The Complexity Dilemma: A Reflection on Teaching a Simulation Course in Business Planning

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THE COMPLEXITY DILEMMA:
A REFLECTION ON TEACHING A SIMULATION COURSE IN BUSINESS PLANNING

FRANKLIN A. GEVURTZ*

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In this essay, I wish to share a dilemma with which I have struggled during almost four decades of teaching a course in business planning. This dilemma stems from the need to sensitize students to spotting and addressing the complexity potentially hidden in what might at first glance appear to be basic tasks facing the business lawyer. At the same time, one strives to leave the students feeling confident that they can undertake such tasks, and also to present material only at a level of detail and in such a manner as to maximize the students’

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understanding of the legal and business issues such tasks entail. The dilemma is that the best means to achieve the former goal might not be most conducive to the latter concerns. The nature of the business planning course makes this dilemma particularly acute in teaching this class.

This essay proceeds in four parts. The first part provides a basic overview of the complexity dilemma. The second part explains why this dilemma is particularly acute in the business planning course. The third part provides a specific example of this dilemma in operation by looking at a problem and assignment from the business planning course which calls upon students to draft a limited liability company (LLC) agreement for a new business venture. The final part discusses some not totally satisfactory approaches to deal with the dilemma.

I. THE COMPLEXITY DILEMMA IN TRANSACTION COURSES

A couple decades ago, I attended a conference on “Teaching Corporate Law” at the University of Georgia. One panel at the conference addressed the use of problems and one panelist discussed the use of problems in a basic business associations course. The panelist described two problems she used in the course. The first turned out to be the business formation problem found in the appendix to my Business Planning casebook published by Foundation Press.1 Her second problem, which involved a corporate scandal, came from a situation she had encountered while working at a law firm before entering teaching. What is important for present purposes is how she characterized the two problems. She characterized the business formation problem from my book as overly simple, but okay for a basic business associations course. She characterized the corporate scandal problem as much more complex, thereby allowing students to address a more complicated problem as they advanced through the course.

Unfortunately, she had it upside-down. The scandal problem was simpler. The events had occurred. Application of the law (which had some, but not overwhelming, complexities) to the existing facts was

1. See Franklin A. Gevurtz, Business Planning 1069–1072 (5th ed. 2015). For those curious about such matters, I was sitting in the audience shortly before the panel began when this professor came up and introduced herself to me. She explained that she was using this problem in her course and a couple of people had told her she should ask permission. I told her that while I was fine with her using the problem, I did not hold the copyright and she should contact the good folks at Foundation Press.
the sort of exercise students had done from the beginning of their law school career. Public relations, as well as gathering information within an organization, presented added wrinkles, but not mind-blowing ones. By contrast, the business formation problem from my book is far more challenging. Indeed, as this paper will discuss later, the Rubik’s Cube of business organization and tax complexities buried in this problem (which, candidly, I have never fully resolved) make it extremely difficult even for an advanced elective.

My goal is not to play gotcha or criticize this professor. Rather, it is to illustrate a challenge we face in educating students for transactional business practice. The reason this professor got it upside-down is because she did not spot the complexities in the business formation problem. Yet, she is extremely intelligent, graduated with honors from an elite law school, worked on matters for major corporate clients at a prestigious law firm, and was teaching business associations at a top-tier law school. If she does not spot the complexities in a business formation problem, then how many of our graduates do?

This experience reinforced a view that I already long held. One of our primary objectives (or learning outcomes in the modern lexicon) when educating students for transactional business practice is to develop the skill of spotting, understanding and addressing the potentially extreme complexities hidden in the transactions they will confront. The dilemma involves how to achieve this objective.

This brings us to the cliche about giving a person a fish versus teaching a person how to fish. We can walk through with our students a transaction on which they might be asked to perform legal work, such as drafting a specific type of agreement, point out to them the various issues are that are likely to arise with this particular transaction, and carefully explain to them the legal and business aspects of these issues and how their clients might address these legal and business concerns. This is giving a fish. Alternately, we could seek to develop in our students the ability to spot on their own the complex issues hidden in a specific business transaction, to read and comprehend the relevant legal and other materials necessary to understand these issues, and to formulate means to address them. This is teaching how to fish.

Attempting the latter would appear to call for having the students undertake assignments in which it is up to them to spot, understand and address the complexities buried in the situation. The dilemma arises from the fact that this is an extremely difficult assignment, which is frustrating to the students. Indeed, the more complexity exists in the problem, the more difficult and frustrating the assignment. This, in
turn, can undermine the goal of building the students' confidence. It also goes contrary to pedagogical theories calling for the staged development of skills and understanding by creating a scaffolding through the introduction of the relevant skills and concepts in bite-sized bits. Yet, the more one seeks to reduce the complexity of the issues presented to the students in a business transaction problem, to break up the overall task into manageable bits with the issues flagged, and to thereby build the students' confidence, the less the students develop the skill of spotting and dealing with complexity on their own. Worse, instead of frustration, we instill overconfidence in which our graduates, much like the panelist using my problem, do not even realize how complex the task is.

One might object that my characterization of the dilemma results from viewing courses and assignments in isolation. If assignments in which the students, on their own, must identify, understand and resolve complex issues in a transaction occur as a capstone to other courses and assignments in which students are presented with material in a more digestible manner, then the dilemma is solved. Sounds reasonable. Unfortunately, we commonly teach at institutions in which electives are presented to students as a “Whitman’s Sampler” from which they pick in random order. Moreover, the units allocated to a single elective limit the ability to undertake this sort of development within the individual course.

II. THE BUSINESS PLANNING COURSE

A. The Three Layers of Complexity in Business Planning

The complexity dilemma is particularly acute in the business planning course. To understand why, it is useful to explain a bit about the history and vision behind the course. The course originated at Harvard Law School in the early 1960s. The course represented a combination of three seemingly innovative (at the time) ideas.

The first is to structure the course around a set of factually rich problems. This represented a deliberate push-back against the then (and


still) dominant case method of legal education centered on the Socratic dissection of appellate court opinions.4 These problems involve fact patterns that run for pages and present numerous issues, in contrast to the short hypotheticals presenting a single issue found in the note material of traditional casebooks. The second key idea is that these problems are transactional, rather than litigation, oriented. This also represented a departure from the then (and still) dominant litigation orientation of legal education, not only in the presentation of materials (appellate court opinions) but in its view of the lawyer’s role. Finally, but critically, the course sought to escape from the traditional legal subject matter silos in which students learn and apply the law. Specifically, instead of corporate law issues being addressed in corporation classes and tax issues being addressed in tax classes, the casebook problems raise both tax and corporate law issues and the casebook contains cases and materials covering both tax and corporate law.

Each of these three key aspects of the business planning course significantly increases its complexity and difficulty. Structuring the course around problems can be more demanding upon students than the case method. The case method is a ground-up approach in which students start by reading court opinions, which identify for the students the issue(s) created by a set of facts, and then present the relevant law, the arguments of the opposing parties, the court’s analysis and conclusion. Thereafter, students presumably move to the higher-order exercise of applying the rules and analysis they (hopefully) mastered through the study of the cases to address different factual situations in which the students must identify the issues, select the appropriate rule and undertake the analysis of how the rule applies to this new set of facts. By contrast, presenting the students at the outset with an elaborate fact pattern from which they are to produce some sort of legal work product (albeit this can be as simple as providing a legal analysis) requires the students to identify for themselves the relevant issues, law and analysis (assuming the fact pattern does not include this) prior to classroom discussion of the law and its application generally or with respect to the problem.

4. There is a certain irony in this terminology. Business schools refer to structuring a course around fact rich problems as the “case method”; albeit the business schools originally borrowed this term from law schools because of the popularity at the time of the law school appellate case method.
Transactional, rather than litigation, problems ratchet up the difficulty by an additional order of magnitude. This is because, unlike a litigation problem in which the students know what the dispute is, a transactional assignment calls for students to anticipate and address a potentially large number of possible disputes that have a reasonable chance of arising in the future. The difference is between reacting to a single history that is written versus conjuring up the innumerable alternate realities of the multiverse.

Transactions in the business associations field can ratchet up the complexity yet another order of magnitude. This is because these often involve long-term relational contracts. The attorney, and hence the student, must consider not only the immediate implementation of the contract (as in a sale of widgets to be delivered in a week and paid for in a month), but must consider events that might occur many years later after the parties’ relationship, the business, the parties themselves, and even the law, have all evolved.5

Finally, crossing traditional legal subject matter boundaries further and dramatically increases complexity. There are two ways in which this aspect of business planning elevates complexity. The obvious is that it broadens the legal fields the student is required to understand and apply at once. Reflecting a somewhat hypocritical recognition of the challenge this creates, some schools have a corporate law professor and a tax professor team teach the business planning course.6

Moreover, the legal subjects addressed in business planning (especially tax) are highly complex in themselves. In fact, I recall some years ago reading an article discussing transactional courses, in which the author characterized business planning as having a highly regulatory focus—which, I assume, was referring to applying highly complex fields of law like tax.

5. This suggests that the common perception as to whether the formation or the sale of a business entails inherently greater complexity for the transactional attorney might be wrong. Traditionally, we assume that the formation is the simpler problem, while the sale is the more complex. Indeed, sale documents are often longer with more lawyers engaged. This, however, might reflect more the economic stakes in the transaction than it does the inherent complexity of the situation. Because it entails establishing a long-term relational contract, the formation problem may implicate greater inherent complexity and difficulty.

6. My understanding was that the original plan when the course was introduced at Harvard, but the tax professor was appointed to a post in the Kennedy administration and so the corporate law professor, David Herwitz, ended up teaching the course on his own.
B. Is this Trip Really Necessary?

Perhaps much of this complexity in business planning is unnecessary. Obviously, the greater complexity of transactional, rather than litigation-oriented, courses is something we cannot avoid if we are to teach transactional lawyering. Nevertheless, the other two aspects of the course could be changed.

1. Simplifying the Problem Method

One can ease up the difficulty of the problem method considerably. In fact, the original blueprint for the business planning course reduced much of the challenge created by the problem method. The problems in Professor Herwitz’ Business Planning casebook included extensive topic outlines that presented to the students the issues raised by the fact pattern and cross-referenced specific reading assignments in the casebook addressing each issue.\(^7\) It is unclear what Professor Herwitz had the students do with the problems.\(^8\)

The first time I taught business planning, I used Professor Herwitz’ casebook and problems. I tried to question the students as to how they would address the issues in the problems but found the result entirely unsatisfactory. Even the most diligent students in the class, who appear to have carefully read the assigned material, had given only cursory thought to the problems and the issues they presented. As a result, my attempt at prodding the students to discuss the areas of concern, and how they could be resolved, collapsed, leaving me to simply lecture. In mulling over what happened, I realized that I should not have been surprised. In fact, I acted the same as a student.

Still, what is wrong if the professor just ends up using problems as a structure around which to organize a lecture? This question returns to the learning outcomes we seek. If the only objective is to communicate how to approach a transaction which is essentially the same as that involved in the problem, perhaps there is nothing wrong with this. Of course, this ignores the considerable research on the effectiveness of active versus passive learning on understanding and

\(^7\) DAVID R. HERWITZ, BUSINESS PLANNING: MATERIAL ON THE PLANNING OF CORPORATE TRANSACTIONS A6–A9 (Temp. 2d ed. 1984). My book separated this sort of outline from the problems, putting the problems into an appendix of the book and placing the outlines in the teachers’ manual so that instructors have the option of whether to follow Herwitz’ approach. See FRANKLIN A. GEVURTZ, BUSINESS PLANNING 1069–1072 (5th ed. 2015).

\(^8\) I was told by a former, senior colleague who had attended Herwitz’ class that Herwitz simply lectured following the outline of topics.
retention of the information the instructor seeks to convey. More fundamentally, however, we are back to simply giving students a fish. How do we expect students to go from understanding what the issues are and how to resolve them in this one transaction to spotting the issues and knowing how to resolve them in a different transaction? Essentially, the model created by lecturing about a transaction is that a lawyer learns how to address a transaction by having someone else explain to the lawyer what the issues are and how to address them. Maybe this is the way transactional lawyers operate. If so, transactional law school courses might be largely a waste of time and we should get into the business of selling continuing legal education classes.

I concluded that the effective use of problems requires assigning students to do something with the problem. Generally speaking, this means producing some sort of written work product. Moreover, to have the students take it seriously, this work product should be graded. This immediately creates a stress point in the course: Students must produce a graded work product addressing a problem before the classroom discussion of the problem. Some students will object that they are not graded on what they learned in the class (or, more accurately, in the classroom component of the course). This complaint, in turn, overlaps with the question of appropriate prerequisites for the course. This is because grading on work done before classroom discussion potentially increases the advantage possessed by students who have taken partnership and corporate tax and securities law over students who have not. Still, one could address this grading concern by giving a final examination or having students do additional assignments primarily designed to see what they picked up from the class discussion of the problems in which they were initially on their own. This, however, increases the students' workload for the course (which is already higher than most) in order to perform tasks whose utility is primarily for grading, rather than learning.


10. An alternative for some transactions, such as the sale of a business, might involve assigning the students to prepare for and undertake an in-class negotiation. Also, assigning individual students to prepare for and present an analysis of the problem for the class might work in some instances.

11. In an upper-level elective like business planning, in contrast to required bar courses, the primary purpose of summative assessment is to incentivize work rather than to evaluate the student. Grading the projects already incentivizes the students to work hard on the projects.
Even if the professor assigns the students to do something with the problems, the assignments could be narrow and structured to remove much of the complexity—for example, the production of a series of short office memoranda responding to specific inquiries about issues raised in the problem. The problem with this approach is that it forfeits what is perhaps the primary payoff available by following the problem approach (pun intended). Specifically, at some point, a transactions attorney must be able to view as a transaction as a whole, identify the issues present, and structure the overall work product to get the transaction done. The more the professor breaks up the problem into short assignments and flags the issues for the students, the less the students develop this overarching skill. Indeed, responding to a specific inquiry about a narrow legal issue might develop the students’ skills little beyond the research memorandum assignments of the basic legal research and writing course.

2. Narrowing the Legal Fields

The second means to decrease the complexity of the business planning course is to narrow the legal fields involved in the problems. Especially, one could drop out considerations of tax—as indeed done by a leading competing casebook to mine. From a personal teaching standpoint, I would be in favor of this. Indeed, when I first started teaching, I told the associate dean that the only courses I would prefer not to teach were tax courses. The merits of this from the standpoint of learning objectives, however, raises a couple concerns.

The first involves the degree of specialization by business attorneys. The common argument for dropping tax issues is that these are matters for a tax attorney, not the business attorney. This argument assumes that business attorneys typically will be working in teams with tax attorneys on any transaction, such as the formation of a new business, likely to involve significant tax issues. The degree to which the practice of law has reached this stage could use more empirical research and less assumptions.

A story relayed to me by a former colleague, who taught partnership tax, provides a note of caution in this regard. He gave a continuing legal education course on partnership tax, after which one

Having invested time into doing the projects, curiosity is normally sufficient for students to participate in and pay attention to class discussion of the problems and projects.

of the lawyers in attendance came up to him to say how useful the lawyer found the course. The punchline of the story, which my former colleague thought I would appreciate, was what the lawyer then said. The lawyer explained that he had been including various provisions, which stemmed from partnership tax concerns, in the agreements he had drafted to form businesses without a clue as to what those provisions meant or why they were there except they were in the forms he used. Moreover, he evidently was not having a tax expert review his agreements. Oh dear.\(^{13}\)

Even if we assume, however, that business lawyers will practice in teams with tax attorneys, there is still the question of whether the failure of the business lawyers to understand at least generally the tax issues, and the tax attorneys to appreciate the business issues, is all that healthy. Specifically, transactions and agreements must work as a whole. This means there either must a be a quarterback for the project who understands how the various specialized pieces (business organizations, tax, etc.) fit together or the specialist attorneys need to be able to understand enough about the other attorneys’ topics to communicate and thereby weigh tradeoffs and come up with solutions to potential problems raised in their areas of specialty.

The drafting of an LLC agreement provides a good illustration of these interrelationships between tax and other issues. For this reason,

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13. A personal experience a few years back further illustrates the importance of corporate law experts appreciating the tax aspects of transactions. I was retained as an expert witness in a trial involving a large foreign motor vehicle maker’s purchase of a major U.S. truck manufacturing company in the early 1980s. Decades later, the successor to the truck manufacturing company faced huge liabilities under CERCLA and its insurer was trying to shift part of those costs to other insurance companies who had insured the purchased company prior to its sale. The transaction was structured as the purchase of all of the stock in the truck manufacturer by a newly created subsidiary of the foreign motor vehicle maker, followed by the liquidation of the purchased company into the subsidiary. The issue was whether the new subsidiary assumed contingent liabilities of the purchased company; a matter upon which the documents were ambiguous. The defendant insurance companies retained one of the leading corporate law scholars in the United States, who has written extensively on mergers and acquisitions, as their expert. He opined that the liquidation was structured to shed the contingent liabilities. The plaintiff retained me also as a corporate law, not a tax, expert. Because of my background covering tax issues in business planning, however, I became suspicious that the treatment of the contingent liabilities in the liquidation was based upon tax considerations. Specifically, this turned out to be an attempt to achieve a tax advantage—based upon who would pay claims arising during the three-year liquidation period—rather than an attempt to shed the contingent liabilities that became known thereafter. This explained the totality of the liquidation documents and why the successor went ahead and paid such liabilities after the liquidation. The failure of the defendants’ expert to be aware of the tax concerns blinded him to what the deal documents were trying to do. But for the happenstance of teaching business planning, I would have made the same assumption he did.
among others, drafting an LLC agreement serves as this essay's illustration of the complexity dilemma in operation.

III. THE COMPLEXITY DILEMMA IN A “SIMPLE” PROBLEM

A. The LLC Formation Problem

In order to fully appreciate the complexity dilemma, it helps to see it in the context of a specific example. As just stated, we can use the formation of a new business as an LLC. The business formation problem, either in casebooks or in real life, often follows a typical pattern: This involves some variation of marrying an entrepreneur, who has an idea for a new venture, to a financial backer, who wants a share in the income and perhaps some role in management.

In the Herwitz book, the formation problem involved a sole proprietor, who for some years has been producing women’s belts and who wants to expand production with money supplied by an investor and the services of a worker. Reflecting a time in which the entity of choice for almost everyone but the unsophisticated or professional firms was a corporation, Herwitz’ problem entailed forming a corporation.

The business formation problem in my book, reflecting its later vintage, involves a technology venture—specifically, the development of a food preservative from an enzyme modified through a process created by the scientist in the problem. The financial backing for the initial phase of this development will come from the other party in the problem, who has a business background. The basic terms of the deal are to split profits equally between the scientist and the investor, but the investor wants his money back before any distribution of profits. The parties plan to divide responsibilities to match their areas of expertise—the scientist to handle development of the preservative and the investor (given his business background) taking the lead on the business aspects of the venture. Reflecting changes in tax and business entity law since Herwitz’ day, the situation calls for the use of an LLC.


B. Some Rubik’s Cube Aspects of the Problem

1. Generally

In law, business, and perhaps daily life, there seems to be a trend toward ever-increasing complexity. Even without getting into the specific complexities of the business formation problem in my book, it is useful to note how the contemporary nature of the problem makes it inherently more complex than the older Herwitz problem (which students had found difficult as it was).

Part of this stems from dealing with a technology-development venture instead of a very simple manufacturing business. At the very least, this introduces greater intellectual property concerns. Still, many of my students over the years have been involved in technology-development businesses and a technology-development venture captures the interest of the other students as well. Given broader trends, it is difficult to say that forming a technology-development business is not something to which students should be exposed.

In addition, the use of the LLC produces more hidden complexity than the corporation. The LLC normally elects to follow partnership tax rules. Indeed, this was the original purpose for importing this form of business into the United States.15 This makes it more difficult to cabin the tax considerations away from the rest of the agreement. To some extent, this is because the very decision to select an LLC based upon tax concerns makes it a bit strange to shove those concerns off to one side when drafting the agreement. More fundamentally, the partnership tax aspects inexorably intertwine with the key financial terms of an LLC. By contrast, the corporate tax concerns involved in Herwitz’ formation problem were mostly peripheral and, with a couple of easily understood and implemented exceptions,16 did not impact what the parties agree to do.

In any event, the combination of the technology development aspects of the problem with the use of an LLC ultimately creates a Rubik’s Cube puzzle that defies solution.

15. E.g., FRANKLIN A. GEVURTZ, CORPORATION LAW § 1.1.1.e (2d ed. 2010).
16. These exceptions involved the use of shareholder loans and not issuing stock in exchange for services.
2. Management and Exit Issues

Turning to specifics of the LLC agreement, the management and exit issues involved in the two-person technology-development venture can be complex, albeit no more so than in Herwitz' corporate formation problem. The management problem in a two-person business is pretty obvious. The difficulty lies in coming up with a suitable solution.

The interactions of the management provisions with both the financial terms of the deal and the exit rules are subtler and thus provide students with examples of hidden complexities. The interactions between management and financial terms occurs if the LLC agreement ties voting power to "membership interests," which are the parties' economic interests. These economic interests, however, can change depending upon future contributions, as well as expected flip-flops in profit allocations discussed below. This can unexpectedly upset an intended equal division of voting power. The result is a teachable moment on the need to review agreements for potential unintended consequences resulting from the interrelationships between various provisions and to minimize such surprises by avoiding unnecessary linkages.

With respect to the relationship between management and exit rules, it is surprising how often students fail to recognize the possibility that dissension between the two parties in managing the venture will turn into consideration of exit—either as one party wants out, or one party or both parties want the other out. Again, the result can be a very useful teachable moment: in this instance on the need for attorneys to identify future contingencies the agreement should address and to map through the different ways in which those contingencies might play out (much like planners at the Pentagon game out potential international crises). Exploring the ability of a party to use contractual provisions drafted in anticipation of other circumstances triggering exit, or statutory provisions providing for mergers or involuntary dissolution, to either exit or force the other party to exit, provides further lessons along this line.17

While these examples of teachable moments show the power of learning through making mistakes, they also illustrate the dilemma this creates. In the immediate term, there is the grading concern. (Sorry for the rhyming.) Obviously, if the goal is to get students to learn by giving

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them the opportunity to make mistakes, then the instructor should not grade the students down for making the mistake. Instead, since the purpose of grading projects before class discussion is to incentivize student effort, I try to grade on effort rather than results (including the absence of mistakes). Unfortunately, I am often forced to ponder whether a student’s mistake, particularly one of omission, happened despite the student’s effort, rather than because of a lack effort.

There are, of course, projects in which students can demonstrate that they are learning from their mistakes as they go to the next stage of the project. For example, a written advocacy project in which students write a memorandum of points and authorities in support of a motion to the trial court, and later write a draft of an appellate brief, and then close by writing the final appellate brief, all on the same issue, enable students to demonstrate improvement both in substantive argumentation and in writing style based upon feedback at earlier stages. By contrast, correcting glitches and omissions in a contract after the glitch or omission has been pointed out might not demonstrate that much upon which to base a significant grade. In an ideal world, one would have students draft another LLC agreement with facts and issues sufficiently different to see how much the students learned from the first drafting exercise. The tradeoff arises from the fact that there are only so many credit hours allocated to, and therefore work one can assign in, the course. If the purpose for a follow-on assignment is essentially for grading, then, as mentioned earlier, the course time and workload might be better employed in moving on to a different sort of problem.

Beyond the grading concern is the impact of learning by making mistakes upon the student’s confidence. There is fine line between instilling in students a healthy awareness that deals involve hidden complexities and scaring students out of working as a business transactions attorney altogether.

3. Financial Aspects

The real heart of the complexity dilemma for the LLC formation problem lies in the financial aspects of the deal. At first glance, the financial aspects of the deal seem simple: Return the investor’s money and then split the profits equally.
a. Losses

An immediate gap, however, is what to do about losses. In fact, the business plan calls for spending money on R&D, rather than making any money for the time being. Suppose the whole thing ends up being a flop. The reader might recall the Kovacik decision found in many business associations casebooks. (My Business Planning book contains a case presenting a similar situation but with a contrary holding.) These cases show that the investor might sue the scientist seeking return of half the money the investor put in. The theory is that, without such reimbursement, the parties have not shared losses equally. The California Supreme Court in Kovacik rejected such claim, reasoning that, even without reimbursing the investor, the partner contributing services to the venture bore the same share of losses as the investor because the services partner put in work of the same value as the cash and had nothing to show for it.

This, however, would be the wrong answer to put in an agreement. It will saddle the services provider with immediate taxable income from having received a capital interest in the firm in exchange for services. (This illustrates why drafting LLC agreements without knowing anything about partnership tax is dangerous.) It also potentially interferes with returning the investor’s money before splitting profits equally.

An alternate approach, suggested by the essence of an LLC, is simply to provide that members will have no obligation to pay anything beyond their agreed contribution. This, however, creates the potential for a conflict between a loss sharing provision in the agreement (or statutory default rule) and the obligation disclaimer. Perhaps the solution is to forgo any provisions in the agreement directly allocating

21. This seems to be the result called for under the Uniform Partnership Act in the absence of an agreement on the issue. Whether LLC statutes change this outcome in the absence of an agreement addressing the question is unclear. See, e.g., GEVURTZ, supra note 1, at 168–170.
22. Kovacik, 315 P.2d at 170.
23. E.g., Johnston v. Comm’r, T.C. Memo 1995-140 (1995). Johnston illustrates that this might also happen by drafting agreements which give services and cash contributors equal “interests” in the LLC.
24. The reasons are analogous to the impact discussed below of placing a significant value on the contributed intellectual property.
losses, or even profits, but instead, like a corporation, have the agreement only address distribution rights. The problem is that members of an LLC electing taxation under partnership tax rules must report their share of each year’s taxable income, losses, etc. If the agreement simply addresses distribution rights, then everyone must work backwards to figure out what their share of the year’s taxable income, loss, etc., are based upon their contributions and distribution rights. The I.R.S. or, if things get to that point, the court, would then compare the participants’ claimed income, loss, etc. against the amorphous “partner’s interest in the partnership” test to see if this working backwards worked.

The answer is to allocate the losses to the investor. This not only solves the Kovacic problem, but also gives more favorable tax treatment to the investor, who, unlike the scientist, should be able to use the losses to offset other taxable income. Notice incidentally, how getting to this stage involved a bouncing back and forth between business and tax considerations.

Unfortunately, however, this solution triggers an avalanche of further complexity. To begin with, the agreement needs to adjust the profit allocation to have the investor recoup any losses prior to the agreed equal division of profits (if, for no other reason, then to meet the investor’s demand to get his money back before equal distribution of profits). Students find it difficult to come up with language to provide this in the contract. It also creates the problem mentioned earlier of accidently altering the voting power to give the investor control until the recoupment is finished if the agreement can be read to tie voting power to the parties’ interests in profits.

More head-spinning is all the partnership tax complexity this unleashes. This is because the loss and profits allocation must comply with the substantial economic effect test of Section 704(b) of the Internal Revenue Code and the regulations issued to interpret this section (or else we are back to the partners’ interest in the

25. See, e.g., Cal. Corp. Code § 17704.04(a) (making this the default rule for California LLCs).


27. E.g., GEVURTZ, supra note 1, at 191–192.

28. This is because the investor has both significant other income and will have a tax basis in his interest in the firm by virtue of his investment; neither of which is true for the scientist. Since the investor plans to actively participate in the management of the business, the limits on using passive activity losses to shelter other income do not apply.
partnership). LLC form agreements commonly contain provisions calling for member capital accounts to follow the partnership tax rules arising out of Section 704(b), which, in turn, can lead to the phenomenon described earlier in which the parties are agreeing to things potentially having both tax and financial consequences, which the business attorney, and therefore presumably the parties, do not understand.

Moreover, we only have been discussing losses funded by the investor's money. After the investor's money runs out, losses might be funded with debt—either negotiated loans or bills for various expenses incurred by the LLC. The former might involve either just the investor or both members signing a personal guarantee, while the LLC renders the latter effectively non-recourse debt. Allocation of the losses funded with such debt introduces mind-blowing complexity straddling the worlds of Section 704(b)'s substantial economic effect constraint and Section 704(d)'s rules regarding the impact of debt upon the partners' basis in their partnership interests (or LLC members' basis in their LLC interests when electing partnership tax treatment). To deal with this, more elaborate LLC agreement forms contain provisions referring to mysterious things such as "minimum gain" or "qualified income offset." Some student agreements will further complicate the question of the investor's basis in his LLC interest by having the investor loan instead of contribute money to the venture.

b. Contribution of Rights to the Process

Actually, however, we have not yet arrived at the twist in the puzzle which renders a complete solution impossible. This is because we have not addressed the contribution of the scientist's idea (intellectual property) to the venture. In terms of learning from mistakes, it is amazing how many students overlook making sure that the LLC obtains some sort of rights in the process developed by the scientist. Contributing such rights to the LLC raises a number of non-tax issues. The scientist is a professor at a university with a claim to

29. E.g., GEVURTZ, supra note 1, at 179–182.
31. For a discussion, see GEVURTZ, supra note 1, at 182–183, 196–200.
32. RIBSTEIN & KEATINGE, supra note 30.
33. It turns out not to matter under these specific facts; but it takes careful analysis, which lawyers should do rather make assumptions, to figure this out.
intellectual property developed by its faculty. Depending upon negotiations with the university, this might lead to the LLC only obtaining license rights, instead of outright ownership of the process. This obviously further complicates the picture. Another issue involves potential rights to any spin-offs from the process, which the scientist might come up with in the future.

The more intractable issue, however, is what financial rights the scientist gains in the LLC by virtue of whatever ownership or licensing rights the LLC gains in the process. If the only financial rights received by the scientist is the 50 percent share of the profits made by the LLC, then, if the LLC were to immediately sell its rights to the process, the scientist and the investor would split the proceeds of this sale equally—even though all that has happened is that the firm has sold its rights to the scientist’s idea at a value equal to what the rights had before the scientist contributed them to the firm. If the attorney explains this scenario to the scientist, the scientist might object and request that the agreement provide the scientist return of the value of the process upon its contribution before splitting profits equally. This, in turn, triggers consideration of how to determine this value. Herwitz’ problem involved transferring a small going business to the corporation; thereby allowing students to apply techniques for valuing going businesses. By contrast, the preservative process in my problem has not reached a point enabling the parties to even begin constructing earnings projections upon which to base a valuation. As the founding of Facebook shows, this is not farfetched.

Students often deal with the valuation question by assuming that the value of the scientist’s idea equals the amount of the investor’s cash contribution, since the parties are agreeing to share profits equally. This is the rationale of the court in Kovacik. The difficulty then becomes trying to square the circle by reconciling the optimal sharing of losses for tax purposes with the investor’s demand to have his investment paid back first, at the same time the parties place a substantial value on the scientist’s contributed rights to the process.

Let’s first go back to the scenario in which the whole thing is a flop. At first glance, crediting the scientist with contributing intellectual property rights with a value equal to the investor’s cash solves the Kovacik problem without the tax disaster of treating the scientist’s services as a capital contribution.34 On the other hand,

34. See I.R.C. § 721 (2020) (no recognition of income upon contributing property to a partnership).
writing off the process does not produce any tax-deductible losses, while spending the investor’s money does produce such tax-deductible expenditures. Since the investor, not the scientist, will be able to use these deductions to offset other income, the optimal tax result is to allocate them to the investor, rather than having the parties share them equally as a corollary to their equal sharing of losses. Actually, allocations under Section 704(c) of the Internal Revenue Code can get to this result, but the agreement should select the right option to achieve this.

This all breaks down, however, if instead of the venture being a complete flop with nothing left or a tremendous success in which huge returns dwarf everything else, it becomes a muddle in the middle. Specifically, suppose after spending the investor’s money on R&D, the process ends up being worth only about an amount equal to the investor’s cash contribution—in other words, what the students commonly assume was its original value. Allocating the R&D expense deductions funded by the investor’s money to the investor in order to maximize the investor’s tax benefit from the deal will mean that the scientist is entitled to the proceeds of selling the process—thereby blowing the demand that the investor get his money back first.

There appears to be no solution to get loss deductions to the investor, give the investor his money back first, and place a substantial value on the rights contributed by the scientist—one of these must give. A former attorney, who worked on many such scientist and investor deals, told me that what gets jettisoned is placing any significant value on the contributed rights. This reflects the bargaining position of the parties and the unlikelihood of an immediate sale of the rights. The potential future strife this answer creates, however, comes from the incentives it gives to the investor when it becomes clear there will be no big payday. Since the investor will get paid back first, the investor will want the firm to sell the rights even if this produces little or nothing.
for the scientist. The scientist’s likely opposition to this, in turn, swings us back to the management provisions—thereby illustrating the fundamental principle of Dirk Gently’s Holistic Detective Agency that everything is connected.

IV. COPING WITH THE COMPLEXITY DILEMMA

The bottom line is that the “simple” LLC formation problem is anything but simple, and a lawyer who thinks this is a simple task that he or she can knock out without considerable knowledge creates a lawsuit waiting to happen. Graduates who practice in substantial law firms under the watchful eye of experienced business attorneys will hopefully discover that this is not simple before inflicting damage on their clients or careers. On the other hand, if all our graduates are going into what is essentially an apprenticeship after graduation, then one might question whether transactional simulation courses are an effective use of law school time.

How then should we deal with the complexity dilemma? As suggested earlier, in an ideal world, a course like business planning would be a capstone whose prerequisites would include not only business associations and basic income tax, but also corporate and partnership tax and securities regulation. Unfortunately, in an era of decreased enrollment in which electives might not be offered every year, things are moving in the opposite direction.

I have experimented with various approaches to apply scaffolding to the assignments without losing the critical opportunity for students to discover hidden complexities on their own. The book itself contains comprehensive textual material explaining the relevant law and business considerations involved in transactions from the formation to the sale of a business. A problem course is difficult enough on its own without expecting the students to figure out the law from reading cases. This simulates practice in which the attorney reads secondary source material addressing business transactions. His or her task is to then figure out what is relevant to the specific situation at hand and what is not.

I also emphasize to the students that the cases in the book are commonly selected for their illustration of mistakes that could apply to the problems. For example, a court opinion involving a real estate development LLC that did not end up owning the real estate it was
developing is designed to alert the students into thinking about the ownership of the intellectual property developed by the scientist. A scaffolding I have tried is to have the students list what mistake they see in each case in the chapter dealing with LLC formation and how that mistake might apply to the problem. Still, it is challenging to get students out of the habit of reading cases just for narrow rules and holdings and view them as stories from which one can learn life lessons.

I try to make up for the lack of prerequisite courses in corporate and partnership tax and securities regulation by doing continuing legal education style tutorial lectures for the students on some of the more complex legal areas relevant to the problems while the students are working on their projects. Obviously, there is not time to cover everything and so I have the students take ownership for this by selecting the areas I will address based upon what they found confusing when reading the book.

There are ways in which to sequence the production of an LLC agreement in stages. I have the students first prepare and turn in a term sheet covering in simple imprecise language what the key provisions of the agreement will say without worrying about detailed contractual language covering everything. The hope is that students will look at the big picture and think about the situation at hand and the material in the book before they use the language of a form contract as a crutch to turn out a product without giving enough thought to what they are doing.

When all is said and done, however, as with the financial terms of the LLC problem, one must make choices between imperfect alternatives. My choice is above all else to instill respect for the complexities hidden in even a fairly basic business transaction by having the students experience jumping into the deep end.

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40. Viewing cases in this manner, by the way, was the genesis for Hodge O’Neal’s classic work on oppression of minority shareholders in closely held corporations.