
REPRESENTING OWNERS & MANAGEMENT OF CLOSELY HELD ENTITIES

AN OVERVIEW

Speaker: Chuck Blumenstock

Presented By:
Pennsylvania Bar Institute
Business Law Institute

All rights reserved.

November 7, 2018:

I. COVERAGE AND DEFINITIONS



A. COVERED IN THIS PRESENTATION

1. Commonly-used, closely-held entities, such as corporations and limited liability companies, but (other than some incidental notes) not Statutory Close Corporations or Benefit Corporations
2. The focus will be on sources of duties, potential liabilities, and defenses for owners and managers of the closely held entities

B. DEFINITIONS FOR PURPOSES OF THIS PRESENTATION (MANY FROM TITLE 15 OF PA C.S.A.)

1. Association or Entity – includes corporations, limited liability companies, and partnerships
2. Public Organic Record – articles of incorporation of corporation, certificate of organization of limited liability company, and similar instruments filed with the Department of State to create an entity
3. Record Form – written or stored in an electronic or other medium and retrievable in perceivable form

-
4. Governor – person who exercises management control including director of a corporation, manager of a manager-managed limited liability company, etc.
 5. Interest Holder or Owner – shareholders of corporations, members of limited liability companies
 6. Associations Code – Title 15 of Pennsylvania Statutes (15 Pa. C.S.A. §§ 101 et seq.)
 7. LLC Act – Pennsylvania Uniform Limited Liability Act of 2016, 15 Pa. C.S.A. §§ 8811 et seq
 8. Business Corporation Law or BCL – Business Corporation Law of 1988, Subpart B of Associations Code, 15 Pa. C.S.A. §§ 1101 to 4146

II. FORMING THE ENTITY/ENTITIES



A. WHO DO YOU REPRESENT – ENTITY OR OWNER?

How to resolve conflicts. Single owner vs. multiple owners. Rule 1.13 of the Pennsylvania Rules of Professional Conduct. See Rule 1.13(e) and Rule 1.7.

B. IF MULTIPLE ENTITIES

- – e.g., entities that lease assets to operating company

I. What if ownership of entities differs?

SAMPLE LANGUAGE

- As we discussed, we are representing all of you. While we will attempt to bring conflicts of interest between you to your attention as and when we see them, we may not always spot such conflicts as we focus on the group/entity matters. If you wish to protect your individual interests, you may each wish to consult separate counsel to review matters as they affect your own particular interests if you feel that is important.

III. EVALUATING OWNERS' AND GOVERNORS' (MANAGERS) RIGHTS/DUTIES

SOURCES

A. PENNSYLVANIA BCL AND LLC ACT GENERALLY

1. Flexible statute – many provisions may be varied by the governance documents
2. Duties
 - a) Corporations:
3. BCL § 1712 (a) and (c)—contrast language—while similar, officer language omits statement of fiduciary relation. Distinction noted in *Santoro v. Morse*, 781 A.2d 1220 (Pa. Super 2001) and *Orthivita, Inc. v. Erbe*, 021408 Pa. ED, 07-2395 (2008) (defendant officer was not a director and had no fiduciary duty to corporation such that claim for breach of fiduciary duty failed.)
4. BCL § 1713(a) liability standard—self-dealing, willful misconduct or recklessness
5. BCL § 1716—alternative standard
 - a) LLCs:

6. LLC Act Sections 8849.1 (members) and 8849.2 (managers)
 - a) Loyalty
 - b) Care
 - c) Good faith and fair dealing
 - d) But some changes to duties are permitted by varying the duties in the Operating Agreement. See Section 8815.

B. GOVERNING DOCUMENTS

I. Corporations:

- a) Articles of Incorporation
- b) Bylaws
- c) Shareholders' Agreement

2. LLCs:

- a) Certificate of Organization
- b) Operating Agreement

IV. SPECIFIC ISSUES TO CONSIDER AT TIME OF FORMATION



A. INDEMNIFICATION PROVISIONS

1. Corporations: 15 Pa. C.S.A. §§1741 et seq
2. LLCs: 15 Pa. C.S.A. §8848 (note language “shall indemnify” except for listed sections. However, 15 Pa. C.S.A. §8815(a) would allow modification as long as it does not attempt to expand indemnification to cover things specified as limited in 15 Pa. C.S.A. § 8848)
3. Advancements and Undertaking Agreements
 - a) Corporations: 15 Pa. C.S.A. §1745
 - b) LLCs: 15 Pa. C.S.A. § 8848(c)
 - c) Is a promise to repay enough?

B. BUY—SELL PROVISIONS

1. Triggering Events
2. Deadlock/Russian Roulette
 - a) BCL §§1767 (b)(1) and 1981 (a)(3) permit shareholders by agreement to provide means of breaking deadlocks and thereby avoid appointment of custodian or receiver on account of deadlock
 - b) Beware of situational differences such as owners with vastly differing means
 - c) Note regarding Statutory Close Corporations: BCL §§2333 and 2334—additional requirements for appointment of trustee (in addition to BCL §1767 requirements) and alternative appointment of provisional director
3. Valuation

C. DISPUTE RESOLUTION

1. Mediation?
2. Arbitration?
 - a) See IV.A.2 below

D. SUPERMAJORITY PROVISIONS

- I. Note re Statutory Close Corporations: BCL §2302(a)(2)—
some actions need minimum 2/3 vote

V. OWNERS' RIGHTS

A. FINANCIAL STATEMENTS—BCL §1554

1. BCL §251 I makes requirement of financial reports inapplicable to Registered Corporation
2. Can waive right to receive

B. INSPECTION OF BOOKS AND RECORDS—

BCL § 1508 (CORPORATIONS); LLC ACT § 8850 (LLCS). REILLY V. COPPERTECH, INC., 19 PA. D&C3D 349 (1981)

I. Books and records include (BCL § 1508 and cases)

- | | |
|--------------------------------------------|---------------------------------------------------------------------|
| a) stock book | g) checkbooks |
| b) stock ledger | h) bank reconciliations |
| c) minute books | i) federal and state tax returns |
| d) cash receipts and disbursements | j) compensation records |
| e) accounts receivable and payable ledgers | k) dividend records |
| f) financial reports | l) contracts relating to the sale or purchase of assets of services |

2. Books and Records LLC Act – more generic description and no cases, but should encompass all such items to the extent they exist.

DISSENTERS RIGHTS

- Corporation concept – exclusive remedy. In absence of fraud or unfairness, no injunction.
- LLCs – add by contractual right?

INTERNAL CLAIMS

- Appointment of Custodian
- Involuntary Dissolution - Avoiding action by contractually providing means of resolving deadlock
- Quasi-fiduciary Duty of Majority shareholders to minority shareholders

EXTERNAL CLAIMS

- Deepening Insolvency
- Piercing the Entity's Veil
- Participation Theory
- Wage Payment and Collection Law
- Responsible Person Tax Penalty
- ERISA

DEFENSES & PROTECTIONS

- Statutory Limitations
- Business Judgment Rule
- Ratification or Fairness
- Indemnification