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# CORPORATION, SECURITIES & BUSINESS LAW FORUM

The newsletter of the ISBA's Section on Corporation, Securities & Business Law

## *Kern v. Arlington Ridge Pathology, S.C.:* An unsound decision illustrating a lack of awareness of basic corporate law principles

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A recent Illinois Appellate decision, *Kern v. Arlington Ridge Pathology, S.C.*, 384 Ill.App.3d 528 (1st Dist. 2008), illustrates the necessity for lawyers and judges to have a

mastery of corporate law, in general, and the Illinois Business Corporation Act ("BCA"), in particular. The attorney who drafted Arlington's corporate documents inserted greater than majority voting requirements at the shareholder level in the bylaws instead of in the articles, as required by the BCA, while counsel at trial could have broadened several arguments that might have swayed the trial and the appellate court. Moreover, the Appellate Court ignored several bases that would have been sufficient to reverse the trial court's order granting summary judgment. Specifically, Plaintiff's counsel could have bottlenecked his argument that the bylaws constituted a contract, by also positioning the bylaws as a shareholders agreement of the type recognized by *Galler v. Galler*. The court mistakenly failed to recognize that the majority shareholders breached their fiduciary duty to the

minority shareholder by threatening to terminate her, that the conduct of those in control was oppressive, and that the cumulative voting provisions of the BCA precluded defendant's from removing Plaintiff as a director. In addition, the Court relied upon a questionable abrogation of bylaws theory to uphold summary judgment, failed to recognize that the meeting in question was not held pursuant to proper notice, and misapplied Illinois fiduciary duty law.

*Kern v. Arlington* involved three pathologists (Plaintiff, Dr. Manglani, and Dr. Regan) who were the sole directors and shareholders of a corporation that maintained an exclusive services agreement with Northwest Community Hospital. Plaintiff and Dr. Manglani were both original founders of the corporation in 1994 and Dr. Regan was admitted as a shareholder and elected as a director years later. In 2001 a dispute arose

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between Plaintiff and Bruce Crowther, chief executive officer of Northwest. This animosity continued until 2005 and culminated with an accusation that Plaintiff acted unprofessionally when addressing an Arlington employee. As a result, Mr. Crowther issued a letter to Dr. Regan in August 2005 stating that plaintiff created a hostile work environment, and pursuant to the agreement between the hospital and Arlington, Crowther threatened to terminate Arlington's exclusive services agreement if Plaintiff was not sent to professional counseling or terminated.

Approximately two months later, Dr. Regan and Dr. Manglani voted to amend the articles of incorporation to allow the bylaws to be amended by a two-thirds shareholder vote instead of the eighty percent required under the bylaws. However, Plaintiff was not present because the meeting occurred and ended before the noticed time. Subsequently, the same two directors voted to change the voting requirements for removing directors, terminating physician employment, and board action for major decisions from 67 percent of outstanding shares to two-thirds. The slight difference between the foregoing two percentages was significant because the two defendants and shareholders held 66.93 percent of the shares, more than two thirds but less than 67 percent.

The first, and most costly, mistake occurred when Arlington's corporate documents were drafted. Even though the founders of Arlington intended to preclude a majority of shareholders from ganging up on a minority of shareholders, which is clearly evidenced by a bylaw provision which requires an 80 percent vote to remove a director or to alter the bylaws, this provision was not placed in Arlington's articles of incorporation, which was statutorily required. Section 7.60 of the BCA requires a greater than majority quorum or voting requirements with respect to shareholders meetings must be set forth in the articles. In the case at bar, these provisions were inserted in the bylaws.

Moreover, there should also have been a provision that the articles themselves could not be amended except by an 80 percent shareholder vote. Otherwise, it could be determined that a mere majority vote could eliminate the other 80 percent voting provisions. Since initially there were five shareholders, the clear intent of the provision was that it took more than a mere majority of the shareholders to disadvantage another shareholder. Once the number of shareholders

dropped below five, it would have been prudent to amend the articles to provide for a unanimity requirement, so as to preclude a court from interpreting such provision as permitting majority action. The oversight in failing to put these provisions in the articles of incorporation ultimately caused the present litigation.

In an attempt to rectify the incorporating attorney's mistake, Plaintiff's counsel argued that the bylaws constituted an enforceable contract between the shareholders. This is a valid argument, based upon *Crotty v. Peoria Law Library, Ass'n*, 76 N.E. 707 (1906); however, while the court recognized this rule of law, it then ignored it in formulating its opinion. This argument could have been reinforced by citing *Galler v. Galler*, 203 N.E.2d 577 (1964), where the Illinois Supreme Court upheld the right of shareholders in close corporations to create agreements concerning the management of the corporation, even if such agreement is counter to statutory language, as long as there is no complaining minority interest, fraud, or injury to the public or creditors.

In reaching this conclusion, the *Galler* Court stressed the need to protect the financial interests of minority shareholders in close corporations because of the inability to readily sell their shares on the open market. *Id.* Instead of merely claiming that the bylaws constituted an enforceable contract, it would have been desirable to argue that the bylaws constituted a shareholders agreement to protect the interest of minority shareholders. If this argument were made, an inquiry into the intent of the parties would have been necessary. At the very least, this would have precluded summary judgment.

The court rejected Plaintiff's breach of fiduciary duty argument. However, this was not phrased in terms of the duty of majority shareholders to minority shareholders. If this were done, Dr. Manglani and Dr. Regan would have had the burden of showing a legitimate business purpose in seeking to terminate Plaintiff's employment. If defendant satisfied this burden, Plaintiff would have had the opportunity to show that, even if terminating her employment were a legitimate business purpose, the same purpose could have been achieved through an alternative course of action less harmful to Plaintiff's minority's interest.

This argument would have been supported by one of the seminal cases on controlling shareholder fiduciary duty, *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657, 665 (1976), where the

court held that terminating the minority shareholder's employment breached the majority's fiduciary duty, because employment in the corporation is one of the basic reasons for investing in a close corporation, especially when the earnings of that close corporation are distributed primarily through salaries. *Id.* at 662. Therefore, because the business purpose for Plaintiff's termination was her strained relationship with Northwest's CEO, Plaintiff's counsel could have at least argued that eliminating Plaintiff's contacts with Northwest's CEO, or some other arrangement, could have satisfied the same business purpose as termination, without destroying the value of Plaintiff's minority interest.

The facts would also seem to support an allegation of oppressive conduct on the part of the majority shareholders. After the 1995 amendments to the BCA Illinois Supreme Court has made it clear that courts are encouraged to use the numerous alternative remedies in section 12.56 of the BCA. *See Schirmer v. Bear*, 271 Ill.App.3d 778, 786 (1995). Plaintiff counsel could have argued that seeking to remove Plaintiff as a director, terminating her employment, and conducting a board meeting before the noticed time, constituted "heavy-handed treatment," which has been historically sufficient to satisfy a claim for oppression under 12.56. *See Compton v. Paul K. Harding Realty Co.*, 285 N.E.2d 574 (1972); *Notzke v. Art Gallery, Inc.*, 405 N. E.2d 839 (1980); and *Hager-Freeman v. Spircoff*, 593 N.E.2d 821 (1992). It could also have been argued that the "reasonable expectations test" was the appropriate standard in determining whether oppression existed. Under this test, Plaintiff could have claimed that she, as one of the founders of the corporation, made her investment on the expectation that she would be employed as a pathologist with an exclusive services agreement with Northwest, not terminated a few years later because of a personal disagreement.

The next issue that was not dealt with by the court was that Plaintiff could not have been removed as a director because section 8.35 of the BCA, which is the default rule if the articles do not provide otherwise, prevents a director from being removed if the votes against removal would have been sufficient to elect the director. Plaintiff owned 166 shares out of 502. Applying the cumulative voting formula, even if there were only three directors, Plaintiff needed only 126 shares to elect herself as a director. Therefore, Plaintiff could not have been removed as

a director under section 8.35 of the BCA. See 7 Charles W. Murdock, *Illinois Practice -- Business Organizations*, §9.14.

The Court also incorrectly focused on whether Arlington's bylaws were abrogated by nonuse. In reaching its conclusion that Arlington's bylaws were abrogated, the court relied upon the fact that the only three directors have acted for the corporation in the past couple of years when the bylaws required a minimum of four directors. However, a quorum is still possible if all three directors show up. This is exactly what happened. Every decision of the board of directors was unanimous. Thus, the argument that the directors were acting in accordance with the bylaws is at least as consistent as the argument that they had abrogated the bylaws.

Even if you accept that the bylaws were abrogated, the issue of what the requisite vote was still remained. The unanimous votes over the years and the 80 percent voting requirement in the bylaws reflected an intent not to allow majority shareholders to disadvantage minority shareholders. If the directors impliedly had determined that there were only three directors, it could also be argued that they had impliedly determined to act by unanimous consent. The Court should have determined the

intent of the parties at a hearing, not on a motion for summary judgment.

What is absolutely clear is that the meeting the two directors held was not in accordance with the notice, since the two defendant directors met prior to the noticed time of the meeting. Thus, the meeting was invalid for failing to comply with proper notice. While this could have been cured by the defendants, reversing the trial court might have provided the opportunity for the parties to negotiate a settlement in lieu of continuing to litigate.

Finally, the appellate court rejected the breach of fiduciary duty count on the basis that there was no unlawful underlying act. This is an improper statement of what is necessary to constitute a fiduciary duty. Failure to meet the reasonable expectations of a shareholder can constitute a breach of fiduciary duty even though the actions of the majority are not specifically unlawful. Note the cases cited above.

The net effect of the decision of the trial court, as affirmed by the appellate court, has been to oust plaintiff from a lucrative position in a corporation which she helped form about a decade earlier. This is particularly sad when the legal bases relied upon by the court are at best suspect.

## Asset protection skills and techniques: How well do Subchapter S Corporations and LLCs work?

By David F. Rolewick, *ROLEWICK & GUTZKE, P.C., Wheaton, IL*

### I. Liability Insurance

**A**sset Protection's first line of defense is insurance coverage. A good business advisor or estate planning attorney should be discussing liability insurance coverage with her client before the discussion of off-shore trusts and at the beginning of the relationship or the inception of the business. Adequate liability coverage will protect the asset base of the business and its owners from the vast majority of claims and provide the cost of defense. Exhibit 1 to this presentation provides a list of insurance coverages that you

should review with your clients regularly, but it is not exhaustive.

It is surprising what risks can be insured. In our experience we have had clients obtain coverage or quotes for coverage insuring: the life of an eighty year old; that no golfer in a tournament will get a hole in one; that our client's patent will not be challenged.

The issue often is not what cannot be covered but rather what will the premium be and who issues the policy. We all know insurance companies fail more frequently than banks; and we all know about banks so, the client needs to assess the strength of the carrier which can be accomplished

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through the several rating services and augmented by the general agents sources and the states' Departments of Insurance.

Again, generally speaking, criminal and intentionally wrongful acts cannot be insured over because indemnity for intentionally wrongful conduct is against the public policy of every state. Depending on the risk involved, it benefits the client to have coverage and exclusions reviewed by competent advisors, the most obvious being the independent insurance agent. When the business managers lose confidence in the insurance agent, the managers need to approach their lawyers, policies in hand, for the review.

Exclusions do not necessarily preclude the carrier from providing the lawsuit defense. Usually the carrier provides the cost of the defense with a reservation of the carrier's rights to enforce the exclusion in a separate action. Remember, in Illinois 98 percent of filed cases settle. Cost of defense therefore, may be the most significant exposure for your client. Also, while plaintiffs' attorney currently seem to prefer the shotgun approach to pleading a complaint, they usually focus the proof to fall within insurance coverage where the "deep pocket" is, except in the case of the very large and well capitalized defendant.

Careful counsel concerned about protecting the assets of owners, directors or officers may wish to revisit the Operating Agreements and By-Laws of the business to insure that officers, directors or managers and members are provided with the broadest indemnifications and expense advancements right permitted under law. In unfortunate litigation with governmental agencies such provisions may become outcome determinative and organized efforts of the U.S. Attorneys to force corporations not to honor such provisions of governance documents has been roundly criticized by the federal courts.

Finally, it also surprises me how many of my sophisticated and wealthy clients fail to have comprehensive personal insurance coverage. Any client who needs a will should have at least \$1 million of umbrella coverage in excess of homeowners and auto coverage, again if for no other reason than cost of defense. Many do not. In discussing coverage limits the measure is not of assets but of risk.

## II. Limited Liability Business Entities

Asset Protection is a process and not

a product. We can benefit the clients we serve greatly by educating them about this important distinction well before asset protection becomes an imperative in their lives for reasons more fully discussed later in this seminar regarding Fraudulent Transfer Laws. Suffice it to say here that as we serve the business client or its owners, we need to discuss the benefits and risks of various forms of entities that are available and the asset protection benefits each form of entity provides.

I intend today to talk about the asset protection characteristics of the corporation and LLC. Use of these entities for conducting business is part of the asset protection process that every business and business investor should undertake. Neither are the final solution, just as I suspect you will determine today, no one devise is. We have seen the LLC proclaimed to be "bullet proof". One asset protect promoter proclaims "For Asset Protection purposes the LLC is creditor proof." ("Estate Street Partner LLC" Limited Liability Company 2008) while a learned Illinois lawyer writes in the Illinois Bar Journal "Don't Use an LLC for Asset Protection." (Illinois Bar Journal, Vol. 96 No. 6, page 314, et seq. June 2008), I suggest the truth is that corporations and LLCs (as well as Limited Partnerships) are very useful and successful asset protection tools and, in the case of corporations, have been for many years. Corporations are the original asset protection devise to protect shareholders (owners) from business creditors. (Hagendorf, Wayne; *Protecting Your Assets*; Knowles Publishing, Inc. 2007) and Limited Partnerships and LLCs, while being more recent creatures of state legislatures, are even better at asset protection when viewed as a process and not a product. We should recognize these entities for their asset protection benefits and identify their weaknesses.

### A. C & S Corporations and Turnover Orders.

Your outline in the promotional brochure for this seminar references "S & C Corporations" under "How Well Do Subchapter S Corporations and LLCs Work"? I did not write the title or the sub-heading. To me they imply a distinction being made between S and C corporations for purposes of asset protection. In my study of the case law concerning creditors efforts to collect judgments against shareholders by obtaining their interest in corporations or in attempting to pierce the corporate veil of a corporation, I have seen no reference to S or C

status as a contributing factor one way or the other. In the cases I reference today you will note the courts do not even mention the tax status in regard to creditor's rights.

However there are nuances to a creditor obtaining a turnover order for a debtor's S corporation stock that do not exist relative to C corporation stock.

1. Because of the restrictions on S corporation shareholder status, in the Internal Revenue Code, the creditor may be able to force the conversion of an S corporation to a C corporation because the creditor does not qualify as an S corporation shareholder. This would disqualify the corporation for pass through tax treatment. (26 USC 1361(b)(1)). Such a change in taxpayer status may have undesirable effects on the company and other shareholders causing them to negotiate with the new creditor/shareholder.
2. Alternatively, if the creditor who obtains title to S corporation shares does qualify as an S corporation shareholder, he may find himself receiving a report of his share of the corporation's income (IRS form K-1). The corporation may or may not make distributions at least sufficient to pay taxes. Some S corporations in their governance documents provide for non-payment of distributions as an asset protection devise. Whether such a provision is enforceable on a new (creditor) shareholder is not clear. However there are cases which suggest that failure to make distributions sufficient for shareholders to pay the taxes on S corporation income is oppressive and subjects the corporation to shareholder litigation. We have found no such case, however, in Illinois. This standoff of rights suggest that when it gets to the point where a creditor of a shareholder in a S corporation is about to get a turnover order for the S corporation shares, someone representing the corporation or its other shareholders needs to have the authority to negotiate a settlement, or the corporation needs to have the right via a Shareholders Agreement to redeem the shares if the creditor is not a qualified S corporation shareholder.

### B. LLCs, Limited Partnerships and Charging Orders.

The charging order was originally developed in Common Law to distinguish a partner's personal debt from that of a partnership of which he was a member and, in recognition of the

entity, to prohibit the creditor from forcing the sale of partnership assets (see *Taylor v. S & M Lamp Co.*, 190 Cal. App. 2d 700 (1953)). The concept has been transferred into virtually every state's Limited Partnership and LLC Act (See Mata, Mario, Use of Domestic Family Limited Partnerships and Limited Liability Companies in Asset Protection Planning, *Asset Protection Strategies*, Volume I, ABA Publications 2005). Under the Illinois Limited Partnership and LLC Acts this charging order and its foreclosure is the only remedy available to a creditor of a member of an LLC or a limited partner of a Limited Partnership. The creditor can seek the order that the entity make any distributions due the debtor to the creditor instead. The creditor however cannot force the sale of entity assets to satisfy the debt. Unlike the S corporation, Limited Partnerships and LLCs do not have IRS restrictions on their membership, which can be leveraged by the creditor to force some resolution of payment to the creditor. So the creditor may experience phantom income via a K-1 without any cash distribution. The creditor in a LLC or Limited Partnership is an assignee or transferee of the partner's interest and has no voice in management or even the election of management. So the creditor could be worse off for the charging order. However, and without finding any case on the topic, it has been argued the transferee of a LLC distributional interest may seek dissolution of the LLC. (see Illinois Bar Journal, Hanson, Lin; *Don't Use an LLC for Asset Protection*, Vol. 96, No. 6 June 2008). Similar provisions providing relief for transferees are not part of the Illinois Limited Partnership Act.

Clearly, the charging order exclusive remedy makes the LLC or Limited Partnership a preferable business entity than the corporation from an asset protection perspective. The relentless creditor never becomes an equity owner of the business, nor does he obtain the power to force a change in taxation as in the S corporation setting. However, he is not powerless and can cause problems distracting the company and its managers from their primary responsibilities. A well drafted Partnership Agreement and operating agreements can protect the company from such distractions by providing flexibility for the redemption of the distributional interest before the charging order is entered. The price is the payment to the member or partner who then has lost her equity. The business's advisors must help management and owners balance the different interests

and reach the best result on a case-by-case basis. This analysis and the resulting agreement must be in place before the creditor comes knocking with the charging order.

### C. Piercing the Corporation Veil And Other Attacks On Shareholders and Members.

#### 1. Direct Participant Liability.

In an opinion file on February 17 of 2007, the Illinois Supreme Court recognized a cause of action against a parent corporation in tort based on the wrongful conduct of its subsidiary corporation. In *Forsythe et al v. Clark USA Inc.*, 224 Ill. 2d 274 (2007) the court found, reviewing the circuit court grant of summary judgment to the defendant, Clark USA (which was reversed by the Appellate Court) that a sole shareholder of a corporation may be liable for the subsidiary's negligent conduct if the plaintiff can prove allegations that the parent was the central figure in the subsidiary's corporation's tortious activity in disregard of the separate legal personality of the subsidiary.

The Supreme Court went to great lengths to state that the general state of the law in Illinois is that a shareholder will not be liable for the conduct and obligations of a corporation and that in this case the liability of the sole parent company did not arise under a theory of piercing the corporate veil or alter ego. Rather the court found that when a parent "exercised direct control over a specific (wrongful) transaction"... a shareholder may be liable if he is a "central figure" in the corporations tortious conduct". While the standard is a high one, this is a case every lawyer representing business entities needs to study. It is a case of first impression in Illinois.

#### 2. Piercing the Corporate Veil.

In *Tower Investors, LLC v. Ill East Chestnut et al.* 371 Ill. App. 3d 1019 (2007). The Appellate Court set out the standard for piercing the corporate veil to find a "sister" business entity liable. The Court wrote:

"Piercing [the] corporate veil is a task which courts should undertake reluctantly". *Pederson v. Paragon Pool Enterprises*, 214 Ill. App. 3d 815, 819, 574 N.E.2d 165, 167, 158 Ill. Dec. 371 (1991) The court should not interfere with the corporate form anymore than it would a private contract, and the corporate veil should only be pierced when it appears that something in the particular situa-

tion has "gone amiss". 1 W. Fletcher, *Cyclopedia of Corporations* § 41, at 557 (1999). Particularly, in breach of contract cases, courts should apply even more stringent standards to determine when to pierce the corporate veil than they would in tort cases. 1 W. Fletcher, *Cyclopedia of Corporations* § 41.85, at 692 (1999). "This is because the party seeking relief in a contract case is presumed to have voluntarily and knowingly entered into an agreement with a corporate entity, and is expected to suffer the consequences of the limited liability associated with the corporate business form." 1 W. Fletcher, *Cyclopedia of Corporations* § 41.85, at 692 (1999).

Illinois courts will pierce the corporate veil where: (1) there is such a unity of interest and ownership that the separate personalities of the corporation and the parties who compose it no longer exist, and (2) circumstances are such that adherence to the fiction of a separate corporation would promote injustice or inequitable circumstances. *Pederson*, 214 Ill. App. 3d at 819-20, 574 N.E.2d at 167. In a breach of contract case, "additional compelling facts," such as a finding of fraud, may also be required, *Baker*, 86 Ill. 2d at 205-06, 427, N.E. 2d at 101-02.

Corporate formalities and commingling of funds were not discussed because they were not alleged.

In *Westmeyer v. Flynn et al.*, 889 N.E. 2d 671, (2008 Ill. App. March 2008) The First District Illinois Appellate Court confirmed that after obtaining a judgment against a Delaware limited liability company, a creditor may bring a separate action to pierce the corporate veil and obtain judgment against its members. The plaintiff here alleged undercapitalization, failure to observe formalities, alter ego and perpetration of a fraud. The court found under Delaware Law (and the Illinois Act as well) members and managers may be liable under a piercing of the corporate veil theory. The court noted that lack of corporate formalities is not a factor under the Illinois Act to pierce the veil of an LLC.

For a comprehensive discussion of the law of piercing the corporate veil of a LLC see *Judson Alkinson Candies, Inc. v. Latini Hohberger Dhemontea*, 2008 WL 2246431 (7<sup>th</sup> Cir. June 2008)

However, this relief is available only

to creditors of the company. A director, a shareholder or even the company itself may not attempt to pierce the corporate veil. *Rehabilitation of Centour Insurance Company* 158 Ill. 2d 166 (1994); *Semande v. Estes*, 374 Ill. App. 2d 468 (2007).

For a good example of when a court will pierce the corporate veil of an LLC see *Netjets Aviation, Inc. et al. v. LHC Communications, LLC et al.* (United States Court of Appeals for the 2<sup>nd</sup> Circuit, Docket No. 06-3340-cv 2008 U.S. App. LEXIS 16727 (August 8, 2008).

### 3. Breach of Fiduciary Duty

The *Judson Alkinson Candies* case cited above is instructive in regard to another theory of liability of directors, officers or managers also. The court rejected the plaintiff's efforts at traditional claim for piercing the corporate veil. The plaintiff alleged that because of insolvency, the creditors of the company become constituents benefiting from the fiduciary duty of officers and managers. The court noted the Illinois Supreme Court has not ruled whether an insolvent corporation's creditors may bring a direct claim for breach of a special-circumstance fiduciary duty. The appellate courts have recognized the claim *Engineering Ltd.*, 53 ESupp.2d at 101012; *O'Connell v. Pharmaco, Inc.*, 143 Ill. App.3d 1061 (1986); *Circle Security Agency, Inc. v. Ross*, 99 Ill. App. 3d 1111 (1981). Other courts have noted the claim or cause of action runs to all creditors, and only the corporation or its representative in bankruptcy can bring the claim (*Prime Leasing, Inc. v. Kendig*, 332 Ill. App. 3d. 300 (2002).

The Court of Appeals had already noted that the plaintiff was only able to demonstrate the company was losing money but not that it was insolvent. It rejected of the piercing of the corporate veil claim. It rejected the breach of fiduciary duty claim on the same basis observing that the facts did not require it to decide the standing issue. The point here, of course, is that whether the cause of action lies with a creditor class representative or corporate representative or with individual creditors, the managers, director and officers of business LLCs and corporations that are insolvent have a duty and are liable to the company's creditors.

### 4. One Member LLC Are Special Problems

The *Netjets* case is a good segue into our next topic, one member LLCs. We can sum this topic up by saying: "The nice thing about Limited Partnerships is that they always have two or more

partners. Avoid single member LLCs whenever possible." You will recall that earlier I touched on the Common Law roots of the charging order. It is a construct to avoid the sale of partnership assets and thus damage the interest of innocent partners to satisfy the obligations of a debtor partner. It made sense to transport this concept to the Limited Partnership and even to the LLC, which has many partnership characteristics. But then, state by state, our legislatures provided for one member LLCs and the lack of logic has been effectively utilized to encourage bankruptcy courts to treat one member LLCs differently when the member seeks bankruptcy protection.

In *Federal Trade Commission v. Olmstead et al.* The single members of two Florida LLCs challenged the court's authority to appoint receivers to sell assets for the benefit of creditors. (528 F. 3d 1310 [May 2008]) The Court of Appeals wrote:

After considering the parties' arguments and given the absence of controlling case law on point, we conclude that Florida law is not sufficiently well-established for us to determine with confidence whether the district court's surrender order is permissible under Section 608.433(4). The Florida Constitution authorizes this Court to certify a question about state law to the Florida Supreme Court if it "is determinative of the cause and for which there is no controlling precedent of the supreme court of Florida". Fla. Const. Art. V, § 3(b)(6). Because we have found no such controlling precedent, we certify the following questions to the Florida Supreme Court:

Whether, pursuant to Fla. Stat. § 608.433(4), a court may order a judgment-debtor to surrender all "right, title, and interest" in the debtor's single-member limited liability company to satisfy an outstanding judgment.

At the time of writing this paper, we have been unable to determine if the Florida Supreme Court has ruled on the question.

No doubt you are aware of *In Re: Albright*. In that case the bankruptcy trustee of the estate of the bankrupt member included the assets of the LLC in the bankrupt estate. (291 B.R. 538 2003 Bankr., 50 Collier Banker. Cas. 2d (MB) 1. In rejecting the bankrupt's argument that a charging order was the trustee's only

remedy against the LLC on account of the membership interest the court wrote:

However, the charging order, as set forth in Section 703 of the Colorado Limited Liability Company Act, exists to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interest affected.

The Bankruptcy Court in Baltimore, Maryland followed the *Albright* decision in *In Re: Nader Modanlo; In Re: New York Satellite Industries, LLC 2006 Bankr.* LEXIS 4524. (May 2006) As in *Albright*, the court was clear in pointing out the results would be different if there were another member with even a minute interest in the LLC.

That being said, I suggest this very logical attack on the charging order remedy in a single member LLC may migrate to creditors from the current arena of bankruptcy trustees. To the end, as I said above "The nice thing about Limited Partnerships is they always have two or more partners."

In closing on this topic I wish to point out these are a very few cases, and LLC have been around a while. Limited Partnerships have been around even longer. I suggest that as part of an asset protection process, corporations and more so Limited Partnerships and LLCs are doing a pretty good job. It is in the extreme fact patterns where the equities play out poorly and "hard facts make bad law". By prior planning you can avoid the problem for most clients.

### III. Some Other Important Cases To Review.

I suspect most of you are familiar with *Morganroth & Morganroth v. Norris, McLaughlin & Marcus, D.C. et al.*, 331 F 3d 406 (3<sup>rd</sup> Cir. 2003). In that case a frustrated creditor sued the debtor's lawyers for fraud, conspiracy and aiding and abetting its client in attempting to protect assets. The Court of Appeals found that

the causes of action were sufficiently alleged and the alleged conduct exceeded permissible advocacy and amounted to a scheme to defraud a creditor.

In 2007 the U.S. Court of Appeals for the Eighth Circuit found that a trustee in bankruptcy had standing to bring a claim against a lawyers and his firm for negligence, breach of fiduciary duty and aiding and abetting in their services to an insolvent LLC and its member/manager. (482 F. 3d 997; 2007 U.S. App. LEXIS 7547 2007).

Recently in *Thornwood, Inc. et al. v. Jenner & Block et al.*, 344 Ill. App. 3d 15, the Illinois Appealable Court recognized the cause of action of aiding and abetting brought against a law firm in a different setting than asset protection advise and counsel. But in the *Dowling* case, the Supreme Court seemed to give asset protection planners some encouragement. *Dowling v. Chicago Options Associates, Inc., et al.*, 226 Ill. 2d 277 (2007). This opinion needs your careful study on many levels if you engage in asset protection planning, especially the requirements for the advance payment retainer. For an expanded study of the ethical and liability issues relating to the practice of asset protection see *Attorney Ethical Liability in the Application of the Terms "Fraud" versus "Fraudulent Transfers" Under the Uniform Fraudulent Transfers Act* by Kleinfeld and Fisher in *Asset Protection Strategies*, Volume II, p. 541 et seq. published by the Section of Real Property, Probate and Trust Law of the American Bar Association (2005).

**EXHIBIT 1**

**A. Insurance Coverage Of Liabilities Of Business Entities and Their Employees.**

**Common Coverage.**

**1. General Liability.**

All types of third party liability for property damage and bodily injury. Typical areas of coverage include liability arising from advertising activities, invasion of privacy, defamation and contractual liability. Protects business from incidents occurring on premises or other covered locations where business is conducted. "Loss of use, physical injury to tangible property." It includes:

- a) Bodily Injury;
- b) Property Damage;
- c) Personal Injury (including slander or libel); and
- d) Advertising Injury.

**2. Worker's Compensation.**

Covers employees medical and disability expenses related to work-related illness and on the job injuries.

Also includes employer's liability coverage. Protects business in the event an employee claiming that his or her injury was caused by a business negligence or failure to provide a safe workplace.

**3. Products Liability.**

Protects businesses from claims related to the manufacture or sale of products, food, medicines or other goods to the public.

- a) Manufacturing or production flaws;
- b) Design defect; and
- c) Defective warnings or instructions.

**4. Error and Omissions/ Professional Liability.**

- Written on " named peril basis."
- Generally protects from losses caused by professional negligence.

**5. Owner's Risk.**

- Homeowner's policies cover many losses satisfied by home-based businesses.
- Commercial real property insurance is necessary for real property used solely for business purposes.

**6. Directors and Officers.**

- Protects directors and officers from incurring personal liability from wrongful acts committed by a director or officer. (Discrimination, sexual harassment, acts beyond authority, wrongful termination, defamation).

**B. More specialized coverage.**

1. Employment Claims (Employment Practices Liability Ins.)
  - Covers employment claims related to employment practices wrongful termination, discrimination, sexual harassment, defamation, emotional diseases, breach of employment contract, wrongful discipline.
2. Environmental Impairment Liability.
  - provides environmental liability coverage for operators and for third-party claims that are the result of pollution events on, at, under or coming from a covered location.
3. Environmental Clean-Up and Liability.

- provides first-party cleanup as a result of a discovery of a pollution event, in addition to the environmental liability coverage included in the EIL.
4. Real Estate Environmental Liability.
    - provides environmental liability coverage similar to ECL; however, tailored for real estate transactions.
  5. Lender Environmental Collateral And Protection Liability Insurance.
    - provides environmental liability protection and ECL coverage for lenders and real estate leaseholds or fixed assets.
  6. Securitization Collateral Protection and Environmental Liability Insurance
    - provides environmental liability coverage similar to the above insurance; however, tailored for securitizations.
  7. The Borrowers REEL Program
    - provides commercial real estate borrowers with an environmental liability policy for transferring risk to a financially secure company.
  8. Asbestos In-Place.
    - provides coverage for environmental liability associated with managing asbestos in place rather than removing.
  9. Storage Tank Pollution Liability.
    - provides financial responsibility protection for regulated underground storage tank systems including first party clean-up costs as a result of a discovery of a release of product.
  10. Dealer and Repair.
    - provides environmental liability coverage made to order for auto dealer and repair shops, which includes financial responsibility protection for regulated underground storage tank systems, contingent transportation coverage and non-owned location (disposal site) coverage.
  11. Remediation Stop Loss.
    - provides environmental liability coverage made to order for auto dealer and repair shops, which includes financial responsibility protection for regulated underground storage tank systems, contingent transportation coverage and non-owned location (disposal site) coverage.
  12. Contractor's Pollution Liability.
    - provides environmental liability coverage but only for claims

caused by pollution events arising out of covered operations or completed operations of the covered operation performed by or on behalf of the insured.

- 13. Professional Consultant's Liability.
  - provides environmental liability coverage for environmental liability arising out of acts, errors, or omissions during the rendering of professional services.
- 14. Professional Environmental Consultant's Liability.
  - a hybrid policy that combines professional environmental liability and contractor's pollution liability.
- 15. Patent Infringement Insurance.
  - Covers losses sustained due to patent infringement. Patent infringement resulting from use, dislocation, sale and advertising of the insured's products.
- 16. Commercial Property Insurance.
  - Physical loss or damage to commercial property that is torturous.
  - May also include electrical data processing of electronically controlled equipment.
- 17. Business Interpretation Insurance.

- Protects the earnings that a policyholder would have enjoyed had an interruption to its normal business squashes.
- 18. E-Business Liability Policies.
  - Covers losses incurred due to cyber-activities, security breaches, electronic data loss.
- 19. Commercial Auto.
  - Insures against losses caused by vehicles used by a business.
- 20. Bonds - Surety Bonds.
  - Contract Bonds – guarantees fulfillment of contract obligations.
  - Commercial Bonds – guarantees compliance with law, regulation, private agreement.
  - Performance Bonds – guarantees fulfillment of contract obligations.
- 21. Other Risks.
  - Specific risk insurance – scripted policies.

**C. Personal Coverage of Owners.**

- 1. General Liability and Casualty.
  - Protects owners and operators of business from wide variety of exposure including premises, operation, products, and contract liability.

- 2. Medical and Hospitalization.
  - Protects against expenses incurred from medical treatment or hospitalization.
- 3. Umbrella.
  - Provides additional insurance coverage above policy limits for all policies underneath (typically auto and homeowners).

**D. Indemnification provisions for officers and directors in By-Laws and Operating or Partnership Agreements including Expense Advancement Provisions.**

- Business governance documents should be carefully drafted to require that the business owner against all business related liability that result from unintentional conduct and that the business advance all costs of personal defense of all business related claims, even those brought by the entity.

**E. What cannot be covered by insurance generally?**

- Intentional Wrongful Conduct;
- Criminal Conduct;
- Punitive Damages;
- Attorney Fee Awards; and
- False Advertising.



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