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A Bungle in the Jungle of Partnerships[1]

An Object Lesson Why You Need a Lawyer in Business Organizations and Transactions©

By Donald W. Hudspeth

Introduction

I have written a lot about the causes and effects of business partnership disputes.[2] Two primary causes are ignorance and mal intent.[3] As discussed in my article "Follow the Money," the "first bad actor"[4] often has the advantage. However, where the other partners have the law and equity on their side, they stand to prevail in the end.[5] Fairly often the first actions are so ill-informed that the end result is the opposite of the first actor's original objective. The following hypothetical is based on one of those cases and it is a "doozy."[6] It is an example of what can happen when business partners do not have either sound legal documents or advice.

The Facts

1. Formation:

a. Four friends, who were realtors, formed a real estate agency and brokerage limited liability company [1][7] in 2000 (hereinafter "Brokerage LLC")

b. The majority member (hereinafter "Majority") contributed $60,000 for 60% ownership of the limited liability company.

c. Two members each contributed $15,000 and each received a 15% membership interest and

d. The fourth partner (hereinafter "Minority") contributed $10,000 for a 10% share.[8]

e. A homemade operating agreement was prepared. It allowed for membership voting by percentage interest but Majority did not sign it. [2] and

f. Per the Articles of Organization the company was Manager-managed.

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[1] With thanks and apologies to Jethro Tull. He song of the title "Bungle in the Jungle" was on his War Child album of 1974.

[2] Articles include "Follow the Money," "Briarpatch, One Minute Lectures, The Falsity of Forms, and "What to Expect When You Expect (or Were Not Expecting) to See a Lawyer." These are available on our website at azbvuslaw.com/Publications/Articles

[3] By "ignorance" I mean lack of knowledge of business organization and business law, not stupidity – although some of the things I see are pretty stupid. By "mal intent" I mean acting in a way that is unfair and which cannot be rationally justified.

[4] That is, the partner first to act badly out of self-interest and in a way detrimental to the company and the other owners.

[5] The outcome may depend on the knowledge and practice experience of the law firm handling the case.

[6] The facts have been changed slightly for heuristic purposes.

[7] These numbers [1] etc. mark key facts to be discussed later.

[8] These are not the percentages in the actual case.

g. The original Articles of Organization list Majority as Manager, and as owning 20% or more of the company. But in December 2019 Margaret became Manager and in February 2020, Majority PC is listed as a new Manager. [3]

2. Operations:

a. Years pass.
b. Only the majority owner was still continuously and substantially participating in the business as an active member [4].
c. The other members had ceased active participation in 2010.[5]

3. Filings with the Arizona Corporation Commission, the Official Public Record

a. From 2010 to date the "other members" (i.e. Minority and 15% members) did not work in the business, ask for or receive the financial statements. Any sums "allocated" (i.e. percentage share of profits earned by member but not paid as a distribution) were not paid but rather held by the company. [6] The company paid the taxes for the members.

b. In August 2015 Majority filed Articles of Amendment with the Arizona Corporation Commission to remove herself as both Manager and member. The document is signed by Majority PC as Manager. But:

(i) Majority PC did not show up as a Manager of record until five years later in February 2020.

(ii) No Amendment formally adds Majority PC as a Manager.

(iii) Based on this odd filing it appears that Charles and Angela have no interest or management position in the company and that Fazio PC is not lawfully in place as a Manager. [7]

c. In 2020 Majority transferred the position of Manager from herself to Margaret and her entity, Majority PC. [8] Majority claimed the authority to do this because:

(i) She had the power as Manager, [9]and in any case
(ii) She had the power as the majority (60%) owner of the company. [10]

4. Buy-Out Demands:

a. Beginning in 2019 Majority began the effort to buy out the other members.

b. Majority offered as the purchase price a refund of the members' original investment, i.e. $15,000, $15,000 and $10,000.[9] [11]

c. Majority based her offer on (i) the other members lack of active participation in the business, [12] and (ii) the company's poor financial performance [13].

d. [14] Majority did not disclose the company's stellar financial performance.

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[9] "Money back" has a strong psychological appeal. And, a refund can be a reasonable and "doable" outcome where the company is not doing well. Still, by law and practice the price would be market value.

f. Majority stated (threatened) that if the other members did not accept the refund offer, she could/would (i) dissolve the company [15] – in which case they would get less – or (ii) deem their refusal to sell as a "forfeiture" of their membership interest. [16]

g. Majority assumed that as the company's majority owner she would have the legal right and authority to take these actions [17].

h. As Majority and the other members were friends [18] when they started the company, the 15% members assumed that Majority was being honest and truthful, and accepted Majority's offer. As is often the case, because the company had the funds, Majority used company funds to redeem (purchase by company) the membership interests of the two 15% members. [19][10]

i. This left only Majority and Minority as members of the company.

5. <u>Minority's Refusal to Sell Immediately</u>

a. Minority did not immediately accept Majority's offer to return and refund her investment.

b. Minority wanted to think about it and do some due diligence. To that end she requested a copy of the company's financial statements and tax returns and the right to inspect the company's books and records. [20].

c. Minority received the most recent financial statement showing $44 million in sales and a net profit in 2019 of $1.5 million. Her request to inspect the books was denied.[21]

f. During this time Majority continued to make the threats of dissolution or forfeiture. [22]

g. In response to Minority's rejection (or lack of immediate acceptance) of the refund/buy-out offer, Majority declared Minority's 10% to be "forfeited."

h. Majority also stated that, having purchased the interests of the two 15% members, she now owned 90% of the company, i.e. her 60% plus 15% and 15% and that this left Minority with her original 10%. [23]

5. <u>Sale of the Company</u>

d. In making inquiries Minority also learned that the acquisition of the company by a larger competitor was pending.[24]

e. Majority had not disclosed to Minority or the former 25% members this pending sale of the company. [25]

f. It appears the other 15% members sold and accepted a refund of their investment without knowing this or the value of the company.[26]

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[10] The other option is a "cross purchase" hereby Majority would personally buy the interests. Redemption and cross-purchase have some significant tax consequences so should be discussed with a business CPA or tax lawyer. This firm does not practice tax law.

Issues and Commentary

1. This a paradigm case of a grand plan ruined by what the partner, here Majority, did not know about business law. If Majority's intent were not so malignant, her actions would be almost comical. Here is a list of some critical facts – those marked with brackets [ ] above, with these consequences at law:

[1] The company is an LLC. As LLC's are treated as partnerships by state and federal law, this changes drastically (a) how management authority is derived and (b) ownership accrues or changes.

(a) As to management authority, as noted later, absent an agreement specifying percentage voting, membership voting is *per capita*, i.e. one member, one vote. For purposes of *voting* Majority's majority interest is irrelevant. Majority cannot claim to right to authorize the sale of the company because of her majority interest. As there are now two members, the vote is one and one. This means deadlock if Minority votes against the sale of the company. The company could not be sold without Minority's approval[11]. (As a parenthetical comment it probably was probably not a good idea to fail to disclose vital information and threaten Minority with reprisal if she did not sell.) More on this later.

(b) As for ownership accrual, Majority's membership interest percentage would only increase if she *personally* (not the company) purchased the 25% interests. However, because usually only the company has the funds for purchase, the company "redeems" (i.e. purchases) the interests. In that case as the Company buys the interests, they do not accrue to Majority but rather the purchased interests are divided *pro rata* between Majority and Minority.

In other words, the ownership outcome is ***not*** Majority's 60% plus the two15% interests (i.e. 15% and 15%) for a 90% share to Majority. Rather, Majority's and Minority's additional percentage interest is determined by this formula: From original 60%, 15%, 15% and 10% after the buyout we have Majority's 60% & Minority's original 10%. This means 60 + 10 = 70 is the new denominator. Majority owns 60/70 total remaining interests or about 85% of the purchased interests. Minority owns 15%. So, following redemption of the interests by the company, Majority would own 85% and Minority would own 15% of the company. Majority would get 85% of the profits or proceeds from the sale of the company. This is for distributions, i.e. money.

[2] No operating agreement means there were no buy out provisions or a purchase price formula (e.g. fair value). Fair value for closed company buyouts is higher than fair market value because discounts for lack of control, lack of marketability, minority interest, etc. are not taken in the close sale.

[3 See [7][8] below

[11] Even if the company were Manager-managed and Majority was the Manager, unless an operating agreement gave her authority for transactions out of the ordinary course of business, the sale of the business would require unanimous consent, i.e. Minority's approval. Here there is no operating agreement and most operating agreements would require the members vote of approval for unusual transactions.

[4] The common expectation and assumption is that the co-owners will all actively work in the business ("Active Participation"), and if they do not, that they lose their right to vote, distributions of profit and the value of their interest. The argument is often made that "Your ownership, rights to vote and distributions ended" when you stopped working for the company. While arguably reasonable the assumption is not correct for these reasons:

(a) The law does not require the member to work in the business unless an agreement says so.[12] Thus, citing the lack of Active Participation as a reason for forfeiture or a lower buyout price is not a valid argument.

(b) The way to handle the above lack of Active Participation is to petition the court to allow the working member to be paid at a market rate before profits or the sales proceeds are distributed.

[5] In an LLC the members would be entitled to their share of the profits regardless of whether they worked for or actively participated in the business. Profits would be "allocated" to the members according to their ownership percentage (%). Allocations are not required to be paid out as distributions, *but whether paid out as distributions or not, taxes are due on the allocated income.* [6] This allocation of taxable income for monies never received is called the "phantom income" problem. The members undistributed profits would become a liability of the company to the members and would accrue and accumulate over time.

In other words, the distributions or allocation of monies to the other members are still due. If the company has been making money but the distributions not paid, the amount owed to the members could be huge. By law Majority should not be paying herself a distribution unless one is paid to the other members.

Subject to two exceptions, under the general rule an LLC member is treated as a partner and paid from profits. This means that by definition a partner is not an employee and cannot receive a "salary." If Majority has taken a salary, then she would need to repay the company for salaries taken. This amount would be added to the profits available for distribution. [13]

There are two exceptions to the above "no salary" rule:

(a) The first is the Sub S election. If the LLC files a Sub S election it is then taxed as a corporation. In this case the owner may be an employee and receive a salary.

(b) The second exception is "Guaranteed Payments." The requirements to receive guaranteed payments are a little murky, but generally a "guaranteed payment" is paid to a member, usually as a Manager in a Manager-managed LLC, for providing management services to the company. Unlike distributions, the guaranteed payment is set and paid independent of company

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[12] Absent an agreement under the AZ Limited Liability Act, the law defaults to securities law where ownership is not tied to work, e.g. the right to own shares and receive dividends from General Motors without working there.

[13] However, Per [4](b) immediately above, in court Majority could argue that this repayment due should be reduced or offset against monies due Majority as the working partner.

profits. The primary rationale for same is to pay management when profits are non-existent or uncertain. In other words, the guaranteed payment is made so someone "shows up in the morning" to run the company. If there are no profits a partner may not do so. However, guaranteed payments are usually relatively small, e.g. $85,000 in multi-million-dollar company. They certainly would not be the $1.5 million in profits the company earned in 2019.

[7] [8] Regarding the right to transfer her Manager position to Margaret: It is a somewhat technical point, but it appears that neither the statute, ARS £29-681, nor any agreement, allow Majority as Manager to unilaterally change the company management from herself to Marsha Schaeffer and Majority PC as Managers. ARS£ 29-681 B in pertinent part states:

> If an operating agreement does not provide a manner for designating or electing additional or replacement managers, on the withdrawal or resignation of a manager, management of the limited liability company continues to be vested in the remaining managers, or if there are no remaining managers, management is vested in *one or more new managers to be designated or elected by a majority of the members*. (Emphasis added)

a. Under this statute it appears that new or replacement Manager must be elected by the Members.

b. There is also the question: If Majority removed herself as Manager and Member, and the appointments of Margaret and Majority PC are invalid due to the lack of a *per capita* membership vote, then who is running the company? Normally, if an appointment failed the Manager would remain the same, pending the membership vote. But as Majority removed herself as Manager, and the appointments of Margaret and Majority PC are invalid, it appears here is no Manager in place.

c. Because Majority removed herself as a member, then she could not vote in the new Manager election. Rather, Minority would do this as sole member or with the votes of 15% members if their interests are restored.

[9] If Majority as Manager(s) could not appoint new Managers, could Majority vote Margaret in as Manager by voting her 60% majority membership interest? Probably not.

a. This is where the facts have some surprising and dramatic legal consequences. As discussed above, counter-intuitively and unknown even to some accountants and business law practitioners, the rule is that unless the LLC has an operating or other agreement specifying that the members will vote their "percentage interests," they don't. Absent an agreement then regardless of the members' ownership interests, the vote is *per capita* i.e. one person, one vote. Distributions of profits are by percentage, but not voting.[14] See ARS £29-681E.

[14] The Case of the Evil Aunt. A fun case (for my client, not the opposing party) involved a Dairy Queen. The Aunt who owned 80% of the Dairy Queen LLC was riding roughshod over the rights of her two nephews. The nephews became he firm's client. It turned out that the LLC had no operating or other agreement specifying vote according to percentage interest. Thus, the vote was *per capita*, i.e. one person one vote. This meant my clients had two votes to

b. Here the operating agreement with the percentage interest voting provision was never signed, so is not in effect. This means that the members, as same existed at the time, would need to vote on a *per capita* basis on management changes. Majority could not do this unilaterally as either a manager or majority interest holder.

c. The net effect of this requirement of membership vote on Managers means that management could not change from Majority to Margaret without Minority's vote of approval and the affirmative vote of the other persons who were members at the time.

[10] A Manager cannot just show up out of the blue. The Articles must be amended to show the person as Manager. As an interim measure the operating agreement might be amended but that requires the unanimous consent of the members. ARS £29-681(C)(1) Here, for the above reasons, Majority as Manager and majority member lacked the authority to appoint or elect her entity Majority PC as a Manager. Even if she did:

a. It is not clear that a proper vote of the members with proper prior notice ever occurred, and

b. An Amendment to the Articles of Organization in the Arizona Corporation Commission public record would be required to make the Manager position effective.

For the above reasons it appears the changes of Manager from Majority to Margaret and Majority PC are not in effect. This means that management remains with Majority.

[11] It appears that Majority did not reveal the high sales and income of the company and affirmatively misled the 15% members into thinking the company and their interests had little value. Majority also did not disclose the pending acquisition of the company by a publicly traded corporation. By failing to make these critical disclosures the 15% members can probably rescind the sale of their interest.

[12] While the owners of a closely held company may reasonably expect all owners to be actively involved in the company, the law does not require it. Absent an agreement requiring active participation a member may lawfully not work for the company and still retain the rights of a member, including the right to distributions and fair value of the interest.

[13] To the extent that Majority "just flat lied" about the company, that would be fraud with rescission and punitive damages.

[14] Negligent Misrepresentation or Fraud. Arizona law requires complete and accurate disclosure of information in a commercial transaction. Failure to disclose the company's financial condition and performance incident to the purchase or attempt to repurchase the other members' interest was unlawful. The claim is fraud (deliberate misrepresentation) or negligent misrepresentation. The remedy can be rescission.

[15] A business "dissolution" is like the dissolution of a marriage. It is a divorce. It can be done voluntarily or involuntarily. Generally, the process to terminate a company is (a) dissolution, i.e.

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their Aunt's one. Like the case above this was a complete turnaround of events and control. The Aunt was now subject to the nephews' per capita majority.

the company is dissolved and liquidated by mutual agreement, or by court order (judicial dissolution, a lawsuit) and not unilaterally, (b) winding up, i.e. *the assembling of the company assets and their sale*, usually at auction, (c) distribution of proceeds and (d) then the Articles of Termination. Here, Majority would not be able to dissolve the company because:

a. She probably would not want to sell the accounts and other assets at public auction. She might compete with the acquiring company to buy the assets at liquidation value. and

b. The court would not agree to it. Typically, the judge will not dissolve a company for the benefit of one company owner to the detriment of the others. For example, assume an LLC has two members, each owning 50% of the company. Owners. Next assume the company has earnings of $100,000 or a net worth of $100,000. In dissolution the $100,000 in earnings would be lost. And, because the sale of assets in dissolution is typically at auction or liquidation prices, the company assets may sell for twenty cents on the dollar. This would mean that the owners would not receive $50,000, i.e. one-half of the $100,000 in net worth but more like $10,000, i.e. one half of $20,000. The court is unlikely to reduce the value of a member's interest from $50,000 to $10,000 or less liquidation value just because the other member wants to dissolve.

[16] Regarding "forfeiture:"

a. An LLC membership interest, like a share of stock, is property. "Forfeiture" almost never occurs. And it can't be done by anyone but the member herself. (I can't "forfeit" your ownership interest unless an agreement says I can.[15]

b. Forfeiture would be the member's voluntary surrender of her ownership interest back to the company for no consideration (i.e. payment.) Even that would require the other members' approval.

c. Typically, forfeiture only occurs when the company is doing very badly and has accruing and accumulated state and federal taxes due. Because business owners are personally liable for unpaid sales (aka transaction privilege) taxes[16], and in some cases as the tax matters personal representative can be personally liable for the taxes, forfeiture can be a way to end liability for additional unpaid tax obligations.

d. But even in the case of an owner who wants to surrender her ownership interest under general business law a transfer of interest in a closely held company (i.e. one with few members) requires the consent of the other owners. Thus, even the equity owner could not "forfeit" unilaterally. Here, there is no forfeiture.

e. Absent a buy-sell provision or agreement, n operating or other agreement to the contrary, the other members would be entitled to the "fair value" of their interest. Given the firm's 2019

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[15] Even then the removed member would be a "dissociated" member with financial rights (but not voting). Those financial rights or "economic interest" would include buy-out and a share in distributions, including those from the sale of the company.

[16] Sales taxes are collected by the business for the city or state. Because the monies never belong to the business, when unpaid they are "out of trust." As "trustee" the business owner is personally liable.

income of $1.5 million, it looks like the company may be worth $3 million or more and Minority's 20% share worth $600,000.

[17] Being majority owner or manager would not give Majority the right to "forfeit" another member's interest. As a transaction outside of the company's ordinary course of business, the company's purchase of the interest would probably require the unanimous consent of the members. ARS 29-681(C)(1).

a. The practical effect is that regardless of their percentage of ownership Majority cannot sell the company without the other members' consent.

b. Ironically, this "veto power" puts Minority in the "catbird seat."

[18] Fiduciary Duty from Confidential Relationship. The fact that the members started out as friends may be a reason why the other members were willing to trust Majority over the years, without asking what was going on, and why the 25% owners accepted her avowals that the company was not making money. It is this relationship of trust where one party submits its will to the advice, discretion and action of another that creates a fiduciary duty.

a. A fiduciary duty is the highest duty of care and loyalty imposed by law. In effect Majority would be acting as a "trustee" for the benefit of her friends. And in so doing she could not act out of self-interest. Doing so could lead to claims for compensatory and punitive damages.

[19] The use of company funds to buyout a partner is common. This is called "redemption" or the "redeeming" of shares or interest. Redemption has some practical, deal-point characteristics and may have some adverse tax consequences.

(a) On the deal side in a way the seller is being paid with her own money. For example, company has $100,000 net worth. Partner receives company buyout of 25% interest for $25,000. 25% of that $100,000 was already the partner's money (company net worth times 25%). On these facts the selling partner is trading property for cash. The point is that the partner is not getting anything in addition to what the partner already has, but is only receiving it in a different form. And the partner loses the right to future income, appreciation of company, etc.

(b) On the tax side not all of seller's gain, if any, is necessarily capital gain. Seller's portion of "hot assets" like inventory and receivable may be taxed as ordinary income. Tax topics like this are beyond my expertise.

(c) Because taxes can be the "tail that wage the business dog." No buyout should occur until the parties talk to their accountant about present and future tax consequences.

[20] Due diligence with review of financial statements, tax returns and other information is necessary. And, Minority has an absolute right to inspect the company records on site for the proper purpose of a buyout.

[21] Books and records. Turning over the income statement with nothing more would be in sufficient as a matter of law. By statute the company is required to keep and allow the members to inspect the books and records of the company. This would include, by statute, three years financial

statements and three years tax returns. While the other members should have asked to inspect the records, they are entitled to see the records now. Disclosure or inspection of the financial statements would reveal the $44 million in sales great profit of $1.5 million for the last year.

[22] Earlier we explained why “dissolution” and “forfeiture” were not viable options. To the extent the 15% members sold their shares based on those threats and misinformation, they could probably rescind the sale of their interest. The threats raise the issue of duress, i.e. signing for a reason other than the contract itself, e.g. a gun to the head or threat of ruin. Majority’s offer of “take this or get basically nothing” could be duress, but apparently not a strong case of same.

[23] The declaration of forfeiture is false. And, as discussed above it makes no sense if one knows the law.

[24][25] [26] The pending sale is a huge fact which should have been disclosed. The 15% members could probably rescind their sale because of this non-disclosure.

Legal Claims.

On these facts the Minority and 25% members have a number of actual and possible legal claims. These include:

1. Negligent misrepresentation: The failure to provide complete and accurate information in a commercial transaction; i.e. failure of the duty to disclose. The legal remedy can be money damages, but the most common relief is rescission, i.e. to undo the deal. In that case the 25% owners could rescind the sale of their interests and remain owners of the company.

2. Fraud. Common law fraud is intentional misrepresentation (including omission). The remedy can be damages for actual harm and punitive damages. Plaintiff must be careful to plead bad acts with particularity and the claim is difficult to prove. Still, these facts appear to support a credible claim for fraud.

3. Breach of the Covenant of Good Faith and Fair Dealing. Breach of the covenant of good faith, basically breach of honesty and fair treatment (“bad faith”), is treated as a breach of contract claim. In AZ the claim may be brought without there being a breaching of an express term of the agreement. This claim is usually a good basis for an award of attorneys’ fees.

4. Accounting. In a partnership dispute or business divorce an accounting is a review of the company books and records by an independent, qualified business CPA. A corporate shareholder or LLC member has an absolute right to inspect the books and records of the company for a proper purpose. A proper purpose would be to look for instances of conversion, mismanagement or breach of fiduciary duty. An accounting would be a court-ordered inspect for same.

5. Breach of Fiduciary Duty. Based on the friendship and trust of the members.

6. Duress. In this case the 25% members would still have their interest because the contract to sell was void (for reasons of both misrepresentation and duress).

7. Conversion? In a nutshell, conversion is civil theft. Although we have no facts indicating that Majority misused company funds, e.g. for personal expenditures, it would be the rare partnership

indeed where in this situation of passive ownership the active partner(s) "running the show" did not feel entitled to use company funds as they pleased. Punitive damages may be awarded on a conversion claim.

8. Derivative action.

a. A derivative action is a lawsuit brought by a company member (or shareholder) against company management for gross negligence or deliberate misconduct. Usually the protagonist of this action is an "outsider," e.g. a passive investor, or a member who has been expelled from or locked out of the company or is negatively affected by management's conduct. But the plaintiff in this action is not the aggrieved member; it is the company itself. The defendants are the members who manage the company.

b. The claim is "derivative" because it is brought by the company against its own management. To set up a derivative claim the "outside" member must write a notice and demand letter giving company management up to 90 days to meet and fix the problem. If the company does not act to fix the problem within this notice period then the member may represent the company and sue in the company name. While the plaintiff member has to pay the attorneys' fees to prosecute the action the court may order the company to repay the member at the end.

Here the company purpose is real estate brokerage. If Majority used company funds for some other purpose, like non-business travel or remodeling her house, then she would not only have converted funds but breached her fiduciary duty.

Conclusion

Like the Evil Aunt discussed in footnote 14 above, Majority, the protagonist in this case, faces, a complete turnaround of events and outcome. At the practical level she expected to buy out the other members for pennies on the dollar then resell the company for millions. Instead, the sale cannot happen without the members approval and they will share in the sales proceeds. At the legal level she faces legal claims for fraud and other claims, with punitive damages and attorneys' fees on the bad faith claim. It may be that even the company she has managed for years would now be a derivative plaintiff against her.