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## The First LLC Case

In *Gottsacker v. Monnier*, the first limited liability company case to reach the Wisconsin Supreme Court, the court included in its decision a lengthy discussion of how LLCs work, touching on the technical details and policies behind the law. The decision offers guidance and practical advice to attorneys drafting LLC agreements for their business clients.

### [Planning for Conflict of Interest Transactions](#)

by [Joseph W. Boucher](#) & [George R. Kamperschroer](#)

At long last, the Wisconsin Supreme Court issued its first decision directly dealing with Wis. Stat. chapter 183, the Wisconsin Limited Liability Company Law (WLLCL).<sup>1</sup> *Gottsacker v. Monnier* was decided on June 8, 2005,<sup>2</sup> more than 13 years after the WLLCL first became effective on Jan. 1, 1994. Since its effective date, more than 100,000 limited liability companies (LLCs) have been created in Wisconsin; LLCs make up about 80 percent of all new legal entities formed each year by a filing with the Wisconsin Department of Financial Institutions (DFI).<sup>3</sup> The popularity of LLCs results from their two basic features: limited liability for the entity's members (LLC parlance for owners), and treatment as a partnership for income tax purposes. LLCs also offer minimal filing requirements (filing of articles of organization can be done either on paper or online through the DFI's Web site) and a flexible management structure.

The issues in *Gottsacker* focused on whether the petitioners, two members of an LLC, possessed the majority votes necessary under a written "Member's Agreement" to authorize a transfer of the LLC's sole asset and whether a conflict of interest prohibited them from voting to transfer the property. Regarding the first issue, the supreme court interpreted ambiguous language in the Member's Agreement and found that the petitioners did possess the necessary majority. Second, the court held that the petitioners' material conflict of interest in the transaction did not prevent them from approving the transfer, but that an issue arose as to whether they dealt "fairly" with the LLC and the other member. The supreme court remanded the case to the circuit court to resolve this factual issue.

### Background

Factually, *Gottsacker* is a fairly simple case. Julie Monnier formed New Jersey LLC (the company) in September 1998 as a member-managed LLC. Shortly thereafter, the company purchased for \$510,000 a commercial rental property located at 2005 New Jersey Avenue in Sheboygan. A limited appraisal conducted at the time of purchase valued the property at \$703,000. In January 1999, brothers Gregory and Paul Gottsacker became members of the company. Julie owned 50 percent, and a Member's Agreement signed by all of the members stated that Paul and Gregory "collectively" owned 50 percent and had 50 percent of the voting rights. The company later acquired a second property, which subsequently was sold, and the proceeds were distributed to the members pro rata - 50 percent to Julie and 25 percent each to Paul and Gregory.

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At some point, Gregory and Paul became estranged and Gregory ceased participating in the company's affairs. In 2001 the company, through the actions of Julie and Paul, sold the New Jersey Avenue property to a new LLC named 2005 New Jersey LLC (Newco). Julie owned 60 percent of Newco and Paul owned 40 percent. The formation of Newco and the transfer of the property took place without Gregory's knowledge or involvement.

There was no formal meeting approving the sale nor was there an appraisal of the property. The property was sold by the company for \$510,000, the same price that the company originally paid almost three years earlier, and considerably less than the earlier limited appraisal of \$703,000. After the transfer to Newco, Julie sent Gregory a check for \$22,000, presumably representing a distribution of 25 percent of the equity received from the sale of the property.

Gregory never cashed the check. Instead, he sued Paul, Julie, and Newco in Sheboygan County Circuit Court demanding that the transfer be voided and the property returned to the company. Gregory argued that the sale was an improper transfer, because there was an inherent conflict of interest in that Julie and Paul were on both sides of the transaction.

## Circuit Court

In a detailed memorandum decision,<sup>4</sup> the circuit court ruled that due to the conflict of interest, Julie and Paul were precluded by law from voting on the transaction and that Gregory was correct - the property should be returned to the company. The circuit court concluded that because there was no notice to Gregory of the sale and because the only remaining asset of the company was sold, the purpose of the conveyance was to terminate Gregory's interest in the company. The transfer did not benefit the company nor was it "an exercise of prudent business judgment on behalf of the LLC." The circuit court went on to state that the actions of Julie and Paul contravened the letter and spirit of the WLLCL.

The circuit court focused on Wis. Stat. section 183.0402(1)(a), which provides that unless an operating agreement states otherwise, no member may act or fail to act in a manner that constitutes "a willful failure to deal fairly with the limited liability company or its members in a connection with a matter in which the member ... has a material conflict of interest." In the view of the court, this statute "proscribes a member of a[n] LLC from taking action in the face of a material conflict of interest." Under this analysis, because Julie and Paul were not entitled to vote, the transaction had not been approved by a majority vote of disinterested members. The only "disinterested" member was Gregory, and he clearly did not approve the transaction. Since the sale was not and could not be properly approved, the circuit court ordered Newco to return the property to the company. Under this analysis, the court did not have to address whether Paul had the authority to vote all or part of the interest he held "collectively" with Gregory. Nevertheless, the circuit court did state, in dictum, that even if Paul were not precluded from voting by a conflict of interest, he did not have the right to vote the collective interest without Gregory's assent.

## Court of Appeals

The circuit court judgment was appealed by Julie and Paul to the District II Court of Appeals, which affirmed the lower court decision but applied different reasoning.<sup>5</sup> The court of appeals focused on Wis. Stat. section 183.0402(1)(a) and agreed with the circuit court that there was a conflict of interest. The court of appeals stated that LLC members are fiduciaries, and that by selling the property to themselves, Julie and



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Paul were in a position in which their personal interests were "pitted" against their fiduciary duties to the company.<sup>6</sup> However, the court of appeals disagreed with the lower court's conclusion that the conflict of interest precluded Julie and Paul from voting. Instead, the court of appeals concluded that Wis. Stat. section 183.0402(1)(a) only prohibits a member from dealing unfairly with the LLC or its members. The question, then, was not whether Julie and Paul could vote, but whether they voted their interests "fairly."<sup>7</sup>

The court of appeals concluded that the transaction was "unfair" for two reasons. First, the transaction was not at arm's length. Second, the sale of the property made it impractical for the company to carry on with its intended business. As a result of this unfairness, the transaction was unlawful.<sup>8</sup> As a result of this conclusion the court of appeals did not have to address the issue of whether Paul had the authority to vote the shares he owned collectively with Gregory. The court of appeals upheld the circuit court's decision returning the property to the company. Julie, Paul, and Newco appealed the decision to the Wisconsin Supreme Court.<sup>9</sup>

## Supreme Court Opinion

In an opinion written by Justice Bradley, the Wisconsin Supreme Court reversed the court of appeals' decision and remanded the case to the circuit court.<sup>10</sup> After reciting the facts in detail, the court engaged in a lengthy discussion of the intent of the WLLCL and how LLCs work.<sup>11</sup> The court's discussion touches on many of the technical details and policies behind the law and evidences a solid understanding of the nature of this relatively new business form.

In the opinion, the supreme court addressed several issues. The first issue was whether Julie and Paul possessed the majority necessary to authorize the sale. The court focused on the meaning of the language referring to Paul and Gregory collectively owning a 50 percent interest. The court thought the provision was ambiguous and construed "collectively" to mean the sum of the brothers' two separate 25 percent interests and not a single 50 percent interest that would require both Gregory and Paul to consent to any action.<sup>12</sup> Therefore, Paul and Julie, as the owners of 75 percent of the total interests, possessed the majority necessary to authorize the transaction.

The second question was whether Paul and Julie were prohibited from voting to transfer the property. With very little discussion, the court quickly agreed with both lower courts that the transaction involved a material conflict of interest on behalf of Julie and Paul.<sup>13</sup> The real question was the effect of this conflict of interest. The supreme court analyzed Wis. Stat. sections 183.0402 and 183.0404 and concluded that members with a conflict of interest can vote if their actions do not constitute a willful failure to treat the LLC or the other members "fairly":

"[T]he WLLCL ... prohibits members with a material conflict of interest from acting in a manner that constitutes a willful failure to deal fairly with the LLC or its other members. We interpret this requirement to mean that members with a material conflict of interest may not willfully act or fail to act in a manner that will have the effect of injuring the LLC or its other members."<sup>14</sup>

The issue of "fairness" requires a factual determination, and under the circuit court's analysis that Julie and Paul could not vote at all, that court did not have to make any findings of fact on the fairness issue. Although the court of appeals did decide that the actions of Julie and Paul were not fair, the supreme court held that those conclusions were findings of fact and that the court of appeals did not have the authority to make them. The supreme court therefore remanded the case to the circuit court for further findings on this issue, summarizing its holding as follows:

"In sum, we conclude that ... [Julie and Paul] possessed the majority necessary to authorize the transfer in question. Furthermore, we determine that ... [their] material conflict of interest did not prohibit them from voting to make the transfer so long as they dealt fairly. However, because there was no express determination by the circuit court as to whether the petitioners willfully failed to deal fairly with ... [the

company] or its other member, we reverse the decision of the court of appeals and remand the case for further proceedings."<sup>15</sup>

### What Did "Collectively" Mean?

The supreme court's opinion is based in part on its interpretation of the language that the Gottsacker brothers' "collectively" own a 50 percent interest. The Member's Agreement provides for this collective interest but fails to clarify what it means. The supreme court ultimately concluded that "collectively" means the sum of the brothers' individual 25 percent interests. Essentially, the court came to this conclusion to avoid the outcome of one minority member being able to deadlock the LLC in a voting situation in the absence of express language requiring unanimity.<sup>16</sup>

One commentator has suggested that the issue of Paul's authority to vote the ownership interest could be resolved by resorting to partnership law, an approach in which the justices had expressed interest at the oral argument.<sup>17</sup> Under Wis. Stat. chapter 178, a general partnership needs no formal organizational structure, but is simply an association of two or more persons to carry on as co-owners of a business for profit.<sup>18</sup> On the facts presented, the supreme court could have decided that there was a general partnership between Paul and Gregory as to their 50 percent interest. Under that approach, the case would have revolved more around the relationship between Paul and Gregory, with the outcome of the case turning on issues such as the power of general partners to act on behalf of a partnership and the fiduciary duties owed by a general partner to the partnership and the other partners. By construing the language as it did, the supreme court declined to take this path and did not address it at all in its decision. As a result, the court provided more guidance on the WLLCL than it otherwise might have.

### What is "Fair"?

Although the court of appeals clearly stated that LLC members have a fiduciary duty to the LLC and other members,<sup>19</sup> the supreme court's opinion is silent on this issue. In the supreme court's view, the only standard necessary to determine whether the transfer was appropriate is the statutory standard: whether the members willfully acted or failed to act in a manner that "will have the effect of injuring the LLC or its other members."<sup>20</sup> Further, the supreme court stated that this inquiry contemplates "both the conduct along with the end result, which we view as intertwined," a reference to the distinction between procedural fairness and substantive fairness. In *Gottsacker*, Gregory had no knowledge of the property transfer until after the fact (procedural), there was no new appraisal (procedural and substantive), and the price for which the property was sold was less than the earlier appraisal (substantive).

How the circuit court will treat these and related facts and the "intertwined" nature of procedural and substantive fairness remains to be seen. It is worth noting that the Wisconsin statute on business corporations deals more specifically with conflicts of interest, specifying tests for director action that require *either* procedural fairness, or substantive fairness, but not both.<sup>21</sup>

### Conclusion

*Gottsacker v. Monnier* provides practical guidelines for attorneys. First, and most important, the safest route is for attorneys to advise their clients that in an appropriate case the courts will likely decide that LLC members have a fiduciary duty to the LLC and other members and that clients should act accordingly. Although the supreme court did not discuss this issue, the court of appeals stated this conclusion directly.

Second, attorneys should counsel their LLC clients that regardless of whether they are fiduciaries, as LLC members they have a clear statutory duty to act "fairly" when they have a conflict of interest. All proposed actions involving self dealing should be closely scrutinized using this standard, and until further clarification, the test for fairness should be both procedural and substantive. That is, both the process followed and the resulting actions must be fair. Further, when a self-dealing transaction involves an asset that can be appraised, it is always advisable to appraise the asset.

Moreover, when drafting operating agreements, attorneys should be careful to clearly define the voting rights of all the members. Of course, this principle should be applied to drafting all provisions of any operating agreement (or any other written document). Finally, as is usually true in closely held businesses, more documentation, discussion, and communication are better than less to avoid lengthy and expensive legal challenges.

*Gottsacker* provides Wisconsin the first glimpse of the supreme court's treatment of limited liability companies. Because LLCs are a relatively new form of business entity, attorneys can look forward to more cases in this developing area.

## Endnotes

<sup>1</sup>The WLLCL was drafted in 1992 and 1993 by the State Bar Business Law Committee, consisting of Joseph W. Boucher, chair, and members Leonard Sosnowski, Mark Christopher, Mike Reinecke, Michael Klinker, Robert Fahrenbach, and the Legislative Reference Bureau staff.

<sup>2</sup>*Gottsacker v. Monnier*, 2005 WI 69, \_\_\_ Wis. 2d \_\_\_, 697 N.W.2d 436.

<sup>3</sup>Joseph W. Boucher et al., *LLCs and LLPs: A Wisconsin Handbook* § 2.27a (table "Summary of New Entities Created") (rev. ed. 1999). An update is expected in autumn 2005.

<sup>4</sup>*Gottsacker v. Monnier*, No. 01-CV-636 (Sheboygan Cir. Ct. Nov. 20, 2002).

<sup>5</sup>*Gottsacker v. Monnier*, 2004 WI App 25, 269 Wis. 2d 667, 676 N.W.2d 533.

<sup>6</sup>*Id.* ¶ 15.

<sup>7</sup>*Id.* ¶ 19.

<sup>8</sup>*Id.* ¶ 27.

<sup>9</sup>It is rare for the Wisconsin Supreme Court to hear a case dealing with business entities. Since 1990, there have been about three cases each year concerning the application and interpretation of either Wis. Stat. chapter 178 (general partnerships and LLPs), chapter 179 (limited partnerships), chapter 180 (corporations), or chapter 181 (nonstock corporations). Many of those decisions deal with procedural and tax issues. Very few of those decisions address the substantive governance provisions of those chapters.

<sup>10</sup>*Gottsacker v. Monnier*, 2005 WI 69, \_\_\_ Wis. 2d \_\_\_, 697 N.W.2d 436. Justice Roggensack filed a concurring opinion that was joined by Justice Wilcox. Justice Butler filed a dissent.

<sup>11</sup>*Id.* ¶¶ 14-19.

<sup>12</sup>*Id.* ¶ 25.

<sup>13</sup>*Id.* ¶ 26.

<sup>14</sup>*Id.* ¶ 31.

<sup>15</sup>*Id.* ¶ 37.

<sup>16</sup>*Id.* ¶ 25.

<sup>17</sup>Richard A. Latta, Supreme Court Action May Dramatically Impact Duties of LLC Members, Bus. L. News, March 2005, at 1-5.

<sup>18</sup>Wis. Stat. § 178.03(1).

<sup>19</sup>*Gottsacker v. Monnier*, 2004 WI App 25, 269 Wis. 2d 667, 676 N.W.2d 533.

<sup>20</sup>*Gottsacker v. Monnier*, 2005 WI 69, \_\_ Wis. 2d \_\_, 697 N.W.2d 436.

<sup>21</sup>Wis. Stat. § 180.0831.

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