Appeal No. 2017AP146 **Cir. Ct. No. 2015CV213**

WISCONSIN COURT OF APPEALS
DISTRICT III

DANIEL MARX, FRACSAND, LLC, MICHAEL MURRAY AND R&R MANAGEMENT FUNDS, LLC,

PLAINTIFFS-RESPONDENTS,

V.

RICHARD L. MORRIS AND R.L. CO., LLC,

DEFENDANTS-APPELLANTS.

FILED

Mar. 6, 2018

Sheila T. Reiff
Clerk of Supreme Court

CERTIFICATION BY WISCONSIN COURT OF APPEALS

Before Stark, P.J, Hruz and Seidl, JJ.

Pursuant to WIS. STAT. RULE 809.61 (2015-16),[1] this appeal is certified to the Wisconsin Supreme Court for its review and determination.

ISSUES

1. Does a member of a limited liability company (LLC) have standing to assert a claim against another member of the same LLC based on an injury suffered primarily by the LLC, rather than the individual member asserting the claim?

[1] All references to the Wisconsin Statutes are to the 2015-16 version unless otherwise noted.

2. Does the Wisconsin Limited Liability Company Law, WIS. STAT. ch. 183, preempt common law claims by one member of an LLC against another member based on the second member's alleged self-dealing?

BACKGROUND

This appeal involves a dispute between three members of North Star Sand, LLC—Daniel Marx, Michael Murray, and Richard Morris.[2] The factual background giving rise to Marx and Murray's lawsuit is somewhat complex. However, for purposes of this certification, what matters is that Marx and Murray contend Morris engaged in self-dealing in a transaction in which one of North Star's subsidiaries, Westar Proppants, LLC, was sold to DSJ Holdings, LLC, an entity partially owned by Morris.

Marx and Murray's amended complaint asserted multiple claims against Morris, all based on his alleged self-dealing in connection with the Westar transaction. Marx and Murray asserted claims only on behalf of themselves and their own LLCs; they did not assert any claims on North Star's behalf. First, Marx and Murray asserted that Morris violated WIS. STAT. § 183.0402 by "willfully fail[ing] to deal fairly" with them and "deriv[ing] an improper personal profit."[3]

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[2] In actuality, Marx, Murray, Morris, and three other individuals each formed their own LLCs, which, in turn, owned membership units in North Star. However, for simplicity's sake, and following the parties' lead, we refer to the individuals involved with North Star by name, rather than referring to their respective LLCs.

[3] WISCONSIN STAT. § 183.0402, entitled "Duties of managers and members," states:

> Unless otherwise provided in an operating agreement:
>
> (1) No member or manager shall act or fail to act in a manner that constitutes any of the following:

(continued)

Second, Marx and Murray alleged Morris breached common law fiduciary duties that he owed them as a member of North Star. Third and fourth, Marx and Murray asserted common law claims against Morris for unjust enrichment and breach of the implied covenant of good faith and fair dealing.[4]

> (a) A willful failure to deal fairly with the limited liability company or its members in connection with a matter in which the member or manager has a material conflict of interest.
>
> (b) A violation of criminal law, unless the member or manager had reasonable cause to believe that the person's conduct was lawful or no reasonable cause to believe that the conduct was unlawful.
>
> (c) A transaction from which the member or manager derived an improper personal profit.
>
> (d) Willful misconduct.
>
> (2) Every member and manager shall account to the limited liability company and hold as trustee for it any improper personal profit derived by that member or manager without the consent of a majority of the disinterested members or managers, or other persons participating in the management of the limited liability company, from any of the following:
>
> (a) A transaction connected with the organization, conduct or winding up of the limited liability company.
>
> (b) A use by a member or manager of the property of a limited liability company, including confidential or proprietary information or other matters entrusted to the person as a result of the person's status as member or manager.
>
> (3) An operating agreement may impose duties on its members and managers that are in addition to those provided under sub. (1).

[4] Marx and Murray also asserted, in a separate claim, that Morris breached fiduciary duties he owed them "[a]s acting legal counsel" for North Star. That claim is not relevant to the issues discussed in this certification, which pertain solely to Marx and Murray's claims against Morris in his capacity as a member of North Star.

Morris moved for summary judgment on several grounds. As relevant here, Morris argued Marx and Murray's claims "belong[ed] to North Star" and therefore could not "be asserted directly by its individual members." Morris also argued WIS. STAT. ch. 183 preempted Marx and Murray's common law claims for breach of fiduciary duty, unjust enrichment, and breach of the implied covenant of good faith and fair dealing.

The circuit court issued a written order denying Morris's summary judgment motion. The court rejected Morris's argument that Marx and Murray's claims actually belonged to North Star, reasoning: (1) that argument relied entirely on federal district court decisions and Wisconsin cases involving corporations, rather than LLCs; and (2) the "plain language" of WIS. STAT. § 183.0402(1) indicated "that managers and members have duties to other members," and Marx and Murray were "entitled to their day in court to present their evidence" as to whether Morris violated those duties. The court also rejected Morris's argument that WIS. STAT. ch. 183 preempted Marx and Murray's common law claims, noting Morris had not cited any binding authority in support of that proposition.

Morris petitioned this court for leave to appeal the circuit court's nonfinal order denying his summary judgment motion, and we granted his petition.

DISCUSSION

I. Issue #1: Does an LLC member have standing to assert claims against another member based on injuries sustained primarily by the LLC?

An LLC is "a distinct business entity that adopts and combines features of both partnership and corporate forms." ***Gottsacker v. Monnier***, 2005 WI 69, ¶14, 281 Wis. 2d 361, 697 N.W.2d 436.

> From the partnership form, the LLC borrows characteristics of informality of organization and operation, internal governance by contract, direct participation by members in the company, and no taxation at the entity level. From the corporate form, the LLC borrows the characteristic of protection of members from investor-level liability. Flexible in nature, the LLC allows direct involvement and control by its members yet also permits a corporate representative form of governance if the entity elects to be governed by managers.

Id., ¶15 (citations omitted). The Wisconsin legislature enacted WIS. STAT. ch. 183—permitting the formation of LLCs in this state—in 1993. ***Gottsacker***, 281 Wis. 2d 361, ¶18. The "overriding goal" of ch. 183 was to "create a business entity providing limited liability, flow-through taxation, and simplicity." ***Gottsacker***, 281 Wis. 2d 361, ¶19 (quoted source omitted). The law's drafters "hoped that the LLC would provide an inexpensive vehicle that did not require legal counsel at every step." ***Id.***

Seizing on the LLC's similarities to the corporate form, Morris argues we should apply principles of derivative standing from corporate law to LLCs. As a result, he urges us to conclude that an LLC member lacks standing to assert a claim against another member when that claim is premised on injuries primarily to the LLC, rather than to the individual member attempting to bring the claim.

Wisconsin courts have consistently held that individual shareholders of a corporation lack standing to assert legal claims on their own behalf that, in actuality, belong to the corporation. For instance, in ***Rose v. Schantz***, 56 Wis. 2d 222, 223-24, 201 N.W.2d 593 (1972), a minority shareholder sued a corporation's directors, alleging they had breached their fiduciary duties. The shareholder asserted both a derivative claim on behalf of the corporation and an individual claim on his own behalf. ***Id.*** at 223.

The Wisconsin Supreme Court concluded the circuit court erred by failing to dismiss the shareholder's individual claim, explaining:

> It is true the fiduciary duty of a director is owed to the individual stockholders as well as to the corporation. Directors in this state may not use their position of trust to further their private interests. Thus, where some individual right of a stockholder is being impaired by the improper acts of a director, the stockholder can bring a direct suit on his own behalf because it is his individual right that is being violated.
>
> However, it is also true in this state that: "Rights of action accruing to a corporation belong to the corporation, and an action at law or in equity, cannot be maintained by the members as individuals…."

Id. at 228-29 (footnotes omitted). The court concluded that, in the case before it, "the primary injury set forth is to the corporation, not the individual stockholder bringing the suit." ***Id.*** at 229. The court further explained:

> That such primary and direct injury to a corporation may have a subsequent impact on the value of the stockholders' shares is clear, but that is not enough to create a right to bring a direct, rather than derivative, action. Where the injury to the corporation is the primary injury, and any injury to stockholders secondary, it is the derivative action alone that can be brought and maintained.

Id. (footnotes omitted).

More recently, the supreme court relied on ***Rose***'s holding in ***Notz v. Everett Smith Group, Ltd.***, 2009 WI 30, 316 Wis. 2d 640, 764 N.W.2d 904. In ***Notz***, a corporation's minority shareholder filed suit against the majority shareholder asserting, among other things, an individual claim for breach of fiduciary duty. ***Id.***, ¶10. In addressing whether that individual claim could proceed, the supreme court stated that under ***Rose***, the analysis "centers on a determination of whether the primary injury is to the corporation or the shareholder." ***Id.***, ¶23. The court explained an injury is primarily to an individual shareholder when it "affects a shareholder's rights in a manner distinct from the effect upon other shareholders." ***Id.*** (quoting ***Jorgensen v. Water Works, Inc.***, 2001 WI App 135, ¶16, 246 Wis. 2d 614, 630 N.W.2d 230).

Rose and ***Notz*** stand for the proposition that a corporate shareholder may not bring claims in his or her individual name based on conduct that primarily injured the corporation. Instead, in order to bring an individual claim, the shareholder must show that he or she suffered some unique injury distinct from that sustained by the corporation or other shareholders. Morris argues the same rule should apply to members of LLCs. He contends that, in the instant case, Marx and Murray lack standing because they cannot demonstrate they sustained any unique injury as a result of Morris's alleged self-dealing.

Assuming the principles set forth in ***Rose*** and ***Notz*** apply to LLCs as well as corporations, we are inclined to agree with Morris that Marx and Murray have failed to demonstrate they sustained a unique injury as a result of Morris's conduct. In describing the "individual injury" they allegedly sustained, Marx and Murray assert that, before North Star's members voted on Westar's sale to DSJ, Morris stated any North Star member could participate in DSJ. Marx and Murray contend they wanted to participate in DSJ, but North Star's other members (Morris

excluded) did not. They further contend that, following the sale, Morris reneged on his promise and refused to let Marx and Murray join DSJ, although he did offer to let one of North Star's other members join that venture. Marx and Murray assert that, by preventing them from taking an interest in DSJ, Morris ensured he would pocket a higher percentage of the proceeds when Westar's assets were later sold. Marx and Murray contend Morris's conduct in that regard "affected them in a distinct way compared to the other [North Star] members because they—unlike the other members—wanted the chance to realize fruits of the work they put into Westar."

As the preceding paragraph indicates, Marx and Murray apparently believe Morris injured them individually by promising that they could become members of DSJ as an inducement to sell Westar to that entity, but then reneging on that promise. However, given that Marx and Murray ultimately voted against the sale, they cannot demonstrate that they relied on Morris's promise. Moreover, Marx and Murray do not cite any evidence indicating that any of the other North Star members who voted in favor of the sale would have instead voted against it absent Morris's representation that Marx and Murray could later become members. In other words, Marx and Murray have not cited any evidence to show that Morris's allegedly wrongful conduct was the cause of any individual injury they sustained.

Marx and Murray may also intend to suggest they were harmed by procedural irregularities regarding a telephonic meeting during which North Star's members voted to sell Westar to DSJ. At various points in their appellate brief, Marx and Murray argue they did not receive proper notice that a sale of Westar to DSJ would be discussed during that meeting, and they also question whether all of the members who voted in favor of the sale were disinterested. These assertions,

however, fail to demonstrate any unique harm to Marx and Murray, as opposed to any other member of North Star

We therefore believe the record in this case indicates that Marx and Murray have not sustained any individual injury as a result of Morris's alleged self-dealing. The question therefore becomes whether Morris is correct that, based on corporate law principles, Marx and Murray were required to demonstrate individual injuries in order to assert individual claims against him, as opposed to derivative claims on behalf of the LLC. This is an issue of first impression in Wisconsin, and, as a result, Morris does not cite any binding authority supporting his position.

On the other hand, however, Marx and Murray do not cite any binding authority conclusively rejecting Morris's position. Instead, they note that, in ***Gottsacker***, the plaintiff—a member of an LLC—asserted both an individual claim against the LLC's other members and a derivative claim on behalf of the LLC. *See* ***Gottsacker***, 281 Wis. 2d 361, ¶46 (Roggensack, J., concurring). They then assert that, when addressing the issues raised in ***Gottsacker***, the Wisconsin Supreme Court "never questioned the validity of the individual claim." Be that as it may, there is no indication that the defendants in ***Gottsacker*** ever argued the plaintiff lacked standing to assert an individual claim. Under these circumstances, we do not view ***Gottsacker*** as definitively foreclosing Morris's argument that an LLC member must allege some individual injury in order to assert claims on his or her own behalf against other members of the same LLC.

Marx and Murray nonetheless urge us to reject Morris's corporate law argument because LLC members "have duties to each other" under WIS. STAT. § 183.0402. Marx and Murray contend those duties "are a reflection of the

LLC's partnership qualities." Citing ***Century Capital Group v. Barthels***, 196 Wis. 2d 806, 539 N.W.2d 691 (Ct. App. 1995), Marx and Murray argue individual claims between partners "are, in fact, common."

In essence, Marx and Murray contend LLCs should be treated more like partnerships than corporations for purposes of determining whether individual members have standing to assert claims against other members. This position finds some support in a recent article concerning the fiduciary duties owed by members and managers of Wisconsin LLCs. *See* Joseph Boucher & Andrew Kramer, *Fiduciary Duties of LLC Members and Managers*, WIS. LAW., Jan. 2018, at 30. According to the article, the committee that drafted WIS. STAT. ch. 183 in the early 1990s

> sought to ensure limited liability and partnership income tax treatment following the Wyoming pattern. This meant using partnership law principles, not corporate principles. *Thus, to determine some of the key principles of Wisconsin LLC law, one needs to refer to Wisconsin partnership law at the time.* This means that the existing partnership entity legal principles were the fundamental underlying premises for the original Wisconsin LLC law passed in 1993.

Id. at 31-32 (emphasis added).

The above excerpt supports Marx and Murray's assertion that we should look to partnership law, rather than corporate law, to inform our understanding of the circumstances in which LLC members can bring claims against each other. Even partnership law, however, does not appear to provide a definitive answer to this question. The parties do not cite any authority clearly indicating whether a partner has standing to bring a claim against another partner that is based on injuries primarily to the partnership, rather than to the partner attempting to bring the claim. Neither ***Century Capital Group***, which Marx and

Murray cite, nor ***Hauer v. Bankers Trust New York Corp.***, 65 F.R.D. 1 (E.D. Wis. 1974), which Morris relies upon, addressed that issue.

As further support for his argument that Marx and Murray lack standing to assert claims against him, Morris relies on a federal district court opinion—***Price v. Smith***, 842 F. Supp. 2d 1111 (E.D. Wis. 2012). In ***Price***, Sarah Price and Chris Smith were members of Bluemark Productions, LLC. ***Id.*** at 1112. In 2011, Price filed suit against Smith in Wisconsin state court, asserting both individual claims and derivative claims on behalf of Bluemark. ***Id.*** at 1112-13. On Smith's motion, the case was removed to federal court based on diversity jurisdiction. ***Id.*** at 1113. Price then moved to remand, citing a lack of complete diversity between the parties based on the fact that Smith was a Wisconsin citizen and Bluemark was a Wisconsin LLC. ***Id.*** In response, Smith argued Bluemark "should be dismissed as a plaintiff because Price's derivative claims on behalf of Bluemark are really direct (individual) claims and thus Bluemark's presence in the case is superfluous and only designed to block Smith's ability to remove the case." ***Id.*** at 1114.

The district court rejected Smith's argument that Price was actually asserting only individual claims. The court cited WIS. STAT. § 183.0608(1), which states, "[A] member or manager who votes for or assents to a distribution in violation of s. 183.0607 or of an operating agreement is personally liable to the limited liability company for the amount of the distribution that exceeds what could have been distributed without violating s. 183.0607 or the operating agreement." *See* ***Price***, 842 F. Supp. 2d at 1115. The court also cited WIS. STAT. § 183.0402(2), the statute at issue in this case, noting that statute requires each member or manager to account *to the LLC* for any improper personal profit. ***Price***, 842 F. Supp. 2d at 1115. Based on these two statutes, the court stated,

"Thus, under relevant Wisconsin law, it is clear that the duty to refrain from self-dealing is owed to the LLC as an entity and that the remedies relating [to] improper personal profits or allegedly wrongful distributions are vested in the LLC, not its individual members." ***Id.***

Notably, ***Price*** did not rely on corporate law principles in order to conclude that a claim premised on an LLC member's alleged self-dealing belongs to the LLC, rather than to its individual members. Instead, ***Price*** relied on WIS. STAT. ch. 183 to reach that conclusion. ***Price*** therefore does not support Morris's expansive argument that, based on corporate law principles, all of Marx and Murray's claims against Morris in his capacity as a member of North Star should have been dismissed. Nonetheless, ***Price*** does appear to support a more limited conclusion that, at the very least, Marx and Murray's WIS. STAT. § 183.0402 claim belongs to North Star, not to Marx and Murray individually. However, as a federal district court decision, ***Price*** is not binding authority. *See* ***State v. Wood***, 2010 WI 17, ¶18, 323 Wis. 2d 321, 780 N.W.2d 63. Morris does not cite any binding Wisconsin precedent supporting the proposition that a statutory claim under § 183.0402 belongs exclusively to the LLC.

II. Issue #2: Does WIS. STAT. ch. 183 preempt an LLC member from bringing common law claims based on another member's alleged self-dealing?

As noted above, Marx and Murray have asserted four claims against Morris based on alleged self-dealing he committed as a member of North Star. While Morris argues each of those claims should have been dismissed for lack of standing, he also contends there is an alternative basis to dismiss Marx and Murray's three common law claims—namely, that those claims "merely restate in common law parlance the same allegation as the statutory violation allegation—

improper self-dealing by Morris as a director [sic] of North Star." As such, Morris asserts WIS. STAT. ch. 183 preempts Marx and Murray's common law claims.

Morris's argument in this regard relies entirely on a concurring opinion in ***Gottsacker***, in which then-Justice Roggensack stated an LLC

> is a business entity created by statute where those who hold an interest in the entity are known as members. WIS. STAT. §§ 183.0102(15), 183.0801. The rights and obligations of a limited liability company to its members, of the members to the limited liability company and to each other are set by ch. 183. *Common law concepts such as the fiduciary duty of a majority shareholder of a corporation to a minority shareholder are replaced by statutory obligations.*

Gottsacker, 281 Wis. 2d 361, ¶45 (Roggensack, J., concurring) (emphasis added). In a subsequent footnote, Justice Roggensack criticized the court of appeals for "improperly engraft[ing] a common law fiduciary duty" on the defendant members in ***Gottsacker***, again stating an LLC member's obligations "are set by statute." ***Id.***, ¶45 n.3 (Roggensack, J., concurring).

The plain language of WIS. STAT. § 183.0402—setting forth the duties of LLC managers and members—does not specify whether the duties described therein are the only duties owed by managers and members. An argument could be made that, if the legislature intended these duties to be exclusive, it would have included language to that effect in § 183.0402. The Ohio Legislature took that approach in Ohio's LLC statute, which expressly states that "[t]he only fiduciary duties a member owes to a limited liability company and the other members are the duty of loyalty and the duty of care set forth in divisions (B) and (C) of this section." OHIO REV. CODE ANN. § 1705.281 (West 2017). The absence of similar exclusivity language in the Wisconsin LLC statute arguably

suggests that common law fiduciary duties do apply to LLC managers and members.

Nonetheless, Morris urges us to adopt Justice Roggensack's position that WIS. STAT. ch. 183 has supplanted the duties LLC members would otherwise owe each other under the common law. On that basis, he argues ch. 183 preempts Marx and Murray's common law claims. He contends public policy favors this outcome because parties should not be permitted to "sidestep" express provisions of ch. 183 by asserting common law claims. He further asserts that permitting Marx and Murray's common law claims to proceed would render ch. 183 "advisory," which was "certainly not the intention of the Legislature when enacting such a comprehensive statute."

Justice Roggensack's ***Gottsacker*** concurrence is not binding authority. Nevertheless, it does raise a significant question as to whether LLC members do, in fact, owe each other common law duties. The recent WISCONSIN LAWYER article that we cited above highlights the uncertainty that currently exists on this point in the business law community. The article's authors note that the law is in a state of flux as to "whether WIS. STAT. section 183.0402 is the ceiling or the floor when it comes to member duties." Boucher and Kramer, *supra*, at 33. They urge attorneys involved in entity formation and business litigation to "take note of the existing ambiguity in [WIS. STAT. ch. 183] regarding fiduciary duties" when advising their clients. ***Id.***

The issue of LLC members' fiduciary duties recently came before the Wisconsin Supreme Court in ***Smith v. Kleynerman***, 2017 WI 22, 374 Wis. 2d 1, 892 N.W.2d 734. In that case, the plaintiff urged the supreme court to definitively hold that common law fiduciary duties apply between members of

Wisconsin LLCs. *See* Brief of Plaintiff-Respondent-Cross-Appellant at 20-23, ***Smith v. Kleynerman***, 2017 WI 22, 374 Wis. 2d 1, 892 N.W.2d 734 (No. 2015AP207). The defendant, in contrast, argued the court should conclude, consistent with Justice Roggensack's ***Gottsacker*** concurrence, that LLC members do not have common law fiduciary duties to one another. *See* Brief of Defendant-Appellant-Cross-Respondent-Petitioner at 32-41, ***Smith v. Kleynerman***, 2017 WI 22, 374 Wis. 2d 1, 892 N.W.2d 734 (No. 2015AP207). An equally divided supreme court led to an affirmance of the court of appeals' decision, which had resolved the case on other grounds without addressing whether LLC members owe each other common law fiduciary duties.[5] *See* ***Smith***, 374 Wis. 2d 1, ¶1; ***Smith v. Kleynerman***, No. 2015AP207, unpublished slip op. ¶¶24-26 (WI App June 16, 2016). That question, which is of substantial importance to the Wisconsin business community, therefore remains unresolved.

CONCLUSION

The LLC enjoys "widespread popularity … as a business entity" in Wisconsin. Boucher and Kramer, *supra*, at 33. However, as the foregoing discussion demonstrates, the law regarding important issues related to LLCs is currently unsettled. There is no binding authority clearly addressing whether an LLC member has standing to assert claims for an injury primarily suffered by the LLC against another member based on the second member's alleged self-dealing, nor is there binding precedent addressing whether WIS. STAT. ch. 183 preempts common law claims between LLC members. These questions of law are highly

[5] Justice Daniel Kelly did not participate in the supreme court's decision. *See* ***Smith v. Kleynerman***, 2017 WI 22, ¶2, 374 Wis. 2d 1, 892 N.W.2d 734.

likely to recur, given the popularity of LLCs in this state. *See* WIS. STAT. RULE 809.62(1r)(c)3. Moreover, Morris's arguments, if adopted, would result in new legal doctrines being applied to LLCs; this is not a case in which we are simply being called upon to apply well-settled legal principles to the factual situation at hand. *See* RULE 809.62(1r)(c)1.

The Wisconsin Supreme Court "has been designated by the constitution and the legislature as a law-declaring court." ***State v. Grawien***, 123 Wis. 2d 428, 432, 367 N.W.2d 816 (Ct. App. 1985). "While the court of appeals also serves a law-declaring function, such pronouncements should not occur in cases of great moment." ***Id.*** Given the importance of the issues raised in this appeal, the unsettled state of the law, and the high likelihood that these issues will recur in future cases, we believe this is a case in which it would be appropriate for the supreme court, rather than the court of appeals, to render a decision. A decision by the supreme court "will help develop, clarify or harmonize the law," WIS. STAT. RULE 809.62(1r)(c), thereby providing much needed guidance to Wisconsin businesses, the business law community, and lower courts. We therefore respectfully certify this appeal to the supreme court.[6]

[6] This appeal two raises additional issues, beyond those discussed in this certification. Specifically, Morris argues: (1) Marx and Murray waived or released their claims against Morris; and (2) Morris, in his capacity as an attorney for North Star, did not owe any fiduciary duties to Marx and Murray individually. We do not believe that these issues, in and of themselves, are worthy of certification, and we therefore do not address them further. However, if the supreme court were to accept this certification, it would acquire jurisdiction over the entire appeal, including all issues raised before this court. *See* ***State v. Denk***, 2008 WI 130, ¶29, 315 Wis. 2d 5, 758 N.W.2d 775.