

1 **Proposed Revision of Section 110(f)(4)**
2 **to be part of the discussion in the May 9, 2005 teleconference**
3 **(3 – 5 PM Central Time)**
4 ***The Reporters' Notes have not been revised to reflect the proposed revisions.***
5

6 **SECTION 110. OPERATING AGREEMENT.**

7 (a) Except as otherwise provided in subsections (b) and (f), the operating
8 agreement governs:

9 (1) relations among the members as members and between the members
10 and the limited liability company; and

11 (2) the rights and duties under this [act] of a person in the capacity of
12 manager and the rights under this [act] of a person in the capacity of a dissociated member or
13 transferee.

14 (b) To the extent the operating agreement does not otherwise provide for a matter
15 described in subsection (a), this [act] governs that matter.

16 (c) The operating agreement and any amendment to the operating agreement must
17 be consented to by each member, except that a person that becomes a member in a limited
18 liability company is bound by the operating agreement. When a limited liability company has
19 only one member, the operating agreement is not unenforceable by reason of there being only
20 one person that is a party to the operating agreement. The operating agreement may provide for
21 the manner in which it may be amended, including by requiring the approval of a person that is
22 not a party to the operating agreement or the satisfaction of conditions, and an amendment is
23 ineffective if its adoption does not conform to the specified manner or satisfy the specified
24 conditions.

25 (d) An agreement may be all or part of the operating agreement and

1 hold as trustee for it a limited liability company opportunity; and

2 _____ (B) identify specific types or categories of activities that do
3 not violate the duty of loyalty;

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

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

12 (iv) the operating agreement may provide indemnification for a
13 member or manager and may eliminate a member or manager's liability to the limited liability
14 company and members for money damages, except for:

15 (A) breach of the duty of loyalty;

16 (B) a financial benefit received by the member or manager
17 to which the member or manager is not entitled;

18 (C) a breach of a duty under Section 406;

19 (D) intentional infliction of harm on the limited liability
20 company or a member;

21 (E) an intentional violation of criminal law.

22 (5) eliminate the obligation of good faith and fair dealing under Section

1 409(d), but the operating agreement may prescribe the standards by which the performance of
2 the obligation is to be measured if the standards are not manifestly unreasonable;

3 (6) unreasonably restrict the obligations and rights stated in Section 411;

4 (7) vary the power of a court to decree dissolution in the circumstances
5 specified in Section 701(a)(4) and (5);

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

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

9 (10) restrict the right of a member under Section 1014 to approve a
10 merger, conversion, or domestication; or

11 (11) restrict the rights under this [act] of a person other than in the
12 person's capacity as a member, dissociated member, transferee or manager.

13 (g) In determining under subsection (f) whether a provision of an operating
14 agreement is manifestly unreasonable, the court shall make the determination, shall do so as of
15 the time the provision was adopted or most recently amended, and shall consider:

16 (1) whether, in light of the purposes and activities of the limited liability
17 company:

18 (A) the objective of the provision is patently unreasonable; and

19 (B) the provision is a patently unreasonable means to achieve the
20 provision's objective; and

21 (2) whether the essential ramifications of the provision can be understood
22 through the careful consideration of the provision's language.

Reporters² Notes

Issues to be resolved: whether the Act should prohibit the operating agreement from eliminating the distinction between direct and derivative claims; whether inter se the members the certificate will often (or sometimes) be evidence of the content of the operating agreement; whether the guidance newly stated in subsection (g) is useful and, if so, whether that guidance belongs in the statutory text or a comment.

A limited liability company is as much a creature of contract as of statute, and the operating agreement is the “cornerstone” of the typical LLC. Section 102(12) defines a very broad scope for “operating agreement,” and, as a result, once an LLC comes into existence and has a member, the LLC necessarily has an operating agreement. Accordingly, this draft refers to “the operating agreement” rather than “an operating agreement.”

This phrasing should not, however, be read to require a limited liability company or its members to take any formal action to adopt an operating agreement. Compare Cal. Corp. Code § 17050(a) (“In order to form a limited liability company, one or more persons shall execute and file articles of organization with, and on a form prescribed by, the Secretary of State and, either before or after the filing of articles of organization, the members shall have entered into an operating agreement.”)

The operating agreement is the exclusive consensual process for modifying statutory default rules among the members and between the members and the limited liability company. The operating agreement also has power over the rights and obligations of managers and over the rights under the Act of dissociated members, transferees and managers.

The relationship between an amendment to an operating agreement and the rights of a manager, dissociated member, or transferee prejudiced by the amendment is not (yet?) stated in this section. With regard to the rights of manager, the Committee has decided that, except as provided in subsection (c), the amendment should be effective but subject to the manager²'s rights to claim breach under any separate agreement with the LLC. With regard to dissociated members and transferees, the remedy lies in Section 701(a)(5) (dissolution by court order).

At its February, 2005 meeting, the Drafting Committee again rejected language that would have expressly authorized the operating agreement to include a “no oral modification” provision or otherwise require that all amendments be memorialized in a writing or other record. The Committee also decided to (i) delete language that in prior drafts had expressly overridden any “one year” provision of a generally applicable statute of frauds and (ii) eliminate language permitting a non-member to be party to the operating agreement (which first appeared in the February, 2005 draft).

Subsection (a) – This Act comprises a set of rules that contains two mutually exclusive subsets – those rules that can be changed by the operating agreement and those that cannot. Subsection (a) delineates the realm of the former subset, and subsection (b) explains what

1 happens within that realm to the extent left unaddressed by the operating agreement.
2

3 **Subsection (a)(2)** – This provision has been added to implement a consensus expressed
4 at the February, 2005 meeting.
5

6 **Subsection (c)**: It is important to remember that this subsection is a default rule.
7 Therefore, if the operating agreement (initially agreed to by all the members) permits amendment
8 by the consent of a majority of the members, an amendment agreed to by a majority of the
9 members would be effective.
10

11 The second sentence is based on Del. Code Ann., tit. 6, § 18-101(7), as directed by the
12 Drafting Committee at its February, 2005 meeting.
13

14 The effect of the third sentence is to permit non-members (as well as members) to have
15 veto rights over amendments to the operating agreement. Such veto rights are likely to be sought
16 by lenders but may also be attractive to non-member managers.
17

18 **EXAMPLE:** A non-member manager enters into a management contract with the
19 LLC, and that agreement provides in part that the LLC may remove the manager
20 without cause only with the consent of members holding 2/3 of the profits
21 interests. The operating agreement contains a parallel provision, but the non-
22 member manager is not a party to the operating agreement. Later the LLC
23 members amend the operating agreement to change the quantum to a simple
24 majority and thereafter purport to remove the manager without cause. Although
25 the LLC has undoubtedly breached its contract with the manager, the LLC
26 probably has the power to effect the removal and the manager is remitted to a
27 damage claim – unless the operating agreement provided the non-member
28 manager a veto right over changes in the quantum provision.
29

30 The third sentence is derived from Del. Code Ann. tit. 6, § 18-302(e), which states:
31

32 If a limited liability company agreement provides for the manner in which it may
33 be amended, including by requiring the approval of a person who is not a party to
34 the limited liability company agreement or the satisfaction of conditions, it may
35 be amended only in that manner or as otherwise permitted by law (provided that
36 the approval of any person may be waived by such person and that any such
37 conditions may be waived by all persons for whose benefit such conditions were
38 intended).
39

As originally drafted, the third sentence referred to waiver. At its February, 2005 meeting, the Drafting Committee deleted that reference as surplus, in light of Section 107 (Supplemental principles of law).

Subsection (d): This subsection is added pursuant to a consensus discovered at the February, 2005 meeting of the Committee.

Subsection (f)(4) – This provision combines the references to duty of loyalty and duty of care in order to avoid repetition; two of the clauses [(iii) and (iv)] pertain to both duties.

Subsection (f)(11): This provision is new and attempts to perform the task assigned by the Committee to the co-reporters at the February, 2005 meeting.