

# Updates on the Modifications of Fiduciary Duties for Members of an LLC

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## **Fiduciary Obligations under ULLCA (Uniform LLC Act 1996 Section 409)**

The ULLCA was enacted in 1996 and allowed for the creation of limited liability companies (LLCs). Nearly every state had their own LLC statute, each very different from one another. The ULLCA sought to bring uniformity to the governance of LLCs

### Member-Managed

- All members participate in the decision-making process of the LLC. Each member is an agent of the LLC and has a vote in the business operations and decisions. The only fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care
- A member shall discharge the duties to a member-managed company and its other members under this chapter or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.
- A member of a member-managed company does not violate a duty or obligation merely because the member's conduct furthers the member's own interest.
- ***Duty of Care***
  - A member's duty of care to a member-managed company is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law
  - "Good faith" and exercise a certain level of care in fulfilling their obligation to and directing activities of the LLC
- ***Duty of Loyalty***
  - Fiduciary must put the success of and benefits to the LLC above individual gain.
  - A member's duty of loyalty to a member-managed company and its other members is limited to the following:
    - (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business or derived from a use by the member of the company's property, including the appropriation of a company's opportunity;
    - (2) to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
    - (3) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.

### Manager- Managed Company

- Managers are the agents of the company not the members.
- In a manager-managed company:
  - (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;
  - (2) a manager is held to the same standards of conduct prescribed for members
  - (3) a member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct to the extent that the member exercises the managerial authority vested in a manager by this chapter; and
  - (4) a manager is relieved of liability imposed by law for violation of the standards prescribed to the extent of the managerial authority delegated to the members by the operating agreement.

### Modification of Fiduciary Duties

- Generally, for fiduciary duties under the ULLCA, managers and members can modify the statutorily imposed fiduciary duties of loyalty and care owing to the LLC and to the other members but only in a limited fashion. The ULLCA (and case law interpreting it) does not provide for complete elimination or waiver of fiduciary duties.

### **Revised Uniform LLC Act 2006**

10 years passed and there needed to be revisions, every state was adopting LLC statutes and each statute was different in form and substance. ULLCA's drafting was relied on the Revised Uniform Partnership Act that was member-managed specific. Since then, many states adopted and revised LLC statutes and there was a huge uptick in LLC formation.

### **Fiduciary Obligations under RULLCA Section 409 Standard of Conduct for Members and Managers**

#### Member-Managed

- ***Duty of Care***
  - (c) Subject to the business judgment rule, the duty of care of a member of a member managed LLC in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. In discharging this

duty, a member may rely in good faith upon opinions, reports, statements, or other information provided by another person that the member reasonably believes is a competent and reliable source for the information.

- ***Duty of Loyalty***

- (b) The duty of loyalty of a member in a member-managed LLC includes the duties:
  - (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
    - (A) in the conduct or winding up of the company's activities;
    - (B) from a use by the member of the company's property; or
    - (C) from the appropriation of an LLC opportunity;
  - (2) to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and
  - (3) to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.

#### Manager-managed

- In a manager-managed LLC, the following rules apply: (1) Subsections (a), (b), (c), and (e) apply to the manager or managers and not the members. (2) The duty stated under subsection (b)(3) continues until winding up is completed. (3) Subsection (d) applies to the members and managers. (4) Subsection (f) applies only to the members. (5)
- A member does not have any fiduciary duty to the company or to any other member solely by reason of being a member.

#### Operating Agreement

An Operating agreement is a crucial document for LLCs because it outlines the business structure and functional nature including rules, regulations, and provisions.

#### Key provisions in an operating agreement

- % ownerships
- Voting rights and responsibilities
- Power and duties
- Holding meetings
- Transfer of Units

#### **Revised Uniform LLC Act: Operating Agreement under section 409**

- (d) A member in a member-managed LLC or a manager-managed LLC shall discharge the duties under this [act] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.
- (e) It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the LLC.
- (f) All of the members of a member-managed LLC or a manager-managed LLC may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

### **Waiver of Fiduciary Duty under Section 110 RULLCA**

- (d) If not manifestly unreasonable, the operating agreement may:
  - (1) restrict or eliminate the duty:
    - to account to the LLC and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of an LLC opportunity;
    - to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
    - to refrain from competing with the company in the conduct of the company's business before the dissolution of the company;
  - (2) identify specific types or categories of activities that do not violate the duty of loyalty;
  - (3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;
  - (4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and
  - (5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing
- (e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.
- (f) To the extent the operating agreement of a member-managed LLC expressly relieves a member of a responsibility that the member would otherwise have under this [act] and imposes the responsibility on one or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate, or limit any fiduciary duty that would have pertained to the responsibility.

- (g) The operating agreement may alter or eliminate the indemnification for a member or manager provided by Section 408(a) and may eliminate or limit a member or manager's liability to the LLC and members for money damages, except for:
  - (1) breach of the duty of loyalty;
  - (2) a financial benefit received by the member or manager to which the member or manager is not entitled;
  - (3) a breach of a duty under Section 406;
  - (4) intentional infliction of harm on the company or a member; or
  - (5) an intentional violation of criminal law.
- (h) The court shall decide any claim under subsection (d) that a term of an operating agreement is manifestly unreasonable. The court:
  - (1) shall make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and
  - (2) may invalidate the term only if, in light of the purposes and activities of the 24 LLC, it is readily apparent that:
    - (A) the objective of the term is unreasonable; or
    - (B) the term is an unreasonable means to achieve the provision's objective.

One of the most complex questions in the law of unincorporated business organizations is the extent to which an agreement among the organization's owners can affect the law of fiduciary duty. This section:

- grants broad, general authority to the operating agreement
- establishes this Act as comprising the "default rules" ("gap fillers") for matters within the purview of but not addressed by the operating agreement
- states restrictions on the power of the operating agreement
- contains specific grants of authority for the operating agreement with regard to fiduciary duty and the contractual obligation of good faith
  - Delaware recently amended its LLC statute to permit an operating agreement to fully "eliminate" fiduciary duty within an LLC. This Act seeks to balance the virtues of "freedom of contract" against the dangers that inescapably exist when some have power over the interests of others.
  - This paragraph empowers the operating agreement to eliminate all aspects of the duty of loyalty listed in Section 409. The contractual obligation of good faith would remain as would any other, uncoded aspects of the duty of loyalty.
  - The operating agreement's power to affect this Act's duty of care both parallels and differs from the agreement's power to affect this Act's duty of loyalty as well as any other fiduciary duties not codified in the statute. With regard to all fiduciary duties, the

operating agreement is subject to the “manifestly unreasonable” standard.

- specifically grants the operating agreement the power to provide mechanisms for approving or ratifying conduct that would otherwise violate the duty of loyalty
  - the Act’s default rule for authorization or ratification – unanimous consent.
    - This Act provides four separate methods through which those with management power in an LLC can proceed with conduct that would otherwise violate the duty of loyalty:

Method	Statutory Authority
The operating agreement might eliminate the duty or otherwise permit the conduct, without need for further authorization or ratification.	Section 110(d)(1) and (2)
The conduct might be authorized or ratified by all the members after full disclosure.	Section 409(f)
The operating agreement might establish a mechanism other than the informed consent for authorizing or ratifying the conduct.	Section 110(e)
In the case of self-dealing the conduct might be successfully defended as being or having been fair to the limited liability company.	Section 409(e)

- specifically authorizes the operating agreement to divest a member of fiduciary duty with regard to a matter if the operating agreement is also divesting the person of responsibility for the matter (and imposing that responsibility on one or more other members)
- contains specific grants of authority for the operating agreement with regard to indemnification and exculpatory provisions; expressed so as to state restrictions on those specific grants
- provides rules for applying the “not manifestly unreasonable” standard

duty	extent of operating agreement’s power to restrict the duty (subject to the “manifestly unreasonable” standard) Section 110(d)(1), (3) and (4)	power of the operating agreement to provide indemnity or exculpation w/r/t breach of the duty Section 110(g)
loyalty	restrict or completely eliminate	none
care	alter, but not eliminate; specifically may not authorize intentional misconduct or knowing violation of law	complete
other fiduciary duties, not codified in the statute	restrict or completely eliminate Section 110(4)	complete

### States that follow RULLCA

- Alabama, Arizona, Pennsylvania, Illinois, Connecticut, North Dakota, Vermont, Idaho, Washington, Minnesota, South Dakota, Florida, New

Jersey, California, District of Columbia, Utah, Nebraska, Wyoming, Iowa, Idaho.

- Introduced in South Carolina and more states to come

### **State examples that follow similar rules: Ohio**

- Senate Bill 181 went into effect on July 6, 2016 and it changed the fiduciary duties officers LLCs.
  - ***Duty of Loyalty***
    - Upon a member's withdrawal, a member's duty of loyalty and duty of care continue only with regard to matters arising and events occurring before the member's withdrawal.
      - The only fiduciary duties a member owes to an LLC and the other members are the duty of loyalty and the duty of care
    - A member's duty of loyalty to the LLC and the other members is limited to the following:
      - (1) To account to the LLC and hold as trustee for the LLC any property, profit, or benefit derived by the member in the conduct and winding up of the LLC's business or derived from a use by the member of the LLC's property, including the appropriation of an LLC opportunity;
      - (2) Either to satisfy the requirements of division (A) (1)(a), (b), or (c) or else to refrain from dealing with the LLC in the conduct or winding up of the LLC's business as or on behalf of a party having an interest adverse to the LLC;
  - ***Duty of Care***
    - A member's duty of care to the LLC in the conduct and winding up of the LLC's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
    - A member shall discharge duties to the LLC and the other members pursuant to this chapter or under the operating agreement and shall exercise any rights consistent with the obligation of good faith and fair dealing.
    - A member does not violate a duty or obligation under this chapter or under the operating agreement merely because the member's conduct furthers the member's own interest.
  - **Explanation by Ohio Legislative Service Commission**
    - The act modifies the contents of an operating agreement of an LLC (LLC). Law retained in part by the act prohibits an operating agreement from doing any of a list of several specified actions. One of the prohibited actions is to eliminate the duties of a manager under R.C. 1705.29(B)

(fiduciary duties a manager owes to the LLC). Under continuing law, the operating agreement may prescribe in writing the standards by which performance is to be measured or identify activities that do not violate the manager's duties. The act modifies this prohibition to specify that the articles or the operating agreement may prescribe in writing the above referenced standards or identify the above-described activities or may provide that a manager who is a member of the LLC or who is serving as the representative of a member owes to the LLC and the other members only the duties that would be owed by the member.

### **Other states that have modified fiduciary duties**

- Delaware, Kentucky, Indiana, Kansas, Missouri, North Carolina, Nevada
  - Delaware
    - To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to an LLC or to another member or manager or to another person that is a party to or is otherwise bound by a LLC agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the LLC agreement . . . ." 6 Del. C. § 18-1101(c).
  - Indiana
    - Further, I.C. 23-18-4-4(a)(1) states that a written operating agreement may modify, increase, decrease, limit, or eliminate the duties (including fiduciary duties or the liability of a member or manager for breach of the duties set forth in I.C. 23-18-4-2. This makes it clear that members not only agree to waive or restrict fiduciary obligations, but they also can agree to be held to higher standards and add additional duties to the other members and the company within an Operating Agreement.

### **Operating Agreement Drafting Suggestions**

- Look at the state statute
  - What duties are implied?
  - What are the default rules?
  - Contact an attorney in the area
  - Tailor the operating agreement to fit your specific business needs and operations
    - The operating agreement should state clearly and unambiguously supplant traditional fiduciary duties in their

LLC agreement if they desire certainty that such duties do not apply.

- Absent clear and unambiguous modification or limiting language, parties to an LLC agreement may find themselves subject to fiduciary duties.
- Sample language that can be used to eliminate fiduciary duties in the operating agreement is provided by Bloomberg:
  - "Any standard of care and duty imposed by this Agreement or under the Delaware Act or any applicable law... shall be modified waived or limited, to the extent permitted by law, as required to permit [GP] to act under this Agreement ... so long as such action is reasonably believed by [GP] to be in, or not inconsistent with, the best interests of [LP]."

### **Good Faith and Fair Dealing always exists**

- This is an implied duty, and the courts have the discretion to determine the scope of this implied duty.
  - Objective standard
    - Reasonable person in the same circumstances
  - Subjective standard
- How to best avoid a breach of good faith
  - It is important that you map out every detail of business operations in the operating agreement. The good faith is meant to address the gaps in the operating agreement that neither party anticipating. The best way to avoid this covenant is to make sure the operating agreement is airtight.

### **Reference Material**

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