YOUNG LAWYERS FOCUS

Ready-to-Wear or Custom-Fit: Sizing Up LLC Manager and Member Fiduciary Duties

By Mitchell Bryan

In recent years, individuals who control business entities have encountered greater scrutiny in making major financial, strategic, and governance decisions, guiding operations, and permitting self-benefiting transactions. Well-developed law establishes fiduciary duties that directors, officers, and majority owners owe to a corporation and its shareholders. Less clear are the standards of conduct applicable to managers and controlling owners of unincorporated entities—particularly limited liability companies (LLCs).

LLCs are the newest and most increasingly popular choice of business organization among the four primary alternatives to traditional business incorporation.[1] Statutes under which LLCs are organized vary more from state to state than do those governing general, limited, and limited liability partnerships,[2] and provide a dearth of standards for guiding and evaluating conduct of LLC managers and controlling owners. At this early stage of LLC evolution, case law examining fiduciary duties of LLC managers and controlling owners is less well developed than that involving general and managing partners.

Consistent precedent on the subject of fiduciary duties of LLC managers and members is likely to develop slowly because basic "default" duties are established by statutes that vary among jurisdictions and generally give LLC members considerable latitude to modify the "default" duties by agreement. This article seeks to aid the practitioner by examining generic concepts and statutory patterns most likely to bear upon the determination of fiduciary duties owed by LLC managers and controlling members.

The Hybrid/Contractual Nature of Limited Liability Companies

An LLC is a hybrid entity. The structure and functionality of an LLC include some features characteristic of a corporation and others that are characteristic of a partnership. While enjoying limited liability protection found in corporations,[3] for example, LLC members are treated as partners for tax purposes. This relieves LLC members from double taxation to which corporate shareholders are subject. Under most LLC Acts, unless their LLC operating agreement provides otherwise, all members are agents of the LLC and are vested with joint management authority, along with equal voting rights, profit shares, and, upon liquidation, shares of any residual assets—as though they were general partners. Subject to modification by the operating agreement, each member manager is a fiduciary of the LLC, other member managers, and any nonmanaging members.

An attractive feature of an LLC is that its members are free to agree upon either a decentralized general partnership structure or a more centralized corporate or limited partnership structure. The operating agreement may vest managerial authority in one or more managers, which may include a principal or head manager, or a board of managers, any of whom may, but need not also, be a member of the LLC. Each manager is an agent of the LLC and has a fiduciary relationship with the LLC, its other managers, and its members—much like a director's fiduciary relationship with the corporation, codirectors, and shareholders[4]—and, if the LLC is insolvent, with the company's creditors as well.[5] Similar to a shareholder or limited partner, a nonmanaging LLC member generally has no fiduciary obligations.[6] Just as a majority or controlling shareholder owes fiduciary duties to the corporation and minority shareholders,[7] a majority or controlling LLC member owes fiduciary duties to the LLC and other members.[8]

The Nature and Scope of LLC Manager and Member Fiduciary Duties

The extent of an LLC manager's or nonmanaging member's fiduciary duties depends on whether statutory or common-law duties have been altered by the LLC operating agreement. By definition, a fiduciary is "[a] person who is required to act for the benefit of another person on all matters within the scope of their relationship[.]"[9] A fiduciary relationship "involves discretionary authority on the part of the fiduciary and dependency and reliance on the part of the beneficiary."[10] Such a relationship thus will be recognized for, and corresponding duties will be imposed upon, an LLC manager even where the governing LLC statute imposes none. To a lesser extent in jurisdictions inclined to borrow from principles of partnership law, nonmanaging LLC members may also be subject to certain fiduciary duties.

Duty of Care

State statutes vary in their formulation or non-formulation of an LLC manager's or managing member's duty of care.[11] Some impose an objective duty-of-care standard, requiring the carefulness of an "ordinary prudent person in a like position." Others limit the duty of care to that found in the Uniform Limited Liability Company Act

(ULLCA). The ULLCA "limits" an LLC manager's duty of care to "refraining from engaging in grossly negligent or reckless misconduct, intentional misconduct, or a knowing violation of law."[12] A number of jurisdictions, while not specifying a standard of care, instead immunize managers or managing members from liability in performing their duties unless their actions amount to the type of wrongful conduct referred to in the above-quoted ULLCA provision.[13] Still other state LLC statutes impose no duty of care, or virtually none at all.

Many state LLC statutes permit members to define or modify the statutory "default" duties of their managers and managing members by means of their operating agreement or articles of organization.

In keeping with the contractual nature of an LLC, many state LLC statutes—to one degree or another—permit members to define or modify the statutory "default" duties of their managers and managing members by means of their operating agreement or articles of organization. Some permit this only to the extent that the gross-negligence standard is not unreasonably reduced. The Delaware LLC statute, for example, goes so far as to permit fiduciary duties of a manager or member to "be expanded or restricted or eliminated" by the operating agreement, while expressly preserving liability for bad-faith violation of the implied contractual covenant of good faith and fair dealing.[14] Other state LLC statutes resemble their business corporation counterparts, permitting exculpation of directors in the articles of incorporation.

There is little judicial precedent regarding an LLC manager's duty of care. Under most statutory formats, it appears likely that courts will superimpose upon LLC managers and managing members the same or very similar duties of care to which corporate directors are held accountable.[15] It is well accepted today that a corporate director's duty of care comprises two overarching obligations: to exercise business judgment in making board-level decisions and to monitor and oversee management of the business.

In respect to decision-making, the "business judgment rule" protects LLC managers or managing members much as it protects corporate directors. The rule shields from personal liability directors who make a good-faith business decision (whether it be to act or not to act) on an informed basis, with no conflict of interest, and with an honest belief that their decision was in the best interest of the company. As in the corporate context, the obligation to act or not to act on an informed basis permits an LLC manager or managing member to rely in good faith upon LLC records or upon statements, reports, or opinions of other members, managers, committees, or other persons selected with reasonable care, as to matters reasonably believed to be within the person's professional or expert qualifications.[16] Under the business judgment rule, LLC managers and managing members adhering to these standards can expect that a court will not second-guess their business decisions and risks even if a decision turns out badly and, when viewed in hindsight, resulted from a poor judgment even if amounting to ordinary negligence.

A corporate director's duty of monitoring and oversight, and thus what is likely to be a parallel duty of an LLC manager or managing member, is similarly governed by the business judgment rule.[17] Corporate directors, of course, may delegate managerial duties to board committees or senior executives whose performance they must monitor and oversee. LLC managers and managing members who properly delegate responsibilities to others can expect to be held to a similar duty of monitoring and oversight. In a corporate context, and presumably for an LLC manager, this duty is breached upon "an unconsidered failure . . . to act in circumstances in which due attention would, arguably, have prevented the loss."[18]

Duty of Loyalty

Whether expressly by statute or impliedly by reference to partnership or corporation law, LLC member managers, nonmember managers, and nonmanaging members owe the LLC and its members a duty of loyalty, except to the extent relaxed by their operating agreement. States that have adopted the ULLCA or otherwise borrow from partnership law to set the standard of loyalty for LLC managers and members, specify and limit this duty. The ULLCA defines the duty as follows:

- "account[ing] to the company and [holding] 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;
- "refrain[ing] 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
- "refrain[ing] from competing with the company in the conduct of the company's business before the dissolution of the company."[19]

States that impute a corporate director's duty of loyalty to an LLC manager or member apply the "entire fairness" standard well-known in corporation law.[20] Although not yet apparent from case law, it would seem natural for ULLCA and partnership model states to adopt this standard as well.

As noted above, the business judgment rule presumes directors acted in good faith with an honest belief that their decision was in the corporation's best interests. In contrast, the fairness standard presumes the opposite where directors authorize a self-dealing or related-party transaction. Such transactions are inherently suspect. Unlike the more deferential business judgment rule, therefore the fairness standard places on interested fiduciaries the burden of proving good faith and the transaction's intrinsic fairness to the corporation. Upon ratification of a transaction by disinterested shareholders, which removes the taint of self-interest, the fairness standard shifts the burden of proof back to that of the business judgment rule—that is, the party challenging the transaction must show gross negligence, waste of corporate assets, or bad faith.[21]

Duty of Good Faith

As with corporate directors, the duty of an LLC manager or managing member to act in good faith is a central element of the duties of care and loyalty. This is so even where the governing LLC statute, varying from the ULLCA,[22] does not expressly impose this specific duty. To date, very little case law has addressed this question. Given the highly contractual nature of an LLC, courts in most or all jurisdictions no doubt will imply a covenant, if not a duty, of good faith and fair dealing among LLC members—certainly where they have entered into an operating agreement. So, too, will a court recognize a duty of good faith upon applying the business judgment rule, the classic statement of which expressly incorporates the requirement of good faith. As to the monitoring and oversight component of the duty of care, the Delaware Court of Chancery has described offending conduct as "lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight."[23]

Even in the law of corporations, it remains unclear whether a requirement of good faith is imposed on directors as an independent duty separate from those of care and loyalty. As one commentator recently observed, Delaware decisions beginning with and following *Cede & Co. v. Technicolor, Inc.*,[24] "have embraced the concept of a triad of fiduciary duties of good faith, loyalty, and due care."[25] Recognition and examination of a director's duty of good faith was prominent, for example, in the celebrated litigation over the hiring and termination of Michael Ovitz as President of the Walt Disney Company.[26]

Duty to Creditors

Cases that have considered whether a manager of an insolvent or nearly insolvent LLC owes a fiduciary duty to the company's creditors are even sparser than cases examining fiduciary duties LLC managers owe to the LLC and its members. In most jurisdictions, once a corporation has become insolvent, its directors owe creditors a fiduciary duty to maximize, for the creditors' benefit, the liquidation value of corporate assets and to consider their interests on a par with those of employees, shareholders, and all other parties with an economic stake in the winding down of the company's operations and final disposition of its assets.[27] The few reported decisions to date that have considered whether an LLC manager owes creditors such a duty upon insolvency of the LLC, for the most part, are inconclusive on this point.[28] It would seem to be only a matter of time before courts must address and provide clearer guidance on the issue.

Conclusion

As this area of the law continues to evolve, it is natural to assume that, where LLC fiduciary duties are not stated in statutes and operating agreements, courts more often than not will overlay upon LLC managers and members fiduciary duties to which statutory and common law subject corporate directors, majority shareholders of closely held corporations, and general partners. The variations among state LLC statutes and the contractual nature of relationships among an LLC, its members, and managers leave this area of the law fertile for interesting twists and turns.

On a practical level, when confronting an actual or potential dispute between LLC managers and nonmanaging members, or between members of a member-managed LLC, counsel for each party can provide effective representation only if they have a clear understanding of fiduciary duties established by the governing LLC statute and any modification of those duties by the LLC operating agreement within statutory bounds. In other words, whatever the fabric and style of an LLC's business, when it comes to manager and member fiduciary duties, one size does not fit all. ■

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Endnotes

1. The most common forms of business organization selected as alternatives to traditional business incorporation are general partnerships, limited partnerships, and limited liability partnerships. Corporate trusts are less commonly used.

2. Organization of general, limited, and limited liability partnerships (including limited liability limited partnerships) is commonly pursuant to a particular jurisdiction's enactment of the Uniform Partnership Act of 1914 or the Revised Uniform Partnership Act of 1997 (known as UPA and RUPA, respectively); the Revised Uniform Limited Partnership Act of 1976, as amended in 1985 (known as RULPA); and the Uniform Limited Partnership Act of 2001 (known as Re-RULPA). For a comparative examination of partnership fiduciary duty standards established by each of these uniform acts, see Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 DEL. J. CORP.

L. 343, 354–63 (2005). Only a relatively small number of jurisdictions have adopted the Uniform Limited Liability Company Act of 1996 (known as ULLCA), while limited liability company acts in several other jurisdictions are modeled more closely after the Prototype Limited Liability Company Act (1992) developed by the American Bar Association, Section of Business Law, Committee on Partnerships and Unincorporated Business Organizations (ABA Prototype). *Id.* at 364, 366.

3. LLC members similarly are subject to a variety of traditional veil-piercing principles that may result in personal liability. *See, e.g.*, Anderson v. Stewart, 2006 WL 1118892 (Ark.); Woldeyohannes v. K & K Hartford, LLC, 2006 WL 1133891 (Conn. Super.); Int'l Bhd. of Elec. Workers Local Union 159 v. Circuit Elec., LLC, 2006 WL 623792 (W.D. Wis.); Metcalf v. Lincoln Logs Int'l, LLC, 2006 WL 335595 (E.D. Tenn.); Sakata v. Cook, 2006 WL 164915 (Cal. App. 5th Dist.); Jackson v. Corporategear, LLC, 2005 WL 3527148 (S.D.N.Y.); The Mall at IV Group Props., LLC v. Roberts, 2005 WL 3338369 (D.N.J.); White Family Harmony Inv., Ltd. v. Transwestern W. Valley, LLC, 2005 WL 2893784 (D. Utah); Lily Transp. Corp. v. Royal Inst. Servs., Inc., 832 N.E.2d 666 (Mass. App. Ct. 2005).

4. VGS, Inc. v. Castiel, No. C.A. 17995, 2000 WL 1277372, at *4 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001).

5. Blackmore Partners, LP v. Link Energy LLC, No. Civ. A. 454-N, 2005 WL 2709639, at *6 (Del. Ch. Oct. 14, 2005).

6. *See, e.g.*, Katris v. Carrol, 362 Ill. App. 3d 1140, 1146–47, 842 N.E.2d 221, 225–26 (App. Ct. 2005) (upholding summary judgment granted in favor of two defendants sued for colluding with a nonmanaging member to breach the member's fiduciary duty, because the Illinois LLC Act specifies that a member who is not also a manager owes no duties to the LLC or other members solely by reason of being a member and imposes fiduciary duties on a member of a manager-managed LLC where the nonmanaging member exercises some or all the authority of a manager pursuant to the operating agreement).

7. As a matter of agency law, a majority or controlling shareholder that is a business entity will have vicarious fiduciary responsibility of its subsidiary if it dominates and controls its directors acting in a managerial capacity as directors or officers of the subsidiary. Edwin W. Hecker Jr., *Fiduciary Duties in Business Entities*, 54 KAN. L. REV. 975, 977 (2006) (citing Zahn v. Transamerica Corp., 162 F.2d 36, 40, 46 (3d Cir. 1947); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971)). Dean Hecker notes that a "controlling shareholder" is not limited to a person or an entity that "owns and has the power to vote a majority of the outstanding voting stock," but also includes someone that "otherwise exercises a controlling influence over the management or policies of the corporation or other transaction or conduct in question by reason of the person's position as a shareholder." *Id.* at 978–79 (citing PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §1.10 (1994)).

8. Solar Cells, Inc. v. True N. Partners, LLC, No. Civ. A 19477, 2002 WL749163, at *4 (Del. Ch. April 25, 2002).

9. BLACK'S LAW DICTIONARY 658 (8th ed. 2004). Viewing the concept somewhat more broadly, RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1979) provides that "[a] fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation."

10. Hecker, *supra* note 7, at 976 (citing Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254, 1259 (D. Kan. 2000); Denison State Bank v. Madeira, 230 Kan. 684, 691–92, 640 P.2d 1235, 1241 (1982)).

11. For an exhaustive survey of duty of care variations imposed on LLC managers and managing members under state LLC statutes, *see* Miller & Rutledge, *supra* note 2, at 366–69, nn.91–106.

12. UNIF. LTD. LIAB. CO. ACT § 409(c).

13. The duty of care in some of these jurisdictions is identical to or closely resembles that seen in the ABA Prototype. Miller & Rutledge, *supra* note 2, at 364, 368.

14. DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2007).

15. *Blackmore Partners, LP*, 2005 WL 2709639, at *5 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); Carson v. Lynch Multimedia Corp., 123 F. Supp. 2d 1254 (D. Kan. 2000). *Cf. VGS, Inc.*, 2000 WL 1277372, at *5 (holding the business judgment rule inapplicable to managers' decision that amounted to bad faith breach of duty of loyalty).

16. Hecker, *supra* note 7, at 993.

17. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7, § 4.01 cmt. c.

18. *In re Caremark*, 698 A.2d at 967 (emphasis omitted).

19. UNIF. LTD. LIAB. CO. ACT § 409(b)(1)–(3). *See also* REV. UNIF. P'SHIP ACT § 404(b)(1)–(3).

20. *See, e.g., Solar Cells*, 2002 WL749163, at *4–6; *VGS, Inc.*, 2000 WL 1277372, at *4–5.

21. *Blackmore Partners, LP*, 2005 WL 2709639, at *7.

22. UNIF. LTD. LIAB. CO. ACT § 409(d).

23. *In re Caremark*, 698 A.2d at 971.

24. Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993).

25. Hecker, *supra* note 7, at 995.

26. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003).

27. *See, e.g.*, AMB Eng'g Servs. v. Thompson, 2006 WL 1517776, at *6 (N.D. Ill. May 24, 2006); *In re* McCook Metals, LLC, 319 B.R. 570, 594–95 (N.D. Ill. Bankr. 2005); *In re* Global Servs. Group, LLC, 316 B.R. 451, 459–60 (Bankr. S.D.N.Y. 2004); Ben Franklin Retail Stores, Inc. v. Steinberg, 2000 WL 28266, at *4 (N.D. Ill. 2000); and Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991). *See also* Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45 (1998); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993).

28. *In re* Tri-River Trading, LLC, 329 B.R. 252, 266–67 (8th Cir. BAP 2005) (inconclusive); U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, LLC, 864 A.2d 930, 947 (Del. Ch. 2004), *vacated and remanded*, No. 36, 2005, Del. LEXIS 215 (Del. June 6, 2005) (inconclusive); Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 787–801 (Del. Ch. 2004) (inconclusive). *But see In re McCook Metals*, 319 B.R. 570, 594–95 (N.D. Ill. Bktcy 2005) (LLC managers subject to the same duty as corporate directors); *In re* IDS Holding Co., LLC, 292 B.R. 233 (Bankr. D. Conn. 2003) (LLC managers subject to the same duty as corporate directors).