

ESSAY QUESTION NO. 6

Answer this question in booklet No. 6

Three friends, Janet, Susan and Lisa, decide to form either an Alaska limited liability company or an Alaska partnership to make and sell wild berry jellies, with each friend holding an equal ownership interest. They come to you for legal advice and tell you that their decision hinges on your answers to the following questions. As you answer the following questions, assume that nothing in a limited liability company operating agreement or partnership agreement will modify or vary the presumptions established under the applicable Alaska Statutes governing these business structures.

1. If one of the friends quits and walks away from the business, what would happen to the business interest of the departing friend and what would be the impact on the remaining business if it were a limited liability company? How about if it were a partnership?
2. Could one of the friends assign her interest to a third person without the consent of the other two friends if it were a limited liability company? How about if it were a partnership? In each case, describe the rights and duties of the assignee and assignor with respect to the business organization after the assignment.
3. What is each friend's personal exposure to third party liability for the liabilities of the business if the business were a limited liability company and each friend is a member but not a manager? How about if it were a partnership?
4. If the friends decide to form a partnership and later wish they had instead formed an LLC, what is the easiest way for them to change their business structure and become an LLC?

GRADER'S GUIDE

*** QUESTION NO. 6 ***

SUBJECT: BUSINESS LAW

1. If one of the friends quits and walks away from the business, what would happen to the business interest of the departing friend and what would be the impact on the remaining business if it were a limited liability company? How about if it were a partnership? (30 points)

If an LLC- Unless the operating agreement provides otherwise, a member may not resign from an LLC until it is dissolved and its affairs are wound up. If a member attempts to resign without the consent of the other members, the member will no longer have authority to participate in the operation of the business and will only have rights to receive distributions associated with her prior capital contributions. The business of the LLC would continue uninterrupted. AS 10.50.185.

If a Partnership- A partner can quit a partnership simply by expressing her intent to withdraw from the partnership to the other partners. AS 32.06.601. Once a partner withdraws, that partner no longer has a right to participate in the management of the business. AS 32.06.603(b). Assuming that there are no limitations on the term of the partnership, or partner withdrawal rights, a partner's withdrawal will result in the dissolution and winding up of the partnership business. AS 32.06.801. The withdrawing partner would have a right to return of the partner's prior capital contributions, after satisfying partnership debts and other obligations. AS 32.06.807.

2. Could one of the friends assign her interest to a third person without the consent of the other two friends if it were a limited liability company? How about if it were a partnership? In each case, describe the rights and duties of the assignee and assignor with respect to the business organization after the assignment. (30 points)

If an LLC- A member can assign her interest in an LLC. After the assignment, the assignee will only be entitled to receive distributions. The assignee will not be able to participate in the management of the business. After the assignment, the assignor will continue to be a member of the LLC and be able to exercise her rights as a member. The business of the LLC will continue as before, notwithstanding the assignment, except that the distributions of profits and losses will be made to the assignee. AS10.50.375.

If a Partnership- A partner can assign only her right to receive profits and losses of the partnership business. AS 32.06.501-.502. The assignment does not by itself cause a dissolution and winding up of the partnership, nor does it constitute a withdrawal by the assigning partner. After the assignment, the assignee cannot participate in the management of the partnership business. After the assignment, the assignor continues to retain the rights and duties of a partner (other than the right to receive distributions). AS 32.06.503. Unlike the situation with an LLC, after the assignment, the assignee can request a dissolution and winding up of the partnership, and seek a judicial order of same, if the court finds that the request would be equitable under the circumstances. AS 32.06.801(6)(B).

3. What is each friend's personal exposure to third party liability for the liabilities of the business if the business were a limited liability company and each friend is a member but not a manager? How about if it were a partnership? (30 points)

If an LLC- A member of an LLC is not liable for the liabilities of the business to a third party, whether arising in contract, or tort. Nor is the member liable to a third party for the acts of another member, manager, or employee of the LLC. AS 10.50.265.

If a Partnership- A partnership is liable for loss or injury caused to a third party as a result of actionable conduct by a partner acting in the course of the partnership business. AS 32.06.305. All partners are jointly and severally liable for all obligations of the partnership that are incurred on or after becoming a partner. AS 32.06.306.

4. If the friends decide to form a partnership and later wish they had instead formed an LLC, what is the easiest way for them to change their business structure and become an LLC? (10 points)

Pursuant to AS 10.50.570, the friends can convert their partnership into an LLC by filing a certificate of conversion and articles of organization with the Department of Commerce, Community and Economic Development. This approach eliminates the need to dissolve and wind up the affairs of the partnership prior to forming an LLC. Upon conversion, all of the property, debts, and legal rights of the partnership become automatically vested in the new LLC.

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In all aspects - both p/s and LLC participants owe a duty of fair dealing and loyalty to the entity and partners/members.

#1. In a LLC walking away is less of an option than in a partnership - it is unlikely that the member can. If it does in fact occur, the "walking" member is converted effectively to that of an assignee for the their interest in the LLC. Under a partnership one may walk away and may be "bought out" depending on the p/s agreement may be entitled to the original contribution.

#2. Interests in LLC's are freely assignable. With a partnership, all partners would need to vote on a new partner.

#3. With an LLC, the member is personally insulated akin to that of a corporate veil as just a member. As a partner in a partnership, each of the partners would be liable for the actions of the partnership and each other.

#4. They would need to put together an operating agreement akin to a corporations articles of incorporation, file with the State and receive a certificate.

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1. Business Interests of a Departing Limited Liability Co. Member

The departing member will be entitled to share in the amount of profits or assets identified in the articles of incorporation.

The Remaining Business

The remaining business will be an ongoing business concern in the absence of an agreement otherwise.

Business Interests of a Departing Partner

The departing partner will be entitled to the amount of profits and property and is liable for losses that were established in the partnership agreement.

Dissolution and Winding up

Any change in a partnership is a dissolution. When dissolution occurs the partnership must wind up its current business and the departing partner must notify creditors of the dissolution.

2. Assignment

LLC

An assignor may assign rights in a limited liability company with consent of two-thirds of the members of the limited liability company unless otherwise agreed upon.

The assignee may not participate in any aspect of the business except to receive profits in accordance with the agreement.

Partnership:

A Partner may assign their interest without consent.

The assignor must notify creditors of its departure.

An assignee cannot manage, is not owed a duty of good faith and fair dealing, the assignee may not request inspection of the books nor be allowed to dispose of partnership property. The assignee only has a right to the amount of profits identified in the agreement.

3. Personal Exposure to Third Party Liability

L. L. C.

Each member has no personal liability to third parties for the L. LCs Obligations or Liabilities.

Partnership:

Each Partner is joint and severally liable for the partners debts according to the agreement and are responsible for the wrongful and tortious conduct of other partners unless otherwise agreed.

4. Change from Partnership to LLC

The Partners must agree to dissolve the partnership and wind its business up and make the appropriate notice to their creditors.

The friends must then draft articles of organizations and piled them with the commissioner of the department of economic development establishing their game, the purpose, a registered agent, name address and location of the agent to end the L. LC.

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1. Leaving the organization:

LLC: LLC's can be member managed or manager managed. In Alaska, the default is for a LLC to be member managed. If one of the members leaves the LLC must dissolve and reform under new articles of organization.

Partnership: A recent Alaska case, illustrated that under the new revised uniform partnership act dissolution is not as immediately available as it used to be un the uniform partnership act. In that case, when a partner left the partnership because he could not agree with the other partner, the court held the remaining partner could buy out the exiting partner's assets and rights in the partnership and continue the business even when the exiting partner wanted to wind and dissolve the partnership. Because of that case and RUPA, it would be wise to advise the three friends that if one of them left, the partnership would probably continue if the remaining partners wanted it to. Once the exiting partner expresses her desire to leave the partnership, she loses her right to management in the partnership except in regards to winding up. If the remaining partners wish to continue the partnership, they must pay the exiting partner what she would be entitled to upon wind up.

2. Assigning interest:

LLC: One cannot join a LLC without being written into the articles of organization which creates the LLC. According to how the friends draft the LLC articles of organization, the members may or may not be able to assign their rights. There is a lot of freedom given to parties in how they create a LLC and what rights the parties have. If the friends wanted to they could organize the LLC in such a way that the members/shareholders could not assign their rights without

permission of the others.

Partnership: no one can join a partnership without the consent of all the other partners. A partnership interest may be viewed as personal property and can be assigned freely. However, the assignee of those rights has no rights in the management of the company, only to the profits. Therefore, the trio of friends should be advised that although one of them may assign their partnership interest, the new assignee will not be involved in the management of the partnership. Generally, a partner has a duty of care and loyalty to the partnership. This has recently been clarified in the revised uniform partnership act. They duty of care is to not engage in illegal activity which may harm the partnership. The duty of loyalty is to account to the partners, not to act adversely to the partnership and not to compete with the partnership. However, the assignee does NOT have these duties and the remaining partners do not share these duties towards the assignee. The assignee has a right to be paid what the assignor partner would have been paid, but the other partners owe the assignee NO duty of good faith or care.

3. Personal exposure to 3rd parties:

LLC: the very purpose of the LLC is to provide the tax consequences/benefits of a partnership with the limited liability of a corporation. Therefore, members of a LLC have limited liability for 3rd party claims. A third party cannot pursue them personally for the debts of the LLC. There are exceptions to the general rule of limited liability though such as piercing the corporate veil. Although Alaska has not ruled on whether a LLC can be pierced to get to the personal assets of the members/shareholders, it most likely may be and other jurisdictions have used the same analysis of undercapitalization or alter ego theory to do so.

Partnership: Partners are individually liable for the partnership debts to a 3rd party. They enjoy

no limited liability such as the members of a LLC. A third party creditor may pursue the debts of the partnership directly against the partners jointly and severably. This is one of the dangers of a partnership and is why many now prefer the relative safety of the LLC.

4. Changing a partnership to a LLC:

The three friends should file with the state office articles of organization which outline the LLC, what it does and how it is organized. The LLC is a creature of statute and is not difficult to create. The friends will be able to outline much of how the LLC will operate and have considerable latitude to decide how management will operate.

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1. a. If one of the friends quits and walks away, what would happen to the business interest of the departing friend what would be the impact on the remaining business if it were a limited liability company?

In a LLC, a member may not resign from the LLC in contravention of the operating agreement. If the member does resign in contravention of the operating agreement, the other members may seek damages. In addition, the resigning member loses the right to participate in the business and only retains the right to receive profits. They may not vote, participate, or control the business in any way after their resignation. The impact on the remaining business would be limited. The business can go on as a two member LLC without interruption.

b. A partnership

In a partnership, disassociation occurs either at the express will of one of the partners or as a result of the partnership agreement. If it is a partnership at will, meaning that there was no written agreement, the partnership must dissolve and begin the process of winding up the business. If there is a partnership agreement, the business could continue but the other partners would have to pay the disassociating member the amount of money the person would have received in the winding up process. The other partners could also choose to dissolve the business and begin the process of winding up. Again, once the person disassociates, they lose all rights to manage and control the business. The only rights remaining in a person quitting a partnership is the right to share profits and losses with the other partners and to receive whatever their contribution was.

2. Assignment

a. In a LLC

In a LLC, a member generally may not assign their interest to a third party. If the member does assign their interest without permission of the other members, the other members may seek damages from the assignor. In a LLC, if a member assigns their interest to a third party, the third party does not receive any of the rights to participate in the management, control, or operation of the LLC. The assignee may receive the economic benefits of the assignor. The assignor loses any right to bind the company and the assignee cannot bind the company either.

b. In a partnership

In a partnership, a partner cannot assign their interest to a third party. If they do and the assignee is unaware of the restriction, the assignee may still receive the assignor's share of the profits and the losses. However, the assignee does not receive the right to make decisions and control the business. That right is not assignable regardless of the assignee's knowledge. In addition, the assignee is not owed a duty of good faith and fair dealing or any other fiduciary duty from the other partners. Furthermore, the assignment terminates the assignor's duty of care and loyalty to the partnership, particularly the duty to not compete with the partnership. The assignee may petition the court to dissolve the partnership and to seek an accounting for their share of the profits.

3. Third party liability

a. Manager-managed LLC

In a LLC, members are not liable for any acts of the LLC. Members remain liable for their own gross negligence, intentional misconduct, or criminal acts. In a manager-managed LLC, a member cannot bind the LLC because they are not agents so the other members of the LLC would not be liable for transactions entered into by another member on behalf of the LLC.

b. Partnership

Partners are joint and severally liable for acts within the ordinary course of business of the partnership and any acts authorized by the other partners. Knowledge is immediately imputed to the other partners so that any act entered into one partner is essentially authorized by the other partners unless the partner is perpetuating a fraud.

4. If the partnership wanted to change into LLC, it simply would have to adopt an operating agreement and file a certificate with the state, entering the appropriate statutory information of the LLC.

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1. If one of the friends quits and walks away from the business, what would happen to the business interest of the departing friend and what would be the impact on the remaining business if it were an LLC. If it were a partnership.

In the case of an LLC- the llc is formed by members who are not in any way related to each other in terms of fiduciary obligations. the members are part of a contractual obligation. AK defaults say that the LLC would be considered member managed. The members have interests in the LLC that are assignable and if a member determines that the member does not wish to continue with the LLC, the member becomes an assignee to the LLC and is entitled to the value of his shares, or interest in the LLC on a creditor basis.

the impact on the business were a member to depart would be that the LLC would stil continue without the member, and the member would not have the right, by virtue of the resignation, to engage in the business activities of the LLC as a member or agent for the LLC.

In the case of a Partnership- partnerships are formed by people who work together in a business for profit. the partnership at will is one which will be the default if there are no formal partnership documents, or the partnership has not filed a certificate of partnership (Limited Partnership). The partnerships in Ak are governed by the Uniform Partnership Act 2000 which states that partnerships can either wind up and terminate upon the decision of a partner to leave or can continue with the remainng partner. the partner who wishes to leave may do so, will cause either a dissociation or dissolution.

Dissolution of the partnership will result in the partnership winding up. the partners must not

engage in getting new business for the partnership, but must engage in wrapping up business for the partnership as it exists at the time of dissolution. The partner who departs will be entitled to remuneration after the partnership winds up. The following is the order in which everyone will be paid:

creditors first

excess contributions by partners second

capital contributions by partners third

profits- fourth

If the partner wrongfully caused the dissolution of the partnership, then the partner may be prohibited from having anything to do with winding up.

Another option is dissociation. Like dissolution, the partnership enters into a winding up phase where the partnership does not engage in new business. However, dissociation is more prevalent than dissolution and allows the partnership to continue if it so desires with less interruption. Dissociation of a partner can be triggered by many events, including agreement of the partners under the agreement, or expulsion by the agreement of the partners. The payments are made in the same manner as in dissolution. And the results are the same as in a dissolution.

2. A party may assign her interest to a third party in an LLC without the consent of the other members. The same is true of partnerships. In LLCs, the members do not owe each other fiduciary duties, and therefore, they are related to each other much like shareholders in terms of the interests in the LLC. The members can freely assign their interests. So can partners. In both

cases, the assignees are entitled only to the profits of the entity, and cannot partake of any governing or managing of the business. the assignees in a partnership however, may be empowered to cause the dissolution of the partnership by court order, or get a charging order by court

3. In an LLC- the members are liable for their own torts. They are not liable for the torts of the other members of the LLC. Further, they do not owe any duties of care or loyalty to the LLC or to the other members, the breach of which may bring rise to a suit. This is the very essence of LLCs. LLC combine the tax benefits of a partnership with the limited liability of the corporate form. Unlike the LLC, a partnership requires that the partnership assume liability for the partners torts. Likewise, in a partnership the partners owe each other and to the partnership duties of care and loyalty. the duty of care requires that the partners act as prudent individuals would under the circumstances and with regard to the business. The partners must account for the partnership income and must not take business away from the partnership for themselves. The partnership will not be liable for torts that do not include either gross negligence, intentional conduct, or conduct at the express will of the partnership, or reckless behavior. Therefore, the level of liability is somewhat diminished because mere negligence may not be actionable against the partnership, only the higher form of gross negligence.

therefore, if the friends decide to form an LLC, the friends are liable for their own torts only. The friends will, in the partnership, be liable for their own torts and those of the partnership in relation to the conduct of the business and their own breaches of duty of loyalty and care in the partnership. The liability in the partnership context extends to the partners personally and the partners are jointly and severally liable to creditors. Thus, the friends must understand that they may individually bear 100% of the liability of the partnership. Although they may seek

contribution from the other partners, the creditor does not have to seek the satisfaction of judgment from each of the partners. The creditor must first try to seek satisfaction from the partnership assets before going to the partners individually. An LLC, however, prevents the creditor from seeking satisfaction of a judgment against the members individually, or personally, unless that creditor seeks to pierce the corporate veil. This issue has not been resolved in AK however it is plausible that the creditor may try to get personal liability on the members if they formed the LLC with the intent to defraud the public, or cause inconvenience, or if the LLC is an alter ego of another entity.

4. If the friends decide that they want to form an LLC, the friends must engage in the formation of an LLC through the preparation and filing of articles of organization and file same with the state. This is mandatory. Likewise, the friends must compose an operating agreement. LLC operating agreements are generally more specific in order to make clear the rights and obligations of the members. The members cannot exist as an LLC unless they register with the state.

Partnership does not require formal requirements.