



Licensed in Wisconsin and Illinois



## JANUARY 2013 - CLIENT ALERT

### The Corporate Divorce

Not unlike a marital divorce, a dispute between owners of a business, if not handled properly, can escalate to become the most costly and destructive event in the life of a business. Maintaining level heads and obtaining the assistance of professionals skilled in resolving such disputes can make a dramatic difference in the outcome for all involved. The proliferation of limited liability companies (“LLCs”) as the prevailing choice of entity for businesses, particularly for ownership of real estate, has changed the focus and the manner in which these disputes are resolved and litigated. Although corporations, partnerships and trusts have similar remedies, this article focuses upon the tools available for judicial and nonjudicial resolution for LLCs.

Common elements of business disputes between owners include a breakdown of trust brought about by real or sometimes perceived inappropriate or wrongful conduct by one or more of the parties, business reverses, inability to agree upon the direction a business should take and simple greed. A full blown dispute can have all of the elements of a marital divorce including personal hostilities, destructive behavior and costly and stressful litigation.

The resolution of a business dispute between owners starts with the examination of the business’s organizational and governing agreements. In the case of a corporation, these documents include the corporation’s articles of organization, bylaws, buy sell agreements, voting agreements, employment agreements and non-compete agreements. In the case of an LLC, they include the articles of organization and the operating agreement. In the case of a limited liability partnership, limited partnership, or general partnership, relevant documents would include articles of organization, if any, and the partnership agreement.

Under current Internal Revenue Service regulations, an LLC can elect to be ignored for income tax purposes, or be treated as a partnership or as a subchapter “s” or “c” corporation. Resolution solutions are frequently driven by income tax consequences. The analysis of income tax consequences taking into account the type of entity election made by the business is imperative and frequently drives the form of resolution solution. Because of this, an orderly resolution by agreement of the parties is preferable so as to avoid a judicial resolution over which the parties may have no control.

When the organizational and governing documents fail to provide a logical resolution and the parties are unable to forge a logical business plan for resolution, Wisconsin Statutes and case law provide guidance for judicial and nonjudicial resolution. The statutory schemes and case law for resolution may differ significantly depending upon the type of entity and assets involved, however. LLC affairs are generally governed by Chapter 183, Wis. Stats. Since the proliferation of LLCs is relatively new, there is little case law guidance in Wisconsin governing the affairs of LLCs and interpretation of Chapter 183, Wis. Stats.

Some of the statutory, common law remedies and the limited case law guidance frequently used for judicial and nonjudicial resolution of disputes involving LLCs are digested below:

**Statutory Provisions under Chapter 183 of the Wisconsin Statutes:**

- **Dissolution** – An LLC is dissolved under circumstances provided for in the operating agreement of the LLC, the consent of all members, the dissociation of a member from the company if the LLC was formed prior to October 1, 2012 and no steps are taken to continue the business by the remaining members, or a decree of judicial dissolution. Dissolution leads to the LLC’s affairs being wound up.
- **Judicial dissolution** - While generally a remedy of last resort, judicial dissolution enables an aggrieved party to petition a court to dissolve the business. This is accomplished by winding up the affairs of the company and distributing the assets to creditors and owners. Section 183.0902, Wis. Stats., allows judicial dissolution where it is not reasonably practicable to carry on the business of the company, the company is not acting in conformity with an operating agreement, one or more managers are acting or will act in a manner that is illegal, oppressive or fraudulent, one or more members in control of the company are acting or will act in a manner that is illegal, oppressive or fraudulent or the company’s assets are being misapplied or wasted.
- **Winding up** – Whether by operation of the operating agreement, consent of the parties or judicial dissolution, a dissolved LLC will be wound up. Generally, winding up will be performed by the managing member, if any, or another member. However, if the managing member has engaged in inappropriate conduct, a court may be petitioned to oversee the winding up. Winding up generally involves collecting its assets, prosecuting and defending lawsuits, paying its liabilities and distributing any remaining assets to its members.
- **Recovery of wrongful distributions** – There are limitations upon an LLC’s right to make a distribution of assets. The right to distribute assets is limited when after the distribution, the LLC would violate the operating agreement, would be unable to pay its creditors as they become due in the usual course or the LLC’s assets would be insufficient to satisfy its liabilities. Section 183.0608, Wis. Stats., affords a creditor, a member or other interested parties the right to recover inappropriate distributions from the members receiving the distribution.

- **Derivative action** – A member may sue in a derivative action on behalf of the LLC upon an affirmative vote (majority vote absent a contrary provision in the operating agreement) of the members. The majority vote is determined by a vote of all members entitled to vote except a member who would have an interest in the outcome adverse to the LLC. Section 183.1101, Wis. Stats.
- **Dissenters rights** – In the case of a proposed merger of the LLC with another entity, Section 183.1206, Wis. Stats., allows a member who did not vote for the merger, unless otherwise provided in the operating agreement, to dissociate from the LLC and obtain their fair value of the member’s interest in the LLC.
- **Self dealing** – Section 183.0402, Wis. Stats., prohibits a member from a willful failure to deal fairly with the LLC or its members in a matter in which the member has a material conflict of interest, from violating a criminal law, from willful misconduct or from a transaction in which the member derived a personal profit.
- **Obtaining LLC records** – A member may make a demand to inspect and copy LLC records. Section 183.0405(2), Wis. Stats., requires an LLC to provide a member, upon a reasonable request, LLC records required to be kept by an LLC and, unless otherwise provided in the operating agreement, any other LLC record.

**Other Possible Statutory Provisions Applicable to Inappropriate Conduct:**

- **Fraudulent transfers** – A member who is a creditor, and a non-member creditor, can bring an action for a fraudulent transfer under Chapter 242, Wis. Stats., either directly, or a member may bring it as a derivative action where the LLC’s assets have been disposed of or distributed in certain circumstances for insufficient consideration or where the LLC would become insolvent after the transfer.
- **Civil theft** – A commonly used remedy in egregious circumstances is alleging civil theft under §895.446, Wis. Stats. This remedy allows for recovery of treble damages and attorney’s fees.

**Frequently used Common Law Remedies:**

- **Breach of contract actions** – Actions can be brought for breach of contract of the operating agreement, employment agreements or any other agreements between the parties.

- **Action for breach of fiduciary duty** – Certain business constituents owe a fiduciary duty to others under common law and various statutes. The law of fiduciary duty is complex and fact specific. A breach of this duty can lead to an action for damages and other relief. A breach occurs when there is a fiduciary relationship between the constituents, that duty is breached and the breach caused the party damages. In general, it is thought that equal partners do not owe a fiduciary duty to each other in their relationship as owners. A recent Wisconsin Court of Appeals’ case so held in the case of equal shareholders of a corporation. *Estate of Sheppard v. Specht*, 2012 WL 4898083 (October 17, 2012). However, managing members, those who exercise control over the affairs of the LLC, and officers of the LLC may have a fiduciary duty at least to the LLC and possibly to a member.
- **Action for an accounting** – A party may, under appropriate circumstances, seek an accounting of the financial affairs of a LLC under the Common Law Doctrine of an accounting generally applicable to partners in a partnership.
- **Misrepresentation and Fraud** – The several “garden variety” types of fraud and misrepresentation include fraud and strict and negligent misrepresentation. Such tort remedies, however, may be limited by the Economic Loss Doctrine.

**Case Law Guidance –**

- *Sanitary Dist. No. 4-Town of Brookfield v. City of Brookfield*, 317 Wis.2d 532, 767 N.W.2d 316 (Wis.App. 2009) – The oral authorization of a member is sufficient to bind an LLC in a written document signed by one of the members.
- *Price v. Smith*, 842 F.Supp.2d 1111 (E.D. Wis. 2012) - A member may bring a derivative action on behalf of the LLC to recover an inappropriate distribution, and that bringing such an action on behalf of the LLC will make the LLC a party for purposes of determining Federal Court jurisdiction.
- *Israeli v. Dott. Gallina S.R.L.*, 632 F.Supp.2d 866 (W.D. Wis. 2009) - For Federal Court diversity jurisdiction purposes, the citizenship of each of the members is determinative.
- *In re Pawlak*, 467 B.R. 462 (Bkrtcy. W.D. Wis. 2012) – The breach of fiduciary obligations between members of an LLC and violations of §183.0402(1), Wis. Stats., as discussed above, are not automatically synonymous with determining the nondischargeability of a debt in bankruptcy.



- *Kasten v. Doral Dental USA, LLC*, 301 Wis.2d 598, 733 N.W.2d 300 (Wis. 2007) - A member may upon reasonable request inspect and copy all documents required to be maintained by the LLC, as well as any other LLC record. For this purpose emails and drafts of documents constitute LLC records. However, personal emails do not. The request must be reasonable both in terms of the time to comply with the request as well as the breadth and burdensomeness of the request. Section 183.0405(2), Wis. Stats.
- *Decker v. Decker*, 298 Wis.2d 141, 726 N.W.2d 664 (Wis.App. 2006) - A court is empowered to sell the LLC assets in a dissolution proceeding. However, in the absence of an enforceable contrary provision in an operating agreement or other contractual agreement between the members, the court may not order the interest of a member in an LLC sold.
- *Lenticular Europe, LLC, ex rel. Van Leeuwen v. Cunnally*, 279 Wis.2d 385, 693 N.W.2d 302 (Wis.App. 2005) - A minority member may bring a derivative action for breach of fiduciary duty on behalf of the LLC upon majority vote of members. Where the member whose interest conflicts with the interests of the LLC in the outcome of the action, that member is not entitled to vote on whether to bring the derivative action. Thus, it is possible that a minority member may bring a derivative action if the minority member has a majority of the interests in the LLC excluding the interest of the offending member.

**Conclusion:**

The information contained in this letter is general and while it is intended to provide useful background information to our clients, it is not legal advice and should not be relied upon in any specific instance or for any specific matter. Please obtain legal advice prior to taking any action in respect to the matters discussed in this letter.

We hope that you have found this information helpful. If you have any questions or need assistance with matters relating to the subject matter of this letter or other tax, real estate or business matters, we would be pleased to assist you.