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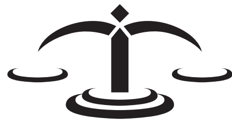

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Puleo v. Topel—A testament to the protection afforded by LLCs

By Edward J. Jarot, Jr., Dystrup, Hoster & Jarot, P.C., Joliet, IL

When advising a client about the benefits of operating his business under the protective shell of a corporation or limited liability company, many advisors tend to focus on the tax and employee benefit differences between the two business forms, without much detailed attention paid to the differences from a liability and asset protection standpoint. The recent case of *Puleo v. Topel*, 368 Ill.App.3d 63, 856 N.E.2d 1152 (2006), a case of first impression under the Illinois limited liability Act, provides an important distinction between the protection afforded a limited liability company compared to a corporation which may help sway your client more towards a limited liability company, especially where insulation of personal assets is of primary concern in selecting the business form.

The primary actors in the *Puleo* case are Thinktank, an Illinois limited liability company engaged in the business of web design and web marketing, and its sole member-manager Mr. Michael Topel. Effective May 30, 2002, Thinktank was involuntarily dissolved by the Illinois Secretary of State for failure to file its 2001 annual report, as required under the Illinois Limited Liability Company Act. Subsequent to involuntary dissolution, Thinktank engaged the services of the plaintiff, an independent contractor, without notifying the plaintiff that the limited liability company had been involuntarily dissolved. After being notified in August of 2003 that Thinktank was ceasing operations, and not having been paid for services performed after the involuntary dissolution, the plaintiff on December 2, 2002 filed suit against Thinktank and Mr. Topel. The complaint sought damages against Thinktank for breach of contract, and in addition sought to hold Mr. Topel, as member-manager, personally liable for any judgement obtained against Thinktank, under the theory that Topel's role as member-manager of the limited liability company was similar to a shareholder or director of a corporation, against whom Illinois courts have previously extended personal liability for debts incurred after dissolution.

In making its determination, the *Puleo* court looked to the plain language of Sections 10-10 and 35-7 of the Illinois Limited Liability Act, which read as follows:

> Section 10-10:
>
> (a) Except as otherwise provided in subsection (d) of this Section, the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.
>
> (b) (Blank)
>
> (c) The failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company.
>
> (d) All or specified members of a limited liability company are liable in their capacity as members for all or specified debts,

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obligations, or liabilities of the company if:

(1) a provision to that effect is contained in the articles of organization; and

(2) a member so liable has consented in writing to the adoption of the provision or to be bound by the provision.

Section 35-7:

(a) A limited liability company is bound by a member or manager's act after dissolution that:

(1) is appropriate for winding up the company's business; or

(2) would have bound the company under Section 13-5 before dissolution, if the other party to the transaction did not have notice of the dissolution.

(b) A member or manager who, with knowledge of the dissolution, subjects a limited liability company to liability by an act that is not appropriate for winding up the company's business is liable to the company for any damage caused to the company arising from the liability.

The *Puleo* court ruled that, under the express language of Section 10-10(a), a member of an Illinois limited liability company cannot be held personally liable for the debts of the company, unless both provisions of subsection (d) of the section are met. As there was neither any indication that the articles of organization provided for such personal liability, nor any consent signed by Mr. Topel, the *Puleo* court ruled that Mr. Topel could not be held personally liable for the debts of Thintank incurred subsequent to dissolution. In making this determination, the *Puleo* court placed importance on the 1998 amendment to Section 10-10 of the Illinois Limited Liability Act, whereby the language which provided for personal liability of members and managers of limited liability companies was removed from the statute, and the court refused to imply a contrary intent into Section 10-10(a).

In addition, the *Puleo* court reviewed the provisions of Section 35-7, and found that while the section provides that a manager of a limited liability company is liable to the company for damages incurred where a manager exceeds his authority in winding up the affairs of a limited liability company, the court refused to go beyond the plain language of the section in extending liability to third parties.

As a result of the *Puleo* decision, and so long as the Act is not amended, advisors can comfortably state that utilizing a limited liability company as a business form affords more protection from a liability and asset protection standpoint, under sections 10-10(a) and 10-10(c) of the Act , regardless of whether the business follows the corporate/business formalities which advisors routinely recommend, as well as after dissolution, both voluntary and involuntary, pursuant to the provisions of Section 35-7. Advisors should note, however, that efforts are under way in the Illinois legislature to amend the Act to eliminate the additional protection that the *Puleo* case found to be afforded to limited liability companies by the Act.

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Minority shareholders receive a Christmas gift from the governor

By Derek P. Usman, Usman Law Group, P.C., Chicago

Effective January 1, 2007, amendments to the Illinois Business Corporation Act now provide a more precise definition of the fair value of minority interests. The new Illinois legislation is quite similar to the 1999 amendments to the Model Business Corporation Act. The Illinois Business Corporation Act now explicitly states that "fair value…means the proportionate interest of the shareholder in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability."

Prior to 2007, "fair value" proceedings in Illinois courts have often resulted in the application of minority and marketability (liquidity) discounts. Even though the Illinois Supreme Court repeatedly discouraged the use of discounts, the position of trial courts remained inconsistent with the majority of courts throughout the country that disallowed discounts. Also, while other states considered discounts to be a question of law, Illinois considered the appropriateness of discounts as one of fact. During "fair value" proceedings, Illinois trial courts left the calculation of fair value to valuation experts and subsequently, the appellate courts deferred to the trial courts. Nevertheless, the newly enacted legislation explicitly prohibits the application of discounts in calculating the fair value of minority shares.

"Fair value" proceedings arise to resolve conflicts between the majority and minority shareholders where the controlling shareholders would benefit at the expenses of the minority shareholders. For example, a conflict is present when a minority interest is discounted in a merger or stock restructuring but the majority interest ends up retaining the discounted value after the reorganization. As a potential remedy, Section 8.60 of the Illinois Business Corporation Act requires the majority shareholders to demonstrate that a fair value was provided for the minority interests.

Sections 11.65 and 11.70 of the

Illinois Business Corporation Act provide for dissenter's rights to a shareholder of a corporation by allowing the shareholder to obtain payment for his shares in the event of certain corporate actions. Alternatively, the presence of oppressive conditions also avails remedies to an injured shareholder. Upon satisfying any of the conditions listed under Section 12.56(a)(1)(4), a petitioning shareholder of a private corporation may request judicial intervention. Subsequently, a possible remedy for the statutorily defined oppressive situations includes a court ordered share purchase after a determination of the fair value of shares.

As a starting point, the "fair value" standard must be distinguished from the "fair market value" standard in analyzing the reasoning behind prohibition of minority discounts in "fair value" proceedings. Illinois courts have stated that fair market value is "based on the price that would be agreed upon in an arms length transaction between a willing buyer and willing seller on the open market, neither under a compulsion to act, and both parties possessed of all relevant facts." Furthermore, the fair market value standard is used in gift and estate tax valuations where minority and liquidity discounts are routine. On the other hand, fair value is often calculated for interests purchased by the remaining shareholders of an entity and the fair market value is inapplicable. The two standards are not analogous; nor are they utilized under similar circumstances. Therefore, the application of discounts is not necessarily appropriate under the "fair value" standard.

Still yet, a minority discount adjustment is based on the theory that non-controlling shares are not worth their proportionate share of the company's value because they lack voting power to control corporate actions. On the other hand, a marketability discount is an adjustment for a lack of liquidity. Here the theory is that there are a limited number of potential buyers for the stock of a closely-held corporation. However, minority and marketability discounts are inappropriate when the purchaser of the stock is either the majority shareholder or the corporation itself. The application of a minority discount is not appropriate because different interests are present when a there is a sale to an outside third party. Upon a sale to a third party, the value of the shares remains constant or drop in value because the third party does not gain a right to control or manage the corporation. On the other hand, a sale to a majority shareholder or to the corporation increases the interests of those already in control. Consequently, the application of a minority discount in a sale to "insiders" would result in a windfall to the buyer.

Nevertheless, litigation is still inevitable because there is a lack of legislative history that discusses exactly when the statutory exception for "extraordinary circumstances" warranting a discount for lack of marketability arises. So, just what will these extraordinary circumstances entail? Even though the amended statutes are void of any guidance, the American Law Institutes' Section 7.22 of the Principles on Corporate Governance is a good starting point. Illinois' newly adopted definition of fair value mirrors the American Law Institute's definition of fair value. The ALI endorses the national trend of interpreting fair value as the proportionate share of a going concern "without any discount for minority status or, absent extraordinary circumstances, lack of marketability." The ALI has further recommended that to determine fair value, the trial court must determine the aggregate value for the firm as an entity, and then simply allocate that value pro rata in accordance with the shareholders' percentage ownership.

Similar to Illinois, the ALI's definition of fair value also includes the exception for "extraordinary circumstances." Unlike the Illinois statute, the ALI provides guidance as to just when extraordinary circumstances might arise. Comment e to Section 7.22 clarifies that extraordinary circumstances must consist of more than an absence of a trading market in the shares. Furthermore, an ALI comment states that the extraordinary circumstances exception is "very limited" and is intended to apply only when the trial court "finds that the dissenting shareholder has held out in order to exploit the transaction giving rise to appraisal so as to divert value to itself that could not be made available proportionately to other shareholders."

The comment also provides an example of "extraordinary circumstances." In the example, a financially strained corporation lacking liquid assets makes relatively minor changes in its governance and structure which trigger appraisal rights. Since the corporation is financially troubled and only has illiquid assets, a fair value appraisal proceeding would likely result in a higher price per share than a market transaction for the shareholder's shares. Furthermore, a shareholder dissents because he had been unsuccessfully attempting to persuade the other shareholders to purchase his shares. Therefore, the dissenting shareholder now has the opportunity to obtain a much higher price for his share by exploiting a relatively minor change. A marketability discount would be proper because the "fair value" proceeding is likely to produce an appraisal higher than the remaining shareholders could receive upon a sale of the corporation or its assets and the dissenter is taking advantage of a minor corporate change. Therefore, if a dissenting shareholder does not have a valid objection to the transaction, the shareholder is deemed to be exploiting a minor change in the charter. Consequently, a marketability discount should be applied to prevent an unfair wealth transfer to the dissenting shareholder. The comment does indicate that under identical facts, if the shareholder dissented to a fundamental corporate change, such as a merge, a marketability discount would be inappropriate.

In 2003, the Colorado Supreme Court analyzed the ALI's definition and interpretation of "fair value" and "extraordinary circumstances" and asserted that that the "extraordinary circumstance" exception is intended to enable trial courts to utilize their equitable powers and provide a fair result when extraordinary circumstances are present. (For brevity's sake I'm excluding a discussion of cases that analyze the applicability of the "extraordinary circumstance" exception. Nevertheless, all of those cases emphasize the limited nature of the exception.)

In addition to the strict statutory limitations on discounting minority shares, courts across the nation have recognized that discounts unjustly benefit the majority shareholders. As the Delaware Supreme Court stated in the leading "fair value" case in *Cavalier Oil Corp. v. Harnett*, "…to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control, and enriches the majority shareholders who may reap a windfall from the appraisal process by chasing out a dissenting shareholder, a clearly undesirable result."

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