

LLC OR NOT LLC -- WHAT SHOULD BE THE QUESTION:  
CONSEQUENCES OF ENTITY CHOICE  
Friday, April 11, 2008 8:00 a.m. to 10:00 a.m.

Paul Keiffer, Chair  
Small Business Bankruptcy Subcommittee of the Business Bankruptcy Committee  
Hance Scarborough Wright Ginsberg & Brusilow  
Dallas, Texas

Moderator:

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Panelists:

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The Honorable Russell F. Nelms  
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Fort Worth, Texas

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Nelson Castellano joined the firm in 1992, became a Shareholder in 1999 and currently co-chairs the firm's Business Transactions Practice. His practice focuses primarily on corporate matters, providing general business advice to emerging growth and middle market companies, capital raising transactions, including private placements of debt and equity and venture capital, mergers and acquisitions, and business formation and entity selection.

He is a member of the American Bar Association and Hillsborough County Bar. He is also admitted to practice before the U.S. Tax Court and the U.S. District Court for the Middle District of Florida. Nelson previously served as co-chair of the ABA Small Business Section Task Force on Private Placement Broker Dealer Registration. In addition, together with Al O'Neill and Tate Taylor of the firm, he co-authored the current Florida Limited Liability Company Forms and Practice Manual for Data Trace Publishing Company.

### **The Honorable Russell F. Nelms**

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Judge Nelms has been a bankruptcy judge for the Northern District of Texas, Fort Worth Division, since November 22, 2004. He graduated from Texas Tech University with a degree in history in 1975. He received his law degree from Texas Tech University School of Law in 1978. He served in the United States Army Judge Advocate General's Corps from 1978 to 1984, and practiced with Carrington, Coleman, Sloman & Blumenthal, L.L.P. from 1984 to 2004.

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Ms. Redmond is a frequent lecturer both locally and nationally on various aspects of bankruptcy, particularly issues involving Chapter 11. In 2002 she received the Eleventh Judicial Circuit Pro Bono Award. Ms. Redmond serves as an Adjunct Professor of Law at the University of Miami School of Law where she received the Richard M. Hausler Golden Apple Award as outstanding Professor of Law for the year 2002-2003. Ms. Redmond also serves as the co-chair of Programs and Publications Subcommittee of the Business Bankruptcy Committee of the Business Law Section of the American Bar Association.

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David M. Washburn is a Shareholder in Nathan Sommers Jacobs, A Professional Corporation. He chairs the firm's Corporate and Tax Section. He practices primarily in the areas of corporate and business law and taxation. In particular, his practice emphasizes the formation of corporations, partnerships, limited liability companies and other business entities; mergers and acquisitions; providing tax advice in business transactions; and corporate, individual and estate tax planning.

Mr. Washburn is Board Certified in Tax Law by the Texas Board of Legal Specialization. He is a member of the Houston Bar Association, the State Bar of Texas, and the American Bar Association, and is a member of the Tax Section of each. He is also admitted to practice before the United States Tax Court. Mr. Washburn attended Cornell University and the University of Virginia School of Law.

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Mr. Weinstein founded the firm and has represented clients across the entire spectrum of its practice. He has extensive experience in reorganization matters and complex bankruptcy litigation, including at all stages of the bankruptcy appellate system.

Clients for whom Mr. Weinstein has served as lead counsel include Clothestime Stores, Inc., a retail chain of over 200 clothing stores; Walden Leasing, Inc., a major fleet buyer and lessor of automobiles; California Psychiatric Management Services, an owner and operator of psychiatric hospitals; Sony Pictures Entertainment; the former owner of the Century City Shopping Center & Marketplace, a major regional shopping mall in West Los Angeles, California; major creditors in the Super Shops Stores and Sizzler Restaurant Chapter 11 cases; a labor union in the Orange County bankruptcy case; trustees presiding over the bankruptcy estates of restaurants, airlines, automobile dealerships, loan companies, a munitions manufacturer, a hazardous waste disposal company, and mining interests; committees of creditors of Steakhouse Partners, Inc., the owner of a chain of upscale steak and chop houses; BMK, Inc., a national merchandiser of consumer goods; Scour, Inc., a cutting edge Internet leader in peer-to-peer communications; Urjet Backbone Network, the owner of network installations for the provision of telecommunications to users in the west; Flashcom, Inc. and Fastpoint Communications, Inc., both DSL providers; and a variety of high-income, high visibility individuals such as medical doctors, real estate syndicators and

entertainers reorganizing their business affairs in Chapter 11. Mr. Weinstein also frequently represents other lawyers and law firms' own interests in bankruptcy cases.

Prior to founding this firm, Mr. Weinstein was associated for 13 years with another bankruptcy boutique in Los Angeles. For seven years as a partner, he was responsible for supervising one of the firm's three practice areas.

Mr. Weinstein's writings are published often in regional and national publications concerning bankruptcy and commercial law, including law journals, the California Bankruptcy Journal and other publications, and he is in demand as a speaker before local and national groups concerning bankruptcy litigation, reorganization issues, and other topics relating to the bankruptcy process. He has leadership roles in the American Bar Association's Judicial Division (Lawyers' Conference) and its Business Law Section (Corporate & Business Litigation and Small Business Committees) and he formerly chaired the Subcommittee on Trustees and Examiners, the Chapter 11 Subcommittee, and the Task Force on Affiliated Entities of the American Bar Association's Business Bankruptcy Committee. He is an active member of the American Bankruptcy Institute, American Bar Association, Financial Lawyers Conference, Los Angeles County Bar Association and Los Angeles Bankruptcy Forum.

## **Hypotheticals**

- (1) Acquisition of an existing industrial park. The park has possible environmental issues. It consists of a number of small to medium size tenants, with leases of varying lengths. Capital for the acquisition will be raised through a bank loan. The loan will be put in a securitized pool.
- (2) Acquisition of the assets of a financially distressed manufacturer of components for the aerospace industry by a manufacturer of other somewhat related components. The assets of the target consist of a plant, equipment, and intangible assets. The buyer is a corporation.
- (3) Three individuals starting up a restaurant. They hope to eventually open additional locations and/or franchise their concept, but they are initially starting with a single location. They are buying some assets from the owner of a defunct restaurant and are leasing the space formerly occupied by that prior restaurant, but will be remodeling and starting with a new name and concept. They will be raising the necessary capital through contributions of their own money and by offering equity interests to friends, family, and acquaintances

## Tax Treatment of Limited Liability Companies

### I. Tax Classification of LLCs.

A. State Law Treatment. Under the limited liability company acts of the various states, a limited liability company (an “LLC”) is an entity distinct from other possible entities, such as a corporation, a general partnership, a limited partnership, a limited liability partnership, or a trust.

### B. Federal Tax Law Treatment.

1. General. The status of an entity as an LLC for state law purposes is not determinative of its treatment for federal income tax purposes. Such treatment is determined under the separate federal income tax rules.

2. Four Factor Test. Prior to the “check-the-box regulations” discussed below, the status of an entity for federal income tax purposes depended upon an analysis of four factors. This regime resulted in uncertainty and frequently created controversies as to the proper tax treatment of an entity.

3. Check-The-Box Regulations. In 1996, the Treasury Department issued regulations under Section 7701 of the Internal Revenue Code of 1986 (the “Code”), which are commonly referred to as the “check-the-box regulations”. These Treasury Regulations (“Regs.”) simplify the classification of business entities for federal income tax purposes. They are particularly useful in the tax classification of LLCs, and afford significant flexibility in the tax treatment of LLCs.

a. General Rules. Generally, an LLC has a choice as to its tax treatment. The choices depend on whether the LLC has a single member or more than one member. The Treasury Regulations also provide the default treatment if the LLC fails to make an election. The default treatment also depends on whether the LLC has a single member or more than one member.

b. Single Member LLCs. A single member LLC may elect to be treated either as a disregarded entity or as a corporation for federal income purposes. *Regs. § 301.7701-3(a).* The election is made by filing Form 8832 with the IRS within 75 days of the formation of the LLC (although relief may be afforded for late filings under certain circumstances). *Regs. § 301.7701-3(c)(1)(i); Revenue Procedure 2002-59.* The default treatment of a single member LLC is as a disregarded entity. *Regs. § 301.7701-3(b)(1)(ii).* If the LLC decides to accept the default treatment as a disregarded entity, it need not file Form 8832. *Regs. § 301.7701-3(a).* If the LLC elects to be treated as a corporation, it then also has the choice of being taxed as a “C corporation” or as an “S corporation,” as discussed below.

i. Disregarded Entity Treatment. If an LLC is treated as a disregarded entity, then its separate existence is essentially ignored for federal income tax purposes. *Regs. § 301.7701-2(a).* If its single member is an individual, then the LLC’s activities will be treated as a sole proprietorship of that individual. If the single member is an entity, then the LLC’s activities will be treated as a branch or division of the member entity for federal income tax purposes. If the LLC is treated as a disregarded entity, it does not file its own tax return; instead, its member reports the activities of the LLC on the member’s tax return.

ii. Corporation Treatment. See c.ii below.

- c. Multiple Member LLCs. Multiple member LLCs may elect to be treated either as a partnership or as a corporation for federal income tax purposes. *Regs. § 301.7701-3(a)*. The election is made by filing Form 8832 as discussed in b above. The default treatment of a multiple member LLC is as a partnership. *Regs. § 301.7701-3(b)(1)(i)*. If the LLC decides to accept the default treatment as a partnership, it need not file Form 8832. *Regs. § 301.7701-3(a)*. If the LLC elects to be treated as a corporation, it then also has the choice of being taxed as a C corporation or as an S corporation by filing Form 2553 as discussed below.
  - i. Partnership Treatment. If an LLC is treated as a partnership, then it is not taxed at the LLC level but instead is a pass-through entity such that its income is taxed to its members. However, the LLC must file a partnership income tax return.
  - ii. Corporation Treatment. Regardless of the number of members, an LLC may elect to be treated as a corporation for federal income tax purposes. If it makes such election, then it will be treated as a C corporation (which may be subject to double taxation - see II.A below) unless it further makes an election to be treated as an S corporation by filing Form 2553 with the IRS no later than 2 months and 15 days after the beginning of the tax year in which the election is to apply (although relief may be afforded for late filings under certain circumstances). *Revenue Procedures 2003-43 and 2004-32*. An S corporation is a pass-through entity the tax treatment of which is similar to that of a partnership. However, see II.A, E, F, and K below for important differences in the tax treatment of partnerships and S corporations.

C. State Tax Treatment.

- 1. Texas. Until 2007, the Texas franchise tax, which effectively operated as a state income tax, applied to corporations and LLCs but not to partnerships, including limited partnerships. As a result, many Texas entities were structured (or restructured) as limited partnerships, with an LLC or corporation having a small percentage interest as a general partner. Thus, until recently, LLCs were disfavored in Texas and not nearly as common as in other states.

Effective for 2007, Texas expanded its franchise tax to also apply to limited partnerships and limited liability partnerships (and also restructured the tax as a “margins tax”). However, limited partnerships (but not LLCs or corporations) which have gross income consisting of at least 90% passive income (including gains from the sale of real estate) are exempt from the margins tax. *Sections 171.0002(b)(3) and 171.0003 of the Texas Tax Code*.

- II. Tax Factors Impacting the Choice of an LLC. The following tax factors may impact the decision of whether to use an LLC or a different type of entity. These same factors could also impact the decision of whether to elect to treat an LLC as a corporation or as a partnership or disregarded entity. There is little difference for tax purposes between an LLC electing partnership treatment and a true state law partnership (whether a limited partnership, general partnership, or LLP), so the choice between such entities would generally be driven by non-tax factors.

- A. Double Taxation. An LLC electing partnership treatment will not be subject to tax at the LLC level. Instead, the members are subject to tax on their allocable shares of the LLC’s income. *Code § 701*. A C corporation’s income is subject to a maximum tax rate of 35%, and then distributions by the corporation will again be subject to tax at the shareholder level (15% for qualifying dividends through 2010 and for capital gain distributions, and up to 35% for other distributions). If the C corporation instead makes the payments to the shareholders in the form of compensation, the double taxation will be largely eliminated because the corporation will receive a deduction for

the compensation (if reasonable in amount), but the compensation will be subject to employment taxes as well as income tax. S corporations generally are not subject to taxation at the entity level and instead their shareholders are taxed on their shares of the corporation's income that passes through to them. *Code §§ 1363(a) and 1366(a)*. However, S corporations that were previously C corporations may be taxed on their prior earnings or appreciation of their assets. *Code §§ 1374 and 1375*. The avoidance of double taxation may be particularly important upon a sale of the business, if the sale is to take the form of a sale of the assets of the entity followed by a distribution of the proceeds to the owners.

- B. Contributions and Distributions of Appreciated Property. Generally, contributions of appreciated property to an LLC electing partnership treatment will not be subject to tax. *Code § 721*. With a corporation (whether S or C), this is true only if the transferors will have 80% control of the corporation following the transfer. *Code § 351*. Also, an LLC electing partnership treatment can generally distribute appreciated property to its members without the recognition of gain by the LLC or its members. *Code §§ 731(a)(1) and 731(b)*. On the other hand, if a C corporation distributes appreciated property to its shareholders, the corporation will be subject to tax on the amount of built-in gain inherent in the property and then the shareholders will again be subject to tax. *Code §§ 311(b) and 301(c)*. Distributions by an S corporation are not subject to tax at the entity level except to the extent of any built-in gain that was inherent in its property at the time it made its S election. *Code §§ 1363(a) and 1374*.
- C. Deduction of Losses. The members of an LLC electing partnership treatment and the shareholders of an S corporation may deduct losses incurred by the entity to the extent of their basis in their interest in the entity. *Code §§ 704(d) and 1366(d)*. Losses incurred by a C corporation may not be deducted by its shareholders against their other income.
- D. Phantom Income. Members of an LLC electing partnership treatment and shareholders of an S corporation are subject to taxation on their shares of the entity's income without regard to whether there has been any distributions of such income. Hence, they may owe tax on "phantom" income without having received any distributions with which to pay the tax. Shareholders of a C corporation are taxed only to the extent that they receive distributions from the corporation.
- E. Eligibility for Pass-Through Treatment. An S corporation may have only 100 shareholders and generally may not have any corporations, partnerships, LLCs, trusts, or non-resident aliens as shareholders. *Code § 1361(b)(1)*. None of such restrictions apply to an LLC electing partnership treatment.
- F. Special Allocations. Although an S corporation affords pass-through treatment, such income must be passed through to the shareholders on a per share basis and only one class of stock is permitted. *Code § 1361(b)(1)(D)*. On the other hand, an LLC electing partnership treatment may make special allocations of income, gains, losses, and deductions among its members, as long as such allocations have substantial economic effect under the Section 704(b) Treasury Regulations.
- G. Medicare Taxes. Members of an LLC electing partnership treatment are subject to the 2.9% Medicare tax on all of their income from the LLC. With a corporation, however, the same 2.9% Medicare tax applies only to amounts paid by the corporation to its shareholders as compensation. However, the shareholders of the corporation may be able to structure the payments so that only a portion of the total payments are treated as compensation, and the remainder are treated as dividends that are not subject to the Medicare tax.
- H. Inclusion of Debt in Basis. The tax basis of an owner in his interest in an entity is important in determining the deductibility of pass-through losses and of the taxation of cash distributed. The basis of an LLC member in his interest in the LLC includes the member's share of the LLC's debt. *Code § 752*. Although a shareholder of an S corporation may include the amount of his loans to an S corporation, he may not include in his basis any of the S corporation's debt. *Code § 1366(d)(1)(B)*.

- I. Tax Returns. An LLC treated as a disregarded entity need not file a separate tax return. Other pass-through entities such as partnerships and S corporations must still file a return even if there is no tax at the entity level.
- J. Taxable Year. A C corporation is generally able to adopt any taxable year. However, an LLC treated as a partnership and an S corporation must generally adopt a calendar year as its tax year. *Code §§ 706(b)(1)(B) and 1378.*
- K. Accumulation of Earnings. A C corporation that accumulates and retains a large amount of earnings in the form of liquid assets may be subject to the Code Section 531 accumulated earnings tax, as well as the Code Section 541 personal holding company tax. Neither of these taxes applies to an LLC treated as a partnership. An S corporation that was previously a C corporation may be subject to tax at the corporate level on personal holding company income and may potentially forfeits its S status if it has too much passive income. *Code §§ 1362(d)(3) and 1375.*
- L. State Tax Considerations. The state tax treatment of an LLC versus other entities should also be considered and may vary from state to state. See, for example, the discussion of the Texas “margins tax” above.

### **Liquidation/Reorganization and Entity Choice**

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One of the difficulties in the liquidation of limited liability companies is the separation of the tax obligations and benefits from the operating entity. This is particularly apparent in the case of a homebuilder/developer. Each of the developer’s entities are usually structured as limited liability companies and each project is a separate entity and subsidiary of a holding company parent. For tax purposes, the holding company parent is the taxpayer, and each of the operating entities where gains in good years and losses in bad years are generated, are ignored for tax purposes. This results in a typical homebuilder/real estate development case in which the tax losses and refunds are payable to the taxpayer and not to the entities where the debt exists.

This is even more important in the context of today’s market where Senate Democrats proposed a second economic stimulus plan targeting housing reform including a proposal to help businesses defray current losses by “carrying back” those losses to earlier, profitable years. The bill would allow businesses to write off losses from 2006, 2007 and 2008 and apply them to taxable income from as far back as 2001. By using net operating losses (NOL) to prior profitable years, entities would be able to receive refunds this year. In the case of a developer family of LLC’s, the tax advantage will inure to the taxpayer parent rather than the projects in financial distress.

## Recent Delaware and Florida Cases Involving the Fiduciary Duties of LLC Managers/Managing Members

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### Delaware Law

- (1) *In re Regional Diagnostics, LLC v. Zelch*, 372 B.R. 3, 28-30 (Bkrcty. N.D. Ohio 2007): Creditors' trustee brought a breach of fiduciary duty claim against LLC Manager-Defendants. Based on Delaware being the state of LLC formation, the Court looked to Delaware law to define the scope of the managers' fiduciary duties. The Court cited extensively to Delaware treatises and case law on corporate directors' fiduciary duties. Because the LLC Agreement only limited liability for actions taken in good faith, not specifically altering the duty of loyalty, the Court rejected the argument that the LLC Agreement eliminated liability for breach of the duty of loyalty. The Court also found that allegations of the managers' failure to exercise oversight by addressing known issues of faulty accounting and operational systems stated a claim for breach of the duty of loyalty.
- (2) *Majkowski v. American Imaging Management Services, LLC*, 913 A.2d 572, 593 (Del. Ch. 2006): In determining whether a "hold harmless" provision in a LLC Agreement entitled the Plaintiff to advancement of his attorney's fees, the Court noted in footnote 55 that it is possible under Delaware law to hold a manager harmless for breaches of the duty of care and the duty of loyalty.
- (3) *Bakerman v. Sidney Frank Importing Co., Inc.*, 2006 WL 3927242, 1, 4, 13, 15, 17-18 (Del.Ch. 2006): Plaintiff was a corporation's legal counsel and was granted an interest in the corporation's non-wholly owned LLC subsidiary. The company later negotiated the sale of it and its subsidiary's assets to a third party in a transaction that required the subsidiary's unanimous consent. (The subsidiary LLC's Operating Agreement contained a provision that required the unanimous consent of the members for any sale of all or substantially all of the LLC's business or assets.) Plaintiff, who had been terminated from his counsel position after the transaction, claimed the subsidiary's managers breached their fiduciary duties by (i) artificially suppressing the price of the product sold by the subsidiary to the parent company (which then distributed the product for a substantial profit), (ii) allocating to the subsidiary an inequitable portion of the purchase price and (iii) failing to disclose their conflict of interest in the transaction (large holdings in the parent company and thus large personal gains).

Re: (i) and (ii), Defendants argued that the Plaintiff had acquiesced and ratified the transaction by accepting an employee bonus after the transaction and waiting 18 months to bring this suit. The Court found from the allegations that the Plaintiff was unaware of the transfer pricing and therefore did not acquiesce and ratify it. It also found that the bonus was related to his employment and not a sign of acquiescence to the allocation of the purchase price because there were no accompanying words or deeds that demonstrated acknowledgment of the legitimacy of the Defendants' conduct.

Re: (iii) Defendants argued that the Plaintiff had consented to the transaction. In turn the Court discussed the managers' duty to disclose all material facts related to the transaction. It stated that "when fiduciaries communicate with their beneficiaries in the context of asking the beneficiary to make a discretionary decision – such as whether to consent to a sale of substantially all the assets of an LLC – the fiduciary has a duty to disclose all material facts bearing on the decision at issue." The Court concluded that the complaint showed it was possible that Plaintiff was unaware of Defendants' substantial holdings in the parent company, and thus it would not dismiss the claim for breach of fiduciary duty.

- (4) *Minnesota INVCO of RSA #7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 788-90, 797-98 (Del. Ch. 2006): Plaintiff-minority LLC member claimed the Defendant-LLC managers breached their fiduciary duty by amending the LLC Agreement to eliminate the minority member's right of first refusal in connection with a proposed sale of the LLC so that the minority member was no longer afforded the opportunity to purchase the units held by the majority member. The Court found that the managers had a good faith belief that the amendment would maximize the sale price for the benefit of both the majority and minority members and had both groups' best interests in mind. Thus, the Court held that the managers did not breach their fiduciary duty by eliminating the minority member's right of first refusal.

- (5) *Douzinias v. American Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149-52 (Del. Ch. 2006): The issue before the Court was whether a claim by LLC members against a managing member re: breach of fiduciary duties was subject to arbitration per the provisions of the operating agreement. The Court stated that because “alternative entity statutes,” such as Delaware’s LLC and Limited Partnership Acts allow contracting parties to expand or restrict “the member’s or manager’s duties [including fiduciary duties]...it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship.” It also cited *Elf Atochem North America, Inc. v. Jaffari*, 727 A.2d 286 (Del. 1999) where the court recognized that the operating agreement’s arbitration requirement also covered claims of breach of fiduciary duties. Thus, the Court held that the broad arbitration provision would apply to a breach of fiduciary duties claim.
- (6) *Flight Options Intern., Inc. v. Flight Options, LLC*, 2005 WL 2335353, 1, 7-9 (Del. Ch. 2005): The issue before the Court was whether to enjoin the consummation of a purchase agreement, whereby the equity interest of the Plaintiff-LLC’s minority member would be diluted to 1%, until arbitration of whether the purchase agreement violated the LLC agreement and was a product of the Defendant-majority member-appointed LLC’s managers failing to discharge their fiduciary duties in accordance with Delaware law. Recognizing that Delaware law authorizes the LLC Agreement to vary fiduciary duties and in examining the LLC Agreement provisions, the Court found that the LLC Agreement required that the proposed transaction between the LLC and the majority member be on arms’ length terms and conditions. Thus, it concluded that the Plaintiff had sufficiently shown that the Defendant may be unable to show that the purchase price was equivalent to the product of an arms’ length transaction and granted the preliminary injunction.
- (7) *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc.*, 854 A.2d 121, 131, 153-54, 163-164 (Del. Ch. 2004): The Court sustained the LLC minority member’s breach of fiduciary duty claim against the majority member and certain managers for failure to disclose a bribery scandal where Defendants knew of the bribery and for certain Defendants, their actual participation in the bribery. The Court stated that a “fiduciary who learns that her earlier communications to her beneficiaries were false and nonetheless knowingly and in bad faith remains silent even as the beneficiaries continue to rely on those earlier statements also breaches her duty of loyalty.”
- (8) *Solar Cells, Inc. v. True North Partners, LLC*, 2002 WL 749163, 3-5 (Del. Ch. 2002): Plaintiff-LLC member alleged that the LLC and the individual LLC managers breached fiduciary duties to Plaintiff by acting in bad faith in the way they approved a proposed merger. Plaintiff sought a preliminary injunction against the merger and argued that the Defendants would be unable to prove the entire fairness of the proposed merger. The Court rejected Defendants’ contentions that a waiver provision in the Operating Agreement regarding conflict-of-interest transactions equated to waiver of all fiduciary duties since the Operating Agreement still required that the managers act in “good faith.” Based on the fact that the Defendant-managers made no mention of the merger to the Plaintiff-LLC managers when they had the opportunity, the Court found that the Defendants would likely have to show the entire fairness of the proposed merger and enjoined the Defendants from moving forward with the merger.
- (9) *VGS v. Castiel*, 2000 WL 1277372, 1, 4-5 (Del. Ch. 2000): A LLC was comprised of 3 entity members. The individual owning 2 of entity members had the authority to appoint and remove 2 of the 3 managers. The Board of Managers consisted of this individual owning 2 of the members, a manager appointed by the same individual and the owner of the third member. The owner of the third member secretly convinced the appointed manager to vote strategically to merge the LLC into a Delaware corporation whereby the original member was left with a minority position in the surviving corporation.

The Court recognized that because the Operating Agreement authorized a simple majority vote by the Board of Managers to approve a merger rather than by the statutory default mechanism of a majority vote of the equity interests, the original member believed he was protecting his equity interest in the LLC by control over appointing two managers to the Board of Managers. The Court stated that the remaining two managers owed the original member-manager a duty to give him prior notice “even if he would have interfered with a plan that they conscientiously believed to be in the best interest of the LLC.” Because the two managers acted without notice to the third manager who would have removed his appointed manager had he known the appointed manager planned to vote against his interests, the Court found that they breached their duty of loyalty to the original member-manager by failing to act in good faith. Therefore, the Court held that the majority vote to

effect the merger was invalid. Also, the Court used the “entire fairness” standard to apply to the actions at issue because the breach of the duty of loyalty precluded the protection of the business judgment rule.

## Florida Law

- (1) *Bank Hapoalim (Switzerland) Ltd. v. xG Technology, Inc.*, 2008 WL 126583, 2 (M.D. Fla. 2008): In a Florida case interpreting Delaware law, the Court considered whether LLC managers owed a duty to parties that were not formally designated as LLC members. Under Del. Code Ann. Tit. 6, § 18-1101(c) a LLC may owe a fiduciary duty to “another person that is a party to or otherwise bound by a LLC agreement.” Plaintiffs needed to prove whether the assignee of a LLC member’s securities assumed member status in the LLC. The Court held that the allegations failed to allege that the LLC managers owed the assignee a fiduciary duty and therefore failed to state a claim of breach of fiduciary duty.
- (2) *Florida Estate Developers, LLC v. Ben Tobin Companies, Ltd.*, 964 So.2d 238, 240 (Fl. 4th DCA 2007): The Court considered whether various factual allegations were sufficient to support a cause of action for breaches of §§ 608.423 and 608.4225. Specifically, it found that there was no violation of the duties of loyalty and care mandated by § 608.423 because there was no allegation that the parties had executed an operating agreement that violated the restrictions in § 608.423. In regards to § 608.4225 the Court found that the facts did not support the allegation that a Defendant had caused the LLC to enter into a usurious loan transaction. It also found that the allegation that Defendant-managing members had denied access to LLC records was not a violation of § 608.4225 but should have been pled as a violation by the LLC of § 608.4101. However, the Court did find that the allegations regarding failure of the managing member to account to the LLC (e.g., failing to make payments or give credit for repair and improvements to the property by the Plaintiff-LLC member), per § 608.4225(1)(a)1, was sufficient to support a claim that the Defendant-managing members violated § 608.4225.
- (3) *Foster-Thompson, LLC v. Thompson*, 2007 WL 1725198, 7-10 (M.D. Fla. 2007): Defendant was the minority LLC member. He was sued by the LLC and the majority member for breach of fiduciary duties, among other claims, and he brought a counterclaim against the LLC and majority member for breach of duties of loyalty and care, among other claims. Among the issues before the Court was a motion for judgment as a matter of law on Defendant’s claim for breach of the duties of loyalty and care. In making this determination, the Court considered (i) whether a prior summary judgment order on the Defendant’s conversion claim would preclude recovery on a breach of fiduciary duties claim (held, no), (ii) whether there was sufficient evidence to support the jury’s finding of liability on Defendant’s claim for breach of duty of loyalty and care and (iii) whether there was sufficient evidence to support the jury’s award of damages on the Defendant’s claim for breach of duty of loyalty and care (held, no). The Court cited the requirements of Fla. Stat. §§ 608.4225(1), 608.4228(1) and 608.423(2) in connection with the fiduciary duties owed, the limitations to personal liability (and exceptions to such limitations) and the statutory prohibition against eliminating the duty of loyalty or unreasonably reducing the duty of care. The Court also cited *Merovich v. Huzenman*, 911 So.2d 125 (Fl. 3d DCA 2005) for the proposition that a LLC member may bring a breach of fiduciary duty claim for money damages against a managing member or another member for the wrongful retention of LLC profits and revenues.

To resolve the sufficiency of evidence question, the Court cited the Defendant’s allegations that Plaintiff’s formation and work for another company led to the wrongful appropriation of LLC funds and staff to promote the other company, which was conduct adverse to the LLC’s interests. The Court found that the Operating Agreement did not limit the duties owed by the Plaintiff to the Defendant and thus the Defendant’s allegations were adequate to support the claim for a breach of the duties of loyalty and care. The Court also rejected the Plaintiff’s argument that because the jury had also found that Defendant had breached his fiduciary duties to the LLC, no reasonable jury could find for the Defendant on the breach of duty claim.

- (4) *In re Grosman*, 2007 WL 1526701, 15-16 (Bkrtcy. M.D. Fla. 2007): The Court reviewed the standard of conduct for LLC managing members per § 608.4225(1) and specifically noted the duty to account to the LLC and hold its property “as trustee.” However, the Court found that such fiduciary duties do not amount to the “extraordinary level” of fiduciary duty necessary to make a debt non-dischargeable under § 523(a)(4) of the Bankruptcy Code because § 608.4225 does not establish an express or technical trust as required by the Bankruptcy Code.
- (5) *Foster-Thompson, LLC v. Thompson*, 2005 WL 3093510, 2-4 (M.D. Fla. 2005): A LLC brought suit against

Thompson, one of its managers. Thompson filed a complaint against two of his fellow managers, alleging that they breached their fiduciary duty owed to the LLC and to himself. In response to the two managers' argument that they did not owe a fiduciary duty to Thompson because F.S. § 608.4225 only creates a duty of loyalty and care to the LLC and its members, the Court stated that though it does not specifically create an obligation titled "fiduciary duty," the provision creates a "duty of care" and "duty of loyalty." Although § 608.4225 was not specifically identified in the complaint, the Court found that the two managers had sufficient notice that they owed such a duty to the LLC members. Accordingly, the Court denied summary judgment to the two managers on this count.

*Merovich v. Huzenman*, 911 So.2d 125, 127-28 (Fl. 3d DCA 2005): Plaintiffs had sued LLC managing members of LLC, in part, for a breach of F.S. § 608.4225 based on the failure to provide information as required by F.S. § 608.4101 and failing to account for revenues and profits of the LLC. In an appeal of a final order that dismissed the Plaintiffs' breach of fiduciary duty claim, the Court rejected the Defendants' argument that the count should be dismissed because it failed to allege that the Defendants were managing members or managers (the operating agreement was attached to the complaint and identified the Defendants as such). The Court held that dismissal of the claim with prejudice was unwarranted where the allegation that the Defendants had wrongfully retained revenues and profits may support a § 608.4225 claim had it been appropriately pled (§ 608.4101 imposes duties upon the LLC itself, not the manager; thus a breach of § 608.4101 cannot justify a violation of § 608.4225 by the Defendants).

## LLC Operating Agreement as an Executory Contract

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"[A] contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'" *Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co., Inc.)*, 139 F.3d 702, 705 (9th Cir. 1998) citing Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L.Rev. 439, 460 (1973). "The materiality of a remaining obligation and whether the failure to perform a remaining obligation is a material breach of the contract is an issue of state law." *In re Texscan Corp.*, 976 F.2d 1269, 1272 (9th Cir. 1992). The court must look at the specific operating agreement at issue to determine whether it contains material, continuing obligations between the members that would make it executory in nature. *Endeka Enter., LLC v. Meiburger (In re Tsiaoushis)*, 2007 WL 2156162 slip op. (E.D.Va. 2007).

### A. Cases Holding LLC Operating Agreement Is an Executory Contract.

In *In re Daugherty Constr., Inc.*, 188 B.R. 607 (Bankr.D.Neb. 1995) the court held that the LLC operating agreement was an executory contract because there were material unperformed and continuing obligations among the members which included participating in management and contributing capital *i.e.* members were obligated to contribute capital if the LLC suffered a fiscal net loss and participate in management and provide contractor services. It went on to explain that "Each LLC is an ongoing business. The continuation of business contemplates an ongoing relationship and mutual obligations between each LLC's members. The member relationships are essentially executory in character. . . . [A] wide range of agreements constitute 'executory contracts'. . ." *Id.* at 612; *see also Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC, et al. (In re Allentown Ambassadors, Inc.)*, 361 B.R. 422 (Bankr.E.D.Pa. 2007) (The operating agreement was an executory contract at the time the debtor, an operator of the LLC, filed its petition. The LLC members had ongoing, material, unperformed obligations to one another and to the LLC including the duty to manage the LLC and the duty to make additional capital contributions if needed by the LLC.); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr.E.D.Va. 1996) *rev'd* on other grounds (§ 365 applies to debtors who were managers of LLC with ongoing duties and responsibilities; because debtors' personal identity and participation were material to the development project; § 365(e)(2) exception to assumption applies); *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 750 (Del.Super. 2004) ("The substantial weight of federal authority . . . treats agreements for the operation of entities like limited partnerships and LLCs as executory contracts when those agreements contemplate an important, on-going role for the debtor in management."); *Sumlin Const. Co., LLC v. Taylor*, 850 So.2d 303 (Ala. 2002) (operating agreement held to be an executory contract which involved in significant part, contribution of personal services by members).

### B. Cases Holding LLC Operating Agreement Is Not an Executory Contract.

In *Tsiaoushis*, 2007 WL 2156162, the LLC operating agreement was held not to be an executory contract for several reasons. First, the debtor was not a manager at the time of his bankruptcy and had no managerial duties. *Id.* Next, the agreement expressly provided that members could engage in other activities outside the LLC without incurring any obligations to the LLC or its members. *Id.* Third, the provision providing that members can vote whether more capital contribution is required by members only created a future possibility, not a current obligation. *Id.* Lastly, the court found the absence of any statutory fiduciary obligation under Virginia law between members of a LLC to be significant in pointing to the operating agreement not being an executory contract.<sup>1</sup> *Id.*

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<sup>1</sup>This is in contrast to California where there is a statutory fiduciary obligation between members of a LLC. West's Ann.Cal.Corp.Code § 17153 provides, "The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership. It is clear that managers of a LLC have a fiduciary duty to other members and members have fiduciary duties to one another and the LLC. *First American Real Estate Info. Servs., Inc. v. Consumer Benefit Servs., Inc.*, 2004 WL 5203206 slip op. (S.D.Cal. 2004); *Barton Properties, Inc. v. King, Purtich, Holmes, Paterno & Berliner*, 2007 WL 1830813 unpub. (Cal.App. 2007).

Another case that must be pointed out in detail is *Samson v. Prokopf (In re Smith)*, 185 B.R. 285, 293 (Bankr.S.D.Ill. 1995). There, the issue was whether a limited partner, after contributing capital, was a passive investor or owes substantial future obligations to the LP. After the limited partner's initial capital contribution, the LP agreement did not allow any further monetary contribution without the consent of all partners. *Id.* The defendants argued that the LP agreement was an executory contract because: (1) it provided for annual meetings of all limited partners; (2) entitled any limited partner to request and get copies of financial statements; (3) entitled any limited partner to seek judicial dissolution of the partnership; and (4) restricted a limited partner's ability to sell his interest without first offering it to the partnership. *Id.* at 294. The court countered that arguments 1-3 referred to rights not obligations; the agreement did not require attendance; it merely allowed judicial dissolution. *Id.* Even if a partner did not exercise those rights, there was no breach and the other partners were without recourse. *Id.* In regards to the buy back provision, it did not create an affirmative obligation but rather restricted the way a partner could liquidate his interest. *Id.* Even if the buy back provision was considered to be a performance obligation, it was not material because its violation would not excuse performance by the non-breaching partners under Illinois law. *Id.*; *see also In re Garrison-Ashburn, LC*, 253 B.R. 700 (Bankr.E.D.Va. 2000) (the operating agreement merely provided structure for management and imposed no duties or responsibilities on its members. Specifically, there was no duty to provide additional capital, to participate in management, and to provide any personal service or expertise to the company. Moreover, Article V permitted any officer or member to resign at any time with written notice. In other words, a member could, without being in breach of the agreement, resign from his position and stop participating in company management.); *In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632 (Bankr.N.D.Ill. 2006) (LLC operating agreement held not to be an executory contract because there was no current obligation or any role for debtor in management of the LLC. Provision providing that if circumstances changed, debtor may have future obligations *i.e.*, indemnify LLC for losses, was a speculative future obligation.); *cf.*, *Movitz v. Fiesta Inv. (In re Ehmann)*, 319 B.R. 200 (D.Ariz. 2005) (upon closer inspection of Article V of the Agreement entitled "Rights and Obligations of Members" the court noted that it identified only rights, not obligations).

C. Implications if the Operating Agreement Is Deemed Not to be an Executory Contract.

If the Operating Agreement is deemed not to be an executory contract, 11 U.S.C. § 365(c) and (e) will not be applicable, and the Agreement may not be assumed, assigned or rejected. Those provisions prohibit the enforcement of certain bankruptcy *ipso facto* provisions in executory contracts. *Garrison-Ashburn, L.C.*, 253 B.R. at 708-09. The purpose of the Code's executory contracts provisions on *ipso facto* clauses is to protect the debtor from the enforcement of unfavorable insolvency triggered clauses in executory contracts. *Spieker Properties, L.P. v. The SPFC Liquidating Trust, et al. (In re Southern Pacific Funding Corp.)*, 268 F.3d 712, 715-16 (9th Cir. 2001). For example, in *Capital Acquisitions and Mgmt Corp.*, 341 B.R. at 637, the court held the right of first refusal was enforceable and not an *ipso facto* clause because it was not triggered by the bankruptcy filing.

The trustee's authority will be controlled by the more general provision governing estate property; 11 U.S.C. § 541. *Ehmann*, 319 B.R. at 206. Section 541(c) provides that the debtor's interest, both economic and non-economic rights and privileges, become property of the estate notwithstanding any agreement or applicable law restricting or conditioning transfer of such interest by the debtor. *Garrison-Ashburn, L.C., supra*. In other words, the trustee has all the rights and powers with respect to the LLC that the debtor had as of the commencement of the case as well as all the duties and obligations under the Agreement. *Ehmann, supra*; *see also Thompkins v. Lil' Joe Records, Inc.*, 472 F.3d 1294, 1306 (11th Cir. 2007) (trustee or debtor cannot accept only the benefits of an executory contract while eschewing the burdens).

Table 1. Comparison of Limited Liability Companies, Limited Partnerships, S Corporations, and C Corporations

Factor	Limited Liability Company	Limited Partnership	S Corporation	C Corporation
<i>A. Business considerations</i>				
1. Limited Liability	Limited liability for members even if they participate in management	Limited liability only for limited partners who do not engage in management; general partner has unlimited liability	Limited liability for shareholders even if they participate in management	Limited liability for shareholders even if they participate in management
2. Management	By any member of a member-managed LLC; by any manager of a manager-managed LLC	By general partner only	Shareholders elect directors; directors elect officers	Shareholders elect directors; directors elect officers
3. Continuity of life	Permitted	Permitted	Permitted	Permitted
4. Free transferability of interests	Permitted	Permitted	Permitted	Permitted
5. Types of owners	No restrictions	No restrictions	No corporations, pension plans, nonresident aliens, partnerships, trusts (except S corporation trusts) and certain estates	No restrictions
6. Number of members	No maximum, but requires at least two for partnership status	No maximum, but requires at least two for partnership status	Maximum of 100, although spouses treated as 1 owner	No maximum
7. Different classes of interests	Permitted	Permitted	Except for voting rights, only one class permitted	Permitted
8. Limited liability in all states	Yes	Yes, to the extent noted above	Yes	Yes
<i>B. Tax considerations</i>				
1. Taxability of income	No tax at entity level, if it qualifies as a non-publicly traded partnership	No tax at entity level, if it qualifies as a non-publicly traded partnership	No tax at entity level, except on certain passive income, capital gains and built-in gains	Entity-level tax imposed

Factor	Limited Liability Company	Limited Partnership	S Corporation	C Corporation
2. Certainty of tax status	Yes	Yes	Risk of violating certain qualification rules; relief may be available if technical violation of certain rules.	Yes
3. Distribution to owners	Generally not taxable, unless a guaranteed payment (Internal Revenue Code § 707)	Generally not taxable, unless a guaranteed payment (Internal Revenue Code § 707)	Payments of salaries deductible by corporation and taxable to recipient; distributions generally not taxable	Payment of salaries deductible by corporation and taxable to recipient; payment of dividends not deductible and generally taxable to shareholders.
4. Special allocations	Permitted, subject to Internal Revenue Code § 704(b)	Permitted, subject to Internal Revenue Code § 704(b)	Not permitted; one class of stock required	Permitted through preferred stock arrangements
5. Deductibility of losses.	Members may deduct their allocable share of the LLC's losses only to the extent of the tax basis in their LLC interest, which includes their allocable share of LLC debt. (At-risk and passive activity rules also apply).	Partners may deduct their allocable share of the partnership's losses only to the extent of the tax basis in their partnership interest, which includes their allocable share of partnership debt. (At-risk and passive activity rules also apply).	Shareholders may deduct their allocable share of the S corporation's losses only to the extent of the tax basis in their S corporation shares and loans to the S corporation, but not loans they have guaranteed. (At-risk and passive activity rules also apply.)	Not deductible by shareholders
6. Basis adjustment available to entity assets	Upon death and sale of interest of a Member (Internal Revenue Code § 754)	Upon death and sale of interests of a partner (Internal Revenue Code § 754)	None	None
7. Flexibility in structuring retirement payments	Yes (Internal Revenue Code § 736)	Yes (Internal Revenue Code § 736)	No	No
8. Taxation upon distribution of appreciated property	No (but see Internal Revenue Code § 704(c))	No (but see Internal Revenue Code § 704(e))	Yes	Yes

9. Insolvency exception to discharge of indebtedness of income provisions (Internal Revenue Code § 108)	Determined at the member level	Determined at the partner level	Determined at the entity level	Determined at the entity level
10. Accounting method	Cash or accrual, but an LLC with C corporate partners (and which has more than \$5 million in gross receipts) and "tax shelters" may not use cash method.	Cash or accrual, but partnership with C corporate partners (and which has more than \$5 million in gross receipts) and "tax shelters" may not use cash method.	Cash or accrual	Accrual, but cash available to C corporations with \$5 million or less gross receipts
11. Taxable year	Can elect fiscal year in certain circumstances	Can elect fiscal year in certain circumstances	Can elect fiscal year in certain circumstances	Any year permissible upon adoption; changes require business purpose.



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