AGENDA

ULLCA II DRAFTING COMMITTEE
Friday, October 21, 2005 – Sunday, October 23, 2005

The ULLCA II Drafting Committee meeting will meet from 8:30 am - 5:00 pm on Friday and Saturday and from 8:00 am – 11:00 am on Sunday. The Committee will proceed through topics in the order set forth below with the intent of addressing Fiduciary Duties on Saturday. The Committee will work from the draft discussed at the NCCUSL 2005 Annual Meeting in Pittsburgh.

I. MANAGEMENT STRUCTURE

A. **Current Act –** ULLCA § 201(a)(3) provides that the articles must state whether an LLC is to be managed by its members or managed by managers.

B. **Problems –** The "dual-track" management structure choice may create nearly as many problems as it solves. What happens if the LLC is to be manager-managed and yet has no manager, for whatever reason? What happens if the articles designate member-management but is managed by the members? The Committee has struggled with these and other questions and retained the "dual-track" anyway because (i) most states retain a similar approach and (ii) manager management is the only way to negate statutory actual and hence apparent authority in members who do not participate in management.

C. **Proposals –** Eliminate the "dual track" structure in the articles. Under this proposal, every LLC would be managed by it members. The members would be free of course to create a different management structure desired under the operating agreement. The operating agreement could therefore create some form of management by less than all the members. This may facilitate further changes (see II below).

Where the operating agreement adopts management other than by the articles, the Act could and should create a simple "one-tier default" management structure with managers reporting to the members. This is the Delaware model.

Although the Committee considered and rejected a "two-tier default" management proposal when the articles designated the choice, the operating agreement method might make it easier for the Act to state a "two-tier default" management structure where the managers report to an

oversight board elected by the members to represent the members. The Committee would consider specifying such a default if it viewed the choice as relevant and meaningful.

The one or two tier management structure could be adopted by the operating agreement.

II. STATUTORY AGENCY AUTHORITY

A. **Current Act –** ULLCA § 301(a) makes every member an agent of a member-managed LLC. ULLCA § 301(b) makes every manager an agent but also provides members not also a manger are not agents.

B. **Problems –** This structure virtually guarantees that every LLC "should" be manager-managed in order to eliminate the statutory apparent authority of members not participating in management. The Committee considered "de-linking" agency authority from management structure but the approach was confusing and largely rejected by the Conference at the 2003 Annual Meeting.

C. **Proposals –** By eliminating the "dual-track" management structure in the articles, the idea that every member MUST be an agent can be simply rejected. This notion would simply adopt the negative from the former manager-management structure and affirmatively state (along the lines of the liability shield) that no "member is a agent simply because they are also a member." The Act need not further state agency authority. Who would then have such authority? Actual "inter se" authority would then proceed from the agreement of the parties (the operating agreement) and not a statutory rule that might not reflect the true understanding.

In those situations where the members would like "inter se" manager authority to be publicly available, a statement of ordinary authority could be filed with the Secretary of State "granting" authority to an office holder, title or particular person. While the statement of authority would create apparent authority it would not be based on a statutory default rule.

By eliminating the "dual-track" management structure, the confusing issue of a "public" articles manager without statutory authority disappears. This in turn makes it possible for the Conference to reconsider the structure and authority "de-link" in a much more simple model. No member is an agent because they are a member – period.

The need to file statements of ordinary authority to "limit" the authority of a member would become quite limited because persons have no statutory

apparent authority to be negated by the filing. This may facilitate further changes (see III below).

III. STATEMENT OF AUTHORITY

A. **Current Act –** ULLCA § 302(a)(2) states that an LLC may file a "statement of authority" to either grant or limit the authority of any person (or office) to (A) execute documents transferring real estate or (B) enter into any other transaction. ULLCA § 302(c) then provides different rules regarding the conclusiveness of the authority in cases of real estate and other transactions.

B. **Problems –** While ULLCA § 302 is much improved in internal integrity over its RUPA counterpart, it remains needlessly Delphic. If the Committee adopts (i) single track management structure in I above and (ii) eliminates all statutory authority in II above, then statements of authority will be confined principally to grants to transfer real estate and grants for management functions. Limitations will largely disappear because there is nothing to negate.

C. **Proposals –** Rewrite Section 302 into two sections. The first, Section 302 could be titled "Statement of Real Estate Authority" and deal with the grant of authority to transfer real estate and could be retained as drafted by carving out the relevant sections from current ULLCA § 302. The second, Section 302 could be titled "Statement of Other Authority" and deal with all other grants of authority and could be pulled from current ULLCA § 302. The advantage is drafting simplicity and drawing attention to the two different statements and the conclusive effect accorded to real estate. Easier to read, easier to understand.

IV. SHELF LLC & THE FIRST MEMBER ISSUE

A. **Current Act –** ULLCA § 102(8) defines an LLC as formed under this Act and having at least one member at formation. ULLCA § 201(a) provides that one or more persons may form an LLC by delivering articles for filing (but those persons need not become members). ULLCA § 201(a) does not require the articles to state the names of any member or to state the existence of a member.

ULLCA § 401(a) focuses upon manifesting assent to become a member as the proper test of membership but fails to precisely consider to whom a single member manifests assent to become the only member. The assumption is that, like with the SMLLC operating agreement, the assent is to that person's self, a rather silly notion that attempts to close the

"loop" that no state closes. So while it is clear that ULLCA § 102(8) affirmatively precludes a shelf LLC, there is little or no merit behind the first member admission.

B. **Problem –** The corporate "shelf LLC" without members at formation is designed to fix two problems: (i) the delay in time to form an LLC (not a true problem in most states) and (ii) to negate lawyer due diligence to determine the existence of a member at formation to issue a duly formed opinion.

At the 2005 Annual Meeting, several Commissioners made clear that Virginia expressly authorized the shelf-LLC "corporate" solution and that many other states did not expressly negate such an approach. Those Commissioners argued the shelf-LLC should exist to make it easier to do what is already done in nearly every state form an LLC without a member but with the intent to have a member soon (normally within 90 days as most LLC Acts require dissolution if no member within 90 days). Many Committee Commissioners also acknowledge this problem of a gap between practice and statutory language that is solved by the shelf-idea. At the same time, many on the Committee are opposed to a "shelf" concept as it directly violates the "agreement" or "consensual" foundation of the LLC and creates untoward complexities that will require an inordinate amount of time to analyze and fix.

In the final analysis, lawyers frequently form LLCs in a shelf form (without a member) and it is normally a problem ignored because most states (other than Alabama) do not require the articles to name any member or even to state the existence of a member.

C. **Proposals –** The problem appears to be more of an opinion standards problem than a shelf problem. Stated another way, the Virginia shelf language eliminates the lawyer's "due diligence" regarding the existence of a member at formation provided there is a member in existence at the time of the opinion. The effort here is to address the "real" problem and at the same time avoid the compromises the corporate shelf implies. This will requires at least a two-step approach: (i) eliminate the definition requirement that an LLC have a member at formation and (ii) amend the language of ULLCA § 209 (certificate of good standing) so that an opinion can be issued ion the basis of the certificate and not the true existence of a member at formation.

If the definition reference to a member at formation in ULLCA § 102(8) is eliminated, ULLCA would be in conformance with nearly every state but would not yet fix the opinion standard problem. **In fact, it is difficult to imagine that a Secretary of State could issue a certificate under ULLCA § 209(a)(2) that the LLC was "duly formed" because the**

definition makes formation dependent upon a member's existence. However, since the articles are silent on members, the Secretary of State has no method to verify membership.

ULLCA § 209(c) states that the certificate is conclusive evidence that the LLC is in existence. If the statutory language is revised to state the LLC is "conclusively" duly formed if a member is in existence at some time before 90 days after the articles are filed, an opinion may be possible on this basis. Another possibility (although clearly less desirable) is to make the organizer a non-economic member.

V. FIDUCIARY DUTIES

A. Current Provisions to Consider

i. **Duty of Care**
ii. **Duty of Loyalty**
iii. **Information Rights**
iv. **Indemnification**

NOTE – IF THE COMMITTEE DECIDES TO ABANDON THE DUAL-TRACK MANAGEMENT AND AGENCY AUTHORITY STRUCTURE, THE STRUCTURE OF FIDUCIARY DUTIES MUST BE RECONSIDERED.

B. Current Act – ULLCA § 409(a) omits the word "only" and then states the fiduciary duties of loyalty and ordinary care in both a member-managed [subsections (b)-(c)] and manager-managed [subsection (f)] LLC. ULLCA § 409(d) states a "contractual" obligation of good faith and fair dealing.

ULLCA § 408 grants member and managers statutory indemnification for liabilities "reasonably incurred" in the "ordinary and proper" conduct of the LLC activities.

ULLCA § 410 states rules applicable to when and how records and other information must be prepared or made available to members.

C. Problems – The RUPA standards have been significantly modified. First, by eliminating the adjective "only" modifying fiduciary duties, the Act obscurely permits judicial imposition of fiduciary duties in the context of member-to-member transactions arguably not permitted in RUPA, ULLCA or ULPA 2001.

Secondly, the Act cures the ambiguities inherent in the RUPA duty of care standard to "refrain from gross negligence" where neither ordinary care nor gross negligence is defined.

However, by switching the RUPA standard to a more demanding ordinary care standard (as is common in most states), the Act ignores the "loss sharing" ratio. ULLCA § 404(a) and ULLCA § 709(b)(2) provide that members share LLC profits equally as distributions. Thus, losses are shared equally at least as to the extent of LLC capital. The ULLCA § 305 member liability shield confines loss sharing to capital (unlike RUPA but like a RUPA, LLP). Is this the right result? The indemnification rules reinforce these rules by making entity capital bear the burden and risk of loss management error.

D. Proposals – Lowering the inter se standard of care (to ordinary care) of a manager who is also a member increases the manager's relative risk that entity capital or insurance may not be adequate to indemnify. Such a person assumes a greater risk than the other members – a risk greater than in a RUPA partnership not also an LLP (where other partners were required to contribute to the shared losses). That issue remains with respect to third parties because the inter se duty of care is not relevant to that liability and risk (again shared unequally by the risk taker as no obligation of other members to contribute). The question is whether a manager should also assume a greater portion of the risk beyond capital to his or her "partners?" The situation is not the same as in a corporation because in most cases the officer is not in a true "partner relationship" with other shareholders.

If the Committee decides to "equalize" the risk of loss among partners but at the same time increase the symbolic duty of care, the ordinary care standard could be maintained while providing for indemnification unless gross negligence. This approach also avoids definition problems associated with "refraining from gross negligence."

VI. SERIES LLC

A. Current Act – No provision.

B. Problem – Six states have now adopted the series LLC concept. Some are now abandoning the "private" series so designated in the operating agreement and are making a "public" series. In the latter case, the series is named in the articles and files a certificate of designation that allows the Secretary of State to issue a certificate of good standing. Newer series legislation also accords elective entity status, contract status, separate

name status, and separate asset and liability (with an "internal" but conditional liability shield between the series).

C. **Proposal** – Given the currency of the series movement, the Committee should consider a series LLC provisions and relevant implementing provisions.

VII. ACCOUNTING REMEDY

At the last meeting, the Committee removed all provisions relating to the accounting remedy. The partial rational was that the remedy was a vestige of the fragile partnership entity that necessarily dissolved when the members brought suit against each other. The remedy has no counterpart in close corporation law because the entity was more independent than old UPA partnerships from the fractured relationships of its owners. Some states have carefully considered the equitable accounting procedure in the context of the LLC. Should the Committee revisit this issue?

VIII. FUNDAMENTAL ORGANIC CHANGES

The Act includes basic organic change "stand alone" statutes to apply when META has not been adopted in a particular state where the Act has been adopted. The current provisions are borrowed from ULPA 2001 with a change to specifically apply to domestications (rather than being treated as a form of conversion). The Committee will consider whether these provisions should be further modified or updated given the META experience that now exists.

IX. OTHER ISSUES TO BE IDENTIFIED AT MEETING (BY ABA)

The issues identified in this Agenda are only the obvious issues. The Committee will allocate time to poll ABA members of the Committee for other issues they consider relevant to consider.

X. THE SINGLE-ISSUE TELECONFERENCE (60 MINUTES)

The Draft is likely to change considerably. Incremental change can be more carefully constructed through a series of single-issue and sixty-minute teleconferences between meetings to discuss and implement changes. The Committee will discuss implementing such a procedure.

THE END