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## PATENTABILITY OF BUSINESS METHODS AFTER IN RE BILSKI

By: Eugenio J. Torres-Oyola

On July 1998, the Circuit Court of Appeals for the Federal Circuit (“CAFC”) in the case *State Street Bank v. Signature Financial Group* established that a business method was patentable if it provided a useful, concrete and tangible result. In doing this, the CAFC rejected the theory that a “method of doing business” was not a patentable subject matter. As a result, business method patents have become important assets for corporations in the software, network security, data management, insurance and financial services industries.

Ten years later, on October 30, 2008, the CAFC issued its decision in *In re Bilski* reaffirming that business methods are patentable and establishing that its previous “useful, concrete and tangible result” test set out in *State Street* is inadequate and should no longer be relied upon as it pertains to the patentability of business methods. In turn, the CAFC stated that the “machine-or-transformation” test set out by the U.S. Supreme Court in various historical decisions such as *Gottschalk v. Benson*, *Parker v. Flook*, and *Diamond v. Diehr*, is the proper test to apply.

The purpose of the machine-or-transformation test is to preclude the patenting of methods which broadly preempt the use of an abstract idea or mental process. The machine-or-transformation test provides that a method is patentable subject matter

if (i) it is tied to a particular machine or apparatus; or (ii) it transforms a particular article into a different state or thing. Although these guidelines seem relatively straightforward, many feel *In re Bilski* has created uncertainty as the test can be interpreted in many different ways to achieve a wide variety of results.

For instance, what is an article and what is a particular machine is unclear. For example, it is unclear whether a machine means a specific device or something as broad as the Internet. Furthermore, it is unclear whether a particular machine must be novel and non-obvious, and specially adapted for carrying out the new process. The *Bilski* court did not opine on these points. Nevertheless, the decision appears to call into question the validity of many business-method patents granted in the last decade.

For example, it is likely that the financial services industry, where business method inventions are common, will be particularly impacted, while sectors such as software and internet technologies also are likely to feel the effects. In addition, although the CAFC did not address life science inventions in *Bilski*, parts of the language could create problems for certain types of biotechnology and pharmaceutical patents as well.

However, in many instances, patent practitioners should be able to draft

claims to meet the more stringent requirements of the machine-or-transformation test. Inherently, internet-related inventions are computer-implemented and so at a minimum can be made to conform to the machine test. It must be noted, however, that the CAFC left open answers to particular questions such as “whether or when recitation of a computer suffices to tie a process claim to a particular machine.” In *ex-Parte Halligan* the Board of Patent Appeals and Interferences (“BPAI”) addressed the question of whether specifying a general purpose computer was enough to tie the method to a particular machine. The Board said no, but it remains to be seen whether the CAFC will agree with this decision.

Claims broadly reciting the observation of a biological phenomenon might be particularly at risk, especially if the claimed method is not tied to the use of a computer or other machine, and can effectively be accomplished mentally.

As it pertains to the transformation prong of the test, the question not clearly answered in *Bilski* is whether a process is patent eligible if the process transforms data that does not represent a physical, tangible object. By way of example, *Bilski* specifically points to chemical reactions as the sort of physical transformation, one physical

substance being transformed into a second physical substance, which will render a process patentable.

It remains to be seen what the final impact of *Bilski* will be. The CAFC’s ruling was mainly directed at cutting back on business method patents, which saw a big flurry of filings starting in 1998 after *State Street*. However, the *Bilski* ruling was not limited to these business method patents and affects any process-oriented patents. Thus, one would assume that many information technology patents could easily be challenged since they relate to data and services rather than physical things such as machines.

In fact, recent decisions by the BPAI have used *Bilski* to overturn claims related to more traditional computer implemented inventions. Four out of five of the initial *Bilski* rejections, for example, were to IBM patent applications not in the business method area.

In January 2009, inventors *Bilski* and *Warsaw* petitioned the U.S. Supreme Court for a writ of certiorari, seeking to overturn the CAFC’s decision and asking the high court to determine whether the new test of patentable subject matter is the correct test.

The petition asks two questions:

licensed under the agreement.

Generally, the limitations placed on the use of software in license agreements are placed for financial reasons. Therefore, to avoid confusion and to clarify the extent of a given software license, the agreement should define the term “use”. Failing to define such use may generate conflicts due to different interpretations of how the software may be implemented or employed by the parties. If the business model of the licensor rests on specific types of uses, not defining them appropriately will most certainly hamper the licensor’s ability to collect revenue from the use of the software by the licensee.

The mishandling of this issue might also grant to licensees rights and permissions that the licensor did not intend to give

Whether the CAFC erred by holding that a “process” must be tied to a particular machine or apparatus, or transform a particular article into a different state or thing despite Supreme Court precedent declining to limit the broad statutory grant of patent eligibility for “any” new and useful process beyond excluding patents for “laws of nature, physical phenomena, and abstract ideas.”; and Whether the CAFC “machine-or-transformation” test for patent eligibility, which effectively forecloses meaningful patent protection to many business methods, contradicts the clear Congressional intent that patents protect “method[s] of doing or conducting business.”

On June 1st, 2009, the Supreme Court decided to grant the petition for certiorari. The Supreme Court’s decision to review this case is highly awaited; in the meantime information technology companies should examine their patents to be sure they hold up under the new test. Some may need to apply for new patents. Others having pending applications, may need to amend them.-

FTMR-

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out. For example, a simple license to “use” software may give the licensee the right to create derivative works from the original software. In such a scenario, a licensee may transform the software into a new program while looking into and modifying the original software’s internal source code.

The definition of use may be combined with the specific software being licensed to delimit the rights of the licensee and protect the licensor’s rights and software. For example, the license may be limited to the object code and it may further exclude the use of the source code. Excluding the use of the source code will cause that the licensee will not have permission to use the source code, regardless of the definition of use. “Use” may be defined as the “installation, running, access, display for private

personal purposes, and execution of software in object code form.” Such a definition of use protects the licensor by clarifying the licensee’s rights.

Another way to protect the licensor is to directly introduce the limitations to the use of the software in the license language. That is, instead of defining “Use” and then licensing the “Use” of the software, the license language may read “the licensee granted is a perpetual, worldwide license to install, run, access, display for private personal purposes, and execute the software in object code form.” Notice that the license language describes it as a perpetual and worldwide license, which are characteristics that are often negotiated between the parties. Perpetual and worldwide licenses are more expensive than their temporary,

territorial counterparts.

Common limitations and restrictions to the scope of the license include limiting the use of the software to one central processing unit (CPU), to a specific user, to a specific kind of computer, to a specific territory, or to a specific time period. These kinds of limitations enable the appropriate creation of a viable business model that adjusts to the software. The licensor has to be aware of the software and technology being licensed as well as the business and financial aspects of the license. Whether the licensor is distributing copies of software in CD-ROM or providing access to software through the internet, a well drafted license will address the uses by the licensee and an appropriate revenue model will stem from such defined use.

## COPYRIGHT INFRINGEMENT: NO MORE RETROACTIVE LICENSES TO DEFEAT LAWSUITS

By: Yolanda Álvarez-Cruz

A co-owner of a work of authorship cannot grant a retroactive license or an assignment of his rights to an alleged copyright infringer. This means that a co-owner will not be able to avoid or defeat law suits for copyright infringement filed by another co-owner.

Although the general practice is that a co-owner may issue unilaterally a non-exclusive license without the consent of the other co-owner(s) (subject to a duty of accounting to the other co-owners for any profits), or may transfer his individual or personal interest in the work, the United States Court of Appeals for the Second Circuit, in *Davis v. Bledge*, 505 F.3d 90 (2d Circuit 2007), determined that these type of licenses and transfers of rights can only be entered into prospectively. Otherwise, those actions would extinguish the right of a co-owner to sue for copyright infringement, since a license from a co-owner protects the licensee from liability for copyright infringement.

In the aforementioned case, the music composer *Sharice Davis* sued a popular record company artist and others for

using two of her songs in the album entitled “No More Drama” without authorization. She alleged that she co-wrote the compositions with non-party *Bruce Chambliss*. The disputed songs were registered by *Davis* with the Copyright Office, listing *Chambliss* as a co-author.

After filing the action, co-owner *Bruce Chambliss* assigned his interest to the song, to *Bruce Miller*, who was one of the defendants. *Chambliss* sustained that five years prior to the complaint, he and *Miller* had a verbal agreement about transmitting certain rights over the compositions.

Afterwards, *Miller* licensed the disputed compositions to one of the co-defendants. In addition, and only one day before taking *Chambliss* deposition, he and *Miller* executed the transfer of both songs by a written instrument, effective the same day the compositions were created. The defendants then claimed that said contract served to confirm or ratify the prior verbal agreement between *Chambliss* and *Miller*. They argued that the result was that *Miller* became into the co-owner of the compositions and that the plaintiff was not entitled to continue with the complaint against *Miller* and those to whom he had licensed the compositions.

The District Court for the Southern

While there are many issues that a software license agreement should address, defining use is one of the most important concerns in the drafting of a software license agreement. Use goes together with the item or software being licensed, as the idea behind the whole agreement is that the licensor grants a license to the licensee to use certain software for certain amount of money. Just as it is important to identify which software is being licensed, and how much the licensor will be paid, properly defining use identifies the rights that the licensor is actually granting and how the licensee may benefit from the software.-

FTMR-

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District of New York validated the agreement and decided that the retroactive license barred the claim and cured the infringement. The District Court concluded that plaintiff’s co-author transferred his rights to one of the defendants through a written agreement stating that it was “retroactive” to the date of the creation of the copyright, which took effect before the alleged infringement and, consequently, barred plaintiff’s infringement claim. It reasoned that a “co-owner has a legal right to grant a license without another co-owner’s permission or transfer his rights in the copyright freely”.

Nonetheless, the District Court declined to determine whether the written ratification of a prior oral transfer complies with the Copyright Act’s requirement, 17 USC §204 (a), that transfers must be in writing or whether the assignment agreements in effect ratified the prior oral agreements between *Chambliss* and *Miller*; it held that “*Chambliss* could cure past infringement through the grant of a retroactive assignment of the copyright.”

*Davis* appealed the New York South District Court’s judgment and the Second Circuit reversed the decision. The Second Circuit held that, although the Copyright Act is silent on the issue of retroactive transfer or license, such

## SOFTWARE LICENSING

By: Leonardo Villarreal-Alejandro



Licenses may be thought of as permissions granted by the licensor to the licensee. Typical characteristics that describe licenses are, to name a few: whether they are perpetual or temporary, exclusive or non-exclusive, assignable or not, personal or not, sub-licensable or not, fully paid or royalty-based, renewable or not, and whether they are applicable worldwide or limited to a given territory. Nevertheless, the drafting of software licensing agreements requires, in addition to addressing the characteristics of general licenses, that attention be paid to the use of the software actually

retroactive transfers violate the basic principle of tort and contract law, and undermine the policies embodied in the Copyright Act.

In its decision, the Second Circuit compared the licenses and right transfers with the settlement agreements and releases. It sustained that settlements are generally retrospective and exclusively between the parties to the settlement --the unauthorized user and the owner; and, absent a clear agreement to the contrary, they are not licenses for the future use. The court determined then that, unlike the settlement agreements, which recognizes the unauthorized use of the work and has no effect on the co-authors, the licenses or retroactive transfers eliminate the unauthorized use from the scene, with the result being that the rights of any co-owner to sue disappear. "A retroactive license or assignment purports to authorize a past use that was originally unauthorized".

The Second Circuit, in reaching its decision, also analyzed the concept of damages and contracts, and stated that the licenses and retroactive transfers are contrary to the rule that the right to

sue is one of the "most valuable sticks of the bundle rights of copyright", because those actions prohibit filing of claims from the party or parties that did not consent, going back in time to eliminate the violation. Likewise, these type of transfers and licenses are controversial to the fundamental principle of contract law, forbidding the parties to obligate the non appearing party; they extinguished the accrued infringement claims of a non-consenting co-owner, destroying his or her right to enforce his or her rights.

In addition, the Second Circuit considered patent law, noting that patent law has recognized the prospective nature of licenses. The Second Circuit cited *Corp. v. Rousell-UCLAF SA*, 104 F.3d 341, 345 (Fed. Cir. 1997), which stated that "the grant of a license by one co-owner cannot deprive the other co-owner of the right to sue for accrued damages for past infringement. That would require a release, not a license, and the rights of a patent co-owner, absent agreement to the contrary, do not extend to granting a release that would defeat an action by other co-owners to recover damages for past infringement."

## QUALIFIED INDIVIDUAL WITH A DISABILITY THAT SUBSTANTIALLY LIMITS A MAJOR LIFE ACTIVITY... WHAT IS IT ABOUT?

By: María Judith Marchand-Sánchez & María del Rosario Fernández-Ginorio

Effective January 1, 2009, the Americans with Disabilities Amendment Act of 2008 ("ADAAA") amends the Americans with Disabilities Act ("ADA"), 42 U.S.C.A. §12111, et seq. and broadens, defines and clarifies who will be protected under ADA. This development has multiple implications on how employers will handle employees with disabilities and their requests for reasonable accommodations in order to reduce potential liabilities.

The initial ADA, enacted in 1990, protected "qualified individuals with disabilities" from discrimination. To determine if individuals are disabled under ADA they need to be "substantially limited in a major life activity." The term disability is defined under ADA as (a) a physical or mental

impairment that substantially limits one or more of the major life activities of such individual; (b) a record of such an impairment; or (c) being regarded as having such an impairment. 42 USCA §12102. After the coming into force of the ADAAA, the definition of disability remains unchanged.

The term "major life activity" was defined by the Equal Employment Opportunity Commission ("EEOC") and by the Courts on a case by case basis and in a restrictive manner. Congress in revising ADA found that the regulations defining the term "substantially limits" as "significantly restricted" were inconsistent with congressional intent by expressing too high a standard, since over the years the lower courts have interpreted the term in a very restricted

Furthermore, the Second Circuit addressed two policy concerns: (1) the need for certainty and predictability in copyright ownership and (2) discouragement of infringement. If the retroactive licenses were allowed such assignment could undo an infringement. Moreover, the infringer would be able to avoid liability and the potential possibility to pay statutory damages under 17 USC §504. Hence, "it would damage the principal purpose of the Copyright Act, which is to encourage the origination of creative works by attaching enforceable property rights to them".

Although, it is not clear whether the preclusion to retroactive licenses applies to all circumstances, including when there is no co-owner, the Second Circuit decision clearly stated that prior oral agreements and/or retroactive transfer of copyright ownership from a co-owner cannot be ratified retroactively to defeat a claim. **-FTMR-**

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manner that limiting who is protected under the ADA. With that in mind ADAAA's framework serves the purpose of broadening the scope of protection. Although it is still not clear how much broader the interpretation will be, we know that change is coming.

The new definition of "major life activities" in regards to the definition of disability includes an extensive and non-exhaustive list that covers a wide array of functions. These activities for purposes of what constitutes a physical or mental impairments, that substantially limits one or more major life activities of an individual include: caring for oneself, performing manual tasks, seeing, hearing, mating, sleeping, walking, standing, lifting, bending, speaking, breathing, learning, reading,

concentrating, thinking, communicating and working. It is important to note that this list is not exhaustive.

"Major life activities" also incorporate the operation of "major bodily functions" which include but are not limited to functions of the immune system, normal cell growth, digestive, bowel, and bladder, neurological, brain, respiratory, circulatory, endocrine and reproductive functions.

Pursuant to ADAAA, the determination of whether an impairment substantially limits major life activity shall be made without regard to the mitigating measures taken by the individual to manage his disability. Mitigating measures such as medication, medical supplies, equipment or appliances, low-vision devices, prosthetics including limbs and devices, hearing aids and cochlear implants or other implantable hearing devices, or oxygen therapy equipment and supplies; use of assistive technology; reasonable accommodations or auxiliary aids or services; or learned behavioral or adaptive neurological modifications, will not be taken into account. Conditions that are episodic or in remission are considered in their active state, in other words they will be considered a disability if it would substantially limit a "major life activity" when active. Low-vision devices do not include ordinary eyeglasses or contact lenses; therefore they can be taken into consideration when determining if the person has or not an impairment that substantially limits a mayor life activity. Also, the ADAAA continues to protect "regarded as claims" but excluded minor, transitory conditions lasting six months or less

ADAAA will affect several aspects of business, particularly employment processes, accommodating employees with disabilities, compliance requests and will certainly spike the number of employment litigation cases. In order to minimize any liabilities that the amendments may cause, it is necessary to review and modify job descriptions in order to ensure that only the essential



job functions are listed. This will be extremely helpful for the employer's defense against a disability claim that may rely on whether the disabled employee was qualified to perform the essential functions of his job. Job descriptions should reflect all essential job functions. Employee manuals and policies should also be examined, revised and modified to reflect ADAAA changes. They should not only be revised now, but periodically to reflect the modifications that will arise from courts' interpretations. Like most statutes ADAAA, it will develop overtime to incorporate rulings and decisions and the employers

will have to be on the lookout for changes to ensure they are protected and remain in compliance. Also, Human Resources professionals should be trained to fully understand ADAAA and how will it affect internal company processes.

Employers should accommodate employees' impairments quickly and seriously in order to avoid any claims. Since a wider range of employees will now qualify as disabled and will be entitled to reasonable accommodation, there should be an established process to channel requests and make sure they are all evaluated and acted upon in a uniform and consistent manner. It is imperative to make all reasonable attempts to accommodate the employee's request. Employers should assume that the disability is covered under ADAAA, because it most likely will be, instead of dismissing the employee's requests and being exposed to a claim. It is better to be safe, than sorry.

Review your policies and make sure they are in compliance with ADAAA. If you have any questions regarding the ADAAA or the issues discussed in this article, please contact your legal counsel. **-FTMR-**

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## CORPORATE STATUTORY REQUIREMENTS

By: Carlos Muñoz-Cotté

Although incorporating a Puerto Rico stock corporation may only entail a simple formality with the Puerto Rico Department of State, our General Corporations Law of 1995, as amended ("GCL") imposes multiple statutory requirements which - if not observed - may end up costing a corporation money or even causing legal disputes and/or the piercing of its corporate veil. Since most are somewhat familiar with the mechanics of organizing a stock corporation this article will bypass any statutory requirements therefore and will focus on those statutory requirements which arise after the corporation has been successfully created. Although not an exhaustive list of applicable requirements, following are some of the most yet commonly overlooked post-incorporation statutory requirements under the GCL:

**Organizational Meeting.** When a corporation is incorporated, its certificate of incorporation ("COI") either leaves the incorporator(s) as the person(s) in charge of the corporation's affairs until the first organizational meeting or sets forth who will be the corporation's director(s). In either case, whether it be the incorporator(s) or the director(s) of the corporation as set forth in the COI, an organizational meeting must be held and documented in a minute or if no organizational meeting is held, a unanimous written consent of all the incorporator(s) or director(s), as the case may be, must be prepared and executed by the corresponding persons. At a minimum, in the organizational meeting, the incorporator(s) or director(s), as the case may be, must adopt the corporation's By-Laws, appoint the corporation's directors if the incorporator did not do so in the COI (close corporations may be shareholder managed and as such do not need to have a Board of Director), and appoint the officers of the corporation (if the directors were appointed in the COI).<sup>1</sup>

**By-Laws.** Although this item was mentioned above in the context of the organizational meeting, its importance warrants additional discussion. All stock corporations must have By-Laws (close corpora-

tions are not required to adopt By-Laws). Not only are they necessary because our GCL requires they be adopted<sup>2</sup> but they provide rules of internal administration by which the corporation's shareholders, officers and directors are bound. Other than those instances where a corporation's By-Laws contravene the Law or the COI, the By-Laws' will regulate and prevail over any dispute regarding the corporate governance of the corporation. Of all corporate documents, in absence of a shareholders agreement, the By-Laws of a corporation should be given great attention, especially when a corporation has more than one shareholder, since well drafted By-Laws will provide the corporation and its stakeholders with structure, consistency and a system of checks and balances. Ordinary provisions in corporate By-Laws include but are not limited to: (i) mechanisms for Shareholder and/or Director meetings; (ii) voting rights; (iii) quorum; (iv) stock transfer; (v) indemnity provisions for of-

ficers and directors; (vi) fiscal year; etc.

**Officers.** A corporation's Board of Directors must appoint its officers in accordance with its By-Laws. At a minimum, a corporation must have a President and a Treasurer and/or a Secretary<sup>3</sup>. All these positions can be held by the same person but they must be filled since such officers' signatures are required for multiple government filings and corporate documentation, such as the corporation's annual report.

**Stock Subscriptions.** Although the GCL doesn't require that stock certificates be used to evidence issued stock, it does require that the stock be fully paid to be non-assessable<sup>4</sup>. The stockholders must subscribe newly issued stock for value received by the corporation, be it cash, assets or service previously rendered<sup>5</sup>. At a bare minimum the corporation must receive at least the par value, if any, of its shares as consideration to their is-

suance. As mentioned above, the GCL does not require stock certificates to be tendered to stockholders but the corporation is required to tender said certificates if requested by any shareholder<sup>6</sup>. The best practice is, however, to issue stock certificates. Ownership issues are breeding grounds for stockholder disputes and having stock certificates or a well kept stock register is the one way to avoid potential disputes.

**Transfer of Stock.** Shares of stock, as any other good, are transferable but for such transfer to be valid any one of the following three requirements must be met: (i) the delivery of the actual stock certificate which must be endorsed in blank or to the order of a particular person or entity by the person or entity to whom such certificate was issued; (ii) the delivery of the actual stock certificate accompanied by another document assigning or empowering the holder thereof to sell, assign or transfer said stock and such document

must be executed by the person or entity to whom such certificate was issued; or (iii) if no stock certificate was issued, by having the appropriate officer or agent of the corporation (normally the corporation's secretary has this function) register such transfer in the stock register of the corporation<sup>7</sup>.

**Stockholder Meetings.** The GCL requires that the shareholders of a corporation must celebrate at least one annual meeting<sup>8</sup>. Failure to do so will not put in jeopardy the corporate veil but any particular director or shareholder could file suit against the corporation to force such meeting which would inevitably result in unnecessary legal costs and expenses.

**Annual Reports.** All corporations are required to file with Department of State on or before the 15<sup>th</sup> of April of each year an Annual Report with its corresponding filing fee as well as a balance sheet which must be audited if gross revenues

exceed \$3,000,000.00. An automatic ninety day extension is available to any corporation who files such extension on or before April 15<sup>th</sup>. Failure to file a corporation's Annual Report on a timely manner will result in a \$500.00 penalty, failure to file an Annual Report at all for two or more years may result in the revocation of the corporation's COI<sup>9</sup>.

**Corporate Records.** The GCL requires that all corporations organized under the laws of Puerto Rico maintain such accounting records or otherwise which would support and establish all financial information which is required to be included in the corporation's tax returns<sup>10</sup>. It also requires all corporations to maintain such records necessary to reflect all the corporation's assets, investments and capital within Puerto Rico and elsewhere.

The aforementioned items are just some of the most relevant statutory require-

ments applicable to Puerto Rico corporations, all of which should be met in order to achieve a solid corporate governance from a compliance perspective. It must be noted, however, that in order for a plaintiff to successfully pierce a corporations veil, many other factors, besides failure to comply with the corporate formalities, are considered in order to decide whether or not to pierce the corporate veil.-FTMR-

1 Art. 1.08 General Corporations Act  
2 Art. 1.08 General Corporations Act  
3 Art. 4.02 General Corporations Act  
4 Art. 5.11 General Corporations Act  
5 Art. 5.02 General Corporations Act  
6 Art. 5.11 General Corporations Act  
7 Art. 6.01 General Corporations Act  
8 Art. 7.01 General Corporations Act  
9 Art. 15.01 General Corporations Act Id.  
10 Art. 15.01 General Corporations Act

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## DO YOU HAVE LIMITED LIABILITY IN YOUR SPECIAL PARTNERSHIP?

By: Pedro Notario-Toll

In Puerto Rico, there are several tax elections which enable its owners to organize their business affairs as a Partnership, Company, or Corporation, while avoiding the double taxation of their earnings. One of the main tax elections currently used in Puerto Rico is the Special Partnership. Currently, partnerships, corporations, and Limited Liability Companies (LLCs) may all elect Special Partnership treatment. However, this has not always been the case.

Special Partnerships were originally adopted by the Puerto Rico Legislature in 1985 pursuant to Act No. 8 of July 19, 1985. Under Act No. 8, only Partnerships were allowed to elect Special Partnership treatment. As a result, Special Partnerships were originally incorporated into our legal system as a special form of the Civil Partnership.

As a special form of Civil Partnerships, the substantive issues of Special Partnerships were regulated by the Puerto Rico Civil Code and by the

partnership agreement. Only the tax aspects of Special Partnerships were regulated by Puerto Rico Tax Laws.

Corporations were first allowed to elect



Special Partnership treatment with the approval of the Puerto Rico Internal Revenue Code of 1994. As a result, for a period of almost 10 years, the Civil Partnership was the only alternative to obtain the tax benefits of a Special Partnership, and therefore, all Special Partnerships organized prior to the approval of the Internal Revenue Code were originally organized as Partnerships.

After the approval of the Puerto Rico Internal Revenue Code, investors seeking the tax benefits of Special Partnerships

had two available options to organize their business venture. The investors were faced with the decision of using the more formal and rigid, but simple and cost effective corporation or the more flexible but costly Civil Partnership. The result of this dilemma has been that during the past 15 years, there have been a significant number of Civil Partnerships and Corporations that have elected Special Partnership status.

On September 23, 2004, the Puerto Rico legislature added the Limited Liability Company (LLC) as a third option for investors seeking to elect a Special Partnership tax treatment. The LLC is a hybrid business entity having characteristics of both a Corporation and a Civil Partnership. It is more flexible than corporations in allowing the establishment of an operating agreement to govern all business affairs, while avoiding many of the disadvantages of Civil Partnerships.

In many cases, the decision of whether to use the Civil Partnership, the Corporation, or the LLC for purposes of organizing a Special Partnership, has not considered the implications of the entity selection on the limited liability benefit. After all, Special Partnerships all enjoy limited liability.

However, there may be a significant difference between the limited liability benefit of Special Partnerships organized as Civil Partnerships and, the Limited Liability benefit of Special Partnerships organized as Corporations or LLCs. Since the Puerto Rico Internal Revenue Code only regulates the tax aspects of Special Partnerships, other substantive aspects of Special Partnerships such as the Limited Liability benefit are regulated by either the Puerto Rico Civil Code in the case of Civil Partnerships, by the General Corporation Law in the case of corporations, and LLCs.

With regard to Corporations, the Limited Liability benefit of corporations is established by Section 1.02(b)(5) of the General Corporation Law of Puerto Rico. For LLCs, the limited liability benefit is established by Section 19.19(a) of the General Corporations Law. Under both laws, the general rule for corporations and LLCs is that its shareholders or members have limited liability.

With regard to Civil Partnerships, the general rule is that partners do not have limited liability. As an exception to this general rule, after the approval of the Puerto Rico Internal Revenue Code, Article 1589 of the Puerto Rico Civil Code was amended in 1997 to limit

the responsibility of Partners to their investment in the Special Partnership, provided that:

1. The Civil Partnership elected Special Partnership treatment,
2. The Civil Partnership complied with all of the conditions of Articles 1330 through 1358 of the Puerto Rico Internal Revenue Code, and
3. The name of the Special Partnership indicated their special status by using the initials S.E. after the partnership name.

Since the Limited Liability benefit is the general rule for corporations and LLCs, the benefit is available to all Special Partnerships organized as corporations and LLCs. However, since the Limited Liability benefit is the exception for Civil Partnerships, the benefit is only available to those Civil Partnerships that have elected Special Partnership Treatment and (1) have complied with all of the conditions of Articles 1330 through 1358 of the Puerto Rico Internal Revenue Code, and (2) are using the initials S.E. after their partnership name.

As a result, the Limited Liability benefit for Civil Partnerships has additional requirements that do not apply to the Limited Liability benefit of Corporations

and LLCs. In particular, the requirement that the Civil Partnership must have complied with all conditions of Articles 1330 through 1358 forces the Civil Partnership to constantly monitor its absolute compliance with all tax laws applicable to Special Partnerships to avoid losing its Limited Liability benefit.

Since making a Special Partnership election is not enough to guarantee the Limited Liability benefit, investors organizing a Special Partnership must consider the Limited Liability benefit among the factors to be considered in the determination of whether to organize as a Corporation, an LLC or a Civil Partnership.

For Special Partnerships that are already organized as Civil Partnerships, the owners should consider the conversion of the entity into a Corporation or an LLC. The conversion documents are normally prepared by a corporate attorney and must be filed with the Puerto Rico Department of State. The conversion documents should also be reviewed by a tax advisor to ensure that all of the requirements of a tax free reorganization are met. -FTMR-

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