PRELIMINARY REPORT *
FOR DISCUSSION ONLY

REVISION OF UNIFORM LIMITED LIABILITY COMPANY ACT

NATIONAL CONFERENCE OF COMMISSIONERS

ON UNIFORM STATE LAWS

MEETING IN ITS ONE-HUNDRED-AND-TWELFTH YEAR
WASHINGTON, DC
AUGUST 1-7, 2003

REVISION OF UNIFORM LIMITED LIABILITY COMPANY ACT

WITH INTRODUCTION AND NOTES

** The Drafting Committee, which began its work in Spring 2003, is presenting this report in order to advise the Conference of its progress to date and to obtain comments regarding certain issues that it is considering. The draft has not been reviewed by the Committee on Style and will not be read line by line.*

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INTRODUCTION

(For a basic explanation of limited liability companies, see the document captioned "LIMITED LIABILITY COMPANIES, A KIND OF BUSINESS ORGANIZATION," available from the Conference's website and provided as part of the materials for the Annual Meeting.)

Background to this Drafting Project: Developments Since the Conference Considered and Approved the Original Uniform Limited Liability Company Act (ULLCA)

The Uniform Limited Liability Company Act ("ULLCA") was conceived in 1992 and first adopted by the Conference in 1994. By that time nearly every state had adopted an LLC statute, and those statutes varied considerably in both form and substance. Many of those early statutes were based on the first version of the ABA Model Prototype LLC Act.

ULLCA's drafting relied substantially on the then recently adopted Revised Uniform Partnership Act ("RUPA"), and this reliance was especially heavy with regard to member-managed LLCs. ULLCA's provisions for manager-managed LLCs comprised an amalgam fashioned from the 1985 Revised Uniform Limited Partnership Act ("RULPA") and the Model Business Corporation Act ("MBCA"). ULLCA's provisions were also significantly influenced by the then-applicable federal tax classification regulations, which classified an unincorporated organization as a corporation if the organization more nearly resembled a corporation than a partnership. Those same regulations also made the tax classification of single-member LLCs problematic.

Much has changed. All states and the District of Columbia have adopted LLC statutes, and many LLC statutes have been amended several times. LLC filings are significant in every U.S. jurisdiction, and in some states new LLC filings approach or even outnumber new corporate filings on an annual basis. Manager-managed LLCs have become a significant factor in non-publicly-traded capital markets, and increasing numbers of states provide for mergers and conversions involving LLCs and other unincorporated entities.

In 1997, the tax classification context changed radically, when the IRS' "check-the-box" regulations became effective. Under these regulations, an "unincorporated" business entity is taxed either as a partnership or disregarded entity (depending upon the number of owners) unless it elects to be taxed as a corporation. Exceptions exist (e.g., entities whose interests are publicly-traded), but, in general, tax classification concerns no longer constrain the structure of LLCs and the content of LLC statutes. Single-member LLCs, once suspect because novel and of uncertain tax status, are now popular both for sole proprietorships and as corporate subsidiaries.

ULLCA was revised in 1996 in anticipation of the "check the box" regulations and has been adopted in several states, but state LLC laws are far from uniform. In many other states, the

LLC statute includes RUPA-like provisions. In 1995, the Conference amended RUPA to add "full-shield" LLP provisions, and today every state has some form of LLP legislation (either through a RUPA adoption or similar revisions to a UPA-based statute). While some states still provide only a "partial shield" for LLPs, many states have adopted "full shield" LLP provisions. In full-shield jurisdictions, LLPs and member-managed LLCs offer entrepreneurs very similar attributes and, in the case of professional service organizations, LLPs might dominate the field.

The Drafting Committee's Work So Far

The Drafting Committee has had one meeting, in May, 2003, during which the Committee considered a briefing memo that identified and explained a set of fundamental issues. In addition, the Committee had a two-hour teleconference on June 26, 2003, to review proposed briefing materials for the 2003 Annual Meeting. After the teleconference, the briefing materials were substantially modified in accordance with the Committee's discussion and placed into their present form.

At the May, 2003 meeting, Committee members and advisors all agreed that the Conference should develop a replacement act, rather than mere amendments to ULLCA. With the help of its advisors, the Committee made some initial decisions on some issues fundamental to a new Act. However, those decisions were tentative, very general in nature, made without reference to any proposed statutory language, and intended merely to allow the Committee to move into its next phase of more focused discussion.

Purpose of the Discussion at the Annual Meeting

This project is on the agenda of the 2003 Annual Meeting so that the Committee of the Whole can consider the policy questions raised by a set of fundamental issues selected by the Drafting Committee. Comments from the Committee of the Whole will inform the next phase of the Drafting Committee's work.

EXECUTIVE SUMMARY OF ISSUES

TOPIC ONE – PURPOSE

Current Uniform Act and Other State LLC Statutes

ULLCA allows a limited liability company to be organized for "any lawful purpose" subject to state law governing or regulating businesses (a defined term including nonprofit businesses). Although this approach conforms to most state LLC laws, a few impose a "lawful business" limitation.

The Drafting Committee's Current View

The new Act should expand ULLCA's language to make clear that a limited liability company may be used for any "lawful purpose" whether or not for profit. This broad approach would encompass charitable purposes, and therefore other state laws controlling the diversion of charitable and trust property may be implicated. The new Act will rely on rather than replicate that other law.

TOPIC TWO -- DURATION

Current Uniform Act and Other State LLC Statutes

ULLCA permits an LLC either to have a term or be at-will and provides that a limited liability company is at-will unless the articles of organization specify a term. State LLC laws do not follow the term/at-will approach; most simply provide that an LLC has a perpetual duration.

The Drafting Committee's Current View

The new Act should provide for perpetual duration, subject to contrary arrangement among the members. While this approach follows the majority of states and conforms to the expectations of most users, it also eliminates a dissolution event that is inevitable under ULLCA and thereby increases the lock-in effect on members. As a result, the new Act must give careful attention to judicial remedies. (See related discussion under Topic Eight).

TOPIC THREE -- OPERATING AGREEMENT

Current Uniform Act and Other State LLC Statutes

Under ULLCA and all state LLC acts, the operating agreement is the fundamental governance document as among the members, any managers and any transferees. On internal matters, ULLCA's rules apply only if the operating agreement does not provide otherwise. Consistent with most state LLC acts, ULLCA does not require the operating agreement to be in writing.

The Drafting Committee's Current View

The new Act should continue ULLCA's basic approach while adding several refinements: (i) providing for an operating agreement in a single member LLC; (ii) binding each new member automatically to whatever operating agreement exists when the person is admitted as a member; (iii) making the limited liability company automatically a party to the operating agreement; and (iv) authorizing an operating agreement to contain an enforceable "no oral modification" clause.

TOPIC FOUR -- "SHELF" LLCs AND BECOMING A MEMBER

Current Uniform Act and Other State LLC Statutes

ULLCA does not allow an LLC to be formed without members (a so-called "shelf" LLC), provides that members are admitted with the consent of all previously admitted members, and does not provide a procedure for admitting initial members (i.e., at formation of the limited liability company). Many state LLC laws provide elaborate admission procedures that formally distinguish among admission of members (i) at formation, (ii) thereafter, and (iii) as part of the transfer of a member's economic rights. Almost all state LLC statutes accord with ULLCA and do not allow an LLC to be created without members.

The Drafting Committee's Current View

The Drafting Committee has only begun its discussion of the "shelf" LLC, which, according to its supporters, would permit flexible formation and long-term planning as well as provide a way to circumvent long filing delays in some states. The topic raises a very fundamental conceptual issue: Is a limited liability company more properly understood as an entity separate from its members or as an arrangement constructed by the agreement of the members? The Committee has not decided, even provisionally, how the new Act should handle this matter and has only directed the reporters to draft language to show how the new Act *might* provide for shelf LLCs. The Committee's early discussions on this topic have involved robust debate.

TOPIC FIVE -- STATUTORY APPARENT AUTHORITY TO BIND THE LLC

Current Uniform Act and Other State LLC Statutes

Following the UPA and RUPA, ULLCA contains a statutory provision on a person's apparent authority to bind the limited liability company. Like most state LLC statutes, ULLCA provides a two-track approach. Every member of a member-managed LLC has statutory apparent authority bind the limited liability company but only a manager of a manger-managed LLC has such authority. Since the management structure is specified in the articles, ULLCA allows a public record to sever the statutory apparent authority of a non-manager member to bind a manager-managed LLC, regardless of whether a third party actually knows of the filing.

The Drafting Committee's Current View

The new Act should eliminate statutory apparent authority, while permitting the articles of organization to identify persons and positions with power to bind the limited liability company. This approach differs substantially from almost all state LLC laws.

TOPIC SIX -- INTERNAL MANAGEMENT STRUCTURE

Current Uniform Act and Other State LLC Statutes

ULLCA provides that a limited liability company is managed by its members unless the articles provide for manager-management and permits both the articles and operating agreement to change the internal governance relationships established by statute. Most state LLC laws are in accord.

The Drafting Committee's Current View

In light of the Drafting Committee's tentative decision to eliminate statutory apparent authority (Topic Five), there is no reason to require the articles of organization (a public document) to specify a limited liability company's internal governance structure. Therefore, the new Act should allocate that specification to the operating agreement. The new Act should continue ULLCA's approach of presuming member-management and should provide an "elective" set of rules for structuring the governance of a manager-managed LLC. Those elective rules should be subject to change by the operating agreement.

TOPIC SEVEN -- FIDUCIARY DUTIES AND THE OBLIGATION OF GOOD FAITH AND FAIR DEALING

Current Uniform Act and Other State LLC Statutes

ULLCA closely follows RUPA's statement of a partner's fiduciary duties and obligation of good faith and fair dealing, except that ULLCA does not allocate the duties and obligations to all members in all situations. As with management structure and statutory apparent authority, ULLCA follows a two-track approach. The duties and obligations apply to all members when the limited liability company is member-managed. When the limited liability company is manager-managed, the duties and obligations apply exclusively to the managers, except to the extent a non-managing member actually assumes a managerial function. State LLC laws vary widely both as to the scope of such duties and who has them.

The Drafting Committee's Current View

The Drafting Committee has only begun its discussion of this topic and has directed the Reporters to draft language merely to serve as a basis for discussion. The suggested new language differs from ULLCA by: (i) not stating that the listed duties of loyalty and care are the "only" fiduciary duties; (ii) not suggesting that the stated duties of loyalty and care are owed *directly* to the members as well as to the limited liability company; (iii) not directly and categorically describing the loyalty and care duties of managers in a manager-managed LLC; (iv) not addressing the loyalty and care duties of a non-member manager.

TOPIC EIGHT -- HOW TO APPROACH JUDICIAL REMEDIES

The Drafting Committee has only begun to discuss this very difficult topic, and, has so far taken no position, not even provisionally. However, the Drafting Committee has made decisions on two related issues, and those decisions increase the significance of judicial remedies:

1. ULLCA did not permit a limited liability company to have perpetual duration. As explained in Topic Two, the Drafting Committee has decided that a limited liability company formed under the new Act will have perpetual duration unless the members choose otherwise.

2. Consistent with its provisions requiring a limited liability company to be either "at will" or for a stated term, ULLCA provided each member a limited "put" right – i.e., the right under specified circumstances to require the limited liability company to buy out the member's interest. This approach is at odds with the overwhelming majority of state LLC statutes and is contrary to the expectations of most persons that use limited liability companies. The Drafting Committee has therefore decided that the new Act should not include a put right.

As a result, it is possible that minority members under the new Act will be more "locked in" and vulnerable to misconduct than are minority members under ULLCA. In the view of the Drafting Committee, this possibility warrants careful reexamination of the judicial remedies provided under ULLCA.

TOPIC NINE -- CHARGING ORDER

Current Uniform Act and Other State LLC Statutes

ULLCA carefully follows the comparable RUPA charging order provision but alters it to fit the different context of an LLC. Most state LLC laws have adopted the simpler ULPA 1985 charging order language.

The Drafting Committee's Current View

The Drafting Committee's current view is not well developed as discussion has only begun on this issue. However, some recent litigation reveals some courts as confused as to whether the creditor of a member can reach LLC assets. Further, both Articles 8 and 9 of the UCC have specific provisions that affect a secured creditor's rights, and thus the need exists to clarify that the exclusive charging order remedy controls only as to unsecured judgment creditors and to explain how the charging order interfaces with the rules of Articles 8 and 9.

End of Executive Summary of Issues

Content and Structure of the Remainder of These Materials

The remainder of these materials discuss in detail the nine topics just described in the Executive Summary. For each topic, the materials provide:

- suggested statutory language for the new Act, which has not been adopted by the Drafting Committee, is not submitted for approval by the Committee of the Whole, and is intended merely to focus discussion[1]
- current ULLCA provisions on the topic – provided for comparison purposes
- explanation of the current ULLCA rule
- description of state LLC law developments
- Reporters' Notes explaining the major issues under consideration by the Drafting Committee and examining some of the questions raised by the suggested statutory language

[1] As explained in Topic Eight, no suggested language is provided for that Topic.

<u>TOPIC ONE – PURPOSE</u>

NEW SUGGESTED LANGUAGE

[to be located either in Article 1 or 2]

SECTION___. NATURE AND PURPOSE

A limited liability company created under this [Act] may carry on any lawful business, purpose or activity, whether or not for profit.

[Alternate Version]

A limited liability company may be created under this [Act] for any lawful purpose and may carry on any lawful affairs and activities, whether or not for profit.

<u>CURRENT ULLCA PROVISION</u>

SECTION 112. NATURE OF BUSINESS AND POWERS

(a) A limited liability company may be organized under this [Act] for any lawful purpose, subject to any law of this State governing or regulating business.. . . .

Reporters' Notes

Current ULLCA Rule -- ULLCA § 112(a) provides that a limited liability company may be organized for any "lawful" purpose but contains two vestiges of a "business purpose" approach. The Section's caption refers to "Nature of Business," and subsection (a) is expressly subject to "any law of this State governing or regulating business." The phrase "any lawful purpose" encompasses activities not intended to produce a profit, but ULLCA § 112(a) does not include the phrase "whether or not for profit." (However, ULLCA § 101(3) defines "Business" as including "every trade, occupation, profession, and other lawful purpose, whether or not carried on for profit.")

State LLC Law Developments –Most states permit a limited liability company to be organized for any "lawful purpose" but do not include the phrase "whether or not for profit." A few states combine the expansive "lawful purpose" language with that further clarifying phrase. *See, e.g.,* 6 Del. C. § 18-106, K.S.A. § 17-7668, 18 Okl. St. §2002, and W. Va. Code § 31B-1-112. Some states impose a "lawful business" requirement. See, e.g., Cal. Corp Code § 17002, C.R.S § 7-80-103, or refer to any business purpose subject to other law. See e.g., Minn. Stat. § 322B.10, N.D. Cent. Code, § 10-32-04, and Tex. Rev. Civ. Stat. art. 1528n 2.01A . (The MBCA takes the "lawful business" approach. See MBCA § 3.01(a).)

The expansive approach is the modern trend for LLC statutes and comports with the Conference's most recently-adopted business entity statute. ULPA (2001) § 104(b) follows ULLCA § 112(a) and allows a limited partnership to be organized for any "lawful" purpose. It is thus possible to have a limited partnership that has no "for profit" purpose. *Compare* UPA § 6 (defining a general partnership as organized for profit), RUPA § 101(6) (same), and RULPA (1976/85) § 106 (delineating the "Nature of [a limited partnership's] Business" by linking back to "any business that a partnership without limited partners may carry on").

Current Approach of the Drafting Committee – The Drafting Committee's current view is that the new Act should:

- continue the current ULLCA § 112 approach – i.e., permit a limited liability company to carry on any lawful purpose and not restrict limited liability companies to activities with a business purpose;

- clarify that a lawful purpose may include non-pecuniary activities; and

- acknowledge in a comment that the new Act has no special provisions to protect the public interest in the event a limited liability company undertakes charitable functions

<u>Relationship of non-pecuniary activities to the new Act's default rules</u> – Many of ULLCA's provisions presuppose a profit-making purpose. *See, e.g.,* ULLCA §§ 101(5) (defining "distribution"), 101(6) (defining "distributional interest"), 401 (form of contribution), 405 (sharing of and right to distributions), and 806 (distribution of assets in winding up). The Drafting Committee has not yet discussed any of these provisions, but it seems likely that the new Act will also contain an elaborate structure premised on profit-making. Those who use the new Act for non-profit purposes will have to take care to provide substitute rules through the operating agreement.

<u>"Lawful purpose" and charitable undertakings</u> – The suggested statutory text does not expressly prevent a limited liability company from being organized to carry on charitable activities, and the new Act will not include any protective provisions pertaining to charitable purposes. Those protections must be (and typically are) found in other law, although

sometimes that "other law" appears within a state's non-profit corporation statute. A comment will make this point clear, and perhaps a legislative note will suggest the need to assure that such other law refers not only to corporations but also to limited liability companies. *See, e.g.,* Minn. Stat. § 317A.811 (providing restrictions on charitable organizations that seek to "dissolve, merge, or consolidate, or to transfer all or substantially all of their assets" but imposing those restrictions only "corporations," which are elsewhere defined as corporations incorporated under the non-profit corporation act).[2]

TOPIC TWO – DURATION

NEW SUGGESTED LANGUAGE

[to be located either in Article 1 or 2]

[Alternative A]

Once created under Section ___, a limited liability company continues in existence until terminated under Section ___.

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[2] For an alternative approach, see Proposed Model Inter-Entity Transactions Act § 1.04(b), an optional provision that states:

> Nonprofit entities.--Property held in trust or for charitable purposes under the laws of this state by a domestic or foreign entity shall not, by any transaction under this [Act], be diverted from the objects for which it was donated, granted or devised, unless and until the entity obtains an order of [court] [the attorney general] specifying the disposition of the property to the extent required by or pursuant to [cite state statutory cy pres or other nondiversion statute].

57 Bus. Lawyer 1569, 1580 (August 2002). The proposed Comment explains:

> This Act applies generally to nonprofit corporations and unincorporated nonprofit associations. . . . . [A] state's laws governing the nondiversion of charitable and trust property to other uses may not be worded in a fashion that will include at least some of the transactions authorized by this Act. To prevent the procedures in this Act from being used to avoid restrictions on the use of property held by nonprofit entities, subsection (b) requires approval of the effect of transactions under this Act by the appropriate arm of government having supervision of nonprofit entities.

Id. at 1580 – 1581.

[Alternative B]

A limited liability company has a perpetual duration.

CURRENT ULLCA PROVISIONS

SECTION 101. DEFINITIONS.

. . . .

(2) "At-will company" means a limited liability company other than a term company.

. . . .

(19) "Term company" means a limited liability company in which its members have agreed to remain members until the expiration of a term specified in the articles of organization.

SECTION 203. ARTICLES OF ORGANIZATION.

(a) Articles of organization of a limited liability company must set forth:

. . . .

(5) whether the company is to be a term company and, if so, the term specified;

. . . .

SECTION 603. EFFECT OF MEMBER'S DISSOCIATION.

(a) Upon a member's dissociation:

(1) in an at-will company, the company must cause the dissociated member's distributional interest to be purchased under [Article] 7; and

(2) in a term company:

(i) if the company dissolves and winds up its business on or before the expiration of its specified term, [Article] 8 applies to determine the dissociated member's rights to distributions; and

(ii) if the company does not dissolve and wind up its business on or before the expiration of its specified term, the company must cause the dissociated member's distributional interest to be purchased under [Article] 7 on the date of the expiration of the term specified at the time of the member's dissociation.

. . . .

SECTION 701. COMPANY PURCHASE OF DISTRIBUTIONAL INTEREST.

(a) A limited liability company shall purchase a distributional interest of a:

(1) member of an at-will company for its fair value determined as of the date of the member's dissociation if the member's dissociation does not result in a dissolution and winding up of the company's business under Section 801; or

(2) member of a term company for its fair value determined as of the date of the expiration of the specified term that existed on the date of the member's dissociation if the expiration of the specified term does not result in a dissolution and winding up of the company's business under Section 801.

. . . .

SECTION 801. EVENTS CAUSING DISSOLUTION AND WINDING UP OF COMPANY'S BUSINESS.

(a) A limited liability company is dissolved, and its business must be wound up, upon the occurrence of any of the following events:

. . . .

(5) on application by a transferee of a member's interest, a judicial determination that it is equitable to wind up the company's business:

(i) after the expiration of the specified term, if the company was for a specified term at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer; or

(ii) at any time, if the company was at will at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer.

Reporters' Notes

Current ULLCA Rule – ULLCA adopts a two-track approach, permitting an LLC either to have a term or be at will. ULLCA § 203(a)(5) provides that "the [a]rticles of organization of a limited liability company must set forth . . . whether the company is to be a term company and, if so, the term specified." The Comment notes that "A company will be at-will unless it is designated as a term company and the duration of its term is specified in its articles under Section 203(a)(5)." See also ULLCA §§ 101(2) (defining an "At-will company" as "a limited liability company other than a term company" and 101(19) (defining "Term company" as "a limited liability company in which its members have agreed to remain members until the expiration of a term specified in the articles of organization"). A member's exit rights are substantially greater in an at-will company than in a term company. *Compare* ULLCA § 603(a)(1) and (2) and *see* ULLCA § 701 (stating a "put" right for dissociated members – i.e., the limited liability company's obligation in limited circumstances to purchase the interest of a dissociated member). The notion of an at-will company and the two-track approach follow the law of general partnerships.

State LLC Law Developments – The notion of an at-will LLC never took hold, and at one time the typical approach was to require an LLC to have a term.[3] Today, a majority of states provide that an LLC, like a corporation, continues perpetually unless the members provide otherwise.

Current Approach of the Drafting Committee – The Drafting Committee's current view is that the new Act should provide for perpetual duration, subject to contrary arrangement by the members, and should not provide any obligation for a limited liability company to purchase the interest of a dissociated member – i.e., no "put" right.

> Perpetual duration: This approach follows the majority of states and conforms to the expectations of most users.
>
> Subject to change in both the operating agreement and articles of organization: The new Act should permit both the operating agreement[4] and the articles of organization to provide for dissolution[5] of the limited liability company, thereby permitting the members to alter the rule of perpetual duration.
>
> This approach might seem at odds with ULLCA § 203(a)(5), which provides for the articles of organization to state "whether the company is to be a term company and, if so, the term specified." However, ULLCA § 801(a)(1) authorizes the operating agreement to specify events of dissolution.
>
> The latter approach isnow commonplace. *See, e.g.*, Del. Code Ann. tit. 6, § 18-801 (a)(1) and (2) (providing for dissolution of a Delaware LLC "[a]t the time specified" or "[u]pon the happening of events" stated in the limited liability company agreement) and Fl. Stat. § 608.441(1)(a) and (b) (same); Colo. Rev. Stats. § 7-80-7-80-801(1)(d) (time or events specified in writing in an operating agreement); NY Limited Liability Company Law § 701(a)(1) and (2) (date specified in articles or operating agreement; event specified in operating agreement).

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[3] The first modern LLC statute required a term, as did all of the first "copy cat" statutes. The statute drafters may have believed that requiring a finite term was important for federal tax classification purposes in order to negate the corporate characteristic of continuity of life. (That belief was almost certainly incorrect and is in any event now moot. See the discussion in the Introduction of the "check the box" tax classification regulations that took effect January 1, 1997.)

[4] The operating agreement is the private agreement among the members of a limited liability company and is discussed in more detail below, in Topic Three.

[5] Dissolution does not terminate the existence of a limited liability company but instead puts the limited liability company into a "winding up" mode. During winding up, a limited liability company may properly engage only in activities appropriate for closing down its activities, paying its creditors (or providing for their payment) and distributing any remaining assets to members.

Under the approach contemplated by the Drafting Committee, the public record pertaining to a limited liability company will not necessarily reveal whether the limited liability company actually has a perpetual duration. *Accord* ULPA (2001) § 103, comment to subsection (c) ("The partnership agreement has the power to vary this subsection [which provides for perpetual duration], either by stating a definite term or by specifying an event or events which cause dissolution. . . . . [The limited partnership act] also recognizes several other occurrences that cause dissolution. Thus, the public record pertaining to a limited partnership will not necessarily reveal whether the limited partnership actually has a perpetual duration.")

<u>Dissolution by member consent</u>: The new Act should provide for dissolution by member consent, even if not authorized by the operating agreement or articles of organization, unless prohibited by the operating agreement or the articles.

Virtually all states take this approach, which is also characteristic of modern corporate law and the law of general and limited partnerships. If an LLC's operating agreement or articles bar such "voluntary" dissolution, an amendment to one or the other will remove the barrier. The Drafting Committee has not yet considered what quantum of consent will be required to voluntarily dissolve an LLC, but logic requires that the quantum be the same as the quantum required to amend the operating agreement.

<u>No statutory "put" right for dissociated members</u>: Although a key part of ULLCA's Article 7, this approach gained little acceptance and does not reflect the expectations of most users. See further discussion in Topic Eight.

<u>No different or additional statutory mechanism for dissolution in a manager-managed limited liability company</u>: Some acts governing other types of entities place special focus on managers. For example, under § 14.02 of the Model Business Corporation Act ("MBCA") shareholders may vote to dissolve the corporation only if the board of directors presents to the shareholders a proposal for dissolution. Under ULPA (2001), § 801(2) and (3), general partners act separately from limited partners in consenting to voluntary dissolution, and the dissociation of a general partner is itself an event that can occasion a decision to voluntarily dissolve.

For several reasons the Drafting Committee views such special focus as inappropriate under the new Act. First, unlike the law of corporations and limited partnerships, the new Act presupposes management by members rather than by managers. Second, to the extent the organizers or members of an LLC want to arrange manager-management, they will have to tailor that structure for themselves.[6] In doing so, they can, if they wish, provide

[6] As discussed below, in Topic Six, the Act will provide a manager-management structure whichthat the new members may elect to use, but, even if chosen, that structure will be subject to any revisions the organizers or members wish to make.

for a special role for managers in provisions relating to dissolution of the limited liability company.

Suppose, for example, that several people contribute capital to an LLC to be managed by one highly-respected and skilled individual. The members generally agree that the venture's success depends on that individual's continuing role as manager. The LLC's operating agreement will necessarily specify the management authority of this individual and can likewise provide for dissolution (or at least the possibility of dissolution) if the individual ceases to act as manager.

Effect when a limited liability company ceases to have any members: Perpetual duration does not create this issue; a term LLC might become "member-less" before the expiration of the term. Perpetuity does, however, increase the likelihood that the issue will eventually arise. The Drafting Committee has noted the importance of this issue but has not yet discussed a solution. Possibilities include: authorizing the legal representative of the last member to become or admit a member; authorizing the transferees to become or admit members

Related Issues: Providing for perpetual duration (and accordingly eliminating ULLCA's Article 7 "put" right) increases the "lock in" effect on members and thereby increases the opportunities for "oppression" of minority interests. Related topics include: rights of members to transfer interests; fiduciary duties of those in control of an LLC; rights to seek judicial intervention for oppressive behavior (Topic Eight).

Alternative A -- This approach has the virtue of accuracy and arguably the disadvantage of omitting the "buzz word" of perpetuity. The Delaware statute, among others, takes this approach. Del. Code. Ann., tit. 6, § 18-201(b) ("A limited liability company formed under this chapter shall be a separate legal entity, the existence of which as a separate legal entity shall continue until cancellation of the limited liability company's certificate of formation.")

Alternative B -- Source: ULPA § 104(c). See also MBCA § 3.02 ("Unless its articles of incorporation provide otherwise, every corporation has perpetual duration . . . .)

In this context, the word "perpetual" is a misnomer, albeit commonplace. The new Act, like all current LLC acts, will provide several avenues to avoid perpetuity: a term specified in the operating agreement or articles; an event specified in the operating agreement or articles; member consent.

The New Jersey LLC Act recognizes the incongruity of a "perpetual" duration that is subject to contingencies. NJ Stat. Ann. § 42:2B-11(4) provides that:

> If the limited liability company is to have perpetual existence, regardless of whether the limited liability company is subject to any dissolution contingencies, then the word "perpetual" shall be stated [in the articles of organization]; if the limited liability company is to have a specific date of dissolution, regardless of whether the limited liability company is subject to any dissolution contingencies, [the articles of organization shall state] the latest date on which the limited liability company is to dissolve.

See also Ariz. Rev. Stat. § 29-635(B) ("A limited liability company continues perpetually unless otherwise provided in its articles of organization or operating agreement or until the limited liability company is dissolved and terminated in accordance with this chapter.")

TOPIC THREE -- OPERATING AGREEMENT

NEW SUGGESTED LANGUAGE

SECTION ___ DEFINITIONS.

. . . .

(__) "Operating agreement" means an agreement under Section ___ and includes any amendments to the agreement.

SECTION ___. OPERATING AGREEMENT

(a) Except as provided in subsection (b):

(1) all the members of a limited liability company may make an operating agreement to govern any aspect or phase of the affairs of the company, the conduct of its activities, and the relations among the members, the company, any managers and any transferees;

(2) it is the policy of this [Act] to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements; and

(3) an operating agreement controls over any contrary provision of this Act.

(b) An operating agreement may not **[list of non-waivable provisions of the new Act to be inserted here; the exact composition of the list is TBD – the Drafting Committee intends a careful review of ULLCA § 103(b)]**

(c) Except as provided in subsection (d), an operating agreement may be oral, implied, in a record, or in any combination. An operating agreement and any amendment to the agreement must be agreed to by each person that will be a member when the operating agreement or amendment takes effect. By being admitted as a member of a limited liability company that has an operating agreement, a person agrees to that operating agreement.

(d) An operating agreement in a signed record which excludes modification or rescission except by a signed record cannot be otherwise modified or rescinded.

(e) A limited liability company is a party to any operating agreement among its members, regardless of whether the limited liability company has itself manifested assent to the agreement. A person that is not a member of a limited liability company may be a party to the limited liability company's operating agreement.

(f) The sole member of a limited liability company may have an operating agreement that is effective under this Act if:

(1) the sole member signs a record stating:

(i) the agreement and

(ii) that the agreement is the limited liability company's operating agreement; or

(2) the agreement was effective as the limited liability company's operating agreement immediately before the member become the sole member of the limited liability company.

CURRENT ULLCA PROVISIONS

SECTION 101. DEFINITIONS.

. . . .

(13) "Operating agreement" means the agreement under Section 103 concerning the relations among the members, managers, and limited liability company. The term includes amendments to the agreement.

. . . .

SECTION 103. EFFECT OF OPERATING AGREEMENT; NONWAIVABLE PROVISIONS

(a) Except as otherwise provided in subsection (b), all members of a limited liability company may enter into an operating agreement, which need not be in writing, to regulate the affairs of the company and the conduct of its business, and to govern relations among the members, managers, and company. To the extent the operating agreement does not otherwise provide, this [Act] governs relations among the members, managers, and company.

(b) The operating agreement may not:

(1) unreasonably restrict a right to information or access to records under Section 408;

(2) eliminate the duty of loyalty under Section 409(b) or 603(b)(3), but the agreement may:

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

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

(3) unreasonably reduce the duty of care under Section 409(c) or 603(b)(3);

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

(5) vary the right to expel a member in an event specified in Section 601(6);

(6) vary the requirement to wind up the limited liability company's business in a case specified in Section 801(a)(3) or(a)(4); or

(7) restrict rights of a person, other than a manager, member, and transferee of a member's distributional interest, under this [Act].

Reporters' Notes

Current ULLCA Rule – ULLCA makes the operating agreement the fundamental document as to the members. ULLCA §§ 103(a) (providing plenary power to the operating agreement to "regulate the affairs of the company and the conduct of its business, and to govern relations among the members, managers, and company," subject to a list of exceptions) and 203(c)(1) (providing that, *inter se* the members and as to transferees, the operating agreement prevails over the articles). ULLCA § 103(a) specifically states that the operating agreement "need not be in writing."

State LLC Law Developments – All LLC statutes accord a primary role to the operating agreement; a few states use a different name for the agreement (e.g. "limited liability company agreement"). LLC statutes generally do not require the operating agreement to be in writing, although some statutes specify a few statutory rules that can be altered only by a written provision of an operating agreement. *E.g.* Cal. Corp. Code § 17005(b) (stating that specified provisions of the California LLC act " may only be varied by the articles of organization or a written operating agreement") and (d) ("The fiduciary duties of a manager to the limited liability company and to the members of the limited liability company may only be modified in a written operating agreement with the informed consent of the members."). The common law is hostile to "no oral modification" (NOM) clauses, and the suggested subsection (d) is therefore at odds with the current common law of most, if not all, states. The suggested language is, however consistent with UCC, Article 2. See the more detailed discussion below in the notes to subsection (d).

Issues under Consideration by the Drafting Committee –

Adopt an "in a record" requirement for the operating agreement? – Although the modern trend is away from statutes of fraud, allowing oral and course-of-conduct operating agreements may create traps for the unwary. The problems may be especially acute for non-founding members and transferees, who will be bound to the operating agreement *whatever it may subsequently be determined to have been.*

This issue highlights the one of the differences between a corporation and a limited liability company (if the limited liability company is understood primarily as a contract-based organization). Compare MBCA § 7.32(b) (requiring a shareholders agreement to be in writing) with Restatement (Second) of Contracts § 317 (discussing assignment of a contract right and requiring neither the contract right nor the assignment to be in writing). Note that an LLC that appears to have perpetual duration may be subject to dissolution according to the terms of an oral understanding among the LLC's original members.

The Committee has decided not to create any "in a record" requirements for the operating agreement. The Committee did, however, tentatively decide to authorize an operating agreement "in a signed record" to include a "no oral modification" provision. See the more detailed discussion below, in the notes to subsection (d).

The Committee is also considering whether the special circumstances of a single member limited liability company ("SMLLC") warrants imposing an "in a record" requirement for SMLLC operating agreements. See suggested subsection (f) and the notes to that subsection.

Should the Act expressly authorize the adoption of an operating agreement before the LLC comes into existence? – Some statutes expressly permit an LLC's operating agreement to be assented to before the LLC comes into existence. At its initial meeting, the Drafting Committee did not decide whether the Act should include such a provision. The issue raises some interesting conceptual problems: for example, if an operating agreement is an agreement among members (rather than an organic document of an entity) and a person cannot be a member of an LLC before the LLC exists, how is pre-existence assent possible?

Some LLC statutes have addressed this issue. *See e.g.* see Cal. Corp. Code § 17001(ab) ("The term 'operating agreement' may include, without more, an agreement between all the members to organize a limited liability company pursuant to the provisions of this title."); Fl. Stat. Ann. § 608.423(1) ("The members of a limited liability company may enter into an operating agreement before, after, or at the time the articles of organization are filed, and the operating agreement takes effect on the date of the formation of the limited liability company or on any other date provided in the operating agreement."); and NY Ltd. Liab. Co. Law § 417(c) ("An operating agreement may be entered into before, at the time of or within ninety days after the filing of the articles of organization. Regardless of whether such agreement was entered into before, at the time of or after such filing, such agreement, may be effective upon the formation of the limited liability company or at such later time or date as provided in the operating agreement; provided, however, under no circumstances shall an operating agreement become effective prior to the formation of such company.") However, none of these statutes completely handle the conceptual problems. For example, under the Florida statute how can "members" "enter into an operating agreement before . . . the time the articles of organization are filed" when, until the articles take effect no LLC exists and therefore there is nothing of which a person can be a "member"?

In any event, contract law provides a solution that is both practical and conceptually sound. Persons intending to organize an LLC and become its initial members can make an agreement that becomes effective upon the occurrence of a set of conditions – namely, the formation of the LLC and the admission of each of the persons as members. The statutory language suggested above therefore does not address this issue.

The last sentence of suggested subsection (e) (authorizing non-members to be parties to an operating agreement) is not intended to authorize an operating agreement to pre-exist the limited liability company. The suggested language assumes that an operating agreement cannot exist until the limited liability company has at least one member to assent to the agreement.

<u>Should the Act expressly provide for the operating agreement's effect on new members?</u> -- Some LLC statutes expressly consider the relationship between an operating agreement and the status of a new member, and the Drafting Committee has tentatively decided that the new Act should do likewise. This decision raised a further issue: should the Act condition membership on assent to the operating agreement, or provide that by becoming a member a person is deemed to assent? At its initial meeting, the Drafting Committee tentatively chose the latter approach.

<u>What is the relationship of the LLC to the operating agreement?</u> May the LLC be a party to what has traditionally been thought of as "an agreement among members"? May the LLC enforce the operating agreement without being a party? May the operating agreement impose obligations on the LLC without the LLC being a party?

Most LLC statutes fail adequately to address this issue. Many statutes imply but do not state that an agreement among members can affect the rights and obligations of the limited liability company, even though the limited liability company is not a party to the agreement and is a legal person that is separate and distinct from those members. *See e.g.* Ariz. Rev. Stat. § 29-682(A) and (B) (stating that "[t]he members of a limited liability company may adopt an operating agreement" and that the "operating agreement governs relations . . . between the members and managers and the limited liability company"). *See also* Cal. Corp. Code §§ 17001(ab) (defining an operating agreement as "any agreement, written or oral, between all of the members") and 17005(a) (stating that "relations . . . between the members and the limited liability company are governed by the . . . operating agreement").

The Delaware LLC statute skips the fundamental contract law question of party status and provides: "A limited liability company is not required to execute its limited liability company agreement. A limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement." Del. Code Ann. tit. 6, §18-101(7). This language does not indicate whether (i) the limited liability company is deemed to be a party to the agreement and (ii) the limited liability company can enforce the agreement.

This topic – the relationship of the limited liability company and its (or the members') operating agreement – reflects the tension between two differing, but co-existing concepts of the limited liability company: an entity separate from its members *versus* an arrangement constructed by the agreement of the members. The Drafting Committee has only begun discussing the topic, but the Reporters predict future agreement on several practical points.

1. The operating agreement should be able to create obligations that directly control and obligate the LLC; that is, if the operating agreement provides that the LLC will do X, a member aggrieved by the LLC's failure to do X should be able to proceed directly against the LLC rather than having to sue the members for failing to cause the LLC to do X
2. The LLC should have standing to sue to enforce a provision of the operating agreement when the breach has caused direct injury to the LLC. For example, if the operating agreement requires a member to refrain from competing with the LLC, the LLC itself should have standing to sue the member for breach.
3. The LLC's standing to enforce the operating agreement should not empower the LLC to block, take control of, or even necessarily participate in a suit by a member brought to remedy an injury directly suffered by that member. For example, if the operating agreement requires the LLC's manager to approve specified payments to a member and the manager wrongfully fails to give the approval, the member – not the LLC – is the proper plaintiff.

Questions as to whether a limited liability company can or should be a party to an agreement among its members may seem abstract, but these questions nonetheless warrant careful consideration. It is generally not a good idea for a statute to use a term in a way that deviates from an accepted and longstanding common law meaning. Unintended consequences may result, not only under the statute but also in the common law. (That is, the common law meaning may confuse courts interpreting the statute, and the statutory usage may influence the common law discourse.)

Given the concern just stated and the practical points listed above, it seems that a limited liability company should be a party to the operating agreement. Generally speaking, a contract cannot impose an obligation on a non-party, and a non-party can enforce a contract only if the non-party is an assignee or an intended third-party beneficiary.

The statutory language suggested above, in subsection (e), is intended to achieve the desired practical results without putting the new Act's concept of "agreement" at odds with the venerable common law concepts. Like all the new Act's provisions that deal with *inter se* matters, subsection (e) is a default rule, subject to change or even negation by the operating agreement.

<u>What is the meaning and role of an operating *agreement* in an entity that has only one owner?</u> – Most, if not all, LLC statutes contemplate operating agreements in a single member limited liability company ("SMLLC"). The notion does violence to the concept of an "agreement," unless the LLC is, or is considered to be, a party. Compare E Allan Farnsworth, Contracts (3rd ed. 1999) § 1.1 at 3 (stating that "the word [contract] as it is used in common speech" pertains to "terms on which the parties have agreed") with Mich. Comp. Laws Ann. § 450.4215 ("An operating agreement of a limited liability company that has 1 member is not unenforceable because only 1 person is a party to the operating agreement.").

Nonetheless, the operating agreement can play an essential role in a SMLLC, because under all LLC statutes the operating agreement is the principal mechanism for overriding statutory default rules. (Under most, perhaps all, LLC statutes, the articles of organization can also perform this function, but why require a SMLLC to make public its variations while permitting multi-member LLCs to use a private document?)

In its preliminary discussions of this issue, the Drafting Committee has decided that (i) the operating agreement will remain the principal method for varying the statutory default rules, and (ii) the new Act will expressly authorize a SMLLC to have an operating agreement. The Committee has not discussed how best to conceptualize an agreement in a SMLLC. The statutory language suggested above, in subsection (f), shows one approach. The Reporters' Notes to subsection (f), below, show alternatives.

<u>What about a "freedom of contract" provision?</u> -- Some LLC statutes expressly exalt freedom of contract principles and contain no express limitations on the power of the operating agreement. *E.g.* Ga. Code Ann., § 14-11-1107(b) ("It is the policy of this state

with respect to limited liability companies to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements.") ULLCA § 103(b) omits any "freedom of contract" language and states specific limits for the operating agreement. (ULLCA follows RUPA § 103(b) on this point, and ULPA (2001) § 110(b) follows ULLCA and RUPA.)

After a brief discussion at its first meeting, the Drafting Committee tentatively decided to try for the best of both worlds – i.e., including generally applicable "freedom of contract" language while stating some limits on the powers of the operating agreement. The Committee has not yet discussed what those limits should be but tentatively envisions them as appearing in subsection (b).

<u>How should the Act resolve conflicts between a limited liability company's articles of organization and operating agreement?</u> – The Drafting Committee has not yet discussed this matter, other than to agree that the issue is important. ULLCA § 203(c)(3) provides generally that the operating agreement controls for *inter se* purposes, while the articles control for outsiders (not including transferees) who reasonably rely. ULLCA § 203(c)(3) will be the starting point for the Committee's further discussion.

<u>Should the Act authorize the operating agreement to provide for penalties?</u> – Some LLC statutes (notably Delaware's and Virginia's) expressly authorize an operating agreement to provide for penalties (which would otherwise be unenforceable as a matter of public policy). At its initial meeting, the Drafting Committee rejected this approach.

Definition of "Operating Agreement" -- This definition is merely a signpost to the operative section that provides comprehensively for the operating agreement. RUPA § 101(7) and ULPA (2001) § 101(13) each contain some operative language, which creates the possibility of confusion between the definition and the operative section. (RUPA § 101(7) refers to "the agreement, whether written, oral, or implied" and ULPA (2001) § 101(13) refers to the "agreement, whether oral, implied, in a record, or in any combination".) The same problem exists, to a much greater extent, under many state LLC statutes.

Subsection (a) -- ULLCA § 103(a) includes an additional proposition: "To the extent the operating agreement does not otherwise provide, this [Act] governs relations among the members, managers, and company." RUPA § 103(a) and ULPA (2001) § 110(a) do likewise. However, such language appears unnecessary, because – subject to the operating agreement -- the Act's provisions apply by their terms to govern the LLC. Moreover, and perhaps more importantly, the suggested language emphasizes that the operating agreement is the first and principal place to look for the *inter se* "rules of the game" and that the *inter se* provisions of the Act are mere gap-fillers. *Compare* Colo. Rev. Stat. § § 7-80-108(1) ("Such provisions [of the operating agreement] shall control over any provision of this article to the contrary except as set forth in subsection (2) of this section.")

Subsection (a)(2) – This provision could be more aggressively phrased (and located) so as to indicate that the "maximizing" philosophy extends to the interpretation of the statutory constraints to be stated in subsection (b). That is, the current suggested language means "maximize freedom of contract, except in the regions delineated in subsection (b)." An alternative approach would essentially direct courts to err on the side of the contract even when determining the scope of the regions delineated in subsection (b).

Subsection (a)(3) – This general proposition is subject to the non-waivable provisions to be listed in subsection (b). The suggested language is functionally equivalent to the approach of ULLCA § 103, although stated differently to further emphasize that the operating agreement is the first place to look for the rules governing the members' *inter se* relationships.

Subsection (b) – RUPA § 103, ULLCA § 103 and ULPA (2001) § 110 all take essentially the same approach to the power of the private agreement among the owners – namely, that the agreement controls all *inter se* matters, subject to a list of non-waivable statutory provisions. The Drafting Committee has tentatively decided to retain this structure and approach, subject to an issue-by-issue discussion of the provisions to be included on the list.

Subsection (c) -- Although it is exceedingly important for an LLC's operating agreement to bind *all* members, most LLC statutes do not consider this point. All statutes empower the operating agreement to set conditions for membership, which can certainly include assent to the operating agreement, but the statute themselves do not impose that condition. (The Michigan statute gets half way: "signing the initial operating agreement" is a condition to becoming a member "[i]n connection with the formation of the limited liability company" but not as to subsequent admissions. Mich. Comp. Laws Ann. § 450.4501(1).)

A few statutes empower the operating agreement to treat a person's actions in becoming a member as constituting agreement to the operating agreement. For example, Ga. Code Ann. § 14-11-101(18) provides:

> A written operating agreement may provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned, and shall become bound by the operating agreement and the provisions of the articles of organization (A) if such person (or a representative authorized by such person orally, in writing, or by other action such as payment for a limited liability company interest) executes the operating agreement or any other writing evidencing the intent of such person to become a member or assignee, or (B) without such execution, if such person (or a representative authorized by such person orally, in writing, or by other action such as payment for a limited liability company interest) complies with the conditions for becoming a member or assignee as set forth in the written operating agreement or any other writing and such person or representative requests in writing that the records of the limited liability company reflect such admission or assignment.

There is great potential for great mischief if a person becomes a member of an LLC without clearly becoming bound to the operating agreement applicable to other members. Leaving this issue to the operating agreement seems to set a trap for the unwary. Accordingly, subsection (c) establishes a statutory rule. Note that the rule is not a panacea; members can still dispute the contents of the operating agreement.

Subsection (d) -- This language comes essentially verbatim from UCC § 2-209(2), as recently revised by the Conference and the ALI. Subsection (d) does not include language parallel to UCC §§ 2-209(4) and (5) (pertaining to waiver). The Act will contain a generally applicable provision as to "other law," including the law of waiver. It is worth noting that the issue of waiver in a multi-party context is far more complicated than in the context of the two-party contracts that are the principal focus of UCC Article 2.

The common law is hostile to contractual attempts to restrict the manner through which parties may subsequently change their agreement. *See, e.g., Wagner v. Graziano Construction Company, Inc.*, 136 A.2d 82, 83 - 84 (Pa. 1957) ("There is nothing sacrosanct about a written agreement. Granted that writing makes for specificity and clarity, reduces the chances for errors, and allows for constant reference as to what was agreed upon, it nevertheless holds no superior position over an oral compact in the realm of authoritative utterances, except where the Statute of Frauds intervenes or is invoked. The most ironclad written contract can always be cut into by the acetylene torch of parol modification supported by adequate proof . . . . Even where the contract specifically states that no non-written modification will be recognized, the parties may yet alter their agreement by parol negotiation. The hand that pens a writing may not gag the mouths of the assenting parties. The pen may be more precise in permanently recording what is to be done, but it may not still the tongues which bespeak an improvement in or modification of what has been written.")

Moreover, an effective "no oral modification" provision can produce unfair results. See *Brookside Farms v. Mama Rizzo's, Inc.,* 873 F.Supp. 1029, 1033 (S.D.Tex. 1995) (rejecting the buyer's attempt to enforce a no oral modification clause because the buyer had itself induced and participated in an extended course of conduct that reflected the modification). *But see* Fl. Stat. Ann. 608.423(1) ("Any inconsistency between written and oral operating agreements shall be resolved in favor of the written agreement.")

Subsection (e) – Making the limited liability company automatically a party to the operating agreement obliges the company to comply with the agreement but does not necessarily give the company standing to enforce each provision of the agreement. The latter issue depends on whether the limited liability company (rather than a member) is directly injured by a breach. Allowing a non-member to be a party permits the operating agreement to include, for example, a non-member manager, a bank, a major supplier, etc. There is obvious utility in allowing a non-member manager to be party to the operating agreement. Allowing in other "third parties" raises potential issues (e.g., conflict-of-interest, nature of the good faith obligation) that the Drafting Committee has yet to consider.

Subsection (f) – The suggested approach expands the ordinary meaning of the word "agreement" but avoids most traps for the unwary. The record requirement in clause (1) seems the only feasible way to require some reliable act of "manifestation" by the party establishing the agreement. *Accord* Ga. Code Ann. § 14-11-101(18) ("In the case of a limited liability company with only one member, a writing signed by that member stating that it is intended to be a written operating agreement shall constitute a written operating agreement."). *But see* Ariz. Rev. Stat. § 29-601(12)(b) (defining an operating agreement to mean "[i]n the case of a limited liability company that has a single member, any written or oral statement of the member in good faith purporting to govern the affairs of a limited liability company or the conduct of its business as of the effective time of the statement"). Clause (2) does not require a record, because that clause contemplates an agreement that at some moment reflected the manifestations of persons to each other.

Here is another possible approach:

> A limited liability company with only one member may have an operating agreement that is effective under this Act if the operating agreement is in a record and the limited liability company is a party to the agreement. The sole member may assent to the operating agreement both for itself and for the limited liability company.

This alternative approach conforms to the ordinary meaning of the word "agreement," but provides a trap for the unwary. The trap might spring either at formation of a SMLLC, or when a multi-member LLC becomes an SMLLC. The record requirement seems the simplest way of providing a reliable manifestation of the "agreement," because in most instances the sole member will be the person manifesting assent on both sides of the agreement. *Compare* Va. Code Ann. § 13.1-1023, subd. A(2)(b) (stating that, "[i]f a limited liability company has only one member, an operating agreement shall be deemed to include . . . [a]ny agreement, regardless of whether the agreement is in writing, between the member and the limited liability company . . . provided that the limited liability company has a manager that is a person other than the member").

It would be possible to combine the approach in subsection (f) with the alternative just discussed. *See, e.g.,* Colo. Rev. Stat. § 7-80-102(11)(b), which provides:

> In the case of a limited liability company with only one member, "operating agreement" includes:
> (I) Any writing, without regard to whether such writing otherwise constitutes an agreement, as to such company's affairs and the conduct of the limited liability company's business signed by the sole member;

(II) Any written agreement between the member and the company as to the limited liability company's affairs and the conduct of the limited liability company's business; or

(III) Any agreement, whether or not the agreement is in writing, between the member and the limited liability company as to a limited liability company's affairs and the conduct of its business if the limited liability company is managed by a manager who is a person other than the member.

N.B. – requiring that the operating agreement in a SMLLC be in a record imposes formalities inconsistent with the Drafting Committee's position against "in a record" requirements and, moreover, burdens with special formalities a type of LLC that often will operate as the most informal of organizations. The Delaware statute does not impose a writing requirement on the operating agreement of a SMLLC. Del. Code Ann. tit. 6, § 18-101(7) ("A limited liability company agreement of a limited liability company having only 1 member shall not be unenforceable by reason of there being only 1 person who is a party to the limited liability company agreement.") This fact is all-the-more interesting given that, under the Delaware act, certain functions can be accomplished only by a "written limited liability company agreement or another written agreement or writing." *Id.* (providing for the enforceability of the operating agreement as to new members) and Del. Code Ann. tit. 6, § 18-109(d) (manager or member consent to jurisdiction).

TOPIC FOUR – "SHELF" LLCs AND BECOMING A MEMBER

NEW SUGGESTED LANGUAGE

SECTION 101. DEFINITIONS

. . . .

(__) "Distribution" means a transfer of money or other property from a limited liability company to a member in the member's capacity as a member or to a transferee on account of a transferable interest owned by the transferee.

. . . .

(__) "Limited liability company" means an entity formed and existing under this [Act].

. . . .

(__) "Member" means a person admitted as a member as provided in Section ___ and that has not dissociated as provided in Section ___.

. . . .

(__) "Transferable interest" means a member's right to receive distributions.

[to be located either in Article 1 or 2]

SECTION ___. SIGNING OF RECORDS

[provisions pertaining to who signs records to be filed by the [Secretary of State]]

. . . .

(__) Before a limited liability company has admitted any members, by any organizer.

SECTION ___. FORMATION

(a) One or more persons may act as organizers to form a limited liability company by delivering to the [Secretary of State] for filing articles of organization that comply with Section ___.

(b) The formation of a limited liability company does not by itself cause any person to be admitted as a member. Before a limited liability company has admitted any members, the limited liability company may not carry on any affairs or conduct any activities except as provided in Sections ___ [amending the articles], ___ [statement of correction], ___ [annual report], ___ [admitting a member], ___ [dissolution] and ___ [statement of termination].

. . . .

SECTION ___. AMENDMENT OR RESTATEMENT OF ARTICLES OF ORGANIZATION

(a) Before a limited liability company has admitted any members, a majority of the organizers may consent to amend the articles of organization.

. . . .

[to be located in Article 3]

SECTION 301. ADMISSION OF MEMBERS

(a) Before a limited liability company has admitted any members, a person is admitted as a member of the limited liability company with the consent of a majority of the organizers. The organizers may consent to admit simultaneously more than one person as initial members.

(b) If a limited liability company has a member, another person becomes a member:

(1) as provided in the operating agreement;

(2) [reserved for reference to a transaction covered by Uniform Entity Transactions Act]; or

(3) with the consent of all the members.

(c) If a limited liability company has admitted a member but no longer has any members, **[TBD – this subsection will address the rights of transferees to choose to become members so as to stave off the dissolution of the limited liability company]**

(d) A person may be admitted as a member without:

(1) making or being obligated to make a contribution to the limited liability company; or

(2) acquiring a transferable interest.

(e) A person's admission as a member is effective **[TBD – this subsection will provide a mechanism for determining *when* a person's admission is effective and will consider whether and to what extent an admission must be reflected in a record in order to be effective]**.

CURRENT ULLCA PROVISIONS

SECTION 101. DEFINITIONS

(5) "Distribution" means a transfer of money, property, or other benefit from a limited liability company to a member in the member's capacity as a member or to a transferee of the member's distributional interest.

(6) "Distributional interest" means all of a member's interest in distributions by the limited liability company.

(9) "Limited liability company" means a limited liability company organized under this [Act].

SECTION 202. ORGANIZATION

(a) One or more persons may organize a limited liability company, consisting of one or more members, by delivering articles of organization to the office of the [Secretary of State] for filing.

SECTION 204. AMENDMENT OR RESTATEMENT OF ARTICLES OF ORGANIZATION.

(a) Articles of organization of a limited liability company may be amended at any time by delivering articles of amendment to the [Secretary of State] for filing. The articles of amendment must set forth the:

SECTION 205. SIGNING OF RECORDS.

(a) Except as otherwise provided in this [Act], a record to be filed by or on behalf of a limited liability company in the office of the [Secretary of State] must be signed in the name of the company by a:

(3) person organizing the company, if the company has not been formed; or

SECTION 503. RIGHTS OF TRANSFEREE.

(a) A transferee of a distributional interest may become a member of a limited liability company if and to the extent that the transferor gives the transferee the right in accordance with authority described in the operating agreement or all other members consent.

Reporters' Notes

Current View of the Drafting Committee – The Drafting Committee has only begun its discussion of the "shelf LLC" concept. According to some supporters of the concept, a "shelf LLC" provision would benefit practitioners by permitting more flexible, long-term planning and providing a way around delays that occur in some state filing offices.

The Committee directed its reporters to draft language to show how the new Act might provide for a shelf LLC, but the Committee has not decided, even provisionally, that the new Act *should* so provide. The Committee's preliminary discussions reflected robust debate on this point.

Comparison of New Suggested Language and ULLCA –

Definitions – There are several differences between the new suggested definitions and ULLCA's definitions, but those differences are essentially matters of style. For example, ULLCA does not define "member," and the new suggested language does. However, the suggested definition is consistent with ULLCA and functions mostly as a signpost to operative provisions ("a person admitted as a member as provided in Section ___ and that has not dissociated as provided in Section ___"). For further example, ULLCA uses the term "distributional interest" to refer to a member's economic rights. The new suggested language reverts to the term used by RUPA ("transferable interest") and incorporates the definition of that term used by ULPA (2001), the Conference's latest business entity act. That definition focuses solely on distribution rights and omits any reference to "profits and losses."[7]

Signing of Records -- ULLCA § 205(a)(3) provides that an "organizer" signs documents to be filed by the [Secretary of State] before the LLC is organized. After that date, documents are to be signed by managers, if any, or members. *See* ULLCA §§ 205(a)(1)-(2).

Under the new suggested language, a person who acts to form a limited liability company is not signing a record *on behalf of the entity* but rather is signing a record to *create the entity*. Moreover, the suggested language contemplates an organizer signing records after the limited liability company is formed.

[7] For the rationale for this omission, see ULPA (2001) § 503, Comment ("This Act has no provision allocating profits and losses among the partners. Instead, the Act directly apportions the right to receive distributions. Nearly all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than this Act, are the proper source of guidance for that profit and loss allocation.")

The difference reflects a different view of the role of organizers and, more fundamentally, of the relationship between (i) a limited liability company's status as a separate legal entity and (ii) the formalities, mechanics and consequences of LLC formation. Although ULLCA does not expressly provide for the admission of initial members, ULLCA § 202(a) does state that "One or more organizers may organize a limited liability company consisting of one or more members . . . ." Thus, ULLCA does not contemplate a "shelf LLC" – i.e., a limited liability company that comes into existence and stays in existence without having any members.

In contrast, the new suggested language separates the formation of a limited liability company and the limited liability company's admission of members. The separation is both conceptual and mechanical and is consistent with the fundamental notion that a limited liability company is a separate legal entity distinct from its members.

<u>Formation/Organization</u> -- ULLCA § 202(a) provides that a limited liability company may be organized with one or more members, implying that upon formation a limited liability company must somehow have at least one member. In contrast, the new suggested language expressly provides that a limited liability company may be formed and continue to exist without any member being admitted. Thus, the suggested new language would authorize "shelf LLCs."[8]

The suggested language does recognize that a limited liability company is *an organization of members* as well as *an entity separate from those members* and therefore strictly limits the permitted functions of a shelf LLC.

<u>Admission of members</u> **--** ULLCA § 202(a) contemplates the organization of a limited liability company with one or more members but does not explain how the initial members became members. The new suggested language empowers the organizer(s) to make the initial admission(s). Once an initial member exists, the organizer's statutory authority ends.

As to new members after the initial member, ULLCA § 404(c)(7) states a general rule (unanimous consent of the members, subject of course to contrary or additional provisions in the operating agreement) and § 503(a) states a functionally identical rule for transferees (unanimous consent or "in accordance with authority described in the operating agreement"). Many other LLC acts have a comparable structure, which probably derives from combining the special treatment of assignee rights in RULPA (1976/85) § 704(a) with the general rule of unanimous consent stated in the general

[8] Different rules will apply for a limited liability company that has had a member and afterwards ceases to have any members. Even if the new Act authorizes "shelf LLCs," it will not permit an LLC that has come off the shelf (i.e., admitted a member) to go back on the shelf (i.e., exist without any members).

partnership act. See UPA § 18(g), preserved in RUPA as § 401(i).

The suggested new language conflates the general and transferee-specific provisions into one provision. *Accord* ULPA (2001) §§ 301 (limited partners) and 401 (general partners). *See also* ULPA (2001) § 702(a)(3) (providing that a transferee *qua* transferee has no management rights but omitting any reference to how a transferee might become a partner).

State LLC Law Developments -- State LLC statutes commonly address admission procedures through three separate categories: (i) admission of initial members at formation, (ii) admission of more members after formation, and (iii) substitute admission of transferees of existing members, once again, after formation. Despite the separate categories, the admission procedures are commonly the same – i.e., as provided in an operating agreement or by consent of some percentage of members or managers.

Some state LLC statutes provide that a person may be admitted as an initial member as provided in an operating agreement. This approach appears to function adequately, although it ignores a conceptual problem discussed in detail in Topic Three and treats the operating agreement like a pre-incorporation agreement.

As to the quantum of member consent needed to approve a new member, most states continue to use unanimity as the default rule. A few states provide for simple majority consent. *See, e.g.,* Vir. Code Ann. § 13.1-1038(1).

Section 301(a) – This provision gets the limited liability company over the conceptual "hump" of being simultaneously an entity created separate from its members and an organization which may function only if it has at least one member.

Section 301(b)(1) – This provision is arguably surplus, since the unanimous consent rule in subsection (b)(3) is subject to change by the operating agreement. The language is included, however, because practitioners are so accustomed to seeing it. *Accord* ULPA (2001) §§ 301(1) and 401(1).

Section 301(d) – Under Section 301, admission is the defining characteristic of a member, and a limited liability company is free to condition and construct membership as it sees fit. This subsection provides that a membership need not have <u>any</u> economic aspect. There is no statutory requirement that a member make a contribution to the limited liability company or be entitled to receive distributions from the limited liability company. A few states have comparable provisions. *See, e.g.* Del. Code Ann., tit. 6 § 18-301(d), Iowa Code § 490A.306, K.S.A. § 17-7686, N.C. Gen. Stat. § 57C-3-01, and NH RSA 304-C:23. As to how a new member becomes subject to a pre-existing operating agreement, see Topic Three.

Section 301(e) – This subsection preserves for future consideration the matter of whether, and if so under what circumstances, a person's admission will be effective only when reflected in a record. While such a rule would provide certainty, it would also incorporate a statute of frauds requirement into the admission process and could frustrate the parties' intent. The Drafting Committee has not considered this matter but has expressed a general antipathy toward statute of frauds provisions. See Topic Three (discussing oral and implied-in-fact operating agreements). However, there are more than a few states that permit oral operating agreements oral but nonetheless make membership status dependant on a record. *See* Ark.C.A. § 4-32-801, Conn. Gen. Stat. § 34-179, Del. Code Ann., tit. 6. § 18-301, D.C. Code § 29-1032, Ga. Code Ann. 14-11-505, Idaho Code § 53-640, Iowa Code § 490A.306, K.S.A. § 17-7686, Miss. Code Ann. § 79-29-301, NH RSA 304-C:23, N.J. Stat. § 42:2B-21, NY CLS LLC § 602, ORS § 63.245, Tex. Rev. Civ. Stat. art. 1528n 4.04A, Va. Code Ann. § 13.1-1038.1, and Rev. Code Wash. (ARCW) § 25.15.115. (Most of the requirements either apply when the operating agreement fails to address the issue or pertain to assignees becoming members.)

TOPIC FIVE -- STATUTORY APPARENT AUTHORITY TO BIND THE LLC

SUGGESTED STATUTORY LANGUAGE

[in the section dealing with the articles of organization]

(a) . . . . [required contents]

(b) The articles of organization may delineate the authority of any person to:

(1) transfer real property held in the name of the limited liability company;

(2) enter into other transactions on behalf of the limited liability company or to otherwise act for the limited liability company in interactions with persons who are not members or transferees.

(c) A delineation under subsection (b)(1):

(1) provides notice of its contents to all persons;

(2) is conclusive in favor of any person that gives value without knowledge to the contrary; and

(3) is conclusive against the limited liability company in favor a person that has not given value if the person:

(i) is not a member or a transferee, and

(ii) relies on the delineation without knowledge to the contrary

(d) A delineation under subsection (b)(2) does not by itself provide notice of its contents but is conclusive against the limited liability company in favor of a person that:

(i) is not a member or a transferee, and

(ii) relies on the delineation without knowledge to the contrary.

(e) A delineation under subsection (b) may:

(1) identify a particular person or may refer to a position that exists in or with respect to the limited liability company; and

(2) state authority, limit authority or negate authority, or any do any combination.

[in the article dealing with management structure]

SECTION 301. A member does not have the right or the power as a member to act for or bind the limited liability company.

CURRENT ULLCA PROVISIONS

SECTION 301. AGENCY OF MEMBERS AND MANAGERS.

(a) Subject to subsections (b) and (c):

1) Each member is an agent of the limited liability company for the purpose of its

business, and an act of a member, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the member had no authority to act for the company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority.

(2) An act of a member which is not apparently for carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company only if the act was authorized by the other members.

(b) Subject to subsection (c), in a manager-managed company:

(1) A member is not an agent of the company for the purpose of its business solely by reason of being a member. Each manager is an agent of the company for the purpose of its business, and an act of a manager, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the manager had no authority to act for the company in the particular matter and the person with whom the manager was dealing knew or had notice that the manager lacked authority.

(2) An act of a manager which is not apparently for carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company only if the act was authorized under Section 404.

(c) Unless the articles of organization limit their authority, any member of a member-managed company or manager of a manager-managed company may sign and deliver any instrument transferring or affecting the company's interest in real property. The instrument is conclusive in favor of a person who gives value without knowledge of the lack of the authority of the person signing and delivering the instrument.

Reporters' Notes

Current ULLCA Rule – Agency law has long recognized that a person may have the "apparent authority" to bind another regardless of whether the person has the "actual authority" to do so. The original Uniform Partnership Act codified the apparent authority of general partners, UPA § 9, providing what might usefully be labeled "statutory apparent authority." The Revised Uniform Partnership Act continued that approach without fundamental change, RUPA § 301, and ULLCA followed RUPA. ULLCA § 301.

However, ULLCA's approach is more complex than either the UPA's or RUPA's, because ULLCA contemplates both member-managed and manager-managed LLCs. Under ULLCA § 301(a), in a member-managed LLC the statutory appearance of authority pertains to each member. Under ULLCA § 301(b), in a manager-managed LLC the appearance of authority attaches to each manager and the status of member conveys no actionable appearance of authority. Thus a public filing can affect a member's statutory power to bind an LLC, regardless of whether a third party actually knows of the filing.

> **Example:** Drake, LLC ("Drake") is organized under the laws of a state that has adopted ULLCA. Initially, Drake is member-managed, and its articles so state. A third party does business with Drake on several occasions, and on each occasion the act of one member suffices to bind Drake to the transaction. (Each transaction is "for apparently carrying on in the ordinary course the company's business. . . ." ULLCA § 301(a)(1).) Drake's members then decide to change their form of management. They amend Drake's articles to state that Drake is manager-managed and elect David as Drake's sole manager. Subsequently, a non-manager member purports to enter into a transaction with the third party on Drake's behalf. The third party cannot rely on the statute to hold Drake to the transaction, regardless of whether the third party knows of the amendment and even if the transaction is "for apparently carrying on in the ordinary course the company's business." (The third party may be able to invoke the common law doctrine of lingering apparent authority, however.)

State LLC Law Developments – Although a few LLC statutes provide corporate-type governance structures, the overwhelming majority of states follow the two-track (member-managed/manager-managed) approach. Most state LLC statutes provide, similarly to ULLCA, that (i) statutory apparent authority attaches to members in a member-managed LLC and to managers in a manager-managed LLC; and (ii) in a manager-managed LLC the status of member creates no apparent authority to bind the LLC. Like ULLCA, these statutes allow a public filing (i.e., the articles of organization) to affect a member or manager's statutory appearance of authority. A few states permit an LLC's private organic document (i.e., its operating agreement) to negate a member (or manager's) statutory power to bind.

Current Approach of the Drafting Committee – The Drafting Committee's current view is that the new Act should eliminate statutory apparent authority, while permitting the articles of organization to identify persons and positions with power to bind the limited liability company.

> Eliminate any statutory provisions on the apparent authority of members and managers -- The Drafting Committee views any statutory power-to-bind provisions as (i) vestiges of partnership law; (ii) inappropriate, given the Committee's decision to eliminate the requirement that the articles of organization state whether an LLC is member-managed or manager-managed; and (iii) unnecessary, given the common law doctrine of apparent authority.
>
> UPA § 9 and RUPA § 301 are codifications of a common law doctrine sometimes known as "apparent authority by position." In the Drafting Committee's evolving view, the modern LLC should not be conceptualized as merely a general or limited partnership with a liability shield. Instead, the Committee views the LLC as a very flexible vehicle, whose internal management structure may be almost infinitely varied.[9] Moreover, corporate law provides no apparent authority by position for shareholders or for individual directors. (The same is true generally of corporate officers. *See* MBCA, § 8.41, Statutory Comparison.)
>
> The Committee also considered providing that each member of an LLC has statutory apparent authority to bind the LLC unless the articles of organization negate that authority. A complex example of that approach appears in the Maryland LLC statute, which (i) makes each member of a Maryland LLC "an agent of the limited liability company for the purpose of its business" with the statutory apparent authority to bind the LLC; (ii) permits both the articles of organization and operating agreement to negate the statutory agent status and permits the articles of organization to eliminate the statutory apparent authority; and (iii) preserves the rights of third parties to invoke common law doctrines of agency and estoppel. Maryland Code, Corps. & Assocs., § 4A-401(Member as agent) provides:
>
> > (a) In general—
> > (1) Except as provided in paragraph (3) of this subsection or in the operating agreement, each member is an agent of the limited liability company for the purpose of its business.
> > (2) Except as provided in paragraph (3) of this subsection, the act of each member, including the execution in the name of the limited

[9] Although "apparent authority by position" is not an internal matter, a position's apparent authority reflects the actual authority normally possessed by a person in that position.

liability company of any instrument, for apparently carrying on in the usual way the business of the limited liability company of which the person is a member, binds the limited liability company, unless:

(i) The member so acting has in fact no authority to act for the limited liability company in the particular matter; and

(ii) The person with whom the member is dealing has actual knowledge of the fact that the member has no such authority.

(3) If the articles of organization contain a statement that the authority of members to act for the limited liability company solely by virtue of their being members is limited:

(i) No member of the limited liability company is an agent of the limited liability company solely by virtue of being a member, and no member has authority to act for the limited liability company solely by virtue of being a member; and

(ii) Each person dealing with a member is presumed to have knowledge that the member has no authority to act for the limited liability company solely by virtue of being a member.

(b) Agency established through proof or estoppel-- Notwithstanding a provision in the articles of organization or operating agreement that the authority of a member to act for the limited liability company solely by virtue of being a member is limited, a person dealing with a member may establish:

(1) That the member is an agent of the limited liability company; or

(2) That the limited liability company should be estopped from denying that the member was its agent.

(c) Nonbinding acts-- Unless the act of a member is authorized by the limited liability company, the act of a member that is not apparently for the carrying on of the business of the limited liability company in the usual way does not bind the limited liability company.

(d) Acts requiring unanimous consent or abandonment of business-- Unless the members unanimously consent or unless all other members have abandoned the business, no member has authority to:

(1) Assign the property of the limited liability company in trust for creditors or on the assignee's promise to pay the debts of the limited liability company;

(2) Dispose of the goodwill of the business; or

(3) Do any other act which would make it impossible to carry on the ordinary business of the limited liability company.

It would certainly be possible to simplify the Maryland approach by confining it to the realm of statutory *apparent* authority and eliminating the categorical exclusions contained in § 4A-401(d). (Those exclusions are remnants of UPA § 9(3), which the Conference discarded when it adopted RUPA.)

The Drafting Committee tentatively decided, however, against any approach that would allot statutory apparent authority to each member. The Committee concluded that a well-counseled limited liability company would almost always negate such apparent authority regardless of how the limited liability company decided to arrange its internal management.

The Committee's view on statutory apparent authority comports with the Committee's decision, discussed in detail in Topic Six, to eliminate any requirement that the articles of organization describe an LLC's basic management structure (i.e., member-managed or manager-managed). Under ULLCA and similar LLC statutes, statutory apparent authority attaches to members or managers depending on whether an LLC is member-managed or manager-managed. There is symmetry and fairness in this approach, so long as an LLC's management structure is "of record." The symmetry and fairness disappear if the public record no longer discloses the LLC's management structure.

Compared to most LLC statutes, the Committee's approach is unusual but not unfair. Common law doctrines of apparent authority and estoppel should suffice to protect third parties, much as they have done for third parties dealing with corporate officers.

<u>Authorize the articles of organization to identify persons or positions within the LLC that have the power to bind the limited liability company, either generally or as to specific transactions or types of transactions</u> -- RUPA § 303 popularized the concept of publicly filed statements of authority.[10] In light of the decision to eliminate any statutory apparent authority, the Drafting Committee considers it essential to permit a limited liability company to create a public record that will delineate a person's or position's power to bind the limited liability company. Such a delineation will assist the limited liability company by allowing it to establish a representative's authority without the limited liability company having to disclose the private arrangements that govern the members <u>inter</u> <u>se</u> (e.g., the operating agreement). Such a delineation can assist third parties by reducing the need for burdensome "due diligence" inquiries into the private records and relationships[11] of the LLC's members.

Comparison of the New Suggested Language with RUPA -- This language is derived from RUPA § 303, with several significant changes. First, with regard to authority to transfer real property, this language does not require a duplicate filing in "the office for recording transfers of that real property." *Compare* RUPA § 303(d)(2) and (e). Second, this language attempts to state more

[10] The official comment to RUPA § 303 notes that "RUPA follows the lead of California and Georgia in authorizing the optional filing of statements of authority."
[11] As explained in Topic Three, the new Act will <u>not</u> require the operating agreement to be in writing.

simply than RUPA the differential effects of statements concerning real property and other statements. (The simplification involves some difference in meaning.)

Third, this language refers generally to "delineation" as encompassing grants, limitations and negations of authority. The use of a general term facilitates cross-references elsewhere in the Act. The reference to negation is added in light of a Delaware Supreme Court case, which held (albeit in a different context) that the concept of "restriction" does not encompass "elimination." *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. 2002) (interpreting a provision of the Delaware limited partnership statute that states that "the partner's or other person's duties and liabilities may be expanded or restricted by provisions in the partnership agreement" and noting that "[t]here is no mention in [the quoted provision] or elsewhere in [the Delaware act] that a limited partnership agreement may eliminate the fiduciary duties or liabilities of a general partner.")

Fourth, this language goes beyond RUPA's reference to the authority of "some or all of the partners" and authorizes delineations (i) as to non-members and (ii) via a description of a person's position. For example, the articles of organization might state, "The general manager has the authority to enter into any contract on behalf of the limited liability company where the contract price does not exceed one million dollars, except that the general manager does not have the authority to transfer any real property belonging to or held in the name of the limited liability company."

Subsection (b)(2) – This provision excludes members and transferees, on the assumption that they should look to the operating agreement. This assumption is consistent with ULLCA § 203(c)(1), which provides that "the operating agreement controls [over the articles of organization] as to managers, members, and members' transferees."

Subsections (c) and (d) -- These subsections reflect a basic paradigm. If the delineation concerns real property, the delineation's effect operates regardless of whether the person asserting the delineation is a member, transferee or third party. (Although, in general, members and transferees should look to the operating agreement, the need for certainty of land title argues for this approach.) Other delineations do not benefit members and transferees because, as to them, the operating agreement is paramount. *See* Reporters' Notes to subsection (b)(2).

There are further distinctions between delineations that are realty-related and those that are not. If the delineation concerns real property:

- the delineation gives constructive notice to the world ("all persons"); and
- if the person asserting the delineation has given value:

~ the person need not show reliance, and
~ the delineation's conclusive effect is not limited to the limited liability company.[12]

[12] If the person asserting the delineation has not given value but has relied, the rules are the same as for non-realty delineations.

Other delineations require a showing of reliance, do not provide constructive notice, and operate only against the limited liability company.

There is no requirement that the reliance be shown to be "reasonable." In essence, the suggested language reflects a decision that it is reasonable to rely on a publicly-filed delineation of authority absent knowledge to the contrary.

The rationale for the distinctions is the interplay between (i) the need to assure certainty of title for real property, and (ii) the policy decision (carried forward from ULLCA) that, as to *inter se* relations, the operating agreement is more important than the articles.

Section 301 -- This language is taken from ULPA (2001), § 302, which pertains to limited partners. The elimination of an LLC member's statutory power to bind as a member is consistent even with member-management, because in a member-managed LLC the members must act collectively to authorize anyone – even a member – to act on the LLC's behalf. This section leaves intact a third party's ability to invoke agency law principles (e.g., actual authority, apparent authority), except that the third party may not premise those theories on the member's status as a member.

> **Example:** A third party attempts to establish X's apparent authority in some ordinary transaction by asserting merely that "X is a member of the LLC. The LLC no where describes itself as having managers. This is a routine, even mundane, transaction. X has apparent authority." This section would defeat the claim.

TOPIC SIX – INTERNAL MANAGEMENT STRUCTURE

SUGGESTED STATUTORY LANGUAGE

SECTION 101. DEFINITIONS.

. . . .

(__) "Manager" means a person, whether or not a member, who is named or designated as a manager of a limited liability company in the operating agreement.

. . . .

(__) "Manager-managed limited liability company" means a limited liability company so designated in the operating agreement.

[to be inserted in Article 4]

SECTION ____. MANAGEMENT OF A LIMITED LIABILITY COMPANY

(a) Except as provided in subsection (b):

(1) Each member has equal rights in the management and conduct of the affairs and activities of a limited liability company.

(2) A difference arising as to a matter in the ordinary course of the affairs and activities of a limited liability company may be decided by a majority of the members. An act outside the ordinary course of affairs and activities of a limited liability company may be undertaken only with the consent of all the members.

(b) In a manager-managed limited liability company:

(1) Each manager has equal rights in the management and conduct of the affairs and activities of a limited liability company.

(2) A difference arising as to a matter in the ordinary course of the affairs and activities of a limited liability company may be decided by a majority of the managers. An act outside the ordinary course of affairs and activities of a limited liability company may be undertaken only with the consent of all the members.

(3) A manager may be designated, appointed, elected, removed, or replaced by a vote, approval, or consent of a majority of the members and holds office until a successor has

been elected and qualified, unless the manager sooner resigns. The dissociation of a member who is also a manger terminates that person's status as a manager.

CURRENT ULLCA PROVISIONS

SECTION 101. DEFINITIONS.

. . . .

(10) "Manager" means a person, whether or not a member of a manager-managed company, who is vested with authority under Section 301.

(11) "Manager-managed company" means a limited liability company which is so designated in its articles of organization.

(12) "Member-managed company" means a limited liability company other than a manager-managed company.

. . . .

SECTION 404. MANAGEMENT OF LIMITED LIABILITY COMPANY.

(a) In a member-managed company:

(1) each member has equal rights in the management and conduct of the company's business; and

(2) except as otherwise provided in subsection (c), any matter relating to the business of the company may be decided by a majority of the members.

(b) In a manager-managed company:

(1) each manager has equal rights in the management and conduct of the company's business;

(2) except as otherwise provided in subsection (c), any matter relating to the business of the company may be exclusively decided by the manager or, if there is more than one manager, by a majority of the managers; and

(3) a manager:

(i) must be designated, appointed, elected, removed, or replaced by a vote, approval, or consent of a majority of the members; and

(ii) holds office until a successor has been elected and qualified, unless the manager sooner resigns or is removed.

(c) The only matters of a member or manager-managed company's business requiring the consent of all of the members are:

(1) the amendment of the operating agreement under Section 103;

(2) the authorization or ratification of acts or transactions under Section 103(b)(2)(ii) which would otherwise violate the duty of loyalty;

(3) an amendment to the articles of organization under Section 204;

(4) the compromise of an obligation to make a contribution under Section 402(b);

(5) the compromise, as among members, of an obligation of a member to make a contribution or return money or other property paid or distributed in violation of this [Act];

(6) the making of interim distributions under Section 405(a), including the redemption of an interest;

(7) the admission of a new member;

(8) the use of the company's property to redeem an interest subject to a charging order;

(9) the consent to dissolve the company under Section 801(b)(2);

(10) a waiver of the right to have the company's business wound up and the company terminated under Section 802(b);

(11) the consent of members to merge with another entity under Section 904(c)(1); and

(12) the sale, lease, exchange, or other disposal of all, or substantially all, of the company's property with or without goodwill.

(d) Action requiring the consent of members or managers under this [Act] may be taken without a meeting.

(e) A member or manager may appoint a proxy to vote or otherwise act for the member or manager by signing an appointment instrument, either personally or by the member's or manager's attorney-in-fact.

Reporters' Notes

Current Drafting Committee Approach – The Drafting Committee's current view is that the new Act should:

- Separate inter-se governance structure from matters governing statutory apparent authority;

- Provide a default member-management structure;

- Provide for election of manager-management in the operating agreement;

- Provide a default "elective" structure for manger-management that applies if the operating agreement designates the limited liability company as "manager-managed"; and

- Provide that the operating agreement may override the default elective manager-management default structure.

The Drafting Committee's current view on the first point differs substantially not only from ULLCA but from almost all state LLC statutes. The Drafting Committee's primary focus has been on limited liability companies whose interests are not publicly traded.

ULLCA Rule -- ULLCA §§ 101(10) & (11) separately provide that the term "manager-managed limited liability company" means a company so designated in the articles of organization and that the term "member-managed limited liability company" means all other limited liability companies. When combined with ULLCA § 203(a)(6), which requires the articles to state that a company will be other than member-managed, the construct provides that all limited liability companies are member-managed unless the articles designate otherwise. When further combined with ULLCA § 301(b), the designation in the articles of a manager-managed company negates the statutory apparent authority of non-managing members and also negates, subject to contrary agreement, any actual authority for those members in ordinary matters. Further, ULLCA § 404(a) (member-management) and ULLCA § 404(b) (manager-management), provide a default management architecture based upon the management choice specified in the articles.

State LLC Law Developments -- Nearly all states provide that a limited liability company is to be managed by its members unless otherwise provided in a publicly-filed document, typically the articles of organization. *See, e.g.*, Code of Ala. § 10-12-22, Ariz. Rev. Stat. § 29-681, A.C.A. § 4-32-301, Cal. Corp. Code § 17150, D.C. Code. § 29-1017, Ga. Code Ann. § 14-11-304, and Iowa Code. § 490A.702. A few states permit the operating agreement to switch the management structure. *See, e.g.,* Fl. St. Ann. § 608.422(1).

Approach of the New Suggested Language -- The approach of the new suggested language is much different.

Severing Inter-Se Governance from Statutory Apparent Authority -- Contrasted with ULLCA, the new suggested language isolates the inter-se governance rules from the statutory apparent authority. See discussion in Topic Five.

Manner of Management Designation -- ULLCA utilized the articles of organization to determine the management-designation of the limited liability company. *See* ULLCA § 203(a)(6). However, in cases of conflict between the operating agreement and the articles, the operating agreement controlled as to members while the articles controlled as to third parties in reliance. *See* ULLCA § 203(c). Accordingly, the articles could provide that a limited liability company was manager-managed and that designation would control as to third parties. But if the members actually equally participated in management and did not utilize a manager, the company would be member-managed as to the members themselves. The suggested new language shifts the "designation" process from the public articles to the actual agreement of the parties and thus avoids this internal-external conflict. This change is consistent with the proposal to eliminate any statutory apparent authority.

The importance of the operating agreement language is substantial. The operating agreement must designate that the company is manager-managed in some unequivocal way. This could be accomplished by designating a specific person as a "manager," by stating that the limited liability company is "manager-managed" or any other equivalent manner. (N.B. – because an operating agreement need not be in a record, it is not necessary for this designation to be made in a record.)

When this "threshold designation" is made, the limited liability company automatically becomes a "manager-managed" company governed internally by the rules expressed in subsection (b) rather than subsection (a). However, the rules of subsection (b) are themselves subject to being overridden by the operating agreement, which can include course of performance. In this way, the subsection (b) structure is intended to be helpful but not mandatory even in a manager-managed company. This approach places less stress on the designation and more emphasis on the actual chosen management style of the members.

Definitions -- Since the new suggested language no longer utilizes the articles to designate the management of the company, it is no longer necessary to define a member-managed company. Accordingly, there will be no parallel to ULLCA § 101(12). The term "manager-managed limited liability company" has been retained because of its importance but has been reformulated to indicate the fundamental change in the designation process (articles to operating agreement).

Subsection (a) – Subject to the operating agreement, the new suggested language provides that the members of the limited liability company will have equal per capita rights to participate in the management of the limited liability company. The Drafting Committee has only briefly discussed this matter and has not yet made even a tentative decision. For the moment, the suggested approach follows ULLCA § 404(a). Also following ULLCA § 404(a), any dispute as to ordinary matters is subject to a decision by the majority of the members and any extraordinary matters must be decided by unanimous consent unless the members have agreed to a different procedure. As for each member's authority to manage ordinary activities in the absence of a known disagreement, the suggested language – like ULLCA, RUPA and the UPA – is silent. The Drafting Committee will further study this matter.

The suggested language does differ with ULLCA in an important respect. ULLCA § 404(c) specifies which matters are extraordinary. The suggested language does not. The danger in specificity is either over or under-inclusiveness. Nearly 100 years of partnership law may have adequately established the line between ordinary and extraordinary matters, and the suggested language relies on that experience and thus "reverts" back to the rule expressed in UPA § 18 and RUPA 401(j) (the basic paradigm for equal management participation rights).

There are, nonetheless, at least two actions that other parts of the suggested new language identify as requiring unanimous consent: amending the operating agreement and admitting a new member. ULLCA § 404(c)(1) and (7) list these two items (among others) as requiring unanimous consent, which is consistent with the UPA, RUPA and ULPA (2001).

Subsection (b) -- When the operating agreement provides that a limited liability company is to be manager-managed, the elective architecture of subsection (b) is invoked. This seemingly places great emphasis on the operating agreement designation. See discussion above. However, since the management structure expressed in subsection (b) is itself merely a default rule, the operating agreement (including course of performance) may provide for different arrangements and thereby override parts or even all of the elective management architecture. The suggested architecture is so far merely illustrative, and has not yet been considered by the Drafting Committee in any detail. (For example, the Committee has not discussed whether majority, supermajority or unanimous consent is the proper "elective" quantum for removing a manager.)

TOPIC SEVEN -- FIDUCIARY DUTIES AND THE OBLIGATION OF GOOD FAITH AND FAIR DEALING

NEW SUGGESTED LANGUAGE

SECTION ___. GENERAL STANDARDS OF CONDUCT

(a) Except as provided in subsection (b), each member of a limited liability company:

(1) owes to the limited liability company a fiduciary duty of loyalty that includes:

(i) accounting to the limited liability company and holding for it as trustee any property, profit, or benefit derived by the member in the conduct or winding up of the limited liability company's affairs and activities or derived from the member's use of the limited liability company's property, including the appropriation of a limited liability company opportunity;

(ii) refraining from dealing with the limited liability company as or on behalf of a party having an interest adverse to the limited liability company; and

(iii) refraining from competing with the limited liability company before the dissolution of the limited liability company;

(2) owes to the limited liability company a duty of care to refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law;

(b) If the operating agreement removes from a member all responsibility for and managerial role in an aspect or phase of the affairs of a limited liability company or the conduct of its activities and the member refrains from any managerial conduct in that aspect or phase, the member does not owe the duties stated in subsection (a) with regard to that aspect or phase.

(c) A member shall discharge any duties to the limited liability company or the other members under this [Act] or under the operating agreement and exercise any rights under this [Act] or that agreement consistently with the obligation of good faith and fair dealing.

(d) A member 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.

CURRENT ULLCA PROVISIONS

SECTION 409. GENERAL STANDARDS OF MEMBER'S AND MANAGER'S CONDUCT.

(a) 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 imposed by subsections (b) and (c).

(b) 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.

(c) A member's duty of care to a member-managed company and its other members in the conduct of and winding up of the company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A member shall discharge the duties to a member-managed company and its other members 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) A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law.

(g) This section applies to a person winding up the limited liability company's business as the personal or legal representative of the last surviving member as if the person were a member.

(h) 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 in subsections (b) through (f);

(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 in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act]; and

(4) a manager is relieved of liability imposed by law for violation of the standards prescribed by subsections (b) through (f) to the extent of the managerial authority delegated to the members by the operating agreement.

Reporters' Notes

Current Rule -- ULLCA § 409 follows RUPA § 404 except that ULLCA § 409 provides that, in a manager-managed LLC, duties apply to the manager(s) and not to any non-managing member. Under ULLCA § 409(d) and (h)(2), the statutory obligation of good faith and fair dealing applies only to members in a member-managed LLC and managers in a manager-managed LLC.

State LLC Law Developments – LLC statutes vary widely in how they state fiduciary duties. Many statutes take an approach similar to ULLCA's. For example, Cal. Corp. Code § 17150 provides:

> Unless the articles of organization include the statement referred to in subdivision (b) of Section 17151 vesting management of the limited liability company in a manager or managers, the business and affairs of a limited liability company shall be managed by the members subject to any provisions of the articles of organization or operating agreement restricting or enlarging the management rights and duties of any member or class of members. If management is vested in the members, each of the members shall have the same rights and be subject to all duties and obligations of managers as set forth in this title.

However, only ULLCA-based and RUPA-influenced LLC statutes include a statutory obligation of good faith and fair dealing.

Comparison Between the New Suggested Language and Current ULLCA – As discussed in more detail below, the suggested new language differs from ULLCA by: (i) not stating that the listed duties of loyalty and care are the "only" fiduciary duties; (ii) not suggesting that the stated duties of loyalty and care are owed *directly* to the members as well as to the limited liability company; (iii) not directly and categorically describing the loyalty and care duties of managers in a manager-managed LLC; (iv) not addressing the loyalty and care duties of a non-member manager. The suggested language assumes that the operating agreement will have broad power to tailor the duty of loyalty. ULLCA § 103(b)(2) so provides, as do RUPA § 103(b)(3) and ULPA (2001) § 110(b)(5).

Issues for the Drafting Committee –

<u>How to provide for fiduciary duties in light of the tentative decision to deemphasize manager-management?</u> – As discussed in Topic Five, the Drafting Committee has tentatively decided to (i) eliminate any requirement that the articles of organization specify a limited liability company's management structure, and (ii) eliminate any statutory provision linking management structure to apparent authority to bind the limited liability company. The new Act will, however, provide a set of rules for manager-management, which an LLC can invoke (and revise) via the operating agreement. However, the Drafting Committee's current thinking is to develop a statute that will easily accommodate and perhaps even encourage great variety in management structure.

It seems necessary, therefore, to provide for fiduciary duties in a way that will match a wide variety of management structures. At the most abstract level, this approach makes sense. Fiduciary duty corresponds to power; the more power one person has over the interests of another, the more likely the law (originally "equity") is to recognize a fiduciary relationship.

As a practical matter, however, the more flexible the statutory language, the more questions there will be as to whether fiduciary duty applies to a particular person in a particular situation. Although function (i.e., power) may be the root of most fiduciary duties, status rather than function is the law's primary method for identifying fiduciaries. E.g. agent, director, trustee, general partner.

ULLCA § 409 takes a status-based approach with a function-based overlay. Fiduciary duty attaches either to members in a member-managed LLC or to the managers in a manager-managed LLC; if in a manager-managed LLC the operating agreement shifts management function from a manager to a member, the fiduciary duty pertaining to that function shifts as well.[13] This approach makes sense but it depends fundamentally on both a sharp demarcation between member-management and manager-management and a dominant paradigm for manager-management.

Suppose, for example, that an LLC's operating agreement does not specify that the LLC is to be manager-managed but does provide that one particular member will "supervise and direct the day-to-day affairs of this company." Certainly, that member should be obliged not to compete with the LLC (unless the operating agreement provides otherwise), but should the non-compete obligation extend to the other members as well? Similarly, do the other members have the right to deal with the LLC its day-to-day affairs?

The statutory language suggested above rests on three premises: (i) in the default mode, an LLC is managed by its members collectively; (ii) any right of any member to act or manage individually must come from a delegation (express or implied) from the members acting collectively; (iii) if the operating agreement shifts management responsibility away from a member, to that extent the member is no longer burdened by the general standards of fiduciary duty.

<u>Fiduciary duties under the Act for non-member managers?</u> ULLCA's definition of "manager" applies "whether or not [the person is] a member" of the LLC and turns on the person being "vested with authority under Section 301." *See* ULLCA § 101(10). Section 301 is ULLCA's provision on statutory apparent authority, which (as explained in Topic Five) the Drafting Committee has tentatively decided to eliminate. The Drafting Committee has not considered whether the new Act should state the fiduciary duties of a

[13] MBCA § 7.32(e) takes a similar approach to shareholder agreements that shift responsibility away from directors.

non-member manager. The language suggested above does not do so, leaving the matter to agency law and whatever contract might exist between the LLC and the non-member manager.

<u>Fiduciary duties for non-managing members?</u> – If a non-managing member owns a controlling interest in a manager-managed LLC, should that member owe fiduciary duties to the LLC? to the other members? Or, to the contrary, should the Act prevent a court from attributing such duties to the member?

The Drafting Committee has not yet discussed this topic, and neither does the statutory language suggested above. However, the suggested construct imposes fiduciary duties and the obligation of good faith on all members, subject only to "stripping away" under subsection (b). Under this construct, a controlling member will likely not qualify for subsection (b) protection. An operating agreement might attempt to insulate a member with a controlling interest by allocating substantial management power to a manager, but so long as the operating agreement does not vitiate the member's ability to control the limited liability company the operating agreement does not "remove[] from [the] member all responsibility for and managerial role in an aspect or phase of the affairs of a limited liability company or the conduct of its activities." Subsection (b) of suggested statutory language.

<u>Different rules for closely held LLCs?</u> -- Should members in a closely-held LLC have fiduciary duties or a good faith obligation to other members? In most states, the law of close corporations recognizes shareholder-to-shareholder fiduciary duties (which are sometimes labeled as obligations of good faith), and those duties can extend to a minority shareholder in situations in which that shareholder has veto power. The Drafting Committee has barely begun discussing this topic, and the law of close corporations approaches these issues by providing remedies rather than rights. See the further discussion in Topic Eight. Accordingly, for the moment at least, the suggested language does not address this topic. (The suggested language does, however, leave the topic more open than does ULLCA § 409. See below, Reporters' Notes to subsection (a).)

<u>Narrow the scope of information available to non-managing members, or impose a duty to protect confidential information?</u> -- ULLCA § 408 provides broad information rights. Should these rights be narrowed for non-managing members so as to more closely resemble the information rights of shareholders or limited partners? Should the Act require non-managing members to protect and not misuse the LLC's confidential information? Should the acquisition of confidential information from the LLC by a non-managing member cause a limitation on that member's right to compete with the LLC? The Drafting Committee has not yet considered this topic, and the statutory language suggested above does not address the issues.

Adjust access to remedies for managerial conduct that injures the LLC? ULLCA recognizes the distinction between direct and derivative claims. Compare ULLCA §§ 410 (actions by members) and 1101 ("action in the right of the company") and see § 410, Comment ("A member pursues [under § 410] only that member's claim against the company or another member under this section. Article 11 governs a member's derivative pursuit of a claim on behalf of the company."). Should the Act preserve the demand requirement for derivative suits? *See* ULLCA §§ 1101 and 1103. Should the Act follow ULPA (2001) and permit the operating agreement to circumscribe a member's right to bring a derivative action? Should transferees have the right to bring derivative actions? Direct actions?

The Drafting Committee has not yet discussed these issues, and the statutory language suggested above does not address them. However, the reformulation of subsections (a) and (b) (stating the duties as owed only to the limited liability company) is consistent with maintaining the distinction between direct and derivative claims. *Accord* ULPA (2001) § 1001(b) ("A partner commencing a direct action . . . is required to plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited partnership.")

Subsection (a) -- ULLCA § 409, RUPA § 404 and ULPA (2001) § 408 each describe the duties as extending to the entity's owners as well as to the entity (i.e., to members, partners and partners, respectively). However, the described duties directly protect only the entity, and the owners benefit only derivatively. For example, it is the limited liability company that directly benefits from a member's obligation not to compete with the LLC's business or from an obligation to account for the usurpation of an LLC opportunity. (It is possible to think of a member-to-member duty of care that applies in member-to-member dealings, but there is no case law support for such a duty in the law of limited liability companies or in the law of analogous entities.)

Therefore, either the ULLCA/RUPA/ULPA (2001) language describing duties as extending to owners is surplus, or it is meant to indirectly negate any fiduciary duties owed directly to owners. In either event, the suggested language takes a different approach, expressing the management duties as being owed to the entity and leaving for another part of the new Act (discussed in Topic Eight) the question of duties owed to owners.

Subsection (b) – This language is based on ULLCA § 409(h)(4) and MBCA § 7.32(e). There is no language corresponding to ULLCA § 409(h)(3) (imposing manager-like duties on a member in a manager-managed LLC when the member performs management functions). Instead, the suggested statutory language in subsection (a) imposes manager-like fiduciary duties on all members, subject to "stripping away" under this subsection. The "stripping away" occurs regardless of whether the operating agreement imposes the "stripped away" responsibilities on another member, a non-member or no one.

An operating agreement can be implied in conduct, so a sustained division of managerial responsibility within a limited liability company might trigger this provision. A member could argue that pattern amounts to an agreement to "remove[] from a member all responsibility for and managerial role in an aspect or phase of the affairs of a limited liability company or the conduct of its activities."

Subsection (c) – At first glance, ULLCA § 409(d) might seem to limit this obligation to member-managed companies. However, that subsection's restrictive language ("shall discharge the duties to a member-managed limited liability company") merely reflects that members *qua* members have no fiduciary duties as members in a manager-managed LLC. *See* ULLCA § 409(h)(1). As explained above (Issues for the Drafting Committee -- How to provide for fiduciary duties in light of the tentative decision to deemphasize manager-management?), the suggested statutory language takes a different approach, presupposing that members will always have some management role and attendant fiduciary duties subject to the "stripping away" under subsection (b). Accordingly, the obligation of good faith and fair dealing is more broadly stated here than in ULLCA § 409(d).

The broader approach also comports with the Conference's most recent business entity statute, ULPA (2001), which imposes the statutory obligation of good faith and fair dealing on limited as well as general partners. ULPA (2001) §§ 305(b) and 408(d). N.B. – expanding the *domain* for the obligation of good faith does not mean that the *contents* of the obligation should be broadly construed.

However, it can also be argued that: (i) members should owe each other no duties except as agreed to in the operating agreement; (ii) to the extent an operating agreement creates rights and obligations *inter se* the members, the *common law* implies an attendant obligation of good faith and fair dealing; and (iii) the *statutory* obligation of good faith and fair dealing should therefore run only to the benefit of the limited liability company and not to the other members.

It could be further argued that it makes no sense to have an obligation of good faith and fair dealing running from an entity's owners to the entity. That type of obligation has traditionally been handled as part of the fiduciary duty of loyalty. "Good faith" in the case law tends to refer either to parties to a contract or to obligations of entity owners to each other.

Omission of ULLCA §409(f) – The language suggested above omits the "same rights" provision of ULLCA §409(f), pending discussion by the Drafting Committee. Although also present in RUPA 404(f) and ULPA (2001) § 112, the provision may be anachronistic and unnecessary. Moreover, to the uninitiated the provision appears to conflict with a member's duty of loyalty. Relocating the provision could help.

Omission of ULLCA §409(g) – Pending discussion by the Drafting Committee, the language suggested above omits the provision of ULLCA §409(g) pertaining to "a person winding up the limited liability company's business". The Committee may decide to adopt a different rule in light of ULPA (2001) § 803(c) and, in any event, the rule may fit better in the article concerning dissolution and winding up.

<u>**TOPIC EIGHT – HOW TO APPROACH JUDICIAL REMEDIES**</u>

Overview

The Drafting Committee has only begun to discuss this very difficult issue, and, therefore, no language is being suggested at this time. However, the Drafting Committee has made decisions on two related issues, and those decisions increase the significance of judicial remedies:

1. ULLCA did not permit a limited liability company to have perpetual duration. As explained in Topic Two, the Drafting Committee has decided that a limited liability company formed under the new Act will have perpetual duration unless the members choose otherwise.
2. Consistent with its provisions requiring a limited liability company to be either "at will" or for a stated term, ULLCA provided each member a limited "put" right – i.e., the right under specified circumstances to require the limited liability company to buy out the member's interest. This approach is at odds with the overwhelming majority of state LLC statutes and is contrary to the expectations of most persons that use limited liability companies. The Drafting Committee has therefore decided that the new Act should not include a put right.

As a result, it is possible that minority members under the new Act will be more "locked in" and vulnerable to misconduct than are minority members under ULLCA. The lock-in issue exists under many state LLC statutes as well. (The lock-in is further strengthened by statutory restrictions on a member's right to transfer a membership interest. These restrictions exist under every state LLC statute.)

ULLCA provides that a rightfully dissociating member is paid the fair value of the member's interest <u>unless</u> the operating agreement states otherwise and, moreover, requires that every limited liability company have a finite term. In contrast, the Drafting Committee's current view is (and most state LLC laws provide) that a limited liability company has perpetual existence and a dissociating member is paid the fair value <u>only</u> <u>if</u> the operating agreement so states. Indeed, most state LLC laws now include a triumvirate of default rules providing (i) for perpetual duration, (ii) that member dissociation does not even threaten to dissolve the limited liability company, and (iii) that a dissociating member will not be paid the fair value of the membership interest. In part, state LLC laws take this approach to enable the limited liability company to be used as an estate planning vehicle. (Valuation discounts depend heavily upon such a set of default rules.) Also, some argue that a default buy-out rule is fundamentally inconsistent with the way in which most LLCs are created and used and thus frustrates the normal intentions and expectations of most persons who form and use LLCs. In any event, to retain ULLCA's approach would create substantial barriers to enactment.

The Drafting Committee believes that its decisions on perpetual duration and the "put" right are correct but understands that these decisions could create opportunities for overreaching by those in control of a limited liability company. The Committee has therefore decided to carefully re-examine ULLCA's provisions on judicial remedies.

The relevant ULLCA sections are provided below, followed by Reporters' Notes that identify some of the issues the Drafting Committee has under consideration.

CURRENT ULLCA PROVISIONS

SECTION 701. COMPANY PURCHASE OF DISTRIBUTIONAL INTEREST.

(a) A limited liability company shall purchase a distributional interest of a:

(1) member of an at-will company for its fair value determined as of the date of the member's dissociation if the member's dissociation does not result in a dissolution and winding up of the company's business under Section 801; or

(2) member of a term company for its fair value determined as of the date of the expiration of the specified term that existed on the date of the member's dissociation if the expiration of the specified term does not result in a dissolution and winding up of the company's business under Section 801.

(b) A limited liability company must deliver a purchase offer to the dissociated member whose distributional interest is entitled to be purchased not later than 30 days after the date determined under subsection (a). The purchase offer must be accompanied by:

(1) a statement of the company's assets and liabilities as of the date determined under subsection (a);

(2) the latest available balance sheet and income statement, if any; and

(3) an explanation of how the estimated amount of the payment was calculated.

(c) If the price and other terms of a purchase of a distributional interest are fixed or are to be determined by the operating agreement, the price and terms so fixed or determined govern the purchase unless the purchaser defaults. If a default occurs, the dissociated member is entitled to commence a proceeding to have the company dissolved under Section 801(a)(4)(iv).

(d) If an agreement to purchase the distributional interest is not made within 120 days after the date determined under subsection (a), the dissociated member, within another 120 days, may commence a proceeding against the limited liability company to enforce the purchase. The company at its expense shall notify in writing all of the remaining members, and any other person the court directs, of the commencement of the proceeding. The jurisdiction of the court in which the proceeding is commenced under this subsection is plenary and exclusive.

(e) The court shall determine the fair value of the distributional interest in accordance with the standards set forth in Section 702 together with the terms for the purchase. Upon making these determinations, the court shall order the limited liability company to purchase or cause the purchase of the interest.

(f) Damages for wrongful dissociation under Section 602(b), and all other amounts owing, whether or not currently due, from the dissociated member to a limited liability company, must be offset against the purchase price.

SECTION 702. COURT ACTION TO DETERMINE FAIR VALUE OF DISTRIBUTIONAL INTEREST.

(a) In an action brought to determine the fair value of a distributional interest in a limited liability company, the court shall:

(1) determine the fair value of the interest, considering among other relevant evidence the going concern value of the company, any agreement among some or all of the members fixing the price or specifying a formula for determining value of distributional interests for any other purpose, the recommendations of any appraiser appointed by the court, and any legal constraints on the company's ability to purchase the interest;

(2) specify the terms of the purchase, including, if appropriate, terms for installment payments, subordination of the purchase obligation to the rights of the company's other creditors, security for a deferred purchase price, and a covenant not to compete or other restriction on a dissociated member; and

(3) require the dissociated member to deliver an assignment of the interest to the purchaser upon receipt of the purchase price or the first installment of the purchase price.

(b) After the dissociated member delivers the assignment, the dissociated member has no further claim against the company, its members, officers, or managers, if any, other than a claim to any unpaid balance of the purchase price and a claim under any agreement with the company or the remaining members that is not terminated by the court.

(c) If the purchase is not completed in accordance with the specified terms, the company is to be dissolved upon application under Section 801(b)(5)(iv). If a limited liability company is so dissolved, the dissociated member has the same rights and priorities in the company's assets as if the sale had not been ordered.

(d) If the court finds that a party to the proceeding acted arbitrarily, vexatiously, or not in good faith, it may award one or more other parties their reasonable expenses, including attorney's fees and the expenses of appraisers or other experts, incurred in the proceeding. The finding may be based on the company's failure to make an offer to pay or to comply with Section 701(b).

(e) Interest must be paid on the amount awarded from the date determined under Section 701(a) to the date of payment.

SECTION 801. EVENTS CAUSING DISSOLUTION AND WINDING UP OF COMPANY'S BUSINESS.

(a) A limited liability company is dissolved, and its business must be wound up, upon the occurrence of any of the following events:

(1) an event specified in the operating agreement;

(2) consent of the number or percentage of members specified in the operating agreement;

(3) an event that makes it unlawful for all or substantially all of the business of the company to be continued, but any cure of illegality within 90 days after notice to the company of the event is effective retroactively to the date of the event for purposes of this section;

(4) on application by a member or a dissociated member, upon entry of a judicial decree that:

(i) the economic purpose of the company is likely to be unreasonably frustrated;

(ii) another member has engaged in conduct relating to the company's business that makes it not reasonably practicable to carry on the company's business with that member;

(iii) it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement;

(iv) the company failed to purchase the petitioner's distributional interest as required by Section 701; or

(v) the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner; or

(5) on application by a transferee of a member's interest, a judicial determination that it is equitable to wind up the company's business:

(i) after the expiration of the specified term, if the company was for a specified term at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer; or

(ii) at any time, if the company was at will at the time the applicant became a transferee by member dissociation, transfer, or entry of a charging order that gave rise to the transfer.

Reporters' Notes

Current ULLCA Rule – Borrowing from the law of close corporations, ULLCA § 801(a)(4)(v) permits a member and a dissociated member to apply to a court for an order dissolving the LLC on grounds of illegal, oppressive, fraudulent, or unfairly prejudicial conduct. The provision does not expressly authorize a court to grant a lesser remedy.

A court might nonetheless have the discretion to do so. There are no reported cases under the ULLCA provision, but corporate cases construing analogous statutes recognize a court's inherent power to decree "half a loaf." *See, e.g.*, *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270, 274 (Alaska 1980) ("Liquidation is an extreme remedy. In a sense, forced dissolution allows minority shareholders to exercise retaliatory oppression against the majority. Absent compelling circumstances, courts often are reluctant to order involuntary dissolution. [citations omitted] As a result, courts have recognized alternative remedies based upon their inherent equitable powers.") and *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387, 395 (Or. 1973) (stating that "in a suit under [a corporate dissolution statute] for ''oppressive' conduct consisting of a 'squeeze out' or 'freeze out' in a 'close' corporation the courts are not limited to the remedy of dissolution, but may, as an alternative, consider other appropriate equitable relief"). There is contrary authority, but these cases are in the minority. *E.g. Giannotti v. Hamway*, 387 S.E.2d 725, 733 (Va. 1990) ("[C]ourts generally should be reluctant to order liquidation of a functioning corporation at the instance of minority stockholders. However, the General Assembly has cloaked courts of equity with, in the words of the statute, 'full power' to liquidate in a proper case where oppressive conduct has been established. The remedy specified by the legislature, while discretionary, is 'exclusive,' and does not permit the trial court to fashion other, apparently equitable remedies.")

State LLC Law Developments – Very few LLC statutes provide remedies comparable to ULLCA § 801(a)(4)(v), and LLC case law on oppression is just beginning to develop. At least with regard to closely held LLCs, many courts will analogize to cases concerning close corporations. A case involving a Texas limited liability company provides a recent example. According to the court:

> *Member* oppression has been defined as follows:
>
> 1. majority *shareholders*' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority *shareholder''s* decision to join the venture; or
>
> 2. burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each *shareholder* is entitled to rely.

Pinnacle Data Services, Inc., v. Gillen, 104 S.W.3d 188, 196 (Tex. Ct. App – Texarkana 2003) (emphasis added).

Issues for the Drafting Committee – The Drafting Committee has had almost no discussion of this topic, other than to acknowledge that the topic is of great importance and will require careful and repeated discussion. The following list of issues is an attempt to begin to shape that discussion.

In light of the dearth of LLC statutes that provide oppression remedies and the contract-based nature of a limited liability company, should the new Act retain ULLCA's oppression remedy? -- Over the past 50 years, the law of close corporations has developed important remedies for oppressed (or unfairly prejudiced) shareholders in close corporations. States vary somewhat in their respective approaches, but there is substantial cross-fertilization among jurisdictions. Consider, for example, the following passage from a recent Texas case, which relies on decisions from New Mexico, South Dakota and West Virginia:

> Courts must exercise caution in determining what shows oppressive conduct. McCauley v. Tom McCauley & Son, Inc., 104 N.M. 523, 724 P.2d 232, 237 (1986). The minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently. Landstrom v. Shaver, 561 N.W.2d 1, 8 (S.D.1997). Therefore, despite the existence of the minority-majority fiduciary duty, a corporation's officers and directors are still afforded a rather broad latitude in conducting corporate affairs. Masinter v. WEBCO Co., 164 W.Va. 241, 262 S.E.2d 433, 438 (1980).

Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex.App.-Houston [1 Dist.] 1999). Seminal cases have been decided by courts in New York, Massachusetts, and North Carolina, among others. *Matter of Kemp and Beatley, Inc.*, 64 N.Y.2d 63, 73 (NY 1984) (approving relief for conduct that "substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture"); *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976) (providing a structured analysis that allows a court to remedy abusive conduct while avoiding unwarranted constraints on any "legitimate action by [a] controlling group," including the exercise of "certain rights to what has been termed 'selfish ownership'"); *Meiselman v. Meiselman*, 307 S.E.2d 551563 (N.C. 1983) (establishing preconditions for finding a shareholder's expectation reasonable and stating: "In order for plaintiff's expectations to be reasonable, they must be known to or assumed by the other shareholders and concurred in by them. Privately held expectations which are not made known to the other participants are not 'reasonable.' Only expectations embodied in understandings, express or implied, among the participants should be recognized by the court.") *See also* MBCA §§ 14.30(2)(ii) (providing for judicial dissolution on grounds of illegal, oppressive or fraudulent conduct) and 14.34 (creating an election to purchase in lieu of dissolution).

LLCs may be destined eventually to supplant the corporation as the entity of choice for closely held businesses. If so, omitting an oppression remedy from the new Act (i) could be interpreted as rejecting the past five decades of legal developments regarding oppression, and (ii) would, at minimum, force courts to consider re-inventing the corporate oppression wheel in the LLC context.

On the other hand, the limited liability company is essentially a contract-based arrangement – at least *inter se* the members (which is relevant focal point for discussions of oppression). The contracting parties may protect themselves to the extent they consider necessary. Moreover, the paucity of LLC statutes with oppression remedies might mean something about proper public policy and certainly has implications for the prospects of uniform enactment.

Yet close corporation law developed its protections for minority shareholders by analogizing to general partnerships, which are at least as much creatures of contract as are limited liability companies (and arguably more so; no public filing is necessary to create a general partnership). Moreover, in most limited liability companies the contractual arrangement is a "relational contract" – i.e., of long duration, with parts of the bargain necessarily left open or subject to discretion, and with the parties to the bargain significantly interdependent. Richard E. Speidel, The Characteristics and Challenges of Relational Contracts, 94 Nw. U.L. Rev. 823 (2000). Although the concept of relational contracts has had little impact on the courts, *Id.* at 824, n. 10, the circumstances described by the concept have occasioned legislative intervention at both federal and state levels. Statutes designed to protect dealers provide the most notable examples. Whether such intervention is good policy is a separate question, but the examples show that on occasion this society chooses to have the government intervene "for the sake of fairness" in arrangements that are primarily contractual.

<u>If the new Act retains an oppression remedy should the Act: (i) expressly authorize lesser remedies, including a buy-out of the complaining member? (ii) specifically authorize the courts to order a buy-out of the complaining member by those members responsible for the oppression (rather than the LLC)? (iii) specifically authorize the courts to order those members responsible for the oppression to sell their interests to the complaining member? (iv) provide courts some specific guidance as to what constitutes oppression, including how a claim of reasonable expectations relates to the contents of an operating agreement? (v) permit the operating agreement to restrict the available remedies? (vi) specify what, if any effect, should be given to a provision of an operating agreement that purports to set a buy-out price applicable to a court-ordered buy-out? (vii) restrict the remedies to closely held limited liability companies (however defined)? (viii) make the remedy available in some form to dissociated members and other transferees?</u> The Drafting Committee has not discussed any of these issues.

<u>TOPIC NINE – CHARGING ORDERS</u>

NEW SUGGESTED LANGUAGE

SECTION ___. RIGHTS OF A MEMBER OR TRANSFEREE CREDITOR.

(a) On application to a court of competent jurisdiction by any judgment creditor of a member or transferee, the court may charge the member or transferee's transferable interest with a lien for the payment of the unsatisfied amount of the judgment with interest. The entry of the charging order requires the limited liability company to pay directly to the judgment creditor the charged member or transferee's share of distributions and any other money due or to become due to the member or transferee in respect of the limited liability company. The court may then or thereafter appoint a receiver of the charged member or transferee's share of distributions and any other money due or to become due to the member or transferee in respect of the limited liability company.

(b) A charging order constitutes a lien on the member or transferee's transferable interest and is not an assignment or an attachment. The entry of a charging order entitles the judgment creditor only to the right to payment from the limited liability company as specified in the charging order and does not constitute a lien on any limited liability company property.

(c) Upon the entry of the charging order or at anytime thereafter, the court may order a foreclosure of the lien and a subsequent sale of the charged transferable interest where circumstances suggest the charging order will not result in payment of the unsatisfied judgment within a reasonable time. The entry of an order of foreclosure terminates the equity of redemption in subsection (d). The purchaser at the foreclosure sale is a transferee. The limited liability company or any of its other members or transferees may purchase the interest at a foreclosure sale.

(d) At anytime prior to the entry of an order of foreclosure, the charged transferable interest may be redeemed from the charging order by the payment of the judgment with interest.

A person that so redeems acquires only the rights of the judgment creditor and is not a transferee. The redemption may be by:

(1) the judgment debtor member or transferee, using property other than the limited liability company's property;

(2) the limited liability company, using its property; or

(3) one or more of the other members, using property other than the limited liability company's property.

(e) This [Act] does not deprive any member or transferee of the benefit of any exemption laws applicable to the member or transferee's transferable interest.

(f) This section provides the exclusive remedy by which a judgment creditor of a member or transferee may satisfy a judgment out of the judgment debtor's transferable interest.

ALTERNATE POSSIBLE PROVISION:

(g) Any creditor of a member or transferee shall have no right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

CURRENT ULLCA PROVISIONS

SECTION 504. RIGHTS OF CREDITOR.

(a) On application by a judgment creditor of a member of a limited liability company or of a member's transferee, a court having jurisdiction may charge the distributional interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order.

(b) A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee.

(c) At any time before foreclosure, a distributional interest in a limited liability company which is charged may be redeemed:

(1) by the judgment debtor;

(2) with property other than the company's property, by one or more of the other members; or

(3) with the company's property, but only if permitted by the operating agreement.

(d) This [Act] does not affect a member's right under exemption laws with respect to the member's distributional interest in a limited liability company.

(e) This section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.

Current Drafting Committee Approach – The Drafting Committee’s current view is that the new Act should:

continue the current ULLCA § 112 approach that recognizes the charging order remedy as a judgment creditor’s exclusive remedy under LLC and other law, and clarify that:

~ the charging order is a mere lien and is not an assignment,
~ foreclosure may be ordered when the charging order lien is not effective,

~ foreclosure is by judicial sale rather than "strict foreclosure," and
~ fiduciary duties apply in the context of whether to use LLC assets to redeem a charging order as well as when other members are involved in the purchase at foreclosure.

The Drafting Committee is aware of the need to coordinate the operation of this provision with the operation of UCC Articles 8 and 9, including UCC §§ 9-406 and 9-408..

(a) This Act makes clear that a charging order may be entered against either a member or a transferee. Since assignments are generally not required to be recorded, a charging order against a debtor member who previously assigned the distributional interesting an unrecorded assignment would not be binding upon the assignees. Accordingly, under the terms of the charging order, the limited liability company would be required to pay to the creditor only those current or future distributions to which the debtor member is entitled. A prior unrecorded assignment may require the limited liability company to pay the assignee rather than the charging judgment creditor. See, e.g., Bank of Bethesda v. Koch, 408 A. 2d 767 (Md. App. 1979). The appointment of a receiver is an optional but available enforcement aid and is available upon application.

(b) This Act makes clear that the charging order is a lien and not a transfer or assignment of the charged distributional interest. This further clarifies that a charging order judgment creditor obtains only a lien on the interest and not the interest itself. The interest itself may be foreclosed upon and subsequently sold in which case the purchaser acquires only the rights of an assignee. The purchaser does not acquire any management rights.

(c) This Act makes clear that the charging order court may also take the extraordinary step of foreclosure and sale of the distributional interest. However, such extraordinary steps should not be taken unless and until it is reasonably clear that the unsatisfied judgment may not be satisfied with reasonable expedition from the charging order itself. Moreover, when the purchaser at a foreclosure sale is a non-debtor member, fiduciary duties may require the purchaser to account for the full value of the membership interest less the amount paid by way of purchase or redemption. See, e.g., J. Gordon Gose, "The Charging Order Under The Uniform Partnership Act," 28 Wash. L. Rev. 1, 18 (1953).

(d) Fiduciary duties should apply to the decision to use LLC assets to redeem or purchase an interest subject to a charging order. See, e.g., J. Gordon Gose, "The Charging Order Under The Uniform Partnership Act," 28 Wash. L. Rev. 1, 18 (1953).

(e) As with previous versions, this Act makes clear that the charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment out of the judgment debtor's distributional interest, the statement is somewhat broad. There has been some confusion regarding this meaning. See, e.g., Nigri v. Lotz, 453 S.E. 2d 780 (Ga. App. 1995) (partner's interest may also be reached in Georgia by a garnishment procedure). To be clear, the language means that adoption of this Act expressly repeals any right to levy execution under an earlier state statute. See, e.g., J. Gordon Gose, "The Charging Order Under The Uniform Partnership Act," 28 Wash. L. Rev. 1, 20 (1953) and Matter of Pischke, 11 B.R. 913 (Bkrtcy E.D. Va 1981).

The statute purports to be the exclusive remedy of only "judgment creditors." This language is not intended to encourage courts to reach contrary results in matters involving parties with claims arising other than by judgment. It simply means this statute does not preclude the court from reaching limited liability company assets. In other cases, however, the correlative statutes make this same result abundantly clear. For example, since a member has no interest in LLC property that may be attached, a divorce court would be blocked from enforcing spousal rights directly against LLC assets. Like the charging order, such spousal rights would be limited to the reach of the spousal member's distributional interest unless fraud was involved in the creation of the LLC to avoid the effects of the spousal order. See, e.g., Graves v. Graves, 967 S.W.2d 632, 636 (Mo. App. 1998) (general rule) and Zisblatt v. Zisblatt, 693 S.W. 2d. 944 (TX App. 1985) (fraud and reverse pierce).

There are circumstances where the exclusivity principles of this section may not apply. For example, under limited equitable circumstances a member's creditor may seek application of a "reverse piercing doctrine" to disregard the separate entity status of the limited liability company to make it liable for the member's personal debt. See G. Crespi, "The Reverse Pierce Doctrine: Applying Appropriate Standards," 16 J. Corp. Law 33 (1990) (referring to such claims in the context of a corporation as an "outsider" reverse piercing claim). Several states have approved the use of this doctrine against corporations and against limited partnerships, notwithstanding the exclusivity of the charging order remedy in the latter context. See, e.g C. F. Trust v. First Flight Limited Partnership, 580 S.E. 2d 806 (Va. 2003). Since reverse piercing is an extraordinary remedy with collateral consequences against other innocent owners of the entity, it is to be sparingly applied. See, e.g., Litchfield Asset Management Corporation v. Howell, 799 A. 2d 298, 310 (CN App. 2002) (applying doctrine to reverse pierce where a judgment debtor transferred assets to a controlled limited liability company after a judgment in an attempt to use the separate legal existence of the LLC to safeguard the transferred assets even when the transfer was not proven to be a fraudulent transfer).

(g) This alternate section is patterned after Delaware § 18-703(f) and would attempt to repeal the reverse piercing and similar equitable doctrines. It is listed as an alternative section since it is questionable whether the statute could constitutionally limit the equitable powers of a court under the separation of powers doctrine. Moreover, the wisdom of a limitation on an equitable remedy is questionable as it removes the flexibility to provide for fraudulent situations that may not be adequately addressed by the fraudulent transfer or conveyance acts.

History of Charging Orders -- The charging order procedure reflects ancient roots and purposes. As first included in UPA 1914 § 28, the concept followed quite closely the analogous earlier provision in the English Partnership Act 1890 § 23. In its early design, the charging order was intended as an exclusive remedy for a judgment creditor of a partner. Much like a garnishment, it allowed the judgment creditor to apply to the court for a charging order to direct the partnership to pay the creditor directly any amounts owed to the debtor partner but, combined with other statutes, clearly denied the creditor access to any specific partnership assets. UPA § 25(c) clarifies that a judgment debtor partner's right in specific partnership property held under a tenancy in partnership was not subject to attachment or execution, except on a claim also against the partnership. UPA § 26 provides that a partner's interest in the partnership is a personal property interest in a share of the profits and surplus.

UPA § 28(1) contemplates four separate court actions. First, a court may order charging the debtor partner's interest with payment of the unsatisfied judgment plus interest. Secondly, if requested, the court may appoint a receiver to receive payment of the debtor partner's share of distributions and other money due or to become due in respect of the partnership. Thirdly, the court may make all other orders for an accounting or other matters which the debtor partner might have made or which the circumstances of the case may require. Fourthly, the court may order foreclosure and a subsequent sale of the debtor's interest in the partnership. UPA § 28(2) provides that the charged interest could be redeemed by the judgment debtor or one or more of the other partners prior to foreclosure which severed the equitable right of redemption. Finally, UPA § 28(3) provides that the debtor partner retained any exemptions rights with regard to the charged partnership interest. The debtor partner's interest should be sold only where the creditor's claim will not be satisfied with reasonable speed from the expected distributions and clearly, other orders required contemplates obtaining an accounting or information regarding the rights to a distribution. See, J. Gordon Gose, "The Charging Order Under The Uniform Partnership Act," 28 Wash. L. Rev. 1 (1953).

If the charged interest was not earlier redeemed by payment of the debt with interest, the court could order foreclosure on the charging lien followed by a judicial sale of the charged interest. Under UPA § 27, the purchaser at foreclosure acquired only the debtor partner's economic rights to distribution and not the debtor partner's rights to participate in management which continued in the debtor partner. However, UPA § 32(2) allows the purchaser to seek judicial dissolution of the partnership at any time if the partnership is at will and after the expiration of the term of a term partnership. RUPA § 504 restated UPA § 28 to also clarify that the charging order is a lien and the creditor's exclusive remedy. ULLCA § 504 generally follows the expanded RUPA § 504.

ULPA (1916) § 22 generally followed UPA § 28 but RULPA (1976 & 1985) § 703 took a different path. It substantially streamlined ULPA (1916) § 22 by removing the provisions relating to the appointment of a receiver, those for making other necessary orders, and the prohibition from using partnership property to redeem. The comments reflected that other law governing creditor's rights and general partner fiduciary obligations would determine those matters. Notwithstanding the streamlined limited partnership version, courts generally construed the provision consistent with UPA § 28. See Madison Hills Limited Partnership v. Madison Hills, Inc., 644 A.2d 363 (CN App. 1994) (applying specific UPA § 28 charging order remedies to a limited partnership governed by ULPA (1985) § 703). ULPA (2001) and ULLCA § 504 both adopted the more explanatory provisions of RUPA § 504.

Current ULLCA Rule – ULLCA § 504 carefully follows RUPA § 504 altering only the context from a general partnership to a limited liability company.

State LLC Law Developments – Most states follow a simple pattern directly linked to the language expressed in ULPA (1985) § 703: "On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest." This has created case law confusion on the relationship between the ULPA version and the state law general partnership charging order variant and the application of both to the context of a limited liability company. *See, e.g.,* A.C.A § 4-32-705, Conn. Gen. Stat. § 34-171, D.C. Code § 29-1038), Fla. Stat. § 608.433, Idaho Code § 53-637, Burns Ind. Code Ann. § 23-18-6-7, Iowa Code § 490A.904, Ken. Rev. Stat. § 275.260, Md. Corp. & Assoc. Code Ann. § 4A-607, ALM GL ch. 156C §40, Minn. Stat. § 322B.32, Miss. Code Ann. § 79-29-703, Rev. Stat. Mo. § 347.119, RSA § 304-C:47, N.M. Stat. Ann. § 53-19-35, ORC Ann. § 1705.19, ORS § 63.259, R.I. Gen Laws § 7-16-37, Va. Code Ann. § 13.1-1041, Rev. Code Wash. (ARCW) § 25.15.255, and Wis. Stat. § 183.0705. In part, this confusion arises because the language states that the charging order creditor has the rights of an assignee. This language implies that a transfer or assignment has occurred thereby making the charging order creditor an assignee owner of the debtor member's economic interest. This confusion is particularly likely in states where strict foreclosure without a judicial sale is permissible. See , e.g., Madison Hills Limited Partnership v. Madison Hills, Inc., 644 A. 2d 363 (CN App. 1994). A few states add that the remedy is exclusive. *See, e.g*., Alaska Stat. § 10-50-380(c), Ariz. Rev. Stat. § 29-655(c), K.S.A. §17-76,113, N.J Stat. § 42:2B-45, 18 Okl. St. § 2034, and Wyo. Stat. § 17-15-145. A few states adopt the RUPA and ULLCA §§ 504 approach which adds the redemption and the "all other orders" language. See, e.g., Cal Corp Code (§ 17302), CRS § 7-80-703, HRS § 428-504, 805 ILCS 180/30-20, Mont. Code Anno. § 35-8-705, S.C. Code Ann. § 33-44-504, S.D. Codified Laws § 47-34A-504, 11 V.S.A. § 3074, W. Va. Code § 31B-5-504. Finally, a few states have adopted language specially treating the matter of exclusivity of the charging order. *See, e.g.,* Del. Code Ann., tit. 6 § 18-703, NY CLS LLC § 607, and N.C. Gen. Stat. 57C-5-03 [all adding that no other equitable or legal remedy may exist against LLC assets] and Ga. Code Ann. §14-11-504 (adding that the charging order is not the exclusive remedy and does not exclude others such as garnishment).