Business Law Developments

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Walmart: Divert Money. Owe Taxes.

In Walmart Stores East, Inc. v. Hinton, No. COA08-450, 2009 Wake 1373113 (N.C. Ct. App. May 19, 2009), the North Carolina Court of Appeals considered the N.C. Department of Revenue's authority to require related companies to file a consolidated state tax return.

In 1996, Walmart transferred all of its North Carolina stores to a subsidiary Delaware real estate investment trust. The REIT then leased the stores to another Walmart subsidiary that operated the stores. On its North Carolina income tax returns, the operating subsidiary deducted rent payments made to the REIT, thereby reducing the operating subsidiary's North Carolina taxable income. The REIT, meanwhile, reported almost no taxable income to North Carolina because of a deduction it took for dividends paid to its parent entity, a third Walmart subsidiary. That parent entity paid no taxes in North Carolina. The Department of Revenue claimed that Walmart's tax strategy resulted in its operating subsidiary underpaying its North Carolina taxes by approximately $30 million from 1998 to 2002.

The Department of Revenue contended that the state's corporate tax statutes authorized it to force the operating company, the REIT, and the REIT's parent corporation to combine their incomes for state tax reporting purposes. Such a combination would eliminate the benefit of the deduction taken by the operating company for rent paid to the REIT and thereby increase the companies' aggregate North Carolina taxable income.

In January 2008, the Wake County Superior Court held that the Department of Revenue acted properly in requiring the Walmart subsidiaries to file a consolidated return because the payments between the Walmart subsidiaries lacked economic substance. In particular, the court stated that, while state tax law might support Walmart's treatment of each discrete step of the transaction between the related Walmart entities, "the Secretary [of Revenue] was authorized to examine the transaction as a whole and to consider the net effect of the entire transaction to determine whether there was any real economic substance" to the payments between the related companies. Looking at Walmart's transaction as a whole, the Superior Court found that there was no evidence "of any economic impact (apart from obvious state tax savings) of the transaction."

The Court of Appeals upheld the Superior Court's ruling against Walmart. Rather than focusing on the issue of economic substance, however, the Court of Appeals examined the extent of the Department of Revenue's authority to force consolidation under North Carolina law. The relevant statute, N.C. Gen. Stat. § 105-130.6, states in part:

If the Secretary finds as a fact that a report by a corporation does not disclose the true earnings of the corporation on its business carried on in this State, the Secretary may require the corporation to file a consolidated return of the entire operations of the parent corporation and of its subsidiaries and affiliates, including its own operations and income. (emphasis added)

Walmart argued that a corporation's "true earnings" consist of "what [its] income would be if it had no affiliates and dealt with all parties on an arm's length basis." In other words, Walmart asserted that the court should interpret the statute as authorizing the Secretary to force consolidation only when he finds that there are payments between related companies in excess of fair value. Walmart contended that, because the payments between the operating company and the REIT were made at fair value, the Secretary had no authority to require consolidation of the companies' incomes.

The Court of Appeals disagreed with Walmart's definition of "true earnings." Instead, the court held that "if the entire enterprise is a unitary business, true earnings in the State may be calculated by apportioning the earnings of the entire enterprise on the basis of sales and other indicia of activity in the State." The court further stated that "functional integration is the key; whether the earnings are derived as divisional profits from a legally integrated enterprise or as dividends from a legally separate entity is of no consequence in determining if a business is unitary for the purposes of computing true earnings." Because the operating company and the REIT formed a unitary business, the court concluded, "the Secretary was properly allowed to combine the returns of those businesses if [he] found that the operating company's return did not disclose its true earnings on its North Carolina business activity."

The Court's interpretation of N.C. Gen. Stat. § 105-130.6 offers the Secretary of Revenue sweeping authority to require related companies to consolidate their returns and leaves taxpayers with little guidance as to when the Secretary may do so. Given the State's current economic difficulties, corporate taxpayers might well expect the Department of Revenue to wield this newfound authority aggressively.

I'm O.K., You're O.K., but We Don't Owe Any Duties to Each Other

In Kaplan v. O.K. Technologies, L.L.C., __ N.C. App. __, 675 S.E.2d 133 (2009), the Court of Appeals affirmed the judgment of the Wake County Civil District Court that the LLC had no duties to the members of the LLC. Kaplan and three other individuals were the members of O.K. Technologies, L.L.C., a North Carolina LLC that held intellectual property relating to aquarium components. The LLC's operating agreement provided that all of the members also were managers. Kaplan owned a 41.5% membership interest and was the company's sole source of funding. Under the company's operating agreement, Kaplan was to make loans to the company totaling $500,000. Without seeking approval from the other members, however, he loaned the company $1,864,749 between 2004 and 2006. Even though the other members had not approved the additional loans, the company and the members accepted the loans and used them to discharge the company's liabilities.

In June 2006, Kaplan demanded repayment of his loans. Following his request, in July 2006, all of the members voted to dissolve O.K. Technologies. Shortly thereafter Kaplan sued the LLC and the other members, seeking a declaratory judgment that the company failed to repay his loans. The other members of the company counterclaimed, alleging that Kaplan had breached his fiduciary obligations to them. The North Carolina Business Court granted summary judgment to Kaplan on the other members' claim for breach of fiduciary duty. The Court of Appeals affirmed the Business Court's ruling.

In its opinion, the Court of Appeals noted that a breach of fiduciary duty claim cannot stand without a fiduciary relationship. The North Carolina Supreme Court has defined a fiduciary relationship as one in which "there is confidence reposed on one side, and resulting domination and influence on the other."
The Court of Appeals stated that the North Carolina Limited Liability Act does not recognize fiduciary duties among members of an LLC. Members “are like shareholders in a corporation in that members do not owe a fiduciary duty to each other or to the company.” The court added, however, that a fiduciary relationship might exist if a member controls an LLC. Nevertheless, because Kaplan owned only a 41.5% membership interest, the Court found that he lacked control of the company and therefore owed no fiduciary duty based on his membership interest in the LLC.

The court then examined whether Kaplan owed a duty to the other members in his role as the company’s sole investor. The other members contended that Kaplan made himself the sole source of funding for O.K., which resulted in the level of domination contemplated by our Courts in defining a fiduciary relationship.” Again, the court disagreed. It found that the operating agreement, to which all of the company’s members consented, contemplated that Kaplan would be the sole source of funding for the company. Based on this fact and Kaplan’s lack of actual domination over the company’s operation, the court concluded that “without more, we cannot find that Kaplan’s status as O.K.’s sole investor creates a fiduciary relationship.”

Finally, the court considered the other members’ claim that the relationship between members of a closely-held LLC is like the fiduciary relationship between partners in a partnership. The court rejected this argument because, as permitted by statute, the company's operating agreement eliminated the personal liability of all managers (including Kaplan) except in certain instances. The court stated that even if an exception applied, Kaplan’s fiduciary duty as a manager was to the LLC, not to the other members. O.K. Technologies was not an appellant in the case; therefore, the court refused to address Kaplan’s potential liability to the company.

Kaplan underscores once again that the fiduciary duties of a member/creditor of an LLC mirror those of a shareholder/creditor of a corporation.

**Without an Operating Agreement, Breaking Up Can Be Hard to Do**

A North Carolina limited liability company primarily is a creature of contract, offering parties flexibility in structuring their business arrangements. The LLC Act recognizes, however, that parties may not address by contract all matters related to operation of an LLC and attempts to fill significant gaps parties may leave open. In Mitchell, Brewer, Richardson, Adams, Burge & Boughman, PLLC v. Brewer, 2009 NCBC 10 (March 31, 2009), the North Carolina Business Court discovered that the LLC Act leaves a bit of a hole when it comes to voluntary withdrawal of a member from an LLC.

The individual plaintiffs and the defendants in the case were members of Mitchell, Brewer, Richardson, Adams, Burge & Boughman, PLLC (the “firm”), a law firm organized as a North Carolina professional limited liability company, which just like any other North Carolina LLC is formed under and subject to the LLC Act. Some of the individual plaintiffs’ claims were derivative; therefore, the firm itself was also a plaintiff.

In June 2005, the individual plaintiffs, under less than amicable circumstances, stopped practicing law with the firm and began practicing law through a new professional limited liability company that they formed. At that time, the firm had a number of unresolved contingent-fee engagements. Some of the engagements remained with the firm after the individual plaintiffs departed; others transferred to the individual plaintiffs’ new firm. The lawsuit before the Business Court arose because the parties disagreed on whether legal fees with respect to the contingent-fee engagements remained with the firm should be shared. The extent to which such fees would be shared depended on the effect of the individual plaintiffs’ ceasing to practice with the firm.

The firm never had a formal written operating agreement. As a result, the parties and the Business Court turned to the LLC Act to try to determine the effect of the individual plaintiffs’ departure from the firm. Unfortunately, the LLC Act does not address the circumstances presented in the case, and the Business Court was forced to rely on equity to reach a decision.

The individual plaintiffs claimed that, as a result of their ceasing practice with the firm, the firm should be treated as having dissolved. If the firm were dissolved, the individual plaintiffs contended, they would share in distributions related to the contingent-fee cases retained by the firm through the winding up process.

The defendants asserted, on the other hand, that when the individual plaintiffs stopped practicing with the firm, they voluntarily withdrew from the LLC and therefore were entitled under N.C. Gen. Stat. § 57C-5-07 to receive the fair value of their interests in the firm as of the date of the withdrawal. The defendants further claimed that the fair value of those interests did not include in any value related to the contingent-fee cases the firm retained because the outcomes of those cases were so uncertain that their value was impossible to quantify.

After considering the parties’ arguments, the Business Court decided that neither “the spirit nor letter of the [LLC Act]” addressed the facts in the case. Its opinion, however, described only its rationale for why a withdrawal under the LLC Act was not supported by the facts; it did not discuss in any detail the question of dissolution.

N.C. Gen. Stat. § 57C-5-06 provides for voluntary withdrawal “only at the time or upon the happening of the events specified in the articles of organization or written operating agreement,” and the court concluded that N.C. Gen. Stat. § 57C-5-06 is the exclusive means for allowing voluntary withdrawal from an LLC. Therefore, because the firm’s articles of organization did not provide for voluntary withdrawal, voluntary withdrawal was possible only if the firm had a written operating agreement that provided for it. The defendants urged that a combination of conduct, writings, and e-mails relating to the individual defendants’ departure from the firm constituted a binding written operating agreement that addressed voluntary withdrawal and that under the terms of that operating agreement the individual defendants had withdrawn. While acknowledging that a collection of documents might be a considered a written operating agreement under certain circumstances, the court determined that this case did not present those circumstances.

Having determined that it could not use the LLC Act to resolve the case, the Business Court turned to equity and the law of estoppel. Applying the law of estoppel, the court ultimately determined that, because of numerous statements they had made indicating that they were withdrawing and because the parties acted as though the individual plaintiffs had withdrawn, the individual plaintiffs were estopped from denying that they had withdrawn.

Based on the facts in the case, the Business Court appears to have reached the correct result in Mitchell, Brewer by resorting to equity. The North Carolina General Assembly should amend the LLC Act, however, to address the issue presented by the case so that future courts need not look to equity when faced with similar circumstances. Absent an amendment, it is critical that parties address voluntary member withdrawal in an LLC’s articles of organization or written operating agreement, and even if the LLC Act is amended, it still will be a good idea for parties to do so.

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