

## **YOUR HONOR – An LLC IS NOT A CORPORATION\***

### **\*Mr. and Ms. Litigator, Your Help Is Needed**

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Too many times our judges issue opinions in cases that do not accurately reflect the law of Colorado business entities. For example, in *Stockdale v. Ellsworth*, 2017 CO 109 (Dec. 18, 2017) [discussed in the December 2017 Colorado Bar Association Business Law Newsletter], the Colorado Supreme Court decided a case involving a Wyoming limited liability company under Colorado law, ignoring Colorado's internal affairs doctrine found at C.R.S. § 7-90-805(4) which would have normally resulted in the application of Wyoming law to the questions at issue. Previously, the Colorado Court of Appeals had similarly ignored Colorado's internal affairs doctrine when affirming the trial court in *Martin v. Freeman*, 272 P.3<sup>rd</sup> 1182 (Colo. App. 2012) [discussed in the February 2012 Colorado Bar Association Business Law Newsletter], applying Colorado law to a Delaware limited liability company merely because the LLC's sole place of business was in Colorado. This type of judicial mistake has emerged yet again in the Court of Appeals' decision in *Gagne v. Gagne*, 2019COA42 (March 21, 2019) (*Gagne II*). Although not in a manner that affected the proper outcome of the case, this type of judicial mistake leads to bad precedent for business lawyers and future litigants and should be addressed.

### **Gagne I – the Battle Begins**

*Gagne II* derived from an earlier Court of Appeals decision (*Gagne v. Gagne*, 2014 COA 127 (2014), "*Gagne I*") initiated in 2012 by Richard Gagne against his mother, Paula, which followed a 2011 mediation. In the mediation, Richard and Paula had attempted to resolve issues that had developed relating to Richard's management of property owned by four LLCs that Paula had financed. The first paragraph of the "Background" discussion in *Gagne I* [338 P.3d at 1156] describes the overall situation which resulted in continuing litigation through *Gagne II*:

Paula and Richard are mother and son, and they are the sole members of the four LLCs, each of which owns multi-unit apartment complexes. Paula and Richard's business relationship has been exceedingly difficult, and it has been marked by extreme dysfunction, allegations of physical altercations, mutual distrust, ongoing allegations of wrongdoing by the other, and legal proceedings or threats thereof.

The LLC operating agreements reflected that Paula was the Chief Executive Manager with 51 percent of the voting rights but only 50 percent of the economic interests. These agreements also acknowledged that Richard had made in-kind contributions earning him an equal ownership interest in the LLCs' income and accumulation of assets. Further these agreements provided that the LLCs' success "requires the active interest, support, cooperation, and personal attention of the Members." As described by the trial court, "[t]here were arguments and allegations, confrontations and criticisms – a continual pattern of regrettable behavior that left the parties on hostile terms."

Because of the dysfunction, in 2012, Richard brought suit for judicial dissolution of the LLCs and a determination of his and Paula's respective rights, status, legal relations, ownership

and management. In *Gagne I*, the Court of Appeals reviewed C.R.S. § 7-80-810(2) setting the standard for judicial dissolution of an LLC when it is shown that “it is not reasonably practicable to carry on the business of the limited liability company in conformity with the operating agreement of said company.” In remanding the trial court’s decision for further action, the Court of Appeals concluded that “genuine issues of material fact preclude the entry of partial summary judgment on Richard’s judicial dissolution claim” [338 P.3d at 1161] and as to certain other issues. [See the discussion of *Gagne I* in Lidstone and Sparkman, *Limited Liability Companies and Partnerships in Colorado*, at § 11.1.4 (CLE in Colorado, 2019).]

On remand and after further information developed, the trial court applied the *Gagne I* factors and ordered dissolution of the four LLCs and determined how distributions were to be made to Paula and Richard, finding that “Paula had engaged in a great deal of self-dealing misconduct.” In the dissolution the district court “adjusted the parties’ respective shares of the assets’ values to account for money Paula had wrongfully pulled out of the LLCs.” Paula again appealed, resulting in *Gagne II* which affirmed the trial court on all points.

### ***Paula’s Breach of Her Duties Under the LLC Act***

In analyzing Paula’s performance of her duties, the Court of Appeals found that Paula had failed to perform her managerial duties “in good faith, in a manner [she] reasonably believe[s] to be in the best interest of the” LLC [quoting the operating agreement]. The Court of Appeals also found that Paula failed to meet various statutory duties, including her duty as manager:

- To refrain from “engaging in grossly negligent or reckless conduct, intentional misconduct, or knowing violation of law.” C.R.S. § 7-80-404(2).
- To discharge her duties as manager and exercise her rights “consistently with the contractual obligation of good faith and fair dealing.” C.R.S. § 7-80-404(3).
- To allow reimbursements if payments are made “without violation of the person’s duties to” the LLC. C.R.S. § 7-80-407.

The Court of Appeals reviewed the facts and stated clearly that “the [trial] court found, with record support, that Paula breached these obligations.” (Slip Op. at 19) The analysis could have stopped there – Paula materially breached her duties and dissolution was warranted.

### ***The Corporate Business Judgment Rule***

But then, the Court of Appeals discusses the corporate business judgment rule. [The Court of Appeals had previously referenced the business judgment rule in Slip Op. at 17.] In note 8 (Slip Op. at 20), the Court of Appeals states that:

“The [business judgment] rule arose in the corporate context. **We assume** it applies in the limited liability company context as well.” [*Emphasis supplied.*]

The corporate business judgment rule does not apply in the LLC context unless specifically incorporated into the LLC’s operations through the operating agreement. While the

Court of Appeals engages in a good discussion of the corporate business judgment rule (including citations to *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) and 3A Fletcher Cyclopedia of the Law of Corporations § 1040 at 52-53), the discussion and the corporate business judgment rule are wholly irrelevant in the context of a limited liability company.

Admittedly, and depending on the language of the operating agreements for the four LLCs (which were not available for review), a business judgment rule analysis may be appropriate since its standards may be consistent with the “contractual obligation of good faith and fair dealing” as set forth in C.R.S. § 7-80-404(3). But that possible analysis is not based on a corporate business judgment analysis since an LLC is not a Corporation.

### ***An LLC is Not a Corporation***

The Colorado Supreme Court has made it crystal clear that the law of corporations does not apply to limited liability companies except in the narrow instance of “piercing the veil” based on the language of C.R.S. § 7-80-107:

- (1) In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.
- (2) For purposes of this section, the failure of a limited liability company to observe the formalities or requirements relating to the management of its business and affairs is not in itself a ground for imposing personal liability on the members for liabilities of the limited liability company.

In *Weinstein v. Colborne Foodbotics, LLC*, 10SC143 (June 10, 2013) [discussed in the June 2013 Colorado Bar Association Business Law Newsletter], the Supreme Court said clearly [*emphasis supplied*]:

¶ 17 Because the LLC Act and the Colorado Business Corporation Act are *two different statutes with different schemes and purposes, and because a corporate shareholder is not equivalent to an LLC member*, the legislature is free to choose a statutory limitation on an LLC's creditors different from what it chooses for a corporation's creditors. See CML V, LLC v. Bax, 28 A.3d 1037, 1043 (Del.2011) (holding that creditors of an LLC did not have the right to bring a lawsuit on the LLC's behalf even though creditors for a corporation did).

¶ 19 We construe the statute as written and assume “that the General Assembly meant what it clearly said.” *Pierson v. Black Canyon Aggregates, Inc.*, 48 P.3d 1215, 1219 (Colo.2002). *Because LLCs and corporations are different business entities, it is reasonable that the common law applicable to corporations does not apply to an LLC* in the context of a claim for unlawful distribution. We conclude that, under section 7-80-606, only the LLC may assert a claim against its members for an unlawful distribution and that the holding in *Ficor* does not apply to LLCs set up under the LLC Act. Hence,

we hold that absent express statutory authority, an LLC's creditor may not assert a claim against the members of the LLC for unlawful distribution.

While paragraph 19 of *Weinstein* states that it is limited to “the context of a claim for unlawful distribution,” it derives directly from paragraph 17 which is much broader in acknowledging that the LLC Act and the CBCA are two **different statutes with different schemes and purposes**. Paragraph 17 also makes it clear that **a corporate shareholder is not equivalent to an LLC member**.

***The Business Judgment Rule Does Not Apply to LLCs, Unless It Is Specifically Incorporated Into the Operating Agreement***

What can be clearer? An LLC is not a corporation and corporate principles should not apply to a limited liability company formed under Colorado law (or in my judgment any other law) except where specifically adopted in the operating agreement. Section 7-80-108 describes operating agreements and concludes:

(4) It is the intent of this article to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.

This of course permits any person to include corporate principles in an operating agreement if he or she chooses to do so, whether intentionally or foolishly. The operating agreements being considered in *Gagne* required Paula, as manager to perform her duties “in good faith, in a manner [she] reasonably believe[s] to be in the best interest of the” LLC. [Slip Op. at 18.] Such a contractual obligation is similar to the Court’s later description of the business judgment rule as obligating directors of a corporation to:

“act[] on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” [Citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).]

Many times we have seen operating agreements include the CBCA language describing the standards of conduct for directors found in C.R.S. § 7-108-401(1):

(1) Each director shall discharge the director's duties as a director, including the director's duties as a member of a committee, and each officer with discretionary authority shall discharge the officer's duties under that authority:

(a) In good faith;

(b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(c) In a manner the director or officer reasonably believes to be in the best interests of the corporation.

[See the discussion of the advisability of an operating agreement including this language at note 33 to Exhibit A (the “Illustrative Form of Multi-Member Operating Agreement”) to Lidstone and

Sparkman, *Limited Liability Companies and Partnerships in Colorado* (CLE in Colorado 2019) at p. 688.]

In most cases it appears that this incorporation of the CBCA's language is poorly considered, if considered at all. Perhaps the language was retained by the drafter from a previous agreement for a different LLC.

Of course, it is entirely possible for the members to sit around the conference room table and advise their lawyer of their *intention* to operate their LLC under corporate principles if that is what they desire. The operating agreement gives members this ability. I would venture a small wager, however, that this discussion seldom, if ever, occurs.

### ***Other Arguments for Paula's Breach of Duties***

The four LLC operating agreements were sealed by the Court, so we have not reviewed them. Thus we don't know whether the operating agreements modified or eliminated the duties of the manager of manager-managed LLCs found in C.R.S. § 7-80-404(1) and § 7-80-405. In many LLC operating agreements, those duties are not addressed. If not, those duties would also have been violated by Paula's self-serving actions.

- Section 7-80-404(1)(a) provides that the manager shall "[a]ccount to the limited liability company and hold as trustee for it any property, profit, or benefit derived by the member or manager in the conduct or winding up of the limited liability company business or derived from a use by the member or manager of property of the limited liability company, including the appropriation of an opportunity of the limited liability company." The trustee duty of the manager under this statutory paragraph is an extremely high duty.
- Section 7-80-404(1)(b) provides that the manager shall "[r]efrain from dealing with the limited liability company in the conduct or winding up of the limited liability company business as or on behalf of a party having an interest adverse to the limited liability company." The trial court's description of Paula's self-dealing actions would have thrown her compliance with Section 404(1)(b) into question.
- Section 7-80-405 creates a principal-agent relationship between the manager and the LLC, and the manager as agent owes significant fiduciary duties to the LLC principal as described in (among other places) the Restatement (Third) of Agency. The actions of Paula as described by the trial court would also have arguably violated these agency duties.

As noted above, these statutory duties could have been modified or eliminated in the operating agreement. Whether limited in the operating agreement or not, these duties could have established a corporate business-judgment-rule like analysis into Paula's performance of her duties. Nonetheless, neither the trial court nor the Court of Appeals analyzed these issues, and there is no evidence in the limited record available for public review that the litigators involved in the case attempted to raise or defend these issues.

***Mr. and Ms. Litigator – Please Help***

I am of the opinion that the Court of Appeals did not need to apply the corporate business judgment rule in order to reach its conclusion that Paula's actions violated her duties as manager of the four LLCs. By doing so in a reported opinion, the Court creates a bad precedent for future decisions looking at *Gagne II* for guidance.

Much of this bad law is not the sole responsibility of the courts. Our hard-working judges have to devote their attention to many areas of the law: criminal, commercial, family, personal injury, tax, real estate, business entities, etc. No person can be an expert in all of these areas, or even in a few.

The litigators presenting these cases have an obligation to develop an expertise in the laws they are presenting to the courts, and to explain them clearly and honestly. Or to use an expert within their own firm or an outside expert to do so.

I believe that the litigators also have the obligation to point out to the court where the court's interpretation is not consistent with the law – even where the court's misinterpretation is helpful to the litigator's position. The accuracy of the court's legal statement, especially at the appellate level, is critically important to future cases and to business lawyers who have to apply the court's interpretation in their future practice.