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ULLCA DRAFTING COMMITTEE

ALTERNATIVE TO SECTIONS 110, 409 AND 410

OF THE 2004 ANNUAL MEETING DRAFT

presented pursuant to the discussion of the Drafting Committee

in its June 16, 2004 teleconference

SECTION 110. EFFECT OF OPERATING AGREEMENT; NONWAIVABLE PROVISIONS.

(a) A limited liability company may have an operating agreement, which may be oral, in a record, or implied, or in any combination thereof. An operating agreement is enforceable whether or not there is a record signed by a party against whom enforcement is sought, even if the operating agreement is not capable of performance within one year of its making.

(b) An operating agreement and any amendment to an operating agreement must be consented to by each member. A person that becomes a member in a limited liability company is bound by any operating agreement then in effect. Whether or not a limited liability company has itself manifested assent to the operating agreement, the limited liability company is bound by and may enforce the operating agreement.

(c) A limited liability company with one member may have an operating agreement. A sole member may make an operating agreement in any manner the member

desires, including by signing a record stating the terms of the agreement and that the agreement is the limited liability company's operating agreement.

(d) To the extent an operating agreement does not otherwise provide, this [act] governs the limited liability company, its activities and the relations among the limited liability company, its members and any managers.

(e) An operating agreement may provide indemnification for a member or manager and may limit or eliminate a member or manager's liability to the limited liability company and members for money damages, except for breach of the duty of loyalty, a financial benefit received by the member or manager to which the member or manager is not entitled, a breach of a duty under Section 406, intentional infliction of harm on the limited liability company or a member, or an intentional violation of criminal law.

(f) To the extent the operating agreement of a manager-managed limited liability company expressly and specifically relieves a manager of a responsibility that the manager would otherwise have under this [act] and imposes that responsibility on one or more members, the operating agreement may also eliminate or limit any fiduciary duty the manager would have had pertaining to that responsibility.

(g) Subject to subsections (e) and (f), an operating agreement may not:

(1) vary the restrictions stated in subsection (e);

(2) vary a limited liability company's capacity under Section 105 to sue, be sued, and defend in its own name;

(3) vary the law applicable under Section 106, but an agreement between a limited liability company and a manager that is not also a member may select, consistent with

otherwise applicable choice of law rules, a different law to govern any term of that agreement which does not address a matter governed by this [act];

(4) vary the requirements of Section 204;

(5) eliminate the duty of loyalty under Section 409(b), but:

(i) the operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and

(ii) all of the members or a number or percentage specified in the operating agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(6) unreasonably reduce the duty of care under Section 409(c);

(7) eliminate the obligation of good faith and fair dealing under Section 409(d), but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

(8) vary the power of a court to decree dissolution in the circumstances specified in section 701(a)(5);

(9) vary the requirement to wind up the limited liability company's business as specified in Section 702;

(10) unreasonably restrict the right to maintain an action under [Article] 9;

(11) **[reserved pending META for a provision prohibiting waiver of a member's protection against "interest holder liability"] or**

(12) restrict the rights under this [act] of a person other than a member or transferee.

Reporters' Notes

Subsection (a) – The Drafting Committee has debated whether an LLC necessarily has an operating agreement upon formation. The first sentence of this subsection appears to take a position on that issue, and the position might not reflect a Committee consensus. The problem might be resolved by revising the first sentence as follows: "~~A limited liability company may have an~~ An operating agreement~~, which~~ may be oral, in a record, or implied, or in any combination thereof."

The second sentence is included in response to an issue raised by the President of the Conference. The language comes from UCC § 8-113. Query whether the sentence should also refer to an amendment to the operating agreement.

Subsection (b) – The rules stated in this subsection, like almost all rules *inter se* the members, are subject to change by the operating agreement. See subsection (d).

Subsection (d) – This subsection states the basic proposition that, with regard to matters *inter se* a limited liability company and its members, this Act provides mere "default rules," which are subject to change by an operating agreement. The power of an operating agreement is itself subject to subsection (g) (non-waivable provisions of the Act).

This subsection can have a complex application when a manager-managed LLC engages a non-member manager. In those circumstances, the LLC and the non-member manager might enter into a contract separate from the operating agreement. That agreement will control as to any matters not addressed by this Act. However, with regard to a matter within this Act, that separate agreement has no power to change the "default rules." This subsection reserves that power to the operating agreement. Query whether an operating agreement could authorize a separate LLC-manager contract to change a default rule provided by this Act.

Subsection (e) – This subsection is based on MBCA § 2.02(b)(4) and (5). MBCA § 2.02(b)(4) authorizes a corporation's articles of organization to include:

> a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33 [director liability for unlawful distributions]; or (D) an intentional violation of criminal law.

MBCA § 2.02(b)(5) contains a parallel provision on indemnification.

Query whether this subsection authorizes a damage limitation applicable to claims of

oppression under Section 701(a)(5). The answer is probably (and properly) no, because oppression involves the "intentional infliction of harm on . . . a member." Moreover, if a money recovery is appropriate, a court can act under Section 701(b), order "a remedy other than dissolution," and style the remedy as restitution rather than damages.

Section 406 of this Act concerns liability for improper distributions.

Subsection (f) – For the situation contemplated by this subsection, Section 409(f)(4) of this Alternative imposes fiduciary duty on the member or members. This subsection addresses the correlative aspect and makes clear that the operating agreement can strip the fiduciary duty away from the manager. Query whether Section 409(f)(4) should be non-waivable.

Under ULLCA § 409(h)(4), "stripping away" occurs by statute (unless otherwise provided in the operating agreement).

ULPA 2001 takes a different approach and – consistent with that Act's assumption of strong, strongly-entrenched management – does not expressly contemplate this phenomenon. See ULPA 2001, §§ 305 (limited partners duties), 406 (management rights of general partners) and 408 (general standards of general partner's conduct). It is left to ULPA's Comments to contemplate reallocation of managerial responsibilities. See, e.g., Section 305, Cmt. ("It is possible for a partnership agreement to allocate significant managerial authority and power to a limited partner, but in that case the power exists not as a matter of status or role but rather as a matter of contract. The proper limit on such contract-based power is the obligation of good faith and fair dealing, not fiduciary duty, unless the partnership agreement itself expressly imposes a fiduciary duty or creates a role for a limited partner which, as a matter of other law, gives rise to a fiduciary duty. For example, if the partnership agreement makes a limited partner an agent for the limited partnership as to particular matters, the law of agency will impose fiduciary duties on the limited partner with respect to the limited partner's role as agent.")

Subsection (g) – The subsection continues the RUPA/ULLCA/ULPA 2001 approach of identifying non-waivable provisions of the Act. The introductory phrase ("Subject to . . .") is intended to coordinate subsections (e) and (f) with paragraphs (g)(5) and (g)(6), which contain RUPA-based provisions on what an operating agreement may and may not do with regard to the duty of loyalty and the duty of care. If the Drafting Committee decides to retain subsections (e) and (f), the co-reporters will further consider the coordination issue.

Previous versions of Section 110 have included language, drawn from Delaware law, to the following effect: "This [act] must be applied to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements." At its April, 2004 meeting, the Drafting Committee decided to delete that language.

Subsection (g)(1) – Subsection (e) expressly authorizes the operating agreement to eliminate or limit specified liabilities, subject to specified restrictions. Those restrictions are

inviolate; the operating agreement cannot override them.

Subsection (g)(3) – In matters pertaining to the LLC, relationships among the members and the LLC are governed by this Act and that choice of law is not waivable. This "internal affairs" principle applies even when, in a manager-managed LLC, a member happens to have the additional role of a manager.

When a manager-managed LLC engages a *non-member* manager, the situation is different. To the extent this Act covers a matter applicable to the role of the non-member manager, this Act provides the governing law. Although the operating agreement may change many of the rules provided by this Act, LLC and the manager may not make a wholesale, "choice of law" election out of this Act. For matters not within the Act's scope, ordinary choice of law principles should apply to the contract between an LLC and a non-member manager.

Subsection (g)(4) – Section 204 states rules for who may sign records to be filed under this Act.

Subsection (g)(5) – This provision essentially follows the RUPA/ULLCA/ULPA 2001 approach. The Drafting Committee has not yet discussed whether the nature and characteristics of an LLC warrant expanding or otherwise changing the specific examples in subparagraphs (i) and (ii). For example, query whether subparagraph (ii) should also refer to "disinterested managers". If so, the Drafting Committee will need to consider whether and, if so, how to define "disinterested" for this context.

In any event, it should be clear (and be made clear) that an operating agreement may authorize a member or manager to compete with the LLC.

Subsection (g)(6) – This provision follows the RUPA/ULLCA/ULPA 2001 approach. However, this Alternative provides a standard of care that differs from the RUPA/ULLCA/ULPA 2001 standard of avoiding gross negligence. Even assuming that this Alternative's standard of care remains in the Act, an operating agreement would certainly have the power to revise that standard to one of avoiding gross negligence.

Subsection (g)(7) – This provision is the standard RUPA/ULLCA/ULPA 2001 formulation.

Other issues still pending – whether a non-member may be a party to the operating agreement; e.g., a non-member manager, a non-member lender; whether (and, if so, how) an operating agreement can bind a non-manager member who is not a party to the agreement.

. . . .

SECTION 409. GENERAL STANDARDS OF MEMBER'S CONDUCT.

(a) The only fiduciary duties a member owes to the limited liability company are the duty of loyalty and the duty of care set forth in subsections (b) and (c).

(b) A member's duty of loyalty to a member-managed limited liability company is limited to the following:

(1) to account to the limited liability 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 limited liability company's business or derived from a use by the member of the limited liability company's property, including the appropriation of a limited liability company opportunity;

(2) to refrain from dealing with the limited liability company in the conduct or winding up of the limited liability company's business as or on behalf of a party having an interest adverse to the limited liability company; and

(3) to refrain from competing with the limited liability company in the conduct of the limited liability company’s business before the dissolution of the limited liability company.

(c) A member's duty of care to a member-managed limited liability company in the conduct of and winding up of the limited liability company's business is limited:

(1) when exercising discretionary authority in making decisions to take or not to take action, to acting:

(i) independently;

(ii) in a manner the member reasonably believes to be in the best interest of the limited liability company; and

(iii) after considering information the member reasonably believes

appropriate in the circumstances, including information provided by another person that the member reasonably believes is a competent and reliable source for the information; and

(2) in all other circumstances, to acting with the care that a person in a like position would reasonably exercise under similar circumstances.

(d) A member of a member-managed company shall discharge the duties under this [act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing.

(e) A member of a member-managed company does not violate a duty or obligation under this [act] or under the operating agreement merely because the member's conduct furthers the member's own interest.

(f) In a manager-managed company:

(1) subject to paragraph (4), a member does not have any duties or obligations under this section in the member's capacity as a member, except that subsections (d) and (e) apply to the member's conduct in that capacity;

(2) a manager is held to the same standards of conduct prescribed for a member in subsections (a) through (d), except that the obligation stated under subsection (b)(3) continues until winding up is completed;

(3) subsection (e) does not apply to a person in the person's capacity as a manager;

(4) if an operating agreement imposes on a member that is not a manager a responsibility that this [act] would otherwise impose on a manager, the standards of conduct prescribed by this subsection for a manager apply to the member with regard to that

responsibility.

Reporters' Notes

Subsection (a) – This is essentially the standard RUPA/ULLCA/ULPA formulation – i.e., the word "only" means that the listed duties are exhaustive. The Drafting Committee continues to debate whether this approach is appropriate for a limited liability company. Previous drafts have eschewed the "exhaustive" approach, and there is considerable support on the Committee and from at least some of the advisors for formulating the duties without using the word "only".

The Drafting Committee has decided that, in any event, this formulation should not refer to a member's duties to fellow members. The listed duties protect the entity and therefore do not provide any correlative direct rights for members. The Drafting Committee has determined that the direct/derivative distinction is an important one for limited liability companies, see Section 901(b), and that determination is consistent with the developing case law. At the moment, the Drafting Committee's discussion of member-to-member duties is taking place in the context of remedies for fraudulent, illegal and oppressive conduct. See Section 701(a)(5) and (b).

Subsection (b) – This subsection is adopted nearly verbatim from RUPA § 404(b) (loyalty). ULLCA and ULPA 2001 also followed RUPA on this point.

Subsection (c) – This subsection employs a bifurcated approach to the duty of care, recognizing that those with statutory management authority within an LLC sometimes perform governance functions and sometimes perform operational tasks. The language is based on (i) MBCA § 8.42(c), which states that in some circumstances officers should benefit from the business judgment rule protection provided to directors under MBCA § 8.31, and (ii) the Comment to MBCA § 8.42(c), which suggests that BJR protections are applicable to "decisions within an officer's discretionary authority."

Subsection (c)(1) – If this Alternative stays in the Act, the Drafting Committee will have to decide whether to have the Act define "discretionary authority" or to leave any further specificity to the Comments. In either event, the co-reporters contemplate building on the definition of "governance authority" in Section 102(7) of the 2004 Annual Meeting draft and stating that discretionary authority includes determining principal policies and strategies for a limited liability company, superintending and conducting oversight of the limited liability company's operations, and making "judgment calls" that concern major activities of the limited liability company. For an example of a "judgment call," consider the question of whether an LLC should "bond" an employee who handles large sums of money. That decision is a matter of "discretionary authority." In contrast, once a decision is made to secure a bond, obtaining the bond is not a matter of discretionary authority.

Subsection (c)(1)(i) – If the Drafting Committee adopts the approach suggested in this

Alternative, the co-reporters will develop a Comment to explain the meaning of "independently." Following is one possible explanation, which is based on the statutory language of MBCA §8.31(a)(2)(iii): To act "independently" means to be free of any conflicting influence that results from any personal stake in the matter or any familial, financial or business relationship with, or domination or control by, another person with a material financial interest in the matter.

N.b. – the reference to "personal stake" raises a question as to whether RUPA/ULLCA/ULPA's notion that self-interest is not per se bad should apply in business judgment rule contexts. As this Alternative is currently drafted, a member is entitled, as under RUPA/ULLCA/ULPA, to consider that member's self-interest and vote accordingly. See Section 409(e) of this Alternative. For example, a member who (with the consent of a member-managed LLC) owns a shopping center in competition with the LLC, may vote against the LLC opening a shopping center that would compete with the member's shopping center– even if the new shopping center would be in the best interests of the LLC. See RUPA § 404, Cmt. 5. As this Alternative is currently drafted, a manager of a manager-managed LLC is not so entitled. See Section 409(f)(3) of this Alternative.

Unlike MBCA § 8.31(a) and MBCA § 8.42(a), this subparagraph does not specifically refer to "good faith." A specific reference here would be duplicative of the Act's overarching obligation of good faith and fair dealing. See Section 409(d) of this Alternative.

Subsection (c)(1)(iii) – Note that business judgment rule protection extends only to decisions. Inattention, failure to adequately supervise, etc. come within the ordinary negligence standard of paragraph (c)(2). The MBCA has an arguably more lenient standard that applies to inattention. If the Drafting Committee prefers to hew more closely to the MBCA approach, the following language would warrant consideration:

> A member's sustained failure to devote reasonably sufficient time and attention to a matter within the member's discretionary authority is a breach of the duty of care, if particular facts and circumstances of significant concern existed which would have alerted a reasonable person in a like position to the need for timely attention and appropriate inquiry.

Subsection (c)(2) – The phrase "with the care that a person in a like position would reasonably exercise under similar circumstances" comes verbatim from MBCA § 8.42(a)(2) – the general standard of care for corporate officers.

Subsection (d) – This language follows the standard RUPA/ULLCA/ULPA 2001 approach.

Subsection (e) – This language follows the standard RUPA/ULLCA/ULPA 2001 approach.

Subsection (f) – This is a "switching section," which describes how the previously stated rules for a member-managed LLC apply in a manager-managed LLC.

Subsection (f)(2) – Continuing the non-compete obligation through winding up reflects the members' dependence on a manager and follows ULPA 2001, § 408(b)(3).

Subsection (f)(3) – Under this paragraph, a member's license for self-interested decision-making does not apply to a member-manager acting *qua* manager. See the Reporters' Notes to Subsection (c)(1)(i), above. To expand on the shopping center example provided there, assume: (i) an LLC is manager-managed; (ii) the LLC is considering building a shopping center that would compete with a shopping center owned by a member who is also a manager; and (iii) the operating agreement does not address this matter. If the member-manager is making the decision as manager, the member-manager may not act to protect the shopping center owned by the member-manager. However, if the members are making the decision, the member-manager may vote so as to protect the interests of the member-manager's shopping center.

Subsection (f)(4) – To the extent that an operating agreement divests the manager of a particular management responsibility and allocates that responsibility to one or more members, the operating agreement will have the power to strip away from the manager any fiduciary duty that corresponds to the divested responsibility. See Section 110(f) of this Alternative.

DELETE SECTION 410 OF THE 2004 ANNUAL MEETING DRAFT

Reporters' Notes

In the 2004 Annual Meeting draft, Section 409 states standards of conduct and Section 410 states standards of liability. This Alternative rejects that dualistic approach.

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