sections 1-303 (Reservation of Name) and 1-304 (Registration of Name).

## **SECTION 8-202. AMENDMENT OR RESTATEMENT OF CERTIFICATE OF TRUST.**

(a) A certificate of trust may be amended or restated at any time.

(b) To amend its certificate of trust, a statutory trust must deliver to the [Secretary of State] for filing an amendment stating:

(1) the name of the trust;

(2) the date of filing of its initial certificate; and

(3) the text of the amendment.

(c) To restate its certificate of trust, a statutory trust must deliver to the [Secretary of State] for filing a restatement designated as such in its heading.

(d) If a trustee knows that any information in a filed certificate of trust was inaccurate when the certificate was filed or has become inaccurate due to changed circumstances, the trustee shall promptly:

(1) cause the certificate to be amended; or

(2) if appropriate, deliver to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

#### **Comment**

Subsection (a) provides a mechanism for updating a statutory trust's filed certificate of trust. The certificate of trust may also be updated by a statement of change under Section 1-205 or by a report under Section 1-407. Subsection (d) imposes an obligation directly on the trustee rather than on the statutory trust.

Under Section 8-104(1), the governing instrument may not override this section.

**SECTION 8-203. SIGNING OF RECORDS TO BE DELIVERED FOR FILING TO [SECRETARY OF STATE].** A record delivered by a statutory trust to the [Secretary of State] for filing pursuant to this [article] must be signed by at least one of the trustees.

#### **Comment**

As provided in Section 1-102(44), "sign" includes any manual, facsimile, conformed, or electronic signature.

**SECTION 8-204. LIABILITY FOR INACCURATE INFORMATION IN FILED RECORD.** If a record delivered to the [Secretary of State] for filing under this [Code] and filed by the [Secretary of State] contains inaccurate information, a person that suffers loss by reliance

on the information may recover damages for the loss from:

(1) a person that signed the record, or caused another to sign it on the person's behalf, and knew the information to be inaccurate at the time the record was signed; and

(2) a trustee of a statutory trust, if:

(A) the record was delivered for filing on behalf of the trust; and

(B) the trustee knew or had notice of the inaccuracy for a reasonably sufficient time before the information was relied upon so that, before the reliance, the trustee reasonably could have:

(i) effected an amendment under Section 8-202;

(ii) filed a petition under Section 1-2104; or

(iii) delivered to the [Secretary of State] for filing a statement of change under Section 1-407 or a statement of correction under Section 1-205.

### **Comment**

**Subsection (a)** – This subsection relates to liability to third parties for inaccurate information in a filed record.

Under Section 8-104(1), the governing instrument may not override this section.

### **[PART] 3**

#### **GOVERNING LAW; AUTHORIZATION; DURATION; POWERS**

**SECTION 8-301. GOVERNING LAW.** The law of this state governs:

(1) the internal affairs of a statutory trust;

(2) the liability of a beneficial owner as beneficial owner, a trustee as trustee, and a person designated under Section 8-103(e)(8) or (9) as a person in the designated capacity, for a debt, obligation, or other liability of a statutory trust or a series thereof; and

(3) the extent to which:

(A) a debt, obligation, or other liability of a series trust is enforceable against the property of any series thereof; and

(B) a debt, obligation, or other liability of a series of a series trust is enforceable against the property of the trust or any other series thereof.

### **Comment**

**Paragraph (1)** provides that the law of this state governs the internal affairs of a statutory trust even if the trust operates in other states. The term “internal affairs” includes the interpretation and enforcement of the governing instrument and the relations among the trustees, beneficial owners, and the statutory trust. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302, cmt. a (1971) (defining “internal affairs” with reference to corporate law as “the relations inter se of the corporation, its shareholders, directors, officers or agents”).

**Paragraphs (2) and (3)** confirm that the law of this state governs the liability of a beneficial owner or a trustee for the debts, obligations, or other liabilities of a statutory trust, and the enforceability of any claim against a statutory trust or the property associated with a series thereof. These rules are stated separately from paragraph (1), because some authorities differentiate liability shield issues from internal affairs for purposes of choice of law. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 (1971) (treating shareholders’ liability separately from the internal affairs doctrine).

Section 8-801 states parallel rules for foreign statutory trusts that are analogous to those of this section.

Under Section 8-104(2), the governing instrument may not override this section.

**SECTION 8-302. STATUTORY TRUST AS ENTITY.** A statutory trust is an entity distinct from its trustees and beneficial owners.

### **Comment**

A common-law trust, whether its purpose is donative or commercial, arises from private action without the involvement of a public official. *See* Uniform Trust Code (2000) (Last Amended 2010) § 401; RESTATEMENT (THIRD) OF TRUSTS § 10 (2003). Because a common-law trust is not a juridical entity, it must sue and be sued, own property, and transact in the name of the trustee in the trustee’s capacity as such. By contrast, as confirmed by this section, a statutory trust is an entity separate from its trustees and beneficial owners. Consequently, a statutory trust has capacity to sue and be sued, own property, and transact in its own name (*see* Sections 8-307 and 8-308), and the trust is solely liable for a debt, obligation, or other liability of the trust (*see* Section 8-304).



### **SECTION 8-303. PERMISSIBLE PURPOSES.**

(a) Except as otherwise provided in subsection (b), a statutory trust may have any lawful purpose, regardless of whether for profit.

(b) A statutory trust may not have a predominantly donative purpose.

#### **Comment**

Under this section, a statutory trust may be formed for any lawful purpose other than a predominantly donative purpose. Section 8-401(c) states a similar rule for the series of a statutory trust. The inclusion of the phrase “regardless of whether for profit” in subsection (a) confirms that a statutory trust’s activities are not limited solely to profit making or business purposes. This is consistent with Sections 5-108(b) (limited liability companies) and 4-110(b) (limited partnerships).

The drafting committee declined the suggestion to prohibit a statutory trust from having a charitable purpose. The committee reasoned that a statutory trust with a charitable purpose would be covered by existing regulatory law applicable to charitable entities. *See, e.g.*, Marion R. Fremont-Smith, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 187-427 (2004).

The limitation to lawful purposes addresses the concern that some states limit the types of organizations that may be used in regulated industries such as banking and insurance. The exclusion of a predominantly donative purpose addresses the concern that a statutory trust might be used in an estate planning or other donative context to evade public policy limitations on donative transfers and common-law trusts. *See, e.g.*, Uniform Trust Code (2000) (Last Amended 2010) § 105; John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004). By prohibiting a statutory trust from having a predominantly donative purpose, the drafting committee avoided the need to design a comprehensive schedule of mandatory rules applicable to statutory trusts with such a purpose, a problematic undertaking in view of the increasing differentiation among the states on these matters, particularly with respect to the rights of the settlor’s creditors in a self-settled trust and the continued application of the Rule Against Perpetuities to interests held in trust. *See, e.g.*, Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356 (2005).

Examples of mandatory rules applicable to common-law trusts that parties might otherwise try to avoid by using a statutory trust include the following:

- the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries;
- the requirement that a trust and its terms be for the benefit of one or more ascertainable beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;

- the power of the court to modify or terminate a trust;
- the effect of a spendthrift provision and the rights of the settlor's and the beneficiary's creditors and assignees to reach the property of a trust;
- the power of the court to adjust a trustee's compensation specified in the terms of the trust that is unreasonably low or high;
- the power of the court to remove a trustee for a serious breach of trust;
- the duty of the trustee to give information and make reports concerning the administration of the trust to the beneficiary;
- the effect of an exoneration clause that purports to limit or eliminate the duties or liabilities of a trustee to a beneficiary;
- the rights of a party, other than a trustee or beneficiary, that transacts with the trustee in the trustee's capacity as such;
- the rules against perpetuities, accumulations of income, and suspension of the power of alienation; and
- the power of the court to take such action and exercise such jurisdiction as may be necessary in the interests of justice.

Most of the foregoing rules are referenced in Uniform Trust Code (2000) (Last Amended 2010) § 105, the UTC's schedule of mandatory rules. For discussion of why the rules that are mandatory with respect to a common-law trust are not mandatory with respect to a statutory trust, see the comments to Sections 8-103 and 8-105.

Because this article authorizes the formation of a statutory trust, and because this section permits a statutory trust to have any lawful purpose other than a predominately donative purpose, any prior judicial decision that holds that a common-law business trust violates the state's corporate law, trust law, or public policy is not applicable to a statutory trust. *See, e.g.,* Robert C. Brown, *Common Law Trusts as Business Enterprises*, 3 IND. L.J. 595, 597-98 (1928); Leland S. Duxbury, *Business Trusts and Blue Sky Laws*, 8 MINN. L. REV. 465, 475-76 (1924). Such decisions reflect the concern that a common-law business trust could be used to evade regulatory limitations on the corporate form.

Under Section 8-104(3), the governing instrument may not override subsection (b) of this section.

#### **SECTION 8-304. LIABILITY OF TRUSTEES AND BENEFICIAL OWNERS.**

(a) A debt, obligation, or other liability of a statutory trust or series thereof is solely the debt, obligation, or other liability of the trust or series thereof. A beneficial owner, trustee, or person designated pursuant to Section 8-103(e)(8) or (9) is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the trust or series thereof solely by reason of being or acting as a beneficial owner, trustee, or person

designated pursuant to Section 8-103(e)(8) or (9). This subsection applies regardless of the dissolution of the trust.

(b) Except as otherwise provided in [Part] 4, property of a statutory trust held in the name of the trust or by the trustee in the trustee's capacity as trustee is subject to attachment and execution to satisfy a debt, obligation, or other liability of the trust.

### Comment

This section implements the concept that a statutory trust is an entity separate from its trustees and beneficial owners in three ways. First, this section confirms that a trustee, as such, is not liable for a debt, obligation, or liability of the statutory trust or a series thereof. This section therefore overrides the outmoded common-law rule that made the trustee liable for the debts of the trust and then gave the trustee a right to indemnity out of the trust fund. *Compare* RESTATEMENT (SECOND) OF TRUSTS §§ 244, 261 (1959) (stating the old rule), *with* Uniform Trust Code (2000) (Last Amended 2010) § 1010 (eliminating the personal liability of the trustee for a debt, obligation, or liability arising in the trustee's fiduciary capacity), *and* RESTATEMENT (THIRD) OF TRUSTS § 106 (2012) (same). However, nothing in this section limits the personal liability of a trustee to the statutory trust for breach of duty under Section 8-505.

Second, this section confirms that a statutory trust is solely liable for the debts, obligations, and liabilities of the trust.

Third, this section confirms the limited liability of a beneficial owner and trustee by providing that neither is liable for a debt, obligation, or liability of a statutory trust. A disclosed agent of the beneficial owner or trustee acting within the scope of the agent's authority is likewise not liable for a debt, obligation, or liability of the statutory trust. This section therefore confirms that the "control test" of *Williams v. Inhabitants of Milton*, 102 N.E. 355 (Mass. 1913), and RESTATEMENT (SECOND) OF AGENCY § 14B (1958), is not applicable to a statutory trust. Under the control test, if a beneficiary of a common-law business trust had a say in the administration of the trust or the right to remove and replace the trustee, the beneficiary might be held liable for the debts of the trust. By contrast, under this section a beneficial owner may participate in the management of the statutory trust without exposure to liability for the debts of the statutory trust. *See* Wendell Fenton & Eric A. Mazie, *Delaware Statutory Trusts* §19.3, in 2 R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* (3d ed. 2009 Supp.).

The last sentence of subsection (a) was added as part of the harmonization project. It refers specifically to dissolution, providing that the rule of that subsection applies regardless of the dissolution of the trust. In clarifying this point by express provision, the harmonization committee did not intend to suggest a negative inference that the rule would not apply after termination of the trust. To the contrary, that the rule of this subsection applies also regardless of the termination of the trust follows ineluctably from the structure of this provision. In other

words, the rule of this section continues to apply as to any debt, obligation, or other liability of the trust incurred before termination of the trust. For further discussion, see the comment to Section 5-304 (limited liability companies).

**SECTION 8-305. NO CREDITOR RIGHTS IN TRUST PROPERTY.** A creditor of a beneficial owner or trustee may not obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of a statutory trust or any series thereof.

### Comment

This section implements the concept that a statutory trust is an entity separate from its trustees and beneficial owners by confirming that a creditor of a beneficial owner or a trustee has no recourse against the property of the statutory trust.

With respect to a trustee, the rule of this section is familiar from the operation of common-law trusts. *See* Uniform Trust Code (2000) (Last Amended 2010) § 507; RESTATEMENT (THIRD) OF TRUSTS § 42, cmt. c (2003); RESTATEMENT (SECOND) OF TRUSTS § 308 (1959). The rule of this section is also consistent with federal bankruptcy law. Property over which a trustee holds legal title as trustee is not part of the trustee's bankruptcy estate. *See* 11 U.S.C. § 541(d) (2014).

With respect to a beneficial owner, the parallel provision in the Delaware Statutory Trust Act is discussed in Wendell Fenton & Eric A. Mazie, *Delaware Statutory Trusts* § 19.4, in 2 R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* (3d ed. 2009 Supp.).

### SECTION 8-306. DURATION.

(a) Except as otherwise provided in its certificate of trust, a statutory trust:

(1) has perpetual duration; and

(2) may not be terminated or revoked except in accordance with this [Code] or the terms of the trust's certificate of trust.

(b) A series of a statutory trust may not be terminated or revoked except in accordance with this [article] or the terms of the governing instrument.

(c) The death, incapacity, dissolution, termination, or bankruptcy of a beneficial owner, trustee, or person designated under Section 8-103(e)(8) or (9) does not result in the

termination or dissolution of a statutory trust or any series thereof.

(d) A statutory trust or any series thereof does not terminate because the same person is the sole trustee and sole beneficial owner.

### **Comment**

The principal source used by the drafting committee in fashioning this section was Delaware Statutory Trust Act § 3808 (2009).

**Subsection (a)** provides a default rule of perpetual duration for a statutory trust. Under Section 8-104(4), this default rule can be modified only by the certificate of trust. By contrast, the Rule Against Perpetuities curtails the duration of a common-law trust. *See* RESTATEMENT (THIRD) OF TRUSTS § 29, cmt. h(1) (2003). Accordingly, unless the governing instrument provides otherwise, under this section a statutory trust is exempt from the Rule Against Perpetuities. The drafting committee concluded that the dead-hand worries that underpin the Rule do not apply to a statutory trust, which under Section 8-303(b) may not have a predominantly donative purpose.

**Subsection (b)** confirms that a statutory trust may be terminated only in accordance with the terms of this Code or the governing instrument (*see* Sections 8-701 and 8-707). Accordingly, a statutory trust is not subject to the common-law rules of trust termination that would otherwise be applicable under Section 8-105. Those rules mediate the tension between donor's intent and subsequent contrary preferences of the beneficiaries, *see* Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 658-63 (2004), an issue that is not applicable to a statutory trust, because such a trust may not have a predominantly donative purpose. Instead, the drafting committee contemplated that the governing instrument would provide for termination of the statutory trust or modification of the governing instrument if such provisions are apt to the circumstances.

**Subsection (c)** confirms that the rule of partnership law under which a partnership is dissolved upon the death or incapacity of one of the partners does not apply to a statutory trust.

**Subsection (d)** overrides the application to a statutory trust under Section 8-105 of the common-law rule of merger whereby legal and equitable title to trust property merge and the trust terminates if the same person is the sole trustee and sole beneficiary. *See* RESTATEMENT (THIRD) OF TRUSTS § 69 (2003); *Comment, The Doctrine of Merger as Applied to Commercial Trusts*, 29 YALE L.J. 97 (1919).

### **SECTION 8-307. POWER TO HOLD PROPERTY; TITLE TO TRUST**

**PROPERTY.** A statutory trust may hold or take title to property in its own name, or in the name of a trustee in the trustee's capacity as trustee, whether in an active, passive, or custodial capacity.

### Comment

This section implements the concept that a statutory trust is an entity separate from its trustees and beneficial owners by providing that a statutory trust may transact and hold property in its own name. The property of a common-law trust, by contrast, is normally held in the name of the trustee in the trustee's fiduciary capacity.

This section also permits a statutory trust to take title to property in the name of the trustee in the trustee's fiduciary capacity, similar to a common-law trust. The drafting committee reasoned that allowing a statutory trust to do so would facilitate transactions with or by a statutory trust in a state that has not provided for a statutory trust entity in its title recording and other property laws. However, nothing in this section affects the liability rules stated in Sections 8-304 and 8-305. Even if the statutory trust takes title to certain property in the name of the trustee in the trustee's fiduciary capacity, the statutory trust and not the trustee is liable for a debt, obligation, or other liability arising from ownership of the property. A similar outcome obtains in a common-law trust, in which the trustee is ordinarily protected from personal liability for a debt, obligation, or other liability arising from ownership or control of trust property, or is personally liable only to the extent of the capacity of the trust estate to support indemnification of the trustee. *See* Uniform Trust Code (2000) (Last Amended 2010) § 1010; RESTATEMENT (THIRD) OF TRUSTS § 106 (2012); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 4 SCOTT AND ASCHER ON TRUSTS § 26.4 (5th ed. 2007).

To police the boundary of the trustee's personal property and the property of the trust, the common law imposes on the trustee duties to earmark trust property and not to commingle it with the trustee's own. *See* Uniform Trust Code (2000) (Last Amended 2010) § 810; RESTATEMENT (THIRD) OF TRUSTS § 84 (2007). The drafting committee contemplated that, under appropriate circumstances, Section 8-505(b) will require similar conduct by a trustee of a statutory trust that takes title to property in the name of the trustee in the trustee's fiduciary capacity.

**SECTION 8-308. POWER TO SUE AND BE SUED.** A statutory trust has the capacity to sue and be sued in its own name.

### Comment

This section implements the concept that a statutory trust is an entity separate from its trustees and beneficial owners by confirming that a statutory trust has the power to sue and be sued in its own name.

Under Section 8-104(5), the trust instrument may not override this section.

## **[PART] 4**

### **SERIES TRUSTS**

#### **SECTION 8-401. STATUTORY TRUST HAVING SERIES.**

(a) The governing instrument may provide for the creation by the statutory trust of one or more series with respect to specified property of the statutory trust if:

(1) records are maintained for the series which reasonably identify the property of the series, including by specific listing, category, type, quantity, or computational or allocational formula or procedure, such as a percentage or share of any property, or by any other method by which the identity of the property of the series is objectively determinable; and

(2) notice that the trust may have one or more series is set forth in the certificate of trust as required by Section 8-201(b)(4).

(b) A series of a statutory trust is not an entity separate from the statutory trust.

(c) A series of a statutory trust may have a purpose, regardless of whether for profit, separate from the trust or any other series thereof if the purpose of the series is lawful and not a predominantly donative purpose.

(d) Subject to Section 8-404, the governing instrument may provide for the creation of one or more classes of trustees, beneficial owners, or beneficial interests having separate rights, powers, or duties with respect to the statutory trust or any series thereof.

#### **Comment**

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009) and Delaware Limited Liability Company Act § 18-215 (2009).

This section states the conditions that must be satisfied if a statutory trust is to have one or more series, making the trust a series trust, a term defined in Section 8-102(a)(8). Under this article, a series is a segregation or partitioning of property within a statutory trust. If a statutory trust has organized as a series trust under this section, then under Section 8-402 a debt,

obligation, or liability associated with the property of a particular series is enforceable only against property of that series, and not against the property of the trust generally or any other series thereof, and only in accordance with the procedures prescribed by Section 8-403.

**Subsection (a)** provides that a statutory trust may organize as a series trust if (1) records are maintained that reasonably identify the property associated with the series, and (2) notice that the trust may have one or more series is set forth in the certificate of trust. The earmarking requirement of subsection (a)(1) safeguards the interests of the beneficial owners and of the trust's creditors in respect of each series by clarifying the boundaries between the property and liabilities of each series. Creditors and other third parties are further protected by subsection (a)(2), which requires notice in the certificate of trust that the statutory trust might have one or more series.

**Subsection (b)** confirms that for ordinary state law purposes, a series is not an entity separate from the statutory trust. Thus, in litigation involving a series trust, the proper party is the statutory trust itself (see Section 8-403), even if the matter pertains exclusively to property associated with a series of the trust. Whether a series is a separate entity for federal tax or other purposes is beyond the purview of this article. The potential for disparate entity status under state organizational law and federal tax or other regulatory law is familiar from the operation of common-law trusts, which are not entities under state trust law, but are commonly taxed as separate entities under federal tax law. *See* Jeffrey G. Sherman, *All You Really Need To Know About Subchapter J You Learned from This Article*, 63 MO. L. REV. 1 (1998).

**Subsection (c)** confirms that a series may have any lawful purpose, regardless of whether for profit, other than a predominantly donative purpose, and that a series may have a purpose separate from the purpose of the statutory trust. The limitation to a lawful purpose that is not predominantly donative is analogous to the limitation in Section 8-303 on the permissible purposes of a statutory trust, the rationale for which is discussed in the comment to that section.

In confirming that a series may have a separate purpose from the statutory trust or any other series thereof, the drafting committee took notice of the fact that the organization of a master trust with multiple series is common among statutory trusts that are registered as investment companies under the Investment Company Act of 1940. Mutual fund complexes commonly organize their various funds, which may have different investment goals and objectives, as separate series of a single statutory trust. *See* Wendell Fenton & Eric A. Mazie, *Delaware Statutory Trusts* § 19.11, in 2 R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* (3d ed. 2009 Supp.); Joseph R. Fleming, *Regulation of Series in Investment Companies*, 44 BUS. LAW. 1179 (1989).

In a series trust that is an investment company under the Investment Company Act of 1940, any series of beneficial interests established by the governing instrument is a series preferred in distribution of property or payment of dividends over all other series with respect to property specifically allocated to the series under Section 18 of the Investment Company Act. *See* 15 U.S.C. § 80a-18 (2014); *see also* Delaware Statutory Trust Act § 3805(h) (2009).

**Subsection (d)** clarifies the distinction between governance classes, meaning an internal grouping of trustees, beneficial owners, or beneficial interests for governance purposes, as is



authorized by Section 8-103(e)(5), and the series concept, which under this article is a segregation or partitioning of property within a single statutory trust. Subsection (d) confirms that governance classes may be implemented in parallel to property series, so that different trustees, beneficial owners, or beneficial interests may pertain to different property series, subject to the rule of Section 8-404, which requires that there be a trustee whose duties run to the trust and all series thereof.

Under Section 8-104(6), the governing instrument may not override this section.

#### **SECTION 8-402. LIABILITY OF SERIES TRUST.**

(a) In a series trust:

(1) a debt, obligation, or other liability incurred or otherwise existing with respect to the property of a particular series is enforceable against the property of the series only, and not against the property of the trust generally or any other series thereof; and

(2) a debt, obligation, or other liability incurred or otherwise existing with respect to the trust generally or the property of any other series thereof is not enforceable against the property of the series.

(b) The rules pertaining to distributions under Sections 8-615 and 8-616 apply to a distribution from a series trust and from the property of any series thereof, except for a distribution under Section 8-405.

(c) The association, disassociation, or reassociation of property of a statutory trust or a series thereof to or with the trust or a series thereof, including by a transaction under [Article] 2, is deemed to be a transfer between separate persons under [Uniform Voidable Transaction Act or other state fraudulent transfer statute] and a distribution under Section 8-615.

#### **Comment**

**Subsection (a)** provides that if a statutory trust creates one or more series in accordance with Section 8-401, a debt, liability, or other obligation associated with the property of a particular series is enforceable only against the property of that series, and is not enforceable against the property of another series or the trust generally. Likewise, a debt, liability, or other obligation associated with the property of another series or of the trust generally is not

enforceable against the property of the series. Thus, a creditor whose claim arises in connection with certain property of a particular series has recourse against the property of that series only, and a creditor whose claim arises in connection with property not associated with a particular series has no recourse against the property of that series. The rules of this subsection are implemented by the procedures prescribed by Section 8-403.

The drafting committee contemplated that an interest secured by a lien on particular trust property would follow that property even if the property was reassociated from one series to another, from a series to the trust generally, or from the trust generally to a series.

Because subsection (a) is not mandatory (it is not scheduled in Section 8-104), a third party dealing with a series trust could condition the party's dealings with the trust on a waiver by the trust of the liability rules stated in subsection (a).

**Subsection (b)** addresses interim distributions made from the property of a series. Liquidating distributions by a series are governed by Section 8-405.

**Subsection (c)** addresses the concern that the series concept might be used to avoid creditors abusively. To protect creditors from abusive movement of property within a series trust, subsection (c) provides that the association, disassociation, or reassociation of property with the statutory trust generally or a series thereof is subject to the state's voidable transaction or fraudulent transfer law. Because each series and the trust generally are treated as separate entities for purposes of the state's voidable transactions or fraudulent transfer law, creditors have precisely the same protection against abusive movement of property within a series trust as the state's law of voidable transactions or fraudulent transfers affords against abusive movement of property among separate entities.

Under Section 8-104(6), the governing instrument may not override subsections (b) or (c).

#### **SECTION 8-403. CLAIMS PERTAINING TO A SERIES TRUST.**

(a) A series of a statutory trust may not sue or be sued in its own name.

(b) If a series trust has a claim against a person which pertains to the property of a series thereof, the trust may assert the claim under Section 8-308 and shall allocate the proceeds of the claim under Sections 8-401 and 8-402.

(c) If a person has a claim against a series trust which pertains to the property of a series thereof, to assert the claim the person must bring the claim against the trust, stating that the claim pertains to the property of a series thereof and specifying the series if known. To the extent the

claim succeeds and is reduced to judgment:

(1) the judgment must state that it is collectable only against the property of the specified series; and

(2) the judgment creditor may levy on the judgment only by serving the series trust, which shall satisfy the judgment using only the property of the specified series.

### **Comment**

This section prescribes implementing procedures for claims pertaining to a series trust.

**Subsection (a)** confirms that a series of a statutory trust may not sue or be sued in its own name. In accordance with Section 8-401(b), which provides that a series of a statutory trust is not an entity separate from the trust, in litigation involving a series trust the proper party is the trust itself (*see* Section 8-308). This is true even if the matter pertains exclusively to property associated with a series of the trust.

**Subsection (b)** addresses claims held by a series trust that pertain to the property of a series of the trust. Under this subsection, the trust may assert the claim in accordance with its capacity to sue under Section 8-308, but the trust will then allocate the proceeds of the claim internally in accordance with its series structure under Sections 8-401 and 8-402.

**Subsection (c)** addresses claims held by others that pertain to the property of a series of a series trust. Under this subsection, to enforce such a claim the claimant must assert it against the trust (*see* Section 8-308). Moreover, the claimant must state that the claim pertains to the property of a series of the trust and must specify which series if the claimant has that information. If the claimant lacks that information, the failure to name the series in the complaint is not grounds for dismissal on the pleadings. Instead, pre-trial discovery can be used to obtain the information, and once the complainant has the information, the court should normally grant leave to amend the complaint to incorporate the information.

If the claim succeeds and is reduced to judgment, subparagraph (1) requires that the judgment state that it is collectable only against the property of the specified series. Subparagraph (2) provides that as judgment creditor the claimant may levy on the judgment only by serving the series trust, which in accordance with Section 8-402 will satisfy the judgment using only the property of the specified series.

Under Section 8-104(6), the governing instrument may not override this section.

**SECTION 8-404. DUTIES OF TRUSTEE IN SERIES TRUST.** If there is at least one trustee of a series trust that, in discharging its duties, is obligated to consider the interests of

the trust and all series thereof, the governing instrument may provide that one or more other trustees, in discharging their duties, may consider only the interests of the trust or one or more series thereof.

### **Comment**

Section 8-401(c) confirms that the various series of a statutory trust may have different purposes and objectives. In such circumstances, it may be sensible for each series to be managed by a trustee whose duties are limited to the best interests of the particular series. This section allows for the appointment of a trustee whose duties are limited to a particular series so long as there is at least one trustee whose duties run to the trust generally and all series thereof. The drafting committee reasoned that, because a series is not a separate entity (*see* Section 8-401(b)), there must always be a trustee whose duties run to the trust and all series thereof.

Under Section 8-104(6), the governing instrument may not override this section.

### **SECTION 8-405. DISSOLUTION OF SERIES.**

(a) A series of a series trust may be dissolved or its property distributed without causing the dissolution of the trust or any other series thereof.

(b) A series of a series trust is dissolved, and its activities must be wound up, on the occurrence of an event or circumstance that the governing instrument states causes dissolution of the series or upon the dissolution of the trust.

(c) On dissolution of a series of a series trust, the persons that under the governing instrument are responsible for winding up the affairs of the series may cause the trust to take all actions permitted under Section 8-703 and shall take actions with respect to the claims and obligations of the series as provided in Sections 8-703 through 8-706.

(d) A person, including a trustee, that under the governing instrument is responsible for winding up the affairs of a series of a series trust is not liable to the creditors of the dissolved series solely because the person acts in that capacity.

## Comment

Although a series is not an entity separate from the series trust of which it is a part (*see* Section 8-401(b)), a series may have a separate purpose from the rest of the trust (*see* Section 8-401(c)), and its property may be segregated from the rest of the property of the trust (*see* Section 8-402). As such, a series has many of the attributes of a separate entity, particularly with respect to the rights of third parties. To protect third parties who deal with a series trust, this section provides for the orderly dissolution of a series.

**Subsection (a)** provides that the dissolution of a series does not trigger the dissolution of the series trust or any other series thereof.

**Subsection (b)** provides that a series is dissolved only under the circumstances specified in the governing instrument. The drafting committee reasoned that, because a statutory trust may have perpetual existence (*see* Section 8-306), so too a series of the trust may have perpetual existence.

**Subsection (c)** provides for the mechanics of dissolution of a series. Under subsection (c), the rules applicable to the dissolution of a statutory trust stated in Sections 8-703 through 8-706, which govern winding up and creditors' rights, apply to the dissolution of a series.

**Subsection (d)** protects a person, including a trustee, from personal liability for a debt, obligation, or other liability associated with the property of a dissolved series over which the person had responsibility for winding up. This provision therefore complements Section 8-304, which provides that a debt, obligation, or other liability of a statutory trust is solely the debt, obligation, or other liability of the trust.

Under Section 8-104(6), the governing instrument may not override subsection (c).

## [PART] 5

### TRUSTEES AND TRUST MANAGEMENT

**SECTION 8-501. MANAGEMENT OF STATUTORY TRUST.** The activities and affairs of a statutory trust must be managed by or under the authority of its trustees.

## Comment

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009), Delaware General Corporation Law § 141 (2009), and Model Business Corporation Act § 8.01.

Section 8-102(a)(12) defines the term “trustee” as a person designated, appointed, or elected as such in accordance with the governing instrument or applicable law. Section 8-103(e)(6)(C) confirms that the governing instrument may provide for trustee appointment. However, because this article does not itself state any default rules for trustee appointment, if the

governing instrument does not address the issue, then under Section 8-105 the state's law pertaining to trustee appointment in common-law trusts controls. On trustee appointment, removal, and succession in common-law trusts, see Uniform Trust Code (2000) (Last Amended 2010) §§ 701-702, 704-706, and RESTATEMENT (THIRD) OF TRUSTS §§ 31-37 (2003).

**SECTION 8-502. TRUSTEE POWERS.** A trustee may exercise:

- (1) powers conferred by the governing instrument;
- (2) except as limited by the governing instrument, any other powers necessary or convenient to carry out the activities and affairs of the statutory trust; and
- (3) other powers conferred by this [article].

**Comment**

The principal source used by the drafting committee in fashioning this section was Uniform Trust Code (2000) (Last Amended 2010) § 815.

This section overrides the application to a statutory trust under Section 8-105 of the outmoded common-law rule that a trustee has only those powers granted by the trust instrument. In accordance with modern trust law, *see* Uniform Trust Code (2000) (Last Amended 2010) § 815; RESTATEMENT (THIRD) OF TRUSTS § 85, cmt. a (2007), this section grants the trustees of a statutory trust the broadest possible powers in the administration of the trust.

However, in exercising or not exercising the broad powers conferred by this section, a trustee must comply with the standards of conduct stated in Section 8-505. That all powers held by a trustee are subject to the trustee's fiduciary duties is familiar trust law. The Restatement characterizes this point as "a basic principle of trust administration," namely, "that a trustee presumptively has comprehensive powers to manage the trust estate and otherwise to carry out the terms and purpose of the trust, but that all powers held in the capacity of trustee must be exercised, or not exercised, in accordance with the trustee's fiduciary obligations." RESTATEMENT (THIRD) OF TRUSTS § 70, cmt. a (2007); *see also id.* § 86 cmt. b ("All powers of trusteeship are held in the trustee's fiduciary capacity and must be exercised in good faith and to serve the interests of the beneficiaries.").

**SECTION 8-503. ACTION BY TRUSTEES.** On any matter that is to be acted on by trustees, the following rules apply:

- (1) The trustees act by majority of the trustees.
- (2) The trustees may act without a meeting, without previous notice, and without a vote, if the minimum number of trustees necessary to authorize or take the action at a meeting at

which all trustees entitled to vote thereon were present and voted consent in a signed record.

However, prompt notice of the action must be given to those trustees that did not consent.

(3) A trustee may vote in person or by proxy, but, if by proxy, the proxy must be in a signed record.

### **Comment**

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009), Delaware General Corporation Law § 228 (2009), and Uniform Trust Code (2000) (Last Amended 2010) § 703.

In accord with Uniform Trust Code (2000) (Last Amended 2010) § 703(a) and RESTATEMENT (THIRD) OF TRUSTS § 39 (2003), paragraph (1) rejects the common-law rule requiring unanimity among the trustees of a private trust, replacing it with a default rule allowing action by a majority of the trustees.

The remainder of this section allows for maximum flexibility in the mechanics of action by the trustees. Section 8-103(e)(4) confirms that the governing instrument may override the rules stated in this section.

The Investment Company Act of 1940 requires a mutual fund's investment advisory contract, underwriting contract, fidelity bond, independent public accountants, and other such matters to be approved by the trustees (directors) of the mutual fund. *See* 15 U.S.C. §§ 80a-15(a), 80a-31(a) (2014); 17 C.F.R. § 270.17g-1 (2014). Investment advisory and underwriting contracts, and selection of independent public accountants must be approved by the noninterested trustees (directors) at an in-person meeting. *See* 15 U.S.C. §§ 80a-15(c), 80a-31(a) (2014).

### **SECTION 8-504. PROTECTION OF PERSON DEALING WITH TRUSTEE.**

(a) A person that in good faith assists a trustee, or in good faith and for value deals with a trustee, without knowledge that the trustee is exceeding or improperly exercising the trustee's power, is protected from liability as if the trustee properly exercised the power.

(b) A person that in good faith deals with a trustee need not inquire into the extent of a trustee's power or the propriety of the exercise of the power.

(c) A person that in good faith delivers property to a trustee need not ensure its proper use.

(d) A person that in good faith and without knowledge that the trusteeship has terminated assists a former trustee as if the former trustee were still a trustee, or in good faith and for value deals with a former trustee as if the former trustee were still a trustee, is protected from liability as if the former trustee were still a trustee.

### **Comment**

**Subsection (a)** protects two different classes of persons: (1) persons that assist a trustee with a transaction, and (2) persons that deal with the trustee for value. As long as the person provided the assistance or dealt with the trustee in good faith and without knowledge that the trustee was exceeding or improperly exercising the trustee's powers, the person is protected from liability to the statutory trust and the beneficial owners.

**Subsection (b)** confirms that a person who deals with a trustee in good faith is not charged with a duty to inquire into the extent of a trustee's power or the propriety of its exercise. So long as a person acts in good faith, the person may assume that the trustee has the necessary power and need not request or examine the trust's governing instrument. Subsection (b) therefore overrides the application to a statutory trust under Section 8-105 of the outmoded common-law rule that third parties that deal with a trustee are charged with constructive notice of the trust's governing instrument and its contents. *See* Austin W. Scott, William F. Fratcher & Mark L. Ascher, 5 SCOTT AND ASCHER ON TRUSTS § 29.2 (5th ed. 2008).

**Subsection (c)** protects a person that in good faith delivers property to a trustee. The standard of protection in RESTATEMENT (SECOND) OF TRUSTS § 321 (1959) is phrased differently, but the result is similar. Under the Restatement, the person delivering property to a trustee is liable only if at the time of the delivery the person had notice that the trustee was misapplying or intending to misapply the property.

**Subsection (d)** extends the protections afforded by this section to assistance provided to or dealings for value with a former trustee. If the person acted in good faith, the person is protected as if the former trustee still held the office.

This section is based on Uniform Trust Code (2000) (Last Amended 2010) § 1012, but differs from that provision in that subsections (a), (b), and (d) are not limited to persons other than a beneficiary.

### **SECTION 8-505. STANDARDS OF CONDUCT FOR TRUSTEES.**

(a) Subject to Section 8-404, in exercising the powers of trusteeship, a trustee shall act in good faith and in a manner the trustee reasonably believes to be in the best interests of the statutory trust.



(b) A trustee shall discharge its duties with the care that a person in a similar position would reasonably believe appropriate under similar circumstances.

### Comment

**Fiduciary Duties.** This section subjects the trustee's exercise or nonexercise of the broad powers granted by Section 8-502 to fiduciary duties of loyalty (subsection (a)) and care (subsection (b)). This section therefore confirms the applicability to a statutory trust of the core principle of trust administration "that a trustee presumptively has comprehensive powers to manage the trust estate and otherwise to carry out the terms and purpose of the trust, but that all powers held in the capacity of trustee must be exercised, or not exercised, in accordance with the trustee's fiduciary obligations." RESTATEMENT (THIRD) OF TRUSTS § 70, cmt. a (2007).

**Corporate Versus Trust Fiduciary Law.** The drafting committee opted to model the particulars of the trustee's fiduciary duties on corporate fiduciary law rather than the more restrictive fiduciary duties of trust law because the statutory trust is used chiefly as a mode of business organization. Unlike the trust law fiduciary obligation, which evolved in the context of donative transfers, the corporate law fiduciary obligation evolved to serve the needs of commercial actors. The drafting committee took Model Business Corporation Act § 8.30 as its model. For a statement of the duties of prudence and loyalty in trust law, see RESTATEMENT (THIRD) OF TRUSTS §§ 77-78 (2007). For a comparison of trust and corporate fiduciary law, see Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 572-82 (2003).

In imposing corporate fiduciary law on the trustees of a statutory trust, the drafting committee departed from the model of the Delaware Statutory Trust Act, which does not prescribe the applicable fiduciary standards. Under the Delaware Act, unless the governing instrument provides otherwise, the applicable fiduciary standards are those of the common law of trusts. See Delaware Statutory Trust Act § 3809 (2009); *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096, 1110-18 (Del. Ch. 2008); see also Wendell Fenton & Eric A. Mazie, *Delaware Statutory Trusts* § 19.7, in 2 R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* (3d ed. 2009 Supp.). In departing from the Delaware Act, the drafting committee was influenced by reports from the committee's Delaware-based advisors and observers that the usual practice in Delaware statutory trusts is to override the default of trust fiduciary law in favor of corporate-style fiduciary rules. As such, this section is consistent with Delaware statutory trust practice.

**Good Faith.** The drafting committee declined the suggestion to define the term good faith on the grounds that such a definition necessarily would be over- and under-inclusive. Instead, the committee contemplated that the term would be interpreted in light of its evolving meaning in the business and trust law cases. Imposing a duty to act in good faith without defining the contours of good faith is familiar trust, statutory trust, corporate, and alternative entity law. See, e.g., Uniform Trust Code (2000) (Last Amended 2010) § 105(b)(2); Delaware Statutory Trust Act § 3806(c), (e) (2009); Model Business Corporation Act § 8.30.

**Series Trusts.** Subsection (a) is subject to Section 8-404, which allows in a series trust

for a trustee's duties and obligations to be limited to the best interests of a particular series if there is at least one trustee whose duties and obligations run to the trust and all series thereof. For further discussion, see the comment to Section 8-404.

**Mandatory and Default Fiduciary Law.** Under Section 8-104(7), the governing instrument may not override the trustee's standards of conduct under this section. However, the governing instrument may prescribe the standards by which good faith, best interests of the statutory trust, and care that a person in a similar position would reasonably believe appropriate under similar circumstances are determined if the prescribed standards are not manifestly unreasonable. A mandatory core of fiduciary obligation is familiar law. *See* RESTATEMENT (THIRD) OF TRUSTS § 86, cmt. b (2007) ("A trustee's duties, like trustee powers, may be modified by the terms of the trust, but the duties of trusteeship are subject to certain minimum standards that are fundamental to the trust relationship and normally essential to it."); RESTATEMENT (THIRD) OF TRUSTS § 96, cmt. c (2012) ("Notwithstanding the breadth of language in a trust provision relieving a trustee from liability for breach of trust, for reasons of policy trust fiduciary law imposes limitations on the types and degree of misconduct for which the trustee can be excused from liability."); *see also* Uniform Trust Code (2000) (Last Amended 2010) § 105(b)(2); Delaware Statutory Trust Act § 3806(c), (e) (2009) (duty of good faith); Delaware General Corporation Law § 102(b)(7) (2009); Delaware Limited Liability Company Act § 18-1101(c), (e) (2009) (duty of good faith); Model Business Corporation Act § 2.02(b)(4)-(5).

**SECTION 8-506. REASONABLE RELIANCE.** A trustee, officer, employee, manager, or committee of a statutory trust, or other person designated pursuant to Section 8-103(e)(8) or (9), is not liable to the trust or to a beneficial owner for breach of any duty, including a fiduciary duty, to the extent the breach results from reasonable reliance on:

- (1) a term of the governing instrument;
- (2) a record of the statutory trust; or
- (3) an opinion, report, or statement of another person that the person to which the opinion, report, or statement is made or delivered reasonably believes is within the other person's professional or expert competence and is made or delivered to the trustee, officer, employee, manager, or committee of a statutory trust, or other person designated pursuant to Section 8-103(e)(8) or (9).

### **Comment**

The principal sources used by the drafting committee in fashioning this section were

Uniform Trust Code (2000) (Last Amended 2010) § 1006 and Delaware Statutory Trust Act § 3806 (2009).

A trustee, officer, employee, manager, committee, or other person administering a statutory trust should be able to rely on (1) the terms of the governing instrument, (2) the records of the statutory trust, and (3) the opinions of experts. This section protects a person that so relies from liability to the trust or to a beneficial owner, but only to the extent that the person's breach of trust resulted from such reliance and only if the person's reliance was reasonable. This section does not foreclose injunctive or other such equitable relief. Under traditional trust law, a trustee "may apply to an appropriate court for instructions regarding the administration or distribution of the trust if there is reasonable doubt about the powers or duties of the trusteeship or about the proper interpretation of the trust provisions." RESTATEMENT (THIRD) OF TRUSTS § 71 (2007).

The drafting committee intended the standard of "reasonable reliance" to have an objective component. *Cf.* RESTATEMENT (THIRD) OF TRUSTS § 77, cmt. b(2) (2007) ("Taking the advice of legal counsel on such matters evidences prudence on the part of the trustee. Reliance on advice of counsel, however, is not a complete defense to an alleged breach of trust, because that would reward a trustee who shopped for legal advice that would support the trustee's desired course of conduct or who otherwise acted unreasonably in procuring or following legal advice. In seeking and considering advice of counsel, the trustee has a duty to act with prudence. Thus, if a trustee has selected trust counsel prudently and in good faith, and has relied on plausible advice on a matter within counsel's expertise, the trustee's conduct is significantly probative of prudence.").

The governing instrument may provide that a person is liable to the statutory trust or to a beneficial owner for breach of trust even if the person's breach of trust resulted from the person's reasonable reliance on (1) the terms of the governing instrument, (2) the records of the statutory trust, or (3) the opinions of experts. However, under Section 8-104(8), the governing instrument may not vary the obligation of a person to act in reasonable reliance if the person is to be protected from liability under this section, albeit the governing instrument may prescribe the standards for assessing whether the person's reliance was reasonable if those standards are not manifestly unreasonable.

#### **SECTION 8-507. INTERESTED TRANSACTIONS.**

(a) In this section, "covered party" means a trustee, officer, employee, or manager of a statutory trust, or a related party of a trustee, officer, employee, manager, or other person designated pursuant to Section 8-103(e)(8) or (9).

(b) Subject to subsection (c), a covered party may lend money to, borrow money from, act as a surety, guarantor, or endorser for, guarantee or assume an obligation of, provide

collateral for, or do other business with the statutory trust and, subject to law other than this [Code], has the same rights and obligations with respect to those matters as a person that is not a covered party.

(c) A transaction described in subsection (b) is voidable by the statutory trust unless the covered party shows that the transaction is fair to the trust.

### **Comment**

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009); Delaware General Corporation Law § 144 (2009).

Consistent with the use of the term “best interests” instead of “sole interest” in Section 8-505(a), this section abrogates the no-further-inquiry rule of the common law of trusts, which makes a self-dealing or conflicted transaction by the trustee voidable by the beneficiaries even if the transaction is fair and in the best interests of the trust and the beneficiaries. *See* RESTATEMENT (THIRD) OF TRUSTS § 78 (2007); John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929 (2005); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEORGETOWN L.J. 67 (2005).

Instead, this section follows the corporate model so that an interested transaction is voidable by the statutory trust unless the related party shows that the transaction is fair to the trust. *See* Model Business Corporation Act § 8.61(b)(3). Because this section is not scheduled in Section 8-104, however, the rule of this section is subject to override in the governing instrument.

The Investment Company Act of 1940, which applies to a statutory trust that is a registered investment company, prohibits a trustee, officer, employee, manager, and their related parties from lending money to, borrowing money from, and engaging in other transactions with the mutual fund without exemptive relief from the Securities and Exchange Commission. *See* 15 U.S.C. § 80a-17(a)-(b), (d) (2014).

**SECTION 8-508. TRUSTEE’S RIGHT TO INFORMATION.** A trustee has the right to receive from a statutory trust or another trustee information relating to the affairs of the trust which is reasonably related to the trustee’s discharge of the trustee’s duties as trustee. The trustee may enforce this right by summary proceeding in [the appropriate court].

## Comment

Under Section 8-104(9), the governing instrument may not override the trustee's right to information under this section. However, the trustee's right to information is limited to information "reasonably related to the trustee's discharge of the trustee's duties as trustee," and the governing instrument may prescribe the standards by which "reasonably related" is determined if those standards are not manifestly unreasonable.

By linking the trustee's information rights to the scope of the trustee's duties as trustee, this section makes the trustee's right to information function-specific. This section therefore facilitates the creation of a limited-role or directed trustee that will not have access to confidential information unrelated to the trustee's limited role—for example, a trustee whose duties run exclusively to a particular series as is contemplated by Section 8-404. At the same time, this section ensures that such a trustee will have access to information reasonably related to discharging the trustee's duties in connection with the trustee's limited role.

Allowing summary or expedited proceedings for access to information is familiar business entity law. *See* Model Business Corporation Act §§ 16.04-16.05.

Section 8-608 addresses a beneficial owner's right to information.

### **SECTION 8-509. REIMBURSEMENT, INDEMNIFICATION, ADVANCEMENT, EXONERATION, AND INSURANCE.**

(a) A statutory trust shall reimburse a trustee for any payment made by the trustee in the course of the trustee's activities on behalf of the statutory trust, if the trustee complied with Sections 8-505 and 8-615 in making the payment.

(b) A statutory trust may indemnify and hold harmless a trustee, beneficial owner, or person designated pursuant to Section 8-103(e)(8) or (9) with respect to any claim or demand against the person by reason of the person's relationship with the trust if the claim or demand does not arise from the person's conduct involving bad faith, willful or intentional misconduct, or knowing violation of law.

(c) Expenses, including reasonable attorney's fees and costs, incurred by a trustee, beneficial owner, or person designated pursuant to Section 8-103(e)(8) or (9) in connection with a claim or demand against the person by reason of the person's relationship to a statutory trust

may be paid by the trust before the final disposition of the claim or demand, upon an undertaking by or on behalf of the person to repay the trust if the person is ultimately determined not to be entitled to be indemnified under subsection (b).

(d) A term in the governing instrument relieving or exonerating a trustee or person designated under Section 8-103(e)(8) or (9) from liability is unenforceable to the extent it relieves or exonerates the trustee or person from liability for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law.

(e) A statutory trust may purchase and maintain insurance on behalf of a trustee, person designated under Section 8-103(e)(8) or (9), or beneficial owner of the trust against liability asserted against or incurred by the trustee, person, or beneficial owner in that capacity or arising from that status even if, under Section 8-104(10), the trust instrument could not eliminate or limit the person's liability to the trust for the conduct giving rise to the liability.

### **Comment**

Under this section the governing instrument may provide for indemnification, advancement of expenses, or exoneration, but not for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law. Section 8-104(10) makes this limitation mandatory. This section does not affect the power of a court to issue injunctive or other equitable relief for breach of trust.

Prohibiting indemnification and exoneration for conduct involving bad faith, willful or intentional misconduct, or knowing violation of law is consistent with familiar trust law. *See* Uniform Trust Code (2000) (Last Amended 2010) § 1008(a) (“A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries.”); RESTATEMENT (THIRD) OF TRUSTS § 96, cmt. c (2012) (“Notwithstanding the breadth of language in a trust provision relieving a trustee from liability for breach of trust, for reasons of policy trust fiduciary law imposes limitations on the types and degree of misconduct for which the trustee can be excused from liability. Hence, an exculpatory clause cannot excuse a trustee for a breach of trust committed in bad faith. Nor can the trustee be excused for a breach committed with indifference to the interests of the beneficiaries or to the terms and purposes of the trust—that is, committed without reasonable effort to understand and conform to applicable fiduciary duties.”).

The Delaware Statutory Trust Act is in accord. Section 3806(e) of that Act provides that the “governing instrument may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a trustee ... ; provided, that [the] governing instrument may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.” Similar limits are common in corporate and alternative entity law. *See* Delaware General Corporation Law § 102(b)(7) (2009); Delaware Limited Liability Company Act § 18-1101(c), (e) (2009); Model Business Corporation Act § 2.02(b)(4)-(5).

In *Nakahara v. The NS 1991 American Trust*, 739 A.2d 770 (Del. Ch. 1998), the court held that a Delaware statutory trust had the power to advance litigation expenses, but denied the trustees’ request for indemnification on the grounds of unclean hands.

An indemnification provision in the governing instrument of a statutory trust that operates as a mutual fund is subject to Section 17(h) of the Investment Company Act of 1940, which generally prohibits a fund from including in its organizational documents any provision that protects a trustee or officer of a fund against liability to the fund or its shareholders by reason of “willful misfeasance, bad faith, gross negligence or reckless disregard” of the person’s duties as trustee or officer. 15 U.S.C. § 80a-17(h) (2014).

The SEC has taken the position that, before advancing legal fees to a trustee of a mutual fund, the “fund’s board must either (1) obtain assurances, such as by obtaining insurance or receiving collateral provided by the [trustee], that the advance will be repaid if the [trustee] is found to have engaged in disabling conduct, or (2) have a reasonable belief that the [trustee] has not engaged in disabling conduct and ultimately will be entitled to indemnification.” *Interpretive Matters Concerning Independent Directors of Investment Companies*, Investment Company Act of 1940 Release No. 24083, 70 SEC Docket 2017 (Oct. 14, 1999). The SEC has also taken the position that there is a rebuttable presumption that an independent trustee (*see* Section 8-512) has not engaged in disabling conduct. *Id.*

#### **SECTION 8-510. DIRECTION OF TRUSTEES.**

(a) The governing instrument may authorize any person, including a beneficial owner, to direct a trustee or other person in the management of a statutory trust.

(b) The governing instrument may provide that neither the power to direct a trustee or other person nor the exercise of the power by any person, including a beneficial owner, causes the person to be a trustee or imposes on the person duties, including fiduciary duties, or liabilities relating to these duties, to a statutory trust or beneficial owner.

(c) If the governing instrument confers on a person a power to direct actions by a trustee

or other person, the trustee or other person shall act in accordance with an exercise of the power, unless the direction is manifestly contrary to the terms of the governing instrument or the trustee knows or has reason to know that following the direction would constitute a serious breach of fiduciary duty by the trustee.

### **Comment**

The principal sources used by the drafting committee in fashioning this section were Delaware Statutory Trust Act § 3806 (2009) and Uniform Trust Code § 808 (2000) (Last Amended 2010).

Subsection (a) authorizes the use of a directed trustee, meaning a trustee that must act in accordance with the directions of another person. Subsection (b) confirms that the governing instrument may provide that a person that has the power to direct the trustee is not a trustee and owes no duties, fiduciary or otherwise, to the statutory trust or to a beneficial owner. Under trust default law in many states, a person that has a power to direct the trustee is presumptively a fiduciary. *See* Uniform Trust Code (2000) (Last Amended 2010) § 808(d); RESTATEMENT (THIRD) OF TRUSTS § 75, cmts. c, e, and f (2007).

Following Uniform Trust Code (2000) (Last Amended 2010) § 808(b), subsection (c) provides that the trustee must refuse to follow a direction that is manifestly contrary to the terms of the governing instrument or that the trustee knows or has reason to know would constitute a serious breach of fiduciary duty. *See also* RESTATEMENT (THIRD) OF TRUSTS § 75 (2007).

The reference in subsection (c) to a “serious” breach of fiduciary duty is meant to exclude an inconsequential, immaterial, or technical breach that does not harm the trust or a beneficial owner. For some purposes, such as trustee removal, trust law distinguishes between “serious” and other breaches of trust. *See, e.g.*, Uniform Trust Code (2000) (Last Amended 2010) § 706(b)(1); RESTATEMENT (SECOND) OF TRUSTS § 107, cmt. b (1959); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 2 SCOTT AND ASCHER ON TRUSTS § 11.10 (5th ed. 2006).

In determining whether a direction is “manifestly contrary to the terms of the governing instrument” or “would constitute a serious breach of fiduciary duty by the trustee,” the trustee must comply with the standards of conduct stated in Section 8-505. The drafting committee contemplated that, in accord with conventional trust practice, a trustee could apply to the appropriate court for instructions in cases of reasonable doubt about whether a direction falls within the exclusion of subsection (c). *See* RESTATEMENT (THIRD) OF TRUSTS § 71 (2007).

Under Section 8-104(11), the obligation of a trustee not to follow a direction that is manifestly contrary to the terms of the governing instrument or that would constitute a serious breach of trust is not subject to override by the governing instrument.

In conjunction with Section 8-511, this section facilitates the practice of creating a



limited purpose trustee—for example, in a securitization transaction the naming of a person who is responsible for computing distributions or whose consent is required before the statutory trust can petition for bankruptcy.

#### **SECTION 8-511. DELEGATION BY TRUSTEE.**

(a) A trustee may delegate duties and powers. The trustee shall exercise the care a person in a similar position would reasonably believe appropriate under similar circumstances in:

- (1) selecting an agent;
- (2) establishing the scope and terms of the delegation; and
- (3) periodically reviewing the agent's actions in order to monitor the agent's

performance and compliance with the terms of the delegation.

(b) Subject to subsection (a), a trustee may delegate duties and powers to a co-trustee.

(c) In performing a delegated function, an agent of a trustee owes a duty to the statutory trust to exercise reasonable care to comply with the terms of the delegation.

(d) A trustee that complies with subsection (a) is not liable to a beneficial owner or to the statutory trust for an act or omission of the agent of the trustee to which a function was delegated.

(e) An agent of a trustee submits to the jurisdiction of the courts of this state by accepting a delegation of powers or duties from a trustee with respect to a claim related to the agency.

#### **Comment**

By reversing the outmoded common-law rule that prohibited delegation by a trustee, *see* John H. Langbein, *Reversing the Nondelegation Rule of Trust-Investment Law*, 59 MO. L. REV. 105 (1994), this section is intended to facilitate delegation to specialists. In authorizing delegation, this section follows the Delaware Statutory Trust Act and modern law with respect to common-law trusts. *See* Delaware Statutory Trust Act § 3806(i) (2009); Uniform Trust Code (2000) (Last Amended 2010) § 807; RESTATEMENT (THIRD) OF TRUSTS § 80 (2007); *see also* Uniform Prudent Investor Act § 9 (1994).

Subsections (a), (c), (d), and (e) are patterned on Uniform Trust Code (2000) (Last Amended 2010) § 807, which is derived from Uniform Prudent Investor Act § 9. However, this

section deviates from those acts on delegation to a co-trustee. Subsection (b) treats delegation to a co-trustee in the same manner as delegation to another person. By contrast, traditional trust law disfavors delegation by one co-trustee to another. *See* Uniform Trust Code (2000) (Last Amended 2010) § 703(e); RESTATEMENT (THIRD) OF TRUSTS § 81, cmt. c(1) (2007). The traditional rule is based on the assumption that, if the donor named more than one trustee, the donor intended each to be a check on the others. That policy does not fit commercial statutory trust practice, in which limited-purpose trustees are common.

There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

This section is designed to strike the appropriate balance between the advantages and the hazards of delegation. It authorizes delegation under the limitations of subsections (a) and (c). Subsection (a) requires the trustee to exercise the care a person in a similar position would reasonably believe appropriate under similar circumstances in selecting the agent, in establishing the terms of the delegation, and in monitoring the agent's compliance with the terms of the delegation.

The trustee's duty of care in framing the terms of the delegation should protect the beneficial owners against overbroad delegation. For example, a trustee could not prudently agree to a delegation agreement containing an exculpation clause that leaves the statutory trust without recourse against reckless action or bad faith by the agent. Leaving the trust without a remedy for willful wrongdoing is inconsistent with the trustee's duty of care in formulating the terms of the delegation.

Although subsection (d) exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection (a), subsection (c) makes the agent responsible to the statutory trust. The beneficial owners can, therefore, rely upon the trustee to enforce the terms of the delegation.

Mutual funds often receive a common set of services from an organization, typically the investment advisor or an affiliate, that specializes in operating mutual funds. The trustees monitor the service providers and the Investment Company Act of 1940 requires the trustees to approve the contracts with the advisor or affiliate. *See* 15 U.S.C. § 80a-15 (2014).

## **SECTION 8-512. INDEPENDENT TRUSTEE IN REGISTERED INVESTMENT COMPANY.**

(a) In this section, "affiliated person" and "interested person" have the meanings set forth

in the Investment Company Act of 1940, [as amended,] 15 U.S.C. Section 80a-1 et seq. [or any successor statute] [and any regulations issued thereunder].

(b) If a statutory trust is registered as an investment company under the Investment Company Act of 1940, [as amended,] 15 U.S.C. Section 80a-1 et seq., [or any successor statute] [and any regulations issued thereunder,] a trustee is an independent trustee for all purposes under this [article] if the trustee is not an interested person of the trust. The receipt of compensation both for service as an independent trustee of the trust and for service as an independent trustee of one or more other investment companies managed by a single investment adviser or an affiliated person of an investment adviser, does not affect the status of the trustee as an independent trustee under this section.

### **Comment**

This section addresses the question of trustee independence in circumstances in which a trustee serves as a director on multiple mutual fund boards within the same fund complex. In *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997) (applying Maryland law), the plaintiffs brought a derivative suit against a fund's investment advisor alleging excessive fees. The plaintiffs did not, however, make a demand on the fund's directors prior to filing suit. The court excused the plaintiffs from the demand requirement because the directors served on multiple boards within the complex, receiving "substantial remuneration," and thus were not independent in light of their close financial relationship with the investment advisor. *Id.* at 793-95.

The Maryland legislature effectively overruled *Strougo* in 1998 by amending the Maryland corporate code to provide that directors who are not "interested persons" under the Investment Company Act of 1940 are deemed disinterested under Maryland law. *See* Md. Code Ann., Corps. & Ass'ns § 2-405.3 (West 2009). A similar provision took effect in Massachusetts in 1999, *see* Mass. Gen. Laws. ch. 182, § 2B (2009), and in Delaware in 2000, *see* Delaware Statutory Trust Act § 3801(h) (2009). Almost all mutual funds are organized as Maryland corporations, Massachusetts trusts, or Delaware statutory trusts. Consistent with the Maryland, Massachusetts, and Delaware legislation, this section rejects *Strougo* by deeming a trustee to be independent if the trustee is not an interested person under the Investment Company Act of 1940. *See* 15 U.S.C. § 80a-2(19) (2014).

## **[PART] 6**

### **BENEFICIAL OWNERS**

#### **SECTION 8-601. BENEFICIAL INTEREST.**

- (a) A beneficial interest in a statutory trust is personal property.
- (b) A beneficial interest in a statutory trust is not an interest in specific property of the statutory trust.
- (c) A beneficial owner does not have a preemptive right to subscribe to any additional issue of beneficial interests or any other interest of a statutory trust.

#### **Comment**

**Subsections (a) and (b)** follow from the principle that a statutory trust is an entity separate from its beneficial owners (*see* Section 8-302). They are based on Delaware Statutory Trust Act § 3805 (2009).

**Subsection (c)** is derived from the Model Business Corporation Act § 6.30.

#### **SECTION 8-602. TRANSFER OF BENEFICIAL INTEREST.**

- (a) In this section, “covered creditor” means a judgment creditor of a beneficial owner or a person to which a beneficial interest in a statutory trust has been transferred by operation of law.
- (b) A beneficial interest in a statutory trust is freely transferable.
- (c) The governing instrument may not limit the transferability of a beneficial interest if the same person is the sole trustee and sole beneficial owner.
- (d) If a beneficial interest in a statutory trust is not freely transferable by a beneficial owner under a provision of the governing instrument such that a transferee may become a beneficial owner without further requirement except notice to the statutory trust, the following rules apply:

(1) On petition by a covered creditor, [the appropriate court] may authorize the petitioner to reach the beneficial owner's interest by attachment of present or future distributions to or for the benefit of the beneficial owner or by other means. The court may limit the award to relief that is appropriate under the circumstances.

(2) On petition by a covered creditor, to the extent a trustee has not complied with a standard of distribution provided in the governing instrument or has abused the trustee's discretion to make a distribution, [the appropriate court]:

(A) may order a distribution to the benefit of the petitioner; and

(B) if a distribution is ordered, shall direct the trustee to pay to the petitioner an equitable amount but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficial owner if the trustee had complied with the standard or had not abused the discretion.

### **Comment**

This section addresses the transferability of a beneficial interest in a statutory trust and the rights of a creditor of a beneficial owner to levy on the owner's interest in the trust.

**Subsection (a)** defines the term "covered creditor" within this section as "a judgment creditor of a beneficial owner or a person to which a beneficial interest in a statutory trust has been transferred by operation of law."

**Subsection (b)** provides as a default rule that a beneficial interest in a statutory trust is freely transferable. This subsection therefore overrides the rule in some states that makes a common-law trust spendthrift by default. *See* Jeffrey A. Schoenblum, *MULTISTATE GUIDE TO TRUSTS AND TRUST ADMINISTRATION* tbl. 5, pt. 1 (2012) (identifying such states). However, because this subsection is not scheduled in Section 8-104, the governing instrument may limit the transferability of a beneficial interest as is confirmed by Section 8-103(e)(2). Subsections (c) and (d) impose safeguards against limits on transferability that are abusive toward creditors.

**Subsection (c)** provides that the transferability of a beneficial interest may not be limited if the same person is the sole trustee and sole beneficial owner. Under the merger doctrine of the common law of trusts, in such circumstances the legal and equitable title in the trust property would merge, and the trust would terminate, so that no person could be both the sole trustee and sole beneficiary of property protected from the person's creditors. This subsection is necessary to reach the same result, because Section 8-306(d) overrides the application to a statutory trust of

the common-law merger doctrine. The drafting committee concluded that the same person could be the sole trustee and sole beneficiary of a statutory trust, but for reasons of policy in such circumstances the beneficial interest must be freely transferable and so reachable by the person's creditors.

**Subsection (d)** addresses the rights of a creditor of a beneficial owner whose beneficial interest in a statutory trust is not freely transferable. Drawing in part on the language of Uniform Trust Code (2000) (Last Amended 2010) § 504, subsection (d) authorizes the “attachment of present or future distributions to or for the benefit of a beneficial owner.” Subsection (d) also authorizes a creditor to stand in the shoes of a beneficial owner for the purpose of compelling a distribution by a trustee who has “not complied with a standard of distribution ... or has abused the trustee's discretion to make a distribution.”

Subsection (d) thus rejects the possibility of a spendthrift statutory trust, that is, the creation of beneficial interests over which creditors of the beneficiary have no recourse. “In the American tradition, ... the trust is regarded as a conditional gift, and a beneficiary takes his interest in the trust subject to any restrictions imposed by the settlor. Within American law, freedom of disposition includes the right to impose conditions on the beneficiary's enjoyment if the trust property, including a disabling restraint on voluntary and involuntary alienation of the beneficial interest.” Jesse Dukeminier & Robert H. Sitkoff, *WILLS, TRUSTS, AND ESTATES* 696 (9th ed. 2013). The drafting committee reasoned that this policy basis for allowing a spendthrift trust, implementing the donor's right to freedom of disposition, does not pertain to a business trust that is a creature of freedom of contract. Under Section 8-303(b), a statutory trust may not have a predominantly donative purpose.

Under Section 8-104(12), the governing instrument may not vary the provisions of subsections (a), (c), and (d).

**SECTION 8-603. VOTING OR CONSENT BY BENEFICIAL OWNERS.** On any matter that is to be acted on by beneficial owners, the following rules apply:

(1) The beneficial owners act by majority of the beneficial interests.

(2) The beneficial owners may take the action without a meeting, without notice, and without a vote, if beneficial owners having at least the minimum number of votes necessary to authorize or take the action at a meeting at which all beneficial owners entitled to vote thereon were present and voted consent in a signed record. However, prompt notice of the action must be given to those beneficial owners that did not consent.

(3) A beneficial owner may vote in person or by proxy, but if by proxy, the proxy must be contained in a signed record.

## Comment

Except for merger, interest exchange, conversion, and domestication transactions under Article 2, dissolution under Part 7, and amendment of the governing instrument under Section 8-103(d), nothing in this article provides for the beneficial owners to act on any matter. However, the governing instrument may provide the beneficial owners such a right. This section supplies default rules for voting by the beneficial owners in such circumstances. In the usual case, the governing instrument will address voting rules by providing a per capital or other share-based allocation of voting rights. The drafting committee declined the suggestion to try to incorporate such a rule as a default, however, because such rules are necessarily transaction-specific and hence infeasible to specify in a default. *Cf.* Section 3-401(h) (1997) (giving each partner “equal rights in the management and conduct of the partnership business”).

The Investment Company Act of 1940 specifies the percentage of votes necessary to approve certain actions related to the investment company. In other instances, that Act requires the action to be approved at a shareholders’ meeting called for that purpose. In such instances, approval of the action by the shareholders’ written consent without notice would not be valid. For example, Section 16(a) provides that “[n]o person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or a special meeting duly called for that purpose.” 15 U.S.C. § 80a-16(a) (2014). In addition, investment companies seeking the vote of shareholders on specific actions must comply with rules governing the communication to, and solicitation of, their shareholders. *See* Rules 14a-1 to 14b-2, 17 C.F.R. §§ 240.14a-1 to 240.14b-2 (2014). These rules are significantly more comprehensive than most state laws governing communications to shareholders and other aspects of shareholder meetings.

Section 8-103(e)(4) confirms that the governing instrument may override the rules stated in this section.

### **SECTION 8-604. FORM OF AND LIABILITY FOR CONTRIBUTIONS.**

(a) A contribution may consist of property transferred to, services performed for, or another benefit provided to the statutory trust or an agreement to transfer property to, perform services for, or provide another benefit to the trust.

(b) A person may become a beneficial owner of a statutory trust and may receive a beneficial interest in a statutory trust without making a contribution or being obligated to make a contribution to the trust.

(c) A person’s obligation to make a contribution to a statutory trust is not excused by the person’s death, disability, termination, or other inability to perform personally.

(d) If a person does not fulfill an obligation to make a contribution other than money, the person is obligated at the option of the trustee to contribute money equal to the value of the part of the contribution which has not been made.

(e) The governing instrument may provide that a beneficial owner that fails to make a required contribution, or comply with the terms and conditions of the governing instrument, is subject to consequences of the failure, including:

(1) reduction or elimination of the defaulting beneficial owner's proportionate interest in the statutory trust or series thereof;

(2) subordination of the defaulting beneficial owner's beneficial interest to that of nondefaulting beneficial owners;

(3) forced sale of the defaulting beneficial owner's beneficial interest;

(4) imposition of an obligation to repay a loan to the statutory trust by another beneficial owner of the amount necessary to meet the defaulting beneficial owner's commitment;

(5) redemption or sale of the defaulting beneficial owner's beneficial interest at a value fixed by appraisal or by formula; and

(6) specific performance of an obligation under the governing instrument.

### **Comment**

**Subsection (a)** deals with the form of a contribution (defined in Section 8-102(a)(4)). Comparable language exists in most corporate and unincorporated business entity statutes.

**Subsection (b)** acknowledges that a beneficial owner may obtain a beneficial interest without an exchange of consideration, a possibility that is not uncommon in existing commercial practice. However, a statutory trust may not be used to effect a donative transfer, as Section 8-303(b) prohibits a statutory trust from having a "predominantly donative purpose."

**Subsection (c)** overrides any common law principle of impracticability or otherwise, such as under RESTATEMENT (SECOND) OF CONTRACTS §§ 261-262 (1981), that might discharge a duty to perform on account of death or incapacity. The reference to "perform personally" is not limited to individuals but rather may refer to any person, including an entity, that has a non-



delegable duty.

**Subsections (d) and (e)** authorize specified penalties for a beneficial owner's failure to comply with an obligation in the governing instrument to make a contribution. *Cf.* Delaware Statutory Trust Entity Act § 3802(c) (2009); Delaware Limited Liability Company Act § 18-502(c) (2009).

Section 8-103(e)(1) confirms that the governing instrument may specify the means for determining beneficial ownership. Section 8-103(e)(12) confirms that the governing instrument may specify the conditions under which a person becomes a beneficial owner.

#### **SECTION 8-605. SHARING OF AND RIGHT TO DISTRIBUTIONS BEFORE DISSOLUTION.**

(a) Any distribution made by a statutory trust before its dissolution and winding up must be in proportion to the beneficial interests.

(b) If a beneficial owner becomes entitled to receive a distribution, the beneficial owner has the status of, and is entitled to all remedies available to, a creditor of the statutory trust with respect to the distribution.

(c) A beneficial owner has a right to a distribution before the dissolution and winding up of a statutory trust only if the trustee decides to make an interim distribution. A beneficial owner does not have a right to demand or receive a distribution from the trust in any form other than money.

(d) Except as otherwise provided in Section 8-703(b), the trust may distribute an asset in kind only if each part of the asset is fungible with each other part and each beneficial owner receives a percentage of the asset equal in value to the beneficial owner's share of the distributions.

#### **Comment**

The principal sources used by the drafting committee in fashioning this section, which deals with interim distributions, were Delaware Statutory Trust Act § 3805 (2009) and Section 5-404 (limited liability companies). Section 8-703 deals with liquidating distributions. Section 8-

615 sets forth limitations on distributions.

In a statutory trust that is a registered investment company organized as an open-end mutual fund, a shareholder (beneficial owner) may request a redemption of any or all of his shares (beneficial interests), and the statutory trust is obligated to honor the redemption request and pay the redemption proceeds within seven days (except under limited circumstances such as an emergency). *See* 15 U.S.C. § 80a-22(e) (2014). The redemption proceeds must be in the form of cash unless the open-end mutual fund has filed with the Securities and Exchange Commission a notification of election on Form N-18F-1. *See* 17 C.F.R. § 270.18f-1 (2014). In such a case, the open-end mutual fund may pay the redemption in kind (*i.e.*, distribute assets of the fund instead of cash) to a shareholder that during the previous 90-day period has redeemed either (1) \$250,000 or more of shares, or (2) shares equal to one or more percent of the net asset value of the fund. *Id.*

Section 8-103(e)(14) confirms that the governing instrument may provide for the establishment of record dates for distributions.

**SECTION 8-606. REDEMPTION OF BENEFICIAL INTEREST.** A statutory trust may acquire, by purchase, redemption, or otherwise, any beneficial interest in the trust or series thereof. A beneficial interest acquired under this section is canceled.

#### **Comment**

The principal source used by the drafting committee in fashioning this section was Delaware Statutory Trust Act § 3806 (2009).

A registered investment company organized as an open-end mutual fund generally is obligated to honor redemption requests by its shareholders at the net asset value per share next calculated after receipt of the request, with payment to be made in cash (or, in some cases, in kind) within seven days of the request. *See* 15 U.S.C. § 80a-22 (2014); 17 CFR § 270.22c-1 (2014). In narrowly defined circumstances, this redemption right and obligation may be postponed. *See* 15 U.S.C. § 80a-22(e) (2014). The redemption proceeds may be reduced by various fees retained by the fund and/or its selling agent (*i.e.*, redemption fees and sales loads). *See* 17 CFR §§ 270.22c-2, 270.6c-10 (2014).

**SECTION 8-607. TRANSACTION WITH BENEFICIAL OWNER.** Subject to Section 8-507, a beneficial owner or related party of a beneficial owner may lend money to, borrow money from, act as a surety, guarantor, or endorser for, guarantee or assume an obligation of, provide collateral for, or do other business with the statutory trust and, subject to law other than this [article], has the same rights and obligations with respect to those matters as a

person that is not a beneficial owner.

### **Comment**

This section validates transactions between a statutory trust and a beneficial owner or a related party of a beneficial owner, unless the beneficial owner or related party of the beneficial owner is a covered party under Section 8-507, in which case the rules of that section apply. Delaware Statutory Trust Act § 3806(h) (2009) is to similar effect.

### **SECTION 8-608. BENEFICIAL OWNER'S RIGHT TO INFORMATION. A**

beneficial owner has the right to receive from the statutory trust or a trustee information relating to the affairs of a statutory trust which is reasonably related to the beneficial owner's interest.

The beneficial owner may enforce this right by summary proceeding in the [appropriate court].

### **Comment**

Under Section 8-104(13), a beneficial owner's right to information under this section is not subject to override by the governing instrument. However, a beneficial owner's right to information under this section is limited to information "reasonably related to the beneficial owner's interest," and under Section 8-104(13), the governing instrument may prescribe the standards by which "reasonably related" is determined if those standards are not manifestly unreasonable.

Imposing a mandatory, minimum right to information necessary for the beneficiary to be able to enforce the trust is familiar law. *See* RESTATEMENT (THIRD) OF TRUSTS § 82, cmt. a(2) (2007) (providing that "a beneficiary is always entitled ... to request such information as is reasonably necessary to enable the beneficiary to prevent or redress a breach of trust and otherwise to enforce his or her rights under the trust"); *see also* Austin W. Scott, William F. Fratcher & Mark L. Ascher, 3 SCOTT AND ASCHER ON TRUSTS § 17.5 (5th ed. 2007); T.P. Gallanis, *The Trustee's Duty to Inform*, 85 N.C. L. REV. 1595 (2007).

The drafting committee declined the suggestion to include in this section a schedule of accessible information on the grounds that such a schedule necessarily would be over- and under-inclusive. Instead, the committee contemplated that the term "reasonably related" would provide a more apt right to information, because the beneficiary could obtain a court order in a summary proceeding for the release of any type of information that bears on the beneficial owner's beneficial interest.

Allowing summary or expedited proceedings for access to information is familiar business entity law. *See, e.g.*, Model Business Corporation Act §§ 16.04-16.05.

Section 8-508 addresses a trustee's right to information.

**SECTION 8-609. DIRECT ACTION BY BENEFICIAL OWNER.** A beneficial owner may maintain a direct action against a statutory trust to redress an injury sustained by, or to enforce a duty owed to, the beneficial owner only if the owner can 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 statutory trust.

### **Comment**

A beneficial owner does not have a direct claim against a trustee merely because the trustee has breached the trustee's standard of conduct or the terms of the trust's governing instrument. To have standing to bring a direct claim, the beneficial owner must be able to show a direct harm or injury—*i.e.*, a harm or injury that is independent of the harm or injury caused or threatened to be caused to the statutory trust.

The reference to “threatened injury” allows for claims for preventive relief, such as a temporary restraining order or preliminary injunction.

Under Section 8-104(14), the governing instrument may not eliminate the right of a beneficial owner to bring a direct action under this section or a derivative action under Section 8-610. However, Section 8-104(14) permits the governing instrument to subject the right to bring an action to additional standards and restrictions, including the requirement that beneficial owners owning a specified amount or type of beneficial interest join in bringing the action, provided that the additional standards and restrictions are not manifestly unreasonable.

In protecting the right to bring suit, but allowing that right to be subjected to additional standards and restrictions that are not manifestly unreasonable, the drafting committee balanced two policy objectives that are in tension. On the one hand, without the right to bring an action, a beneficial owner might have no recourse in the event of trustee misconduct. On the other hand, without appropriate safeguards, a meritless action might be brought with the aim of extracting a nuisance settlement. *See, e.g.*, Reinier Kraakman, Hyun Park & Steven Shavell, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEORGETOWN L.J. 1733 (1994).

For a discussion of remedies, see the comment to Section 8-105.

**SECTION 8-610. DERIVATIVE ACTION.** A beneficial owner may maintain a derivative action to enforce a right of a statutory trust if:

(1) the beneficial owner first makes a demand on the trustees, requesting that the trustees cause the trust to bring an action to redress the injury or enforce the right, and the trustees do not bring the action within a reasonable time; or

(2) a demand under paragraph (1) would be futile.

### **Comment**

**Paragraph (1)** – The demand requirement recognizes that, presumptively at least, the decision to cause a statutory trust to bring suit is a business decision, to be made by those who manage the business. Deborah A. DeMott, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 5.9 (2012).

**Paragraph (2)** – Although some jurisdictions have a universal demand requirement, the futility rule adopted in this paragraph is the majority approach. *Id.* § 5.12.

Under Section 8-104(14), the governing instrument may not eliminate the right of a beneficial owner to bring a direct action under this section or a derivative action under Section 8-609. However, Section 8-104(14) permits the governing instrument to subject the right to bring an action to additional standards and restrictions, including the requirement that beneficial owners owning a specified amount or type of beneficial interest join in bringing the action, provided that the additional standards and restrictions are not manifestly unreasonable.

**SECTION 8-611. PROPER PLAINTIFF.** A derivative action to enforce a right of a statutory trust may be maintained only by a person that is a beneficial owner at the time the action is commenced and:

- (1) was a beneficial owner when the conduct giving rise to the action occurred; or
- (2) whose status as a beneficial owner devolved on the person by operation of law or pursuant to the terms of the governing instrument from a person that was a beneficial owner at the time of the conduct.

### **Comment**

The standing rule stated in this section is conventional in the law of unincorporated entities and in corporate law. A transferee of a beneficial owner has no standing to bring a derivative action.

**SECTION 8-612. PLEADING.** In a derivative action, the complaint must state with particularity:

- (1) the date and content of plaintiff's demand and the response to the demand by the trustees; or

(2) why demand should be excused as futile.

### **Comment**

This pleading requirements of this section implement Section 8-610 and are traceable to Uniform Limited Partnership Act § 1003 (1976/1985).

### **SECTION 8-613. SPECIAL LITIGATION COMMITTEE.**

(a) If a statutory trust is named as or made a party in a derivative proceeding, the trust may appoint a special litigation committee to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests of the trust. If the trust appoints a special litigation committee, on motion by the committee made in the name of the trust, except for good cause shown, the court shall stay discovery for the time reasonably necessary to permit the committee to make its investigation. This subsection does not prevent the court from:

(1) enforcing a person's right to information under Section 8-508 or 8-608; or

(2) granting extraordinary relief in the form of a temporary restraining order or preliminary injunction.

(b) A special litigation committee must be composed of one or more disinterested and independent individuals, who may be trustees.

(c) A special litigation committee may be appointed:

(1) by a majority of the trustees not named as parties in the proceeding; or

(2) if all trustees are named as parties in the proceeding, by a majority of the trustees named as defendants.

(d) After appropriate investigation, a special litigation committee may determine that it is in the best interests of the statutory trust that the proceeding:

(1) continue under the control of the plaintiff;

- (2) continue under the control of the committee;
- (3) be settled on terms approved by the committee; or
- (4) be dismissed.

(e) After making a determination under subsection (d), a special litigation committee shall file with the court a statement of its determination and its report supporting its determination and shall serve each party with a copy of the determination and report. The court shall determine whether the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof. If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court shall enforce the determination of the committee. Otherwise, the court shall dissolve the stay of discovery entered under subsection (a) and allow the action to continue under the control of the plaintiff.

### **Comment**

This section is substantially identical to the comparable provisions in the other unincorporated filing entity acts. *See, e.g.*, Section 5-805 (limited liability companies). This section is consistent with established law in most jurisdictions, modified to fit the context of a statutory trust. Under Section 8-104(15), a governing instrument can preclude the use of special litigation committee, rendering this section inapplicable, but it cannot otherwise vary this section.

The standard of review in subsection (e) follows *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979) rather than *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981), because the latter's reference to a court's business judgment has generally not been followed in other states.

### **SECTION 8-614. PROCEEDS AND EXPENSES.**

(a) Except as otherwise provided in subsection (b):

(1) any proceeds or other benefits of a derivative action, whether by judgment, compromise, or settlement, belong to the statutory trust and not to the plaintiff; and

(2) if the plaintiff receives any proceeds, the plaintiff shall remit them immediately to the trust.

(b) If a derivative action is successful in whole or in part, the court may award the plaintiff reasonable expenses, including attorney's fees and costs, from the recovery by the trust.

(c) A derivative action on behalf of a statutory trust may not be voluntarily dismissed or settled without the court's approval.

### **Comment**

**Subsection (a)** deals with the allocation of any proceeds of a derivative action.

**Subsection (b)** deals with reimbursement of expenses, including attorney's fees and costs.

**Subsection (c)** imposes a requirement of court approval for a voluntary dismissal or settlement of a derivative action. The requirement is intended to prevent abuse by way of a collusive settlement.

### **SECTION 8-615. LIMITATIONS ON DISTRIBUTIONS.**

(a) A statutory trust may not make a distribution, including a distribution under Section 8-703(b)(2), if after the distribution:

(1) the trust would not be able to pay its debts as they become due in the ordinary course of the trust's activities and affairs; or

(2) the trust's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the trust were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of beneficial owners and transferees whose preferential rights are superior to the rights of persons receiving the distribution.

(b) A trustee may base a determination that a distribution is not prohibited under subsection (a) on:



(1) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances; or

(2) a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subsection (e), the effect of a distribution under subsection (a) is measured:

(1) in the case of a distribution by purchase, redemption, or other acquisition of a beneficial interest, as of the earlier of:

(A) the date money or other property is transferred or debt incurred by the statutory trust; or

(B) the date the person entitled to the distribution ceases to own the interest or rights being acquired by the trust in return for the distribution;

(2) in the case of any other distribution of indebtedness, as of the date the indebtedness is distributed; and

(3) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs not later than 120 days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(d) A statutory trust's indebtedness to a beneficial owner or transferee incurred by reason of a distribution made in accordance with this section is at parity with the trust's indebtedness to its general, unsecured creditors, except to the extent subordinated by agreement.

(e) A statutory trust's indebtedness, including indebtedness issued as a distribution, is not a liability for purposes of subsection (a) if the terms of the indebtedness provide that payment of

principal and interest are made only if and to the extent that payment of a distribution could then be made under this section. If indebtedness is issued as a distribution, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is made.

(f) In measuring the effect of a distribution under Section 8-703(b)(2), the liabilities of a dissolved statutory trust do not include any claim that has been disposed of under Section 8-704, 8-705, or 8-706.

### **Comment**

Both this section and Section 8-616 were derived from Model Business Corporation Act § 6.40. The other uniform acts on unincorporated entities contain similar provisions. For further discussion, see the comments to Sections 5-405 and 5-406 (limited liability companies).

### **SECTION 8-616. LIABILITY FOR IMPROPER DISTRIBUTIONS.**

(a) If a trustee consents to a distribution made in violation of Section 8-615 and in consenting to the distribution fails to comply with Section 8-505, the trustee is personally liable to the trust or the series thereof for the amount of the distribution which exceeds the amount that could have been distributed without the violation of Section 8-505.

(b) A person that receives a distribution knowing that the distribution violated Section 8-615 is personally liable to the statutory trust or series thereof but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 8-615.

(c) A trustee against which an action is commenced because the trustee is liable under subsection (a) may:

(1) implead any other trustee that is liable under subsection (a) and seek to enforce a right of contribution from the trustee; and

(2) implead any person that received a distribution in violation of subsection (b) and seek to enforce a right of contribution from the person in the amount the person received in violation of subsection (b).

(d) An action under this section is barred unless commenced not later than two years after the distribution.

### **Comment**

Both this section and Section 8-615 were derived from Model Business Corporation Act § 6.40. The other uniform acts on unincorporated entities contain similar provisions. For further discussion, see the comments to Sections 5-405 and 5-406 (limited liability companies).

## **[PART] 7**

### **DISSOLUTION AND WINDING UP**

**SECTION 8-701. EVENTS CAUSING DISSOLUTION.** A statutory trust is dissolved only by:

- (1) an administrative dissolution under Section 1-602; or
- (2) the filing of articles of dissolution under Section 8-702:
  - (A) with the approval of all the beneficial owners; or
  - (B) as provided in the certificate of trust.

### **Comment**

This section provides that a statutory trust may be dissolved only by delivering articles of dissolution under Section 8-702 or by administrative dissolution under Section 1-602 (*see also* Sections 1-601, 1-603, and 1-604). Under Section 8-306, the governing instrument need not provide for an event or circumstance that triggers dissolution, and may provide that the trust cannot be dissolved even with the approval of all the beneficial owners. In the absence of a contrary provision in the governing instrument, the default rule of unanimity stated in paragraph (2)(A) of this section prevails over the general rule of majority vote stated in Section 8-603(1). However, under Section 8-104(18), the governing instrument cannot override any of the provisions in this part.

## **SECTION 8-702. ARTICLES OF DISSOLUTION.**

(a) If dissolution of a statutory trust is authorized under Section 8-701, the trust shall deliver to the [Secretary of State] for filing articles of dissolution setting forth:

- (1) the name of the trust; and
- (2) the date of the dissolution.

(b) Except as otherwise provided in Section 1-203, a statutory trust is dissolved when articles of dissolution that comply with subsection (a) are filed by the [Secretary of State].

### **Comment**

The filing of articles of dissolution under subsection (a) makes the decision to dissolve a matter of public record and establishes the time when the statutory trust must begin the process of winding up under Section 8-703. Subsection (b) governs the effective date of the dissolution.

Under Section 8-104(18), the governing instrument may not override this section.

## **SECTION 8-703. WINDING UP.**

(a) A dissolved statutory trust shall wind up its activities and affairs, and the trust and each series thereof continues after dissolution only for the purpose of winding up.

(b) In winding up its activities and affairs, a statutory trust shall:

- (1) discharge the trust's debts, obligations, and other liabilities, settle and close the trust's activities and affairs, and marshal and distribute the property of the trust; and
- (2) distribute any surplus property after complying with paragraph (1) to the beneficial owners in proportion to their beneficial interests.

(c) In winding up its activities, a statutory trust may:

- (1) preserve the trust's activities and property as a going concern for a reasonable time;
- (2) institute, maintain, and defend actions and proceedings, whether civil,

criminal, or administrative;

(3) transfer the trust's property;

(4) settle disputes; and

(5) perform other acts necessary or appropriate to its winding up.

(d) Trustees of a dissolved statutory trust that has disposed of claims under Section 8-704 or 8-705 are not liable for breach of duty with respect to claims against the trust that are barred or satisfied under Section 8-704 or 8-705.

(e) The dissolution of a statutory trust does not terminate the authority of its agent for service of process.

(f) On application of any person that shows good cause, [the appropriate court] may appoint a person to be a receiver for a dissolved statutory trust with the power to undertake any action that might have been done by the trust during its winding up if the action is necessary for final settlement of the trust.

### **Comment**

Upon the effective date of the articles of dissolution under Section 8-702, a statutory trust may continue only for the purpose of winding up.

In winding up the statutory trust within a reasonable time, the trustees are neither required to undertake a fire sale of the property of the statutory trust on unfavorable terms nor permitted to continue the trust endlessly under the guise of winding up. The question of what period of time is "reasonable" under subsection (c)(1) turns on the totality of the circumstances. *See* RESTATEMENT (THIRD) OF TRUSTS § 89, cmt. b (2007).

**Subsection (f)** provides for the possibility that after winding up additional unfinished business of the statutory trust is discovered.

Under Section 8-104(18), the governing instrument may not override this section.

**SECTION 8-704. KNOWN CLAIMS AGAINST DISSOLVED STATUTORY TRUST.**

(a) Except as otherwise provided in subsection (d), a dissolved statutory trust may give notice of a known claim under subsection (b), which has the effect provided in subsection (c).

(b) A dissolved statutory trust may in a record notify its known claimants of the dissolution. The notice must:

- (1) specify the information required to be included in a claim;
- (2) state that a claim must be in writing and provide a mailing address to which the claim is to be sent;
- (3) state the deadline for receipt of a claim, which may not be less than 120 days after the date the notice is received by the claimant; and
- (4) state that the claim will be barred if not received by the deadline.

(c) A claim against a dissolved statutory trust is barred if the requirements of subsection (b) are met and:

- (1) the claim is not received by the specified deadline; or
- (2) if the claim is timely received but rejected by the trust:
  - (A) the trust causes the claimant to receive a notice in a record stating that the claim is rejected and will be barred unless the claimant commences an action against the trust to enforce the claim not later than 90 days after the claimant receives the notice; and
  - (B) the claimant does not commence the required action not later than 90 days after the claimant receives the notice.

(d) This section does not apply to a claim based on an event occurring after the date of dissolution or a liability that on that date is contingent.

## **Comment**

Sections 8-704 through 8-706 provide rules under which a dissolved statutory trust may achieve finality with regards to claims. These sections are derived almost verbatim from Model Business Corporation Act §§ 14.06 through 14.08.

Under Section 8-104(18), the governing instrument may not override this section.

### **SECTION 8-705. OTHER CLAIMS AGAINST DISSOLVED STATUTORY TRUST.**

(a) A dissolved statutory trust may publish notice of its dissolution and request persons having claims against the trust to present them in accordance with the notice.

(b) A notice under subsection (a) must:

(1) be published at least once in a newspaper of general circulation in the [county] in this state in which the dissolved statutory trust's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the trust's registered agent is or was last located;

(2) describe the information required to be contained in a claim, state that the claim must be in writing, and provide a mailing address to which the claim is to be sent; and

(3) state that a claim against the trust is barred unless an action to enforce the claim is commenced not later than three years after publication of the notice.

(c) If a dissolved statutory trust publishes a notice in accordance with subsection (b), the claim of each of the following claimants is barred unless the claimant commences an action to enforce a claim against the trust not later than three years after the publication date of the notice:

(1) a claimant that did not receive notice in a record under Section 8-704;

(2) a claimant whose claim was timely sent to the trust but not acted on; and

(3) a claimant whose claim is contingent at, or based on an event occurring after,

the date of dissolution.

(d) A claim not barred under this section or Section 8-704 may be enforced:

(1) against a dissolved statutory trust, to the extent of its undistributed assets; and

(2) except as provided in Section 8-706, if assets of the trust have been distributed after dissolution, against a beneficial owner to the extent of that person's proportionate share of the claim or of the trust's assets distributed to the beneficial owner after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution.

### **Comment**

This section, which is derived almost verbatim from Model Business Corporation § 14.07, aims to balance the need for repose and certainty of title with fairness to a future claimant whose claim arises after the dissolution process is complete and the statutory trust's property has been distributed to the beneficial owners.

Subsection (c) continues the liability of a dissolved statutory trust for subsequent claims for a period of three years after the trust publishes notice of its dissolution pursuant to subsections (a) and (b). The drafting committee reasoned that three years was a reasonable compromise between the competing considerations of providing a remedy to future claimants and providing a basis for the trustee to estimate liabilities so that the trust might distribute its property free of all claims and the beneficial owners might receive that property secure in the knowledge that the property will not be reclaimed.

Under Section 8-104(18), the governing instrument may not override this section.

### **SECTION 8-706. COURT PROCEEDINGS.**

(a) A dissolved statutory trust that has published a notice under Section 8-705 may file an application with [the appropriate court] in the [county] where the trust's principal office is located or, if the principal office is not located in this state, where the office of its registered agent is or was last located, for a determination of the amount and form of security to be provided for payment of claims that are reasonably expected to arise after the date of dissolution based on facts known to the trust and:



(1) at the time of the application:

(A) are contingent; or

(B) have not been made known to the dissolved trust or

(2) are based on an event occurring after the date of dissolution.

(b) Security is not required for a claim that is or is reasonably anticipated to be barred under Section 8-705(c).

(c) Not later than 10 days after the filing of an application under subsection (a), the dissolved trust shall give notice of the proceeding to each claimant holding a contingent claim known to the trust.

(d) In a proceeding under this section, the court may appoint a guardian ad litem to represent all claimants whose identities are unknown. The reasonable fees and expenses of the guardian, including reasonable expert witness fees, must be paid by the dissolved statutory trust.

(e) A dissolved statutory trust that provides security in the amount and form ordered by the court under subsection (a) satisfies the trust's obligations with respect to claims that are contingent, have not been made known to the trust, or are based on an event occurring after the date of dissolution, and such claims may not be enforced against a beneficial owner on account of assets received in liquidation.

### **Comment**

This section is derived almost verbatim from Model Business Corporation Act § 14.08. Under Section 8-104(18), the governing instrument may not override this section.

## **[ARTICLE] 9**

### **BUSINESS CORPORATIONS**

## **[RESERVED]**

**[ARTICLE] 10**

**NONPROFIT CORPORATIONS**

**[RESERVED]**