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AN ANALYSIS OF THE REVISED UNIFORM LIMITED LIABILITY COMPANY ACT

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INTRODUCTION

IN December 2006, the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) promulgated a Revised Uniform Limited Liability Company Act (“RULLCA”).¹ This was NCCUSL’s second try at promulgating a uniform limited liability company (“LLC”) law. In 1995, after nearly every state had already adopted an LLC statute, NCCUSL formulated the first Uniform Limited Liability Company Act (“ULLCA”). While it has existed for more than a decade, the original ULLCA has only been adopted in eight states, including only one major commercial jurisdiction, Illinois.² This dismal adoption record arose even with the rapid rise in LLC filings and corresponding increase in the demand for guidance in the regulation of the LLC form.³

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1. REVISED UNIFORM LIMITED LIABILITY COMPANY ACT (2006) [hereinafter RULLCA], available at http://www.law.upenn.edu/bl/archives/ulc/ullca/2006act_final.pdf.
 2. NCCUSL lists the adopting states as Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia. See National Conference of Commissioners on Uniform State Laws, Uniform Limited Liability Company Act Fact Sheet, available at http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ullca.asp.
 3. Data on LLC filings is presented in INT’L ASS’N OF COMMERCIAL ADM’RS, 2007 ANNUAL REPORT, available at http://www.iaca.org/downloads/AnnualReports/2007_IACA_AR.pdf.

NCCUSL attributes the need for a new uniform act, and by implication the failure of ULLCA, to changes in the legal and business context of LLCs. According to NCCUSL, the key factors included the adoption of the tax classification rules,⁴ the rise in demand for manager-managed LLCs, the rising popularity of single-member LLCs, and the increasing number of limited liability partnership statutes offering full limited liability protection (which present an alternative to the LLC, particularly for professional firms).⁵ However, NCCUSL amended ULLCA to take account of the tax classification rules soon after its initial promulgation⁶ and it offers no explanation of why the other factors demand a new act or how the new act meets those demands.

The more likely explanation of ULLCA's dismal failure, not only to achieve its goal of "uniformity" of LLC law but also to be accepted by a substantial number of state legislatures, is that RULLCA was poorly designed to meet firms' needs. In a detailed analysis of ULLCA written when it was first promulgated, I concluded that

ULLCA is not even a suitable model for future LLC legislation. ULLCA makes many poor policy choices, including terms that are unsuited for informal firms, unnecessary mandatory rules, and rules that are inappropriately borrowed from other business forms. The drafting is often convoluted, complex and otherwise inept.⁷

The underlying problem is that the NCCUSL process tries to achieve uniformity by compromising the conflicting objectives of various interest groups active in LLC legislation. In a paper written contemporaneously with the adoption of ULLCA, Professor Bruce Kobayashi and I showed that NCCUSL failed to follow the obvious route to maximizing uniformity of the incorporating provisions many states had already adopted.⁸ ULLCA instead

4. The Internal Revenue Service's "check-the-box" tax classification rules removed tax classification constraints on LLC statutes by permitting any closely held unincorporated business entity to be taxed as a partnership or disregarded entity unless it elects to be taxed as a corporation. See Simplification of Entity Classification Rules, 26 C.F.R. pt. 1, 301, 602 (Dec. 10, 1996, effective Jan. 1, 1997).

5. See RULLCA, Prefatory Note.

6. See UNIFORM LIMITED LIABILITY COMPANY ACT ANNOTATED, Prefatory Note (1996) [hereinafter ULLCA].

7. Larry E. Ribstein, *A Critique of the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 311, 387 (1995) [hereinafter Ribstein, *Critique*] (footnote omitted).

8. Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and ULLCA*, 66 U.

included idiosyncratic provisions that reflected the influence of lawyers and other powerful interest groups. In a more recent paper, Professor Kobayashi and I presented a formal account of precisely why the NCCUSL institutions that were designed to produce uniformity may actually tend to undermine it, specifically because of the drafting compromises necessitated by the drafting committee's need to obtain full conference approval.⁹ We also demonstrated how RULLCA manifests the drafting failures that result from this procedure.

Apart from NCCUSL's failure to achieve uniformity, both my recent paper with Professor Kobayashi and my earlier critique of ULLCA illustrate serious flaws in the statutes. This casts doubt on the argument that NCCUSL's departures from uniformity-maximization can be explained as an effort to "identify the best elements of the myriad 'first generation' LLC statutes and to infuse those elements into a new, 'second generation' uniform act" in order to produce a state-of-the-art LLC statute.¹⁰

NCCUSL's efforts to promulgate uniform LLC statutes should be contrasted with "model" business association statutes. Model acts avoid the defects of the NCCUSL process of compromising between the conference and the drafting committee, and therefore more fully reflect the intentions of the experts on the drafting committee. My article with Kobayashi on ULLCA found evidence that the Prototype Limited Liability Company Act, proposed in 1992 by a Working Group of the American Bar Association ("ABA"), compares favorably with ULLCA in using existing widely adopted LLC provisions to achieve efficient uniformity.¹¹ An ABA committee is now working independently of NCCUSL to prepare a revised Model LLC Act.¹² Moreover, the model lawmaking process can more easily make changes on a regular basis to reflect business and legal changes affecting the statute. Similarly, the Committee on Corporate Laws of the Corporate and Business Law Section of the ABA has long produced and updated the Model Business Corporation Act, which has substantially influenced the development of corporate law throughout the United States.¹³

COLO. L. REV. 947 (1995). For evidence that LLC statutes, even prior to ULLCA, had achieved uniformity with respect to provisions as to which uniformity was desirable, see Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQUIRY 464 (1996).

9. Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws* (U. Ill. Law & Econ. Research Paper No. LE07-030), available at <http://ssrn.com/abstract=998281>.

10. See RULLCA, Prefatory Note.

11. See Ribstein & Kobayashi, *supra* note 8.

12. See American Bar Association, Section of Business Law, Model LLC Act Task Force, available at <http://www.abanet.org/dch/committee.cfm?com=CL590005>.

13. See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998);

This Article provides further evidence of the defects of NCCUSL's lawmaking process by focusing in detail on RULLCA's most important changes from the original ULLCA. The Article discusses eight significant developments or drafting decisions in RULLCA: (1) the formation of the LLC, particularly the "shelf registration" innovation; (2) the definition and rules regarding the operating agreement; (3) distributions-in-kind; (4) transferee rights, particularly the effect of amendments to the agreement on existing transferees; (5) management, particularly the members' and managers' power to bind the LLC in transactions with third parties; (6) definition and waiver of fiduciary duties; (7) judicial dissolution for oppression; and (8) derivative suits, particularly including the addition of provisions for special litigation committees.

This Article shows that RULLCA imposes enough risks on limited liability companies that state legislators should hesitate to adopt it, and lawyers should consider carefully the pitfalls of advising clients to form LLCs under RULLCA. More generally, this Article casts further doubt on the advisability of state legislators relying on NCCUSL to produce worthwhile legislation, particularly in the area of business association statutes. Because U.S. firms can choose a business association statute by forming in any state and have that law apply wherever they do business,¹⁴ there is a serious question as to whether there is any need for NCCUSL to promulgate uniform law proposals for business association statutes.¹⁵ State legislatures that need expert guidance are better off getting this help from model laws, which are not infected by the political problems inherent in the NCCUSL lawmaking process.

I. FORMATION

In terms of formation, LLC statutes have evolved toward simply requiring a central filing with the secretary of state or equivalent office. However, there are two developments in LLC formation law that NCCUSL was called upon to address: (1) LLCs formed for the "shelf" prior to the admission of members, and (2) the advent of "series LLCs" that provide a

William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success* (Emory U. Law & Econ. Research Paper No. 07-17), available at <http://ssrn.com/abstract=999477>.

14. See *infra* Conclusion.

15. See Bruce H. Kobayashi & Larry E. Ribstein, *Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131 (1996) (analyzing the need for uniform laws, and particularly the effect on this need of parties' ability to contract for the applicable law).

simple mechanism for combining related businesses. As discussed in the following Sections, NCCUSL provided an incomplete and unsatisfactory response to the first development and failed to address the second. As a result, NCCUSL fails to provide either a suitable model or a likely basis for uniformity in these areas.

A. Shelf Registration

The main formation question before the NCCUSL was whether to allow for “shelf registration,” pursuant to which an LLC can be formed without members. Under most statutes¹⁶ and RULLCA,¹⁷ the administrative act necessary to form an LLC is the filing of a specific certificate with the appropriate state official, in some cases subject to an agreed-upon delayed effective date. Many LLC statutes, again including RULLCA, also require an LLC to have at least one member.¹⁸ Under this rule, backlogs in the state filing office and member contribution questions¹⁹ can make it difficult to determine exactly when an LLC comes into existence. Because of uncertainty about the formation of an LLC and the liability shield this confusion creates, potential initial members may be reluctant to join at the risk being held personally liable for debts. Also, a lawyer may be hesitant to issue a legal opinion letter regarding an LLC’s legal existence to a third party that is entering a transaction with that LLC.²⁰

The most straightforward way to resolve these problems would be to permit an LLC to be formed with no members, as the Virginia statute provides.²¹ One problem with this approach is that a no-member LLC might be said to be based on a filing alone, rather than on a contractual relationship, thereby undermining the contractual basis of the LLC.²² However, this is not a realistic concern. Contracts necessarily underlie both incorporated and

16. See LARRY E. RIBSTEIN & ROBERT KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES app. 4-3 (2d ed., 2004).

17. See RULLCA § 201(d).

18. See RIBSTEIN & KEATINGE, *supra* note 16, § 4:3 and app. 4-4.

19. RULLCA section 401(e) provides that a member need not make a contribution. However, the operating agreement may require a contribution. *Id.* Section 401(a)–(b) provides that member or members become such as agreed between the member and the organizer of the LLC. *Id.*

20. See Robert Keatinge, *Shelf LLCs and Opinion Letter Issues: Exegesis and Eisegesis of LLC Statutes*, 23-2 PUBOGRAM 15 (2006); Daniel S. Kleinberger & Carter G. Bishop, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515, 529 n.84 (2007).

21. See VA. CODE ANN. § 13.1-1038.1(A)(3) (2006).

22. See Keatinge, *supra* note 20.

unincorporated firms.²³ Moreover, there is no reason why the firm could not be deemed to be based on a contract among non-member “organizers.”²⁴ Indeed, it is impossible to conceive of the formation of a firm, incorporated or otherwise, without some sort of agreement or, in the case of a sole member, consent.

The more basic problem with a no-member LLC is simply that the states do not allow or recognize them, just as they once did not allow or recognize one-member firms. Even if state statutes permit the formation of such a firm, it is not clear what exists after formation. Even if a no-member “LLC” is a contract among organizers governed by ordinary contract principles, it is not generally considered an LLC.²⁵ Thus, state statutes do not provide default or mandatory rules for the relationship, including the limited liability of the “owner” or “owners.” Moreover, such statutes create potential confusion in applying non-LLC law that depends on the formation of the LLC.²⁶ State legislatures could solve the problem of the no-member LLC just as they solved the problem of one-member LLCs—that is, by authorizing them and designing the statute to accommodate the memberless firm. Although this firm would be a rather strange beast, so is a one-member LLC.

RULLCA takes a no-solution approach to the no-member problem. RULLCA section 201(b)(3) provides that the certificate must state whether it is being filed for a no-member LLC. Section 201(e) provides that this certificate lapses unless, within ninety days of the initial filing, an organizer signs and delivers to the appropriate official a notice declaring that the LLC has at least one member and citing the date on which those individuals became the company’s initial members. The LLC then is deemed to have been formed as of the date of initial membership stated in the notice. However, this first filing has no apparent legal effect. Pursuant to section 201(e), no firm is formed and RULLCA’s provisions do not apply to the

23. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

24. See ULLCA § 111(c).

25. Additionally, the contract among the organizers is not an operating agreement since it is not an agreement of “the members of a limited liability company.” See RULLCA § 102(13).

26. See *ConnectU LLC v. Zuckerberg*, 482 F. Supp. 2d 3 (D. Mass. 2007) (where Delaware LLC formed per the Delaware statute with no members and no agreement about how LLC would be run, and members were admitted pursuant to a later operating agreement retroactively to the date of formation, there were no members when the complaint was filed between the time of formation and the date when the operating agreement was entered into, and therefore no federal diversity jurisdiction, because a memberless LLC was not a citizen of any state).

entity until a member is admitted.²⁷ At most, section 201(b)(3) allows a lawyer to say in a third party opinion letter that a particular administrative act has been accomplished.

Given the minimal effect of RULLCA's shelf registration provision, firms should avoid relying on it. Instead of permitting this odd procedure, states should address the specific problems that shelf registration is intended to address. For example, they could streamline the procedure for creating LLCs to eliminate the potential risk undertaken by the forming member.

B. The Series LLC

For more than a decade, the Delaware Limited Liability Company Act has allowed an LLC to designate a series of members, managers, or LLC interests with separate rights, powers, duties, property, liabilities, profits and losses, business purposes, or investment objectives associated with each series.²⁸ Under the Delaware statute, and in the absence of contrary agreement, each series is managed and controlled separately by the members and managers associated with the series.²⁹ Each series' ability to make distributions to owners depends on the assets and liabilities attributed to that series;³⁰ members who assign their interests cease to be associated with their series without being associated with another,³¹ and a series may be dissolved and wound up without affecting the continued existence of the other series.³² In order to be entitled to this treatment, the LLC must provide for series in the LLC agreement; keep separate records for each series; separately hold or account for the assets each series of the limited liability company; and give notice of the limitation on liabilities of a series in the certificate of formation

27. Unfortunately, the drafters deleted a provision in a draft of ULLCA that would have made this point clearer. For a discussion of the February 2006 draft of RULLCA section 105(b) in Keatinge, see *supra* note 20, at 23, n.58 (providing that LLC cannot carry on specified activities without members).

28. See DEL. CODE ANN. tit. 6, § 18-215 (2005). The California Franchise Tax Board has stated that each cell in a Delaware Series LLC is considered a separate LLC for California franchise tax purposes and, therefore, must file its own tax form and pay its own separate LLC annual tax if it is registered or doing business in California. See Franchise Tax Board, March/April 2006 Tax News, http://www.ftb.ca.gov/professionals/taxnews/tn_06/03_04.shtml (last visited Apr. 19, 2008).

29. DEL. CODE ANN. tit. 6, § 18-215(f) (2005).

30. *Id.* § 18-215(h).

31. *Id.* § 18-215(j).

32. *Id.* § 18-215(k).

of the limited liability company, which constitutes notice of the liability limitation.³³

Several other states have followed Delaware's lead with their own series LLC provisions.³⁴ Delaware applies the law of the state where the LLC was formed to series formed in other states and operating in Delaware.³⁵ It is not clear how series LLCs will be treated in states that do not have these statutes.

An important rationale for series provisions is that, if properly designed and drafted, they may give firms a safe harbor against courts' piercing the veil and holding an entity or entities liable for debts incurred by sister entities or subsidiaries. The Delaware LLC Act provides that liabilities may be charged to the property allocated to one series only, and not to other series.³⁶

RULLCA's drafters rejected including a provision in the uniform law for series LLCs. The prefatory note gives two rationales for this decision. First, it notes "difficult and substantial questions" relating to the extent to which a series or its constituent parts would be separate legal persons, how series LLCs would be treated for tax, bankruptcy, and choice-of-law purposes, and the disclosures that would be necessary under the securities laws. Second, the drafters cited the use of "well-established alternate structures," including multiple single member LLCs or LLC holding companies with subsidiaries.

With respect to the first rationale, it is not clear why such uncertainties should prevent NCCUSL from addressing important issues concerning a device that has already been enacted in several states. NCCUSL's mission

33. *Id.* § 18-215(b).

34. See 805 ILL. COMP. STAT. ANN. 180/37-40 (2008); IOWA CODE ANN. § 490A.305 (2008); 18 OKLA. ST. ANN. tit. 18, § 2054.4 (2007); TENN. CODE ANN. § 48-249-309 (2007); UTAH CODE ANN. § 48-2c-606-616 (2007). The Iowa, Oklahoma, and Utah provisions are modeled closely on Delaware's, while the Illinois and Tennessee provisions diverge from the Delaware model in some respects. For example, the Illinois provision requires a separate certificate of designation for each series in addition to articles of organization for the limited liability company. For an analysis of the Delaware and Illinois provisions and their tax consequences, see Nick Marsico, *Current Status of the Series LLC: Illinois Series LLC Improves Upon Delaware Series LLC but Many Open Issues Remain*, 9 J. PASSTHROUGH ENTITIES 35 (2006); Charles T. Terry & Derek D. Samz, *An Initial Inquiry into the Federal Tax Classification of Series Limited Liability Companies*, 110 TAX NOTES 1093 (2006).

35. DEL. CODE ANN. tit. 6, § 18-215(m) (2005).

36. *Id.* § 18-215(b). The statute may not make clear to what extent the series or its constituents will be treated as separate entities for liability and other purposes. See *GxG Mgmt. LLC v. Young Bros. & Co.*, No. 05-162-B-K, 2007 WL 551761 (D. Me. Feb. 21, 2007) (applying Delaware law) (denying plaintiff's motion to add as a party a series LLC created under Delaware law that allegedly owned the boat that was the subject of breach of warranty and other claims, reasoning that the series was not a separate entity for all purposes under the statute, and that it was not clear whether the series could sue or be sued), *amended by* No. 05-162-B-K, 2007 WL 1702872 (D. Me. June 11, 2007).

should be to clarify the law of LLCs as it is, rather than to wish away questions it would prefer did not exist. The omission is particularly curious given that NCCUSL adopted provisions on shelf registration despite the serious questions regarding this procedure discussed above. Moreover, most of the problems with series provisions arise under non-LLC law, which NCCUSL would not have to address. Federal law can adapt to state law developments, just as the tax classification rules ultimately adapted to the development of the LLC. Firms can weigh and address these uncertainties in deciding whether to adopt series provisions.

With respect to the second rationale for rejecting series LLC provisions, the alternative structures that the RULLCA drafters said were available to fill the gap are not complete substitutes for series LLCs. Indeed, the risk that a court may consider related entities to be part of a single firm is a compelling reason for series LLCs. There may be good business reasons for maintaining economic separation between parts of what a court might deem to be a single business in the absence of a series statute. Although courts retain the power to police fraud, a series LLC statute can provide a clear rule that would help firms distinguish between acceptable and unacceptable practices.

Whether or not states or the NCCUSL permit formation of series LLCs, they need to settle the local treatment of foreign series LLCs. Under RULLCA, as under LLC law generally, the law of the state of formation governs members' and managers' liability for the LLC's debts.³⁷ A RULLCA comment states that it

does not pertain to the “internal shields” of a foreign “series” LLC because those shields do not concern the liability of members or managers for the obligations of the LLC. Instead, those shields seek to protect specified assets of the LLC (associated with one series) from being available to satisfy specified obligations of the LLC (associated with another series).³⁸

NCCUSL therefore not only fails explicitly to address the issues concerning foreign LLCs, but goes out of its way to deter courts from using RULLCA's general choice of law provision to resolve these issues. Moreover, the formal distinction between internal and external shields is not obviously relevant for choice-of-law purposes, since both situations involve the effect of the limited

37. See RULLCA § 801(a)(2).

38. *Id.* § 801(a)(2) cmt.

liability shield on third parties. If there is a policy reason for distinguishing internal and external shields, this is all the more reason to address the interstate effect of the growing number of series LLC statutes.

II. THE OPERATING AGREEMENT

RULLCA has several new provisions defining and attempting to clarify the nature and role of the operating agreement. In some respects, the drafters' passion for detailed drafting has created additional opportunities for compromise in the drafting process and therefore more confusion and uncertainty.³⁹

A. Oral Operating Agreements

RULLCA section 102(13) very broadly defines the operating agreement as the “agreement, whether or not referred to as an operating agreement and whether oral, in a record, implied, or in any combination thereof, of all the members of a limited liability company.”⁴⁰ This includes not only oral express contracts, but “any activity involving unanimous consent of the members,” and “a number of separate documents (or records), however denominated.”⁴¹ This may create significant uncertainty and invite litigation as to the terms of the operating agreement. The benefits of certainty must be balanced against the potential costs of frustrating the parties' intent by refusing to enforce oral agreements, particularly in informal firms.

A specific effect of RULLCA's open-ended approach to the operating agreement is that a person who joins an existing LLC may not easily be able to determine what she is agreeing to. RULLCA section 111(b) provides that “[a] person that becomes a member of a limited liability company is deemed to assent to the operating agreement.” The comment to this subsection notes that “a person becoming a member of an existing limited liability company should take precautions to ascertain fully the contents of the operating agreement.” This obviously presents problems where oral and implied-in-fact terms, and even the parties' unanimous consent to a particular act, can be part of the operating agreement.

39. In addition to the rules discussed in this Part, RULLCA includes extensive limitations on the effect of an operating agreement. Because the most important limitations relate to waiver of fiduciary duties, these will be discussed *infra* Part VI in connection with that topic.

40. RULLCA § 102(13).

41. *Id.* § 102(13) cmt.

Even if a default rule enforcing oral operating agreements is justified, the parties should be able to contract around the default by agreeing that the operating agreement or amendments must be in writing. RULLCA section 110(a)(4) arguably permits such agreements by providing that the operating agreement may include “the means and conditions for amending the operating agreement”; the comment to this subsection states that RULLCA “does not specifically authorize the operating agreement to limit the sources in which terms of the operating agreement might be found or limit amendments to specified modes. . . . [h]owever, this Paragraph (a)(4) could be read to encompass such authorization.”⁴² The comment also notes that RULLCA section 107, which provides for the application of general principles of law and equity, contemplates application of the parol evidence rule if the written agreement includes a merger provision.⁴³ It is not clear why RULLCA’s black letter does not explicitly address the important issue of the enforceability of a writing requirement. The availability of general contract law is not a complete answer, because the statute’s clear authorization of oral agreements, combined with the hedging in the section 110(a)(4) black letter and comment, creates uncertainty about the construction and enforcement of agreements requiring writings.

RULLCA section 110(a)(4) leaves open the specific issue of whether the parties should be able to restrict the enforcement of an oral agreement through the uncertain terms of another oral agreement. For example, a party may claim that a purported oral modification is ineffective based on evidence of an earlier agreement permitting only written amendments. There is a strong argument that such an important constraint on the agreement should be in writing. Alternatively, the statute might reduce uncertainty by providing that a written operating agreement can be amended only by a unanimous vote unless otherwise provided in writing.⁴⁴

B. Application to Third Parties

RULLCA section 102(13) defines the operating agreement as “the agreement . . . of all the members of a limited liability company.”⁴⁵ This definition, however, does not preclude non-members from also being parties to the agreement. Moreover, the terms of the agreement may reach more

42. RULLCA § 110(a)(4) & cmt.

43. *Id.* § 110(a)(4) cmt.

44. *See* ARK. CODE ANN. § 4-32-403(b)(2) (2001); IDAHO CODE ANN. § 53-623 (2000), *repealed on other grounds and reenacted at* § 30-6-407 (2008).

45. RULLCA § 102(13).

broadly than to just the LLC members. Section 110(a) provides that the operating agreement governs, among other things, “the activities of the company and the conduct of those activities.”⁴⁶ The following Subsections address who is bound by the operating agreement.

1. Third Parties Generally

RULLCA section 110(c)(11) provides that the operating agreement may not “restrict the rights under this [act] of a person other than a member or manager.”⁴⁷ However, this is misleading for several reasons. First, even apart from the statute, one may be a third party beneficiary of the operating agreement under general contract law, which applies as a supplemental principle of law pursuant to RULLCA section 107.⁴⁸ Second, the firm or its members can make agreements with third parties that would be fully effective under general contract law both to expand and to restrict third party rights. Even an operating agreement arguably should have this effect if the third party assents and is explicitly made a party to the agreement. As noted above, this effect is not precluded by the statutory definition of the operating agreement.

The RULLCA restriction on application to third parties really means no more than that an operating agreement does not necessarily bind non-parties to the agreement except for managers and transferees, as discussed below. Accordingly, RULLCA does not actually restrict the reach of the operating agreement, but rather expands it to include persons that arguably would not otherwise be reached. More precisely, these persons constructively consent to being made a party to the agreement by dealing with an LLC formed under RULLCA. By suggesting that the operating agreement cannot have this effect, RULLCA unnecessarily creates uncertainty and the opportunity to litigate an issue that would be clear under general contract law.

2. Managers

RULLCA section 110(a) provides, with limited exceptions, that the operating agreement governs not only “(1) relations among the members as members and between the members and the limited liability company,” but

46. *Id.* § 110(a).

47. *Id.* § 110(c)(11).

48. The Delaware statute makes this clear by providing that “[a] limited liability company agreement may provide rights to any person, including a person who is not a party to the limited liability company agreement, to the extent set forth therein.” DEL. CODE ANN. tit. 6, § 18-101(7) (2005).

also “(2) the rights and duties under this [act] of a person in the capacity of manager.”⁴⁹ Section 110(c)(11) provides that the operating agreement may not “restrict the rights under this [act] of a person other than a member or manager.”⁵⁰ RULLCA section 112(a) provides that “[a]n operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition.”⁵¹ Under these provisions, unless the operating agreement provides otherwise, it may restrict the rights under RULLCA and restrict the duties of a manager even if the manager is not a member and has not agreed to these duties or restrictions.

The argument for treating a non-member manager differently from other non-members regarding the effect of the operating agreement is that because the manager is an integral part of the LLC’s governance structure, and because RULLCA deals with the managers’ powers and duties, it would be awkward to force the LLC to deal with the manager in a separate agreement. It is not clear, however, why the non-member manager should be bound without being a party to the agreement. Moreover, as discussed above in Subsection 1, there is no reason why non-members generally could not be parties to the operating agreement. The basis for binding the manager is that the manager has constructively consented to the terms of the statute and the operating agreement by agreeing to manage the LLC. It still is not clear why the agreement could not explicitly make the manager a party.

3. Transferees

RULLCA section 112(b) provides that the operating agreement governs the LLC’s and its members’ obligations to members’ transferees and dissociated members. This section also provides that “an amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person’s capacity as a transferee or dissociated member.”⁵²

While this provision might seem to disregard the transferee’s rights, it is not problematic in most situations. A transferee, like other third parties, may be deemed to have dealt with the LLC in light of the rights and limitations established by the operating agreement and the statute, including the rules

49. RULLCA § 110(a).

50. *Id.* § 110(c)(11).

51. *Id.* § 112(a).

52. *Id.* § 112(b).

regarding amendment of those rights. The transferee can decide in light of these rights how much to pay and whether to seek other protections. The members can decide how to craft their agreement in order to maximize the value of their interests to third parties. Also, because transferees (unlike managers) acquire their status by unilateral member action, it would be costly to require that they explicitly agree to the operating agreement.

The status of dissociated members and their estates is even less problematic. Dissociated members who become transferees of their own interests have consented as direct parties to the operating agreement to this limitation on their rights.⁵³ The member also agrees to any statutory or operating agreement limits on her estate's rights in the LLC.⁵⁴

More troubling, however, is that involuntary tort creditors are also subject to these limits on transferees' rights.⁵⁵ A court may protect a creditor through a court order,⁵⁶ and creditors may be protected by traditional creditor-protection remedies both in and out of bankruptcy. However, such protections are costly and incomplete. Thus, the members' power to amend away third parties' rights in effect enhances the use of the LLC as a sort of backdoor debtor-protection device.⁵⁷

4. *The Limited Liability Company as a Party*

RULLCA section 111(a) provides that “[a] limited liability company is bound by and may enforce the operating agreement, whether or not the company has itself manifested assent to the operating agreement.”⁵⁸ This is consistent with prior cases and statutes.⁵⁹ It may seem odd, however, that the LLC is bound even if the firm does not consent, since RULLCA defines the LLC as a separate entity in sections 102(8) and 104(a). A leading case holding that the LLC is a party to the agreement appears to do so under an aggregate characterization of the LLC,⁶⁰ reasoning that the LLC was the “joint business vehicle” of the “members who are the real parties in interest.”⁶¹

53. *Id.* § 603(a)(3).

54. *Id.* § 504 (providing that the estate has the rights of a transferee).

55. *Id.* § 503 (providing for charging orders on members' interests, which can be foreclosed, leading to transfer of the interest to the judgment creditor).

56. *Id.* § 503(b)(2).

57. See Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 DEL. J. CORP. L. 199 (2005).

58. RULLCA § 111(a).

59. See RIBSTEIN & KEATINGE, *supra* note 16, § 4:16, nn. 41–43.

60. *Elf Atochem N.A. v. Jaffari*, 727 A.2d 286, 293 (Del. 1999).

61. *Id.*

Making the LLC a party to the agreement automatically can easily be reconciled with its entity status and consensual nature by recognizing that the operating agreement is, by RULLCA definition, the agreement of “all the members of a limited liability company.”⁶² By forming an LLC under RULLCA, the members in effect agree to the statutory rule that the LLC is a party to the agreement. In other words, the formation of the LLC itself entails the members’ consent to making the LLC a party.

The real question regarding automatically making the LLC a party to the agreement is not whether this result can be reconciled with the LLC’s entity status or with the consensual nature of the LLC, but whether this is a sensible default rule. The argument for this rule is that it facilitates complete enforcement of the agreement, which is obviously consistent with the parties’ intent when they enter into the operating agreement. A technical argument that precludes enforcement of, for instance, an arbitration clause in the agreement simply because the LLC is not a party to the agreement would likely surprise the members who agreed to arbitration reasonably expecting that it would be enforced.

Assuming that the LLC generally should be bound, there is an additional question of whether the parties effectively can contract around this provision and agree that the LLC is not bound by, or a party to, the agreement. This would effectively make the LLC solely an aggregate of the members. Although this result would be inconsistent with section 104(a) of RULLCA, which states that the LLC is itself an entity, section 104 is not one of the provisions that may not be varied by the agreement under section 110. The parties may want such a provision to reduce the likelihood that the LLC would have to be joined as a party, thereby destroying federal diversity jurisdiction.⁶³

C. The Articles and the Operating Agreement

The effect of the operating agreement and the articles may not be clear when the documents contain different or inconsistent provisions. RULLCA section 112(d) provides that when the documents conflict, the operating agreement controls as to members, dissociated members, transferees, and managers; the filed record, including the articles, controls as to other persons who reasonably rely on the articles to their detriment. It is not clear under this provision which term controls when a filed record contains information in

62. RULLCA § 102(13) (emphasis added).

63. See RIBSTEIN & KEATINGE, *supra* note 16, § 10:6.

addition to, but not conflicting with, the operating agreement, and a third party reasonably relies on the additional information. The comment to section 112(d) states that “the policy reflected in this subsection seems equally applicable to that situation.” In light of that conclusion, it is not clear why the black letter did not clarify the issue. In any event, the problem would seem to be resolved by the broad definition of the operating agreement. As the comment to section 112(d) also notes, “[a]bsent a contrary provision in the operating agreement, language in an LLC’s certificate of organization might be evidence of the members’ agreement and might thereby constitute or at least imply a term of the operating agreement.”⁶⁴

D. Agreements That Are Not Operating Agreements

RULLCA’s limitations on the operating agreement obviously apply by their terms only to agreements that fit within the statute’s definition of an operating agreement—i.e., “the agreement, whether or not referred to as an operating agreement and whether oral, in a record, implied, or in any combination thereof, of all the members of a limited liability company, including a sole member, concerning the matters described in Section 110(a).”⁶⁵ The latter section broadly includes “the activities of the company and the conduct of those activities.”⁶⁶ The definition of the operating agreement matters because only an operating agreement is effective under the statute to waive or modify statutory default rules.

1. Less Than All Members

Under the RULLCA section 102(13) definition, an agreement among less than all of the members would not be an operating agreement. It follows that the LLC equivalent to a corporate-type voting trust or voting agreement would not be effective as an operating agreement to waive or modify statutory defaults. The drafters note that “[a]n agreement among less than all of the members might well be enforceable among those members as parties.”⁶⁷ But this leaves unclear what the effect of such enforceability would be. In particular, would an agreement among fewer than all the parties have the effect of an operating agreement in waiving the statutory default rules as to the parties to the agreement? Suppose, for example, fewer than all of the

64. See RULLCA § 112(d) cmt.

65. *Id.* § 102(13).

66. *Id.* § 110(a)(3).

67. See *id.* § 102(13) cmt.

parties agreed to waive their liability for breach of the duty of loyalty to an extent that would be permitted by RULLCA section 110. Would this have the effect of barring recovery by the consenting members, but permitting recovery by the non-consenting member or members? Or might the non-consenting member claim that the agreement was not enforceable at all because it reduced the deterrent effect of damages without her consent?

Assuming that a less-than-unanimous operating agreement is ineffective, there may often be questions whether the agreement was in fact unanimous, given RULLCA's broad approach to the contents of the agreement discussed above in Part II.A. Even if a member clearly did not expressly consent to the agreement, she might have acquiesced in its performance to the extent of being deemed to have been bound by it.

2. Pre-Formation Agreements

RULLCA creates a new set of rules distinguishing the operating agreement from the agreement made prior to the formation of the LLC. RULLCA section 102(13) defines the operating agreement as one among "members." The drafters observe that "[t]he term 'operating agreement' presupposes the existence of members, and a person cannot have 'member' status until the LLC exists."⁶⁸ As with the "all-members" restriction, this provision only constrains the operating agreement. An agreement made prior to the formation of the LLC would still be effective as an agreement, but not effective as an operating agreement to waive or modify RULLCA's provisions.

The main question concerning pre-formation agreements is when such an agreement becomes the operating agreement. RULLCA section 111(c) provides that two or more persons intending to become LLC members "may make an agreement providing that upon the formation of the company the agreement will become the operating agreement," and that one person intending to become the sole initial member of an LLC "may assent to terms providing that upon the formation of the company the terms will become the operating agreement." In short, the parties can make a pre-formation agreement that provides that it will become the operating agreement when the LLC is formed.

68. *See also id.* § 111(c) cmt. (stating that "[a]n operating agreement is among 'members,' and, under this Act, the earliest a person can become a member is upon the formation of the limited liability company").

What if the parties to a pre-formation agreement say nothing about whether the agreement was to become the operating agreement, but then without further ado form the LLC? This will be common in informal firms since, as discussed above in Part I.A, RULLCA does not require any formalities or writings for an operating or pre-formation agreement. Given that the operating agreement may include oral and implied understandings, it seems to follow that if the parties proceed to operate the LLC without any additional agreement, the pre-formation agreement either becomes the operating agreement or is modified by the parties' conduct in running the firm. In other words, the very broad definition effectively dispenses with the operating agreement as a step in the formation of the firm by making the operating agreement anything the parties do or say upon formation. The drafters note that "[i]t is not plausible that the person would lack any understanding or intention with regard to the LLC. That understanding or intention constitutes an 'agreement of all the members of the limited liability company, including a sole member.'"⁶⁹ Indeed, even in the unlikely event of a gap in which the parties do or say nothing on formation, they would make any pre-formation understandings, or acceptance of the default provisions of the statute, in effect the operating agreement.

As discussed above in Part I.A regarding oral operating agreements, the statute's provisions on the operating agreement are only default rules. The parties may be able to make an agreement limiting the effectiveness of a pre-formation agreement, just as they can limit the effectiveness of any oral agreement. Thus, the parties can effectively agree upon formation—including by oral, constructive, or implicit terms—that any pre-formation understandings will not be the operating agreement.

In short, RULLCA's provisions on pre-formation agreements may add confusion rather than clarity. Without these provisions the operating agreement would be simply whatever the parties agree to, including any agreements prior to formation that the parties implicitly or explicitly accept upon formation. A pre-formation agreement may only be distinguished from one made after formation when the court is adjudicating rights that existed prior to formation, or when an LLC was never formed. In such cases a court would apply ordinary contract law, and there would be no confusion with the operating agreement that the statute needs to resolve. RULLCA's additional provisions on pre-formation agreements misleadingly suggest that in some cases where the parties otherwise would be deemed to have an operating agreement, they only have a pre-formation agreement.

69. RULLCA § 102(13) cmt.

III. DISTRIBUTIONS

A distribution-in-kind can create potential issues about treating members fairly. The distributed asset may be illiquid and its value uncertain. Also, while a cash distribution may trigger tax liability of the recipient, a distribution-in-kind of equal value may not.⁷⁰ Thus, all statutes provide by default for limits on members' rights and obligations to receive non-cash distributions.⁷¹

RULLCA section 404(c) includes a new limitation on distributions-in-kind by providing that

[a] person does not have a right to demand or receive a distribution from a limited liability company in any form other than money. Except as otherwise provided in Section 708(c), a limited liability company may distribute an asset in kind if each part of the asset is fungible with each other part and each person receives a percentage of the asset equal in value to the person's share of distributions.⁷²

The drafters evidently sought a compromise between forcing the firm to sell assets in order to make distributions in cash and forcing the firm to value illiquid assets in order to ensure price equitable in-kind distribution. That compromise, however, appears to be of limited utility. It applies only to the very limited class of assets that can be divided among the members in proportion to each member's share and (because of the fungibility requirement) so that each member receives an identical share.

IV. TRANSFERS

LLC statutes provide rules for admitting new members and for transferring membership interests. In both cases, the default rules reflect the traditional partnership approach of permitting members to choose their colleagues. Thus, members must agree unanimously on the admission of new members and the transfer of management rights, though economic rights are freely transferable. The key membership transfer developments that RULLCA failed to deal with are the problem of admission of members to firms where there are no current members,⁷³ and the problem of the need to

70. See RIBSTEIN & KEATINGE, *supra* note 16, § 17:2.

71. See *id.* § 17:2, app. 6-2.

72. RULLCA § 404(c).

73. See also *supra* Part I.A.

better define the rights of transferees of financial interests. In both cases, RULLCA fails to provide significant improvements.

A. Admission of Members

RULLCA section 401 provides a detailed set of rules for admission of members. On formation, the members are as agreed prior to formation, with the agreement in a one-member LLC being between the member and the organizer, who may or may not be different people. In the case of a “shelf” registration by a firm with no members, a person becomes an initial member of the limited liability company with the consent of a majority of the organizers. After formation of the LLC, a person becomes a member as provided in the operating agreement or as the result of a merger or conversion, or with the consent of all the members. If within ninety days after the company ceases to have any members, the last person to have been a member or that person’s legal representative designates a person to become a member who consents to become a member. Section 401(e) makes clear that “[a] person may become a member without acquiring a transferable interest and without making or being obligated to make a contribution to the limited liability company.”⁷⁴

These provisions articulate the obvious propositions that a person becomes a member of an LLC by her agreement with the other members or pursuant to the operating agreement. The only two details that RULLCA needed to deal with were (1) empowering the last dissociating member of the LLC or her legal representative to keep the firm alive by designating a new member, and (2) permitting a person to become a member without a contribution. The separate question of whether the firm can be formed without members is addressed above in Part I.A.

The drafters apparently felt compelled to go beyond these obvious propositions in order to deal with the metaphysical problem that an unformed LLC cannot have “members” who could agree to their own or others’ admission into the firm. The drafters, however, could have settled that issue simply by providing that the initial members are those who have agreed to be members of the firm. As with pre-formation agreements discussed above in Part I.D.2, the extra verbiage creates the risk that a court will tack more requirements on membership. For example, the court may require a separate agreement among the firm’s organizers prior to formation in order for a person to become a member. The parties may simply have decided to

74. RULLCA § 401(e).

form an LLC and leave the details for later, and to be governed in the meantime by the default provisions of the statute. This should be considered a valid LLC whose members are those who decided to participate in the formation. But there is a danger that without evidence of some additional agreement prior to formation a court may decide that the formation was ineffective.

B. Transferee Rights

Members' transferees are in the largely helpless position of having no management, information, or fiduciary rights with which to protect their economic rights.⁷⁵ This helplessness is not necessarily a problem, however. As discussed above in Part I.B.3, transferees generally can be seen as agreeing to these limitations. Conventional transferees often can protect themselves through their contract with the transferor when they acquire their interests or extend credit. "Bare" transferees, including a member who becomes a transferee of her own interest upon dissociation⁷⁶ and an estate that succeeds to a deceased member's interest,⁷⁷ are protected through the operating agreement.

The problem in most of these situations is not that restrictions are imposed on transferees without their consent;⁷⁸ the difficulty lies in crafting default rules that minimize the costs of contracting. Limiting transferees' rights may be the right default rule. It will usually be worth a lot to the members to bar participation by third parties who presumably lack the same interests or incentives as those who have agreed to join together as LLC members. They will therefore accept the effect these limited rights have on the value of a transferred interest, rather than contracting around the default rules to give the transferees stronger rights.

RULLCA not only accepts the standard rules on weak transferee rights, but takes this approach a step further by making clear that "an amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the

75. *See id.* §§ 502(a)(3) (denying management and information rights), 409(a) (providing that fiduciary rights are owed only to members and the LLC).

76. *See id.* § 603(a)(3).

77. *Id.* § 504.

78. There is one special case: involuntary creditors of members who acquire LLC interests by foreclosing on a charging order. These parties are not in a position to negotiate to compensate for the weakness of their rights. This transforms the LLC into a kind of "back door" asset protection device. *See* Ribstein, *supra* note 57.

person's capacity as a transferee or dissociated member."⁷⁹ The drafters note that the law "is only beginning to grapple in a modern way with the tension between the rights of an organization's owners to carry on their activities as they see fit (or have agreed) and the rights of transferees of the organization's economic interests."⁸⁰ They cite in support of their approach the partnership case of *Bauer v. Blomfield Co./Holden Joint Venture*,⁸¹ and note that the rationale is to prevent former owners and other transferees from being able to "'freeze the deal' as of the moment an owner leaves the enterprise or a third party obtains an economic interest."⁸² The reporters say that the drafting committee therefore ultimately declined to give the assignee the right to seek judicial dissolution of the LLC in cases of serious misconduct.⁸³ RULLCA, however, would permit the operating agreement to provide "that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition."⁸⁴

Although transferees' weak position makes sense in its own terms, it oddly contrasts with RULLCA's convoluted restrictions on fiduciary waivers discussed below in Part VI.D.4. If people can effectively agree to own economic rights in an LLC without any management or fiduciary rights, including even a right to contest a fundamental change in their rights, it is not clear why the members cannot effectively agree to waive their fiduciary duties. This conundrum is one indication of the RULLCA drafters' failure to fully rationalize RULLCA's restrictions on contracting.

V. MANAGEMENT

One of the most distinctive features of LLC law is "chameleon" management—a firm's ability to choose from two sets of default rules, providing for management by managers or by members. RULLCA includes new rules that threaten the viability of this advantageous feature.

The LLC approach to management is best understood against the background of partnership law. The time-honored partnership rule is that each partner has "positional" authority as a partner to bind the firm. This is based on the idea that a partner's ownership interest gives her special concern for the welfare of the firm and therefore the right incentives and interests in

79. RULLCA § 112(b).

80. *Id.* § 112(b) cmt.

81. *Bauer v. Blomfield Co./Holden Joint Venture*, 849 P.2d 1365 (Alaska 1993).

82. RULLCA § 112(b) cmt.

83. *See* Kleinberger & Bishop, *supra* note 20, at 544.

84. RULLCA § 112(a).

the firm to participate in management. A significant problem with the partnership rule is that a centrally managed partnership cannot easily deny partners the apparent authority to bind the firm, because this requires notifying third parties of limitations on members' authority. By contrast, the limited partnership form offers the advantage of permitting the firm to limit the authority of non-managing members by providing that only general partners can bind the firm. Limited partnerships, however, have the potential drawback of inflexibility in the distinction between general and limited partners. The limited partnership control rule traditionally penalized limited partners who participate in control by making them liable as general partners.⁸⁵ Although the most recent uniform law abandons this rule,⁸⁶ the rule is still found in many states' statutes. Also, limited partnership law maintains a clear default rule of centralized management that may be inappropriate for many closely held firms.

The LLC form offers a compromise between the general and limited partnership rules by providing a way to allocate management authority while preserving partnership-type flexibility. LLC statutes generally require the firm to disclose in the certificate if it is managed by members or by managers. An LLC managed by members is like a partnership: each member has the power, as such, to bind the firm, at least as to ordinary matters, while all the members must agree as to extraordinary matters. If it is managed by managers, it is like a limited partnership, as the actual and apparent authority attributed to members devolves to the managers, and the members have no default power to bind the firm to third parties. Unlike a limited partnership under many statutes, the members can freely contract among themselves to allocate management power, for example, by permitting some members to exercise certain powers even in a manager-managed firm. Most statutes, however, provide that these allocations are not effective as to third parties unless they have knowledge or notice of limitations on statutory authority.⁸⁷

This combination of flexibility and clarity has potential costs for third parties dealing with LLCs.⁸⁸ Limiting a member's power in centrally managed LLCs forces third parties to check the certificate to determine whether the firm has opted for management by managers. Even then it may not be obvious who the managers are, since there are generally no rules requiring public disclosure of this information. This structure puts some burden on

85. See REVISED UNIFORM LIMITED PARTNERSHIP ACT § 303 (1985).

86. See UNIFORM LIMITED PARTNERSHIP ACT § 303 (2001).

87. See generally RIBSTEIN & KEATINGE, *supra* note 16, ch. 8.

88. *Id.* (discussing LLC agency rules in §§ 8:5 (member-managed firms), 8:7 (managers' power in manager-managed firms), and 8:9 (members' power in manager-managed firms)).

third parties, thereby increasing their costs of dealing with LLCs. Yet it also limits the costs incurred by LLC members of determining who may bind the firm. State statutes have experimented with a variety of approaches in an effort to achieve the right balance, and the courts have been bringing some clarity to these issues by interpreting the statutory provisions.

RULLCA essentially abandons the careful compromise and distinctive features embodied in the dominant state statutory approach, as well as seeking to halt its evolution, by imposing brand new agency rules on LLCs. While RULLCA preserves the distinction between member-managed and manager-managed LLCs, it undercuts the effect of the distinction. The firm need not disclose its status in the articles⁸⁹ and, more importantly, members and managers have no statutory default agency power to bind the LLC.⁹⁰ By eliminating positional agency power, RULLCA unmoors itself not only from every other LLC statute, but also from the LLC's partnership antecedents clarified in generations of partnership precedents. At the same time, RULLCA does not align the LLC with any other model. The RULLCA LLC becomes a *sui generis* business form regarding the important category of agency rules.

The reporters' main rationale for the change was that the standard LLC rule is a trap for the unwary because third parties may not be aware of whether an LLC is member-managed or manager-managed.⁹¹ In other words, the expectations of a third party dealing with an LLC member may be frustrated if, for example, the third party assumes the member has the power to bind and is unaware that the LLC is manager-managed and that the member is not a manager.

The reporters exaggerated the third party's plight. The costs of checking the public record are low. A third party who checks and learns that the LLC is manager-managed is on notice that only a manager can bind the LLC. If a person represents herself to third parties as a manager, the third party usually can rely on this person having at least the power to bind as to ordinary business unless the third party is aware of limitations or circumstances limiting authority. Moreover, although standard LLC rules may make it harder for third parties to establish non-managing members' apparent authority, agency rules still apply and may provide some relief. The LLC default rules' main effect is in providing a baseline for creating third party expectations. Third parties know at least that members have no authority unless they are managers of a manager-managed firm.

89. RULLCA §§ 102(9)–(10), 407.

90. *Id.* § 301.

91. *Id.*, Prefatory Note; Kleinberger & Bishop, *supra* note 20, at 531.

Even if the new rule were better than the old rule as a matter of policy, RULLCA might still impose net costs by throwing out the existing rule and the attendant case law. There are several cases establishing the positional authority of LLC members and managers,⁹² but none interpreting the new RULLCA rules. Thus, the authority of members and managers of RULLCA LLCs will be unclear until courts decide cases under RULLCA.

RULLCA's comments suggest that existing agency law provides guidance and indicate the results under agency law in some illustrative cases.⁹³ Nevertheless, there is nothing relevant in the black letter of the *Restatement (Third) of Agency*, and there are only a few unhelpful references to LLCs in the Restatement comments. Existing cases relating to LLCs are based on the statutory defaults that RULLCA eliminates. Under existing law, if a third party knows that a person is a member of a member-managed LLC, she knows from that fact alone that the member has the default powers that are familiar from partnership and logical even for non-lawyers. RULLCA, however, establishes that the member has no agency power as such.⁹⁴

RULLCA's drafters observed that the law of agency looks to facts like custom and status.⁹⁵ RULLCA LLCs, however, have no customs to fall back on. For example, the prefatory note to RULLCA confidently states that a member of a manager-managed firm has no apparent authority.⁹⁶ Yet RULLCA undercuts this current rule. RULLCA states that courts may view the statute's default management rules, which are similar to those under existing law, as clothing members and managers with apparent authority.⁹⁷ That would indeed be the case if RULLCA had no provision on members' and managers' authority, since courts could then infer apparent authority

92. See *Rollar Constr. & Demolition, Inc. v. Granite Rock Assoc.*, No. CV020098541S, 2004 WL 1615922 (Conn. Super. Ct. June 25, 2004) (where a sixty percent owner had authority to enter into note and mortgage agreements on behalf of the firm); *Estate of Collins v. Geist*, 153 P.3d 1167 (Idaho 2007) (where a manager of a real estate firm had apparent authority to execute deeds for the sale of lots); *Merrell-Benco Agency v. HSBC Bank USA*, 20 A.D.3d 605 (N.Y. App. Div. 2005) (where a member could bind an LLC to a loan in the ordinary course of business); *Badger State Bank v. Taylor*, 688 N.W.2d 439 (Wis. 2004) (stating the general statutory rule that a member can bind an LLC).

93. See RULLCA § 301 cmt., § 407 cmt. The comment to the transition provisions in RULLCA § 1104 adds that no transition provisions are required for these new rules because the law of agency produces "appropriate results." *Id.* § 1104. However, since the deletion of positional authority does change existing law, whether or not this is an "appropriate" result, some transition is required.

94. *Id.* § 301(a).

95. See *id.*, Prefatory Note (citing RESTATEMENT (THIRD) OF AGENCY § 3.01 cmt., § 4.07(c) cmt. (2005)).

96. See *id.*

97. See *id.* § 407 cmt.

from actual authority. It is not clear, however, what courts should infer, given that RULLCA section 301(a) explicitly provides that “[a] member is not an agent of a limited liability company solely by reason of being a member.”⁹⁸ Although section 301(b) provides that “[a] person’s status as a member does not prevent or restrict law other than this [act] from imposing liability on a limited liability company because of the person’s conduct,”⁹⁹ the courts have yet to develop this law.

RULLCA is the worst of all possible agency worlds. Agency rules typically seek to balance the costs of third parties and those of principals in transacting business through agents. RULLCA, however, manages to increase both sets of costs. For third parties, RULLCA may increase, rather than reduce, the unpredictability inherent in dealing with LLCs. At the same time, RULLCA increases LLCs’ costs of dealing with third parties because they will have no easy way of notifying third parties of the extent of members’ default authority to bind member-managed LLCs. A third party may be able to argue that any member with management power under the operating agreement has at least apparent authority to bind the firm. Though RULLCA provides for a “statement of authority,”¹⁰⁰ this provision gives only limited relief because it restricts members’ or managers’ authority only in real estate transactions.

The RULLCA drafters might have chosen an alternative approach that facilitates flexibility but does not require distinguishing between manager and member power. Delaware law provides that, “unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.”¹⁰¹ This explicitly creates default positional authority in LLC members and managers on which third parties can rely. The Delaware LLC Act provides that this authority can be varied by the operating agreement, thereby giving the firm a simple way to restrict non-managing members’ power. While this approach arguably tilts the balance to the firm, it at least provides a clear default rule, in contrast to RULLCA.

RULLCA’s new agency rules may have implications for choice of form by undermining the special advantages of the LLC. Removing clear positional, apparent authority brings a RULLCA LLC closer to a limited liability partnership, which also has limited liability and flexible governance, but cannot easily notify third parties of limits on members’ agency power. Indeed,

98. *Id.* § 301(a).

99. *Id.* § 301(b).

100. *Id.* § 302.

101. DEL. CODE ANN. tit. 6, § 18-402 (2005).

a RULLCA LLC may be more cumbersome and costly than an LLP because of the uncertainty of how courts will apply the new rules. Firms would be well-advised to consider the LLP form over a RULLCA LLC, because in the former, the members' authority and other issues would be determined by generations of partnership law.

VI. FIDUCIARY DUTIES

RULLCA makes several significant changes with respect to the scope and nature of fiduciary duties, including changes to the duty of care and the waiver of duties. In general, RULLCA muddles the definition of fiduciary duties and adds unacceptable complexity to the LLC contracting process. These problems reflect the sharp disagreements that emerged during drafting concerning the extent to which parties ought to be able to contract for fiduciary duties. Rather than coming down firmly and consistently for a given position, and thereby producing a coherent statute that might be a suitable model for at least some states, the NCCUSL compromise process made a mess that is not a suitable model for any state.

A. "Uncabining" Fiduciary Duties

RULLCA rejects ULLCA's move to explicitly "cabin" fiduciary duties. It provides that "[a] member of a member-managed limited liability company owes to the company and . . . the other members the fiduciary duties of loyalty and care."¹⁰² By contrast, ULLCA section 409(a) provides that the duties of loyalty and care are "[t]he only fiduciary duties a member owes to a member-managed company and its other members."¹⁰³

"Uncabining" fiduciary duties opens a Pandora's Box of potential uncertainty about what other duties members and managers may have. In particular, RULLCA invites courts to impose duties on non-managing members. Indeed, the reporters note that the "oppression" remedy now added to ULLCA section 901(a)(5), discussed below in Part VII, creates space for the courts to recognize member-to-member duties.¹⁰⁴ Recognizing fiduciary duties for non-managers is questionable policy. A fiduciary duty is specifically a duty of loyalty, and is appropriate only for those who exercise open-ended power, which is generally not the case with non-managing

102. RULLCA § 409(a).

103. ULLCA § 409(a) (emphasis added).

104. Kleinberger & Bishop, *supra* note 20, at 538.

members.¹⁰⁵ Courts have refused to impose fiduciary duties on non-managing members, instead basing any liability in this situation on the parties' specific contractual duties interpreted in the light of the general contractual obligation of good faith and fair dealing.¹⁰⁶ To be sure, some members in manager-managed firms may exercise enough power to justify being tasked with fiduciary duties. While ULLCA attempted awkwardly to define these situations,¹⁰⁷ it clearly rejected the idea of imposing fiduciary duties on members acting solely in their capacity as non-managing members.

RULLCA's "uncabining" might be seen as simply an unexceptional return to the majority rule among the states of not limiting fiduciary duties. Unlike most state statutes, however, RULLCA does not merely fail to address additional fiduciary duties, but rather explicitly undoes the "cabining" of duties in ULLCA. Considered against this background, RULLCA explicitly invites courts to create new duties.

B. Duty of Loyalty

RULLCA has two significant developments regarding the duty of loyalty. First, it does not include the ULLCA provision that "[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."¹⁰⁸ The drafters criticize this language as "at best incomplete, at worst wrong, and in any event confusing."¹⁰⁹ However, the drafters overstate the problem with the ULLCA rule. The language is subject to the sensible interpretation that a member can act selfishly except when this violates a duty—specifically, the duty of loyalty. The courts have so interpreted this language both in partnerships¹¹⁰ and LLCs.¹¹¹ This has the virtue of instructing courts to look for a specific duty

105. See Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209.

106. *Id.* at 222–23.

107. ULLCA § 409(h).

108. *Id.* § 409(e).

109. See RULLCA § 409(e) cmt.

110. See *Jones v. Wagner*, 108 Cal. Rptr. 2d 669, 674–75 (Cal. Ct. App. 2001) (holding that partners did not breach fiduciary duty by failing to make mortgage payments to save property from bankruptcy when not required to do so by the agreement, or by bidding on and buying the property in foreclosure sale); *Enea v. Super. Ct.*, 34 Cal. Rptr. 3d 513 (Cal. Ct. App. 2005) (holding that despite this provision, partners may not rent to themselves at a below-market rate).

111. See, e.g., *Melcher v. Apollo Med. Fund Mgt.*, 25 A.D.3d 482, 484 (N.Y. App. Div. 2006) (where similar language in the Delaware statute did not absolve members of duty of loyalty and liability for diverting LLC opportunities).

and not to expand unduly the duty of loyalty. This could have acted as a constraint on the courts' creation of new duties under RULLCA's "uncabining" approach.

RULLCA's second innovation is section 409(e), which provides that "[i]t is a defense to a claim under subsection (b)(2) [conflict of interest transactions] and any comparable claim in equity or at common law that the transaction was fair to the limited liability company." It is not clear how this new fairness qualification will, or should be, applied. The drafters' comment to the subsection is not very illuminating:

Given this Act's very detailed treatment of fiduciary duties and especially the Act's very detailed treatment of the power of the operating agreement to modify fiduciary duties, the statement is important because its absence might be confusing. (An ex post fairness justification is not the same as an ex ante agreement to modify, but the topics are sufficiently close for a danger of the affirmative pregnant.)¹¹²

This cryptic comment can be taken to suggest, among other things, that the fairness defense is somehow a substitute for the parties' power to modify fiduciary duties in their agreement. As the drafters recognized, an ex post fairness justification is very different from an ex ante agreement to modify. The parties to an LLC are in a much better position than the court to determine how fiduciary duties should be limited in their relationship. Moreover, they need to know what the rules are at the time of the relevant conduct rather than having to wait until the conduct is litigated.

C. Duty of Care

RULLCA replaces the gross negligence standard of care, previously provided in ULLCA¹¹³ and many state statutes,¹¹⁴ with a provision stating that

subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a

112. RULLCA § 409(e) cmt.

113. ULLCA § 409.

114. See RIBSTEIN & KEATINGE, *supra* note 16, app. 9-4.

manner the member reasonably believes to be in the best interests of the company.¹¹⁵

The drafters rejected the gross negligence standard as “too low” in “a post-Enron era.”¹¹⁶ After a tumultuous drafting history, the committee “reached a compromise—maintaining an ordinary negligence standard but expressly superimposing the business judgment rule.”¹¹⁷

The RULLCA duty-of-care rule has several problems. First, it introduces confusion and uncertainty. It is unclear whether the new rule means that the standard of care has been tightened, as the section seems to say, or left the same because of the application of the business judgment rule, which incorporates the gross negligence standard that RULLCA supposedly has eliminated. As a committee of lawyers reviewing RULLCA has said, the “language as written appears circular, in that the prefatory language appears to restate what most believe to be the business judgment rule.”¹¹⁸

Second, the drafters’ reliance on the business judgment rule introduces a corporate concept that is an inappropriate default rule for partnership-type and closely held firms. The lawyers’ committee noted that

the introduction of the business judgment rule as a default rule goes beyond what many believe to be the current state of the law with regard to unincorporated entities in many jurisdictions. In general, there is a sense that the imposition of a business judgment rule standard is not an appropriate default rule for a contractual entity.¹¹⁹

Indeed, the drafters’ reference to Enron suggests that the provision was intended for publicly traded firms, which involve significant separation of ownership and control, in contrast to typical closely held LLCs. LLC managers or members of member-managed LLCs arguably are similar to partners in general partnerships in the sense that they are generally motivated by their significant ownership interests, rather than the additional incentive provided by a duty of care.

115. RULLCA § 409(c).

116. See Kleinberger & Bishop, *supra* note 20, at 526–27.

117. *Id.* at n.69.

118. See P’S HIPS AND UNINCORPORATED BUS. ORG. COMM. OF THE SECTION OF BUS. LAW, REPORT OF THE RULLCA TASK FORCE (2007) (“PUBO Task Force,” on file with author).

119. *Id.*

Third, the new standard of care is a fundamental departure from traditional LLC law. Members' and managers' duties in LLCs are derived from partnership law. The original Uniform Partnership Act did not even provide for a standard of care. The Revised Uniform Partnership Act provides for a gross negligence standard,¹²⁰ which is consistent with substantial partnership case law.¹²¹ This is yet another respect in which RULLCA has severed LLC law from the potential guidance of past LLC and partnership cases.

D. Waiver and Limitation of Fiduciary Duties

RULLCA section 110, like the equivalent ULLCA section 103, includes intricate restrictions on the extent to which the LLC operating agreement can effectively waive provisions of the statute. In general, these restrictions on contracting in unincorporated firms find little support in the common law and are debatable policy.¹²² It is not clear why contracts regarding fiduciary duties should be subject to limitations while contracts generally are broadly enforced subject to unconscionability and public welfare restrictions. As discussed in my earlier analysis of ULLCA,

[w]ith respect to protecting members from co-members and managers, it is far from clear why parties to LLCs need to be protected from the entire broad category of contracts waiving fiduciary duties and related judicial dissolution and expulsion rights. LLC members as a group are at least as sophisticated as others whose contracts traditionally are enforced. To the extent LLCs are used as vehicles to prey on the unsuspecting, the law can respond with a specific remedy. On the other hand, generally restricting waivers in the LLC statute will not only prevent the occasional

120. REVISED UNIFORM PARTNERSHIP ACT § 404 (1994).

121. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 6.07(f) (1988).

122. See Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997) (general analysis of fiduciary duty waivers in unincorporated firms); Ribstein, *Critique*, *supra* note 7 (criticizing limitations on agreements in ULLCA); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004) [hereinafter Ribstein, *Limited Partnerships*] (analyzing Delaware limited partnership law and comparing it unfavorably to the restrictions in the Uniform Limited Partnership Act (2001)); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 (1993) (criticizing limitations on waiver in the Revised Uniform Partnership Act).

unconscionable contract, but also will preclude or make more costly a wide range of efficient deals.¹²³

Apart from policy and history, it is significant that several state legislatures, led by Delaware, recently have moved toward broad enforceability of fiduciary duty waivers in LLCs and limited partnerships, and courts have decided many cases under these provisions.¹²⁴ This experience could be instructive as to the potential costs of allowing free contracting in this context. By examining the fiduciary case law and statutory LLC law, and the even more extensive and long-standing case law regarding partnerships and other unincorporated entities, NCCUSL could have identified problems in the cases and developed ideas on how legislators could craft restrictions that would reduce these problems. In fact, detailed case analysis reveals that the courts have done a good job of interpreting and applying limited partnership agreements under the Delaware freedom-of-contract regime.¹²⁵

The key to preventing the potential abuse that concerned the drafters is the contractual obligation of good faith and fair dealing, which prevents a contracting party from, in effect, dishonestly perverting the agreement. As discussed above in Part VI.D.3, this is properly viewed as a mode of interpreting the contract in light of the parties' reasonable expectation rather than a discrete duty that exists independent of the specific contract. This general obligation gives the courts a powerful tool in constraining devious conduct.¹²⁶ This tool alone is enough without subjecting even good faith agreements and conduct to confusing and general limitations.

RULLCA restrictions on waiver are also based on a misguided balance of the costs and benefits of permitting parties to contract regarding fiduciary duties. The drafters' approach seemed to be motivated by a general hostility to what the drafters call the "ultra-contractarian" approach to fiduciary duties and a vague concern for the dangers of potential abuse.¹²⁷ In a 2006 article, one of the reporters described the drafters' approach by reviewing a few LLC and partnership cases that involved the application of restrictions on fiduciary

123. Ribstein, *Critique*, *supra* note 7, at 331–32.

124. See RIBSTEIN & KEATINGE, *supra* note 16, § 9:4.

125. See Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469 (2005); Ribstein, *Limited Partnerships*, *supra* note 122; Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007).

126. See Altman & Raju, *supra* note 125; Steele, *supra* note 125.

127. See RULLCA § 110(d) cmt. (citing Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 14.05[4][a][ii] (2000)).

duties to issues the parties evidently had not anticipated.¹²⁸ The article purports to illustrate the pitfalls of contracting when parties are free to contract. However, the author does not explain why the cases were wrongly decided or, if they were, how statutory limitations on drafting might reduce the likelihood of such judicial errors. Moreover, it is not clear what the problems were with earlier statutes, including RULLCA, that justified developing a unique provision that has less chance of becoming uniform and that has not been interpreted by any courts.¹²⁹

The failure to proceed either from experience or theory is evident in ambiguities and confusion raised by the specific restrictions on contracting in section 110. The following analysis focuses on the most controversial restrictions dealing with fiduciary duties and remedies.

1. *Duty of Loyalty*

RULLCA provides in section 110(c)(4) that the agreement may not eliminate the duty of loyalty, but then provides in section 110(d)(1) that the parties may eliminate each specific aspect of the duty of loyalty identified in RULLCA section 409(b). Since the parties may eliminate all specific duties of loyalty, it is not surprising that the statute also gives the parties power to modify lesser duties, including identifying specific acts or activities that do not violate the duty of loyalty (section 110(d)(2)), and specifying how the parties may authorize an act that would otherwise violate the duty of loyalty (section 110(e)).

Although the parties have significant power to contract regarding the duty of loyalty, they apparently cannot even limit money damages for breach of the duty. RULLCA section 110(g) provides that the parties “may eliminate or limit a member or manager’s liability to the limited liability company and members for money damages, except for: (1) breach of the duty of loyalty; (2) a financial benefit received by the member or manager to which the member or manager is not entitled.”¹³⁰ It is not clear why the parties should not be able to even limit liability for breach of the duty of loyalty when they may

128. Daniel S. Kleinberger, *Careful What You Wish For: Freedom of Contract and the Necessity of Careful Scrivening*, XXIV PUBOGRAM 19 (2006) (Committee on Partnerships and Unincorporated Business Organizations of the ABA Business Law Section), available at <http://ssrn.com/abstract=939009>.

129. Courts have interpreted ULLCA and ULLCA-like restrictions on waiver. *See, e.g.*, Thorpe v. Levenfeld, No. 04-C-3040, 2005 WL 2420373 (N.D. Ill. Sept. 29, 2005) (holding that plaintiff need not prove that a general restriction on fiduciary duties is “manifestly unreasonable”).

130. RULLCA § 110(g).

eliminate all specific duties of loyalty. The distinction might just as easily run in the other direction, allowing elimination of money damages but permitting some enforcement of the duty through injunctive or declaratory relief. Hopefully, courts and parties will not get lost in this maze and parties will be aware of the need to eliminate the duty rather than the liability.

Apart from the duty vs. liability issue, RULLCA offers two broad escape clauses from contractual limits on the duty of loyalty. First, the parties may contract regarding only the specific loyalty duties that RULLCA section 409(b) identifies, and not additional duties that may be imposed as a result of the “uncabining” of fiduciary duties discussed above in Part VI.A. Not only may there be fiduciary duties other than the duty of loyalty, but section 409(b) states that the duty of loyalty only “includes,” and therefore is not necessarily limited to, the specific duties listed in that subsection. Thus, even if the agreement eliminates every duty of loyalty that RULLCA identifies, plaintiffs may still argue that some other duty survives the contract. As discussed below in this Part, RULLCA explicitly prohibits elimination of these other duties, whatever they might be.

The plaintiff’s second escape hatch is that any elimination or modification of fiduciary duties is effective only “if not manifestly unreasonable.”¹³¹ RULLCA section 110(h) attempts a novel definition of this phrase that presents courts with several challenges:

- Under subsection (1), the court considers “only circumstances existing” when “the challenged term became part of the operating agreement.” This raises the question of precisely when the relevant circumstances exist and when they become part of the operating agreement.
- Subsection (2) requires the court to consider whether the term has an unreasonable objective, or is “an unreasonable means to achieve the provision’s objective,” all “in light of the purposes and activities of the limited liability company.” It is not clear what facts are relevant to a determination of “reasonableness.”
- In either case, the unreasonableness must be “readily apparent.” This presents the conundrum of explaining why the parties would have agreed to the term if its unreasonableness at the time of making the agreement was, indeed, “readily apparent.” Put another way, why would the unreasonableness be readily apparent to a court but not to the parties themselves?

131. *Id.* § 110(d).

- It is not clear how the “manifestly unreasonable” standard relates to the parties’ contractual obligation of good faith and fair dealing under section 409(d). As discussed below, the obligation of good faith is best viewed as a mechanism for interpreting the contract in light of the parties’ expectations. If the obligation is not met, the contract would not be enforceable for that reason and the duty of loyalty waiver would be moot. Conversely, if the good faith obligation is satisfied, enforcing the agreement comports with the parties’ reasonable expectations. It now becomes even more puzzling how the term could have been “manifestly unreasonable” and still have secured the parties’ mutual consent.
- It is also not clear how the “manifestly unreasonable” standard relates to the general contract doctrine of unconscionability. Given the strict test of unreasonableness and the relationship between “manifestly unreasonable” and the obligation of good faith and fair dealing, the standard seems to require not just a showing that the contract term was oppressive, but the sort of clear disparity of bargaining position and opacity that would explain why the complaining party agreed to the term. Yet the unconscionability doctrine would be available under RULLCA section 107 (providing for application of “the principles of law and equity”) even without the “manifestly unreasonable” qualification. Moreover, the formation of a business venture seems very different from the standard consumer-to-business transaction in which the unconscionability doctrine normally applies.¹³²

In short, the “manifestly unreasonable” concept seems to hide in the interstices of several established doctrines. It may take some time before the courts can define this elusive niche.

RULLCA lets the parties avoid the limitations on duty of loyalty waivers discussed above through an agreement under section 110(f) that (1) “expressly relieves a member of a responsibility” that the member otherwise would have under the act, (2) imposes this responsibility on one more other members, and (3) “eliminate[s] or limit[s] any fiduciary duty that would have pertained to the responsibility.”¹³³

It is not clear what sort of agreement qualifies under this provision. It seems clear that “responsibility” means “power.”¹³⁴ Since fiduciary duties are

132. RESTATEMENT (SECOND) OF CONTRACTS § 208 illustrations (1979).

133. RULLCA § 110(f).

134. The term may refer to the notion of “accountability.” See MSN Encarta, Dictionary, <http://encarta.msn.com/encnet/features/dictionary/dictionaryhome.aspx> (giving as the first definition of “responsibility”: “the state, fact, or position of being accountable to

associated with the delegation of power,¹³⁵ it logically follows that eliminating the power eliminates the duty. The second prong of section 110(f), imposing the responsibility on other members, should not be necessary to eliminate the fiduciary duty. The courts also will have to work out what it means for the parties to “expressly relieve” a member of a responsibility and impose the responsibility on others. In particular, when does an oral operating agreement, interpreted in the light of custom and practice, give the requisite express relief? And does reducing a member’s power necessarily empower others, or is some further agreement necessary to impose the member’s responsibility on the other members? For example, if LLC members act to benefit a particular group, can a disempowered member of the group escape liability because each other member’s vote acquired additional weight?

2. *Duty of Care*

RULLCA section 110(c)(4) provides that the parties may not eliminate the duty of care, but RULLCA section 110(d)(3) provides that the parties may alter it. It is not clear where the border is between “alter” and “eliminate.” Specifically, is there some irreducible core of the duty that is safe from modification? Although the parties presumably could reduce the duty of care to the prior ULLCA gross negligence standard, it is less clear whether the parties can eliminate all but a duty to refrain from reckless conduct. Recklessness arguably entails an element of intentionality or known risk that qualitatively differs from negligent behavior.

Even if the agreement merely alters the duty of care, it is not enforceable to authorize “intentional misconduct or knowing violation of law.”¹³⁶ This scope of this restriction is unclear. RULLCA uses the somewhat different language of “intentional infliction of harm” and “intentional violation of criminal law” to restrict contractual limits on money damages in section 110(g)(4)–(5), discussed below in Part VI.D.6. This suggests that “intentional misconduct” may fall short of authorization of “harm,” that “knowing” violation of law may be less than “intentional,” and that “law” is broader than “criminal” law. Indeed, “law” is unqualified in the statute, and therefore potentially could include statutory default rules and even the parties’ agreement backed by contract law.

somebody or for something”). However, this definition would make the RULLCA provision circular, since fiduciary duties create accountability.

135. See Ribstein, *supra* note 105.

136. RULLCA § 110(d)(3).

Alteration of the duty of care is enforceable only if not “manifestly unreasonable.” The uncertain meaning of this expression is discussed above in Part VI.D.1. It is not clear what sort of limitation of the duty of care might be “manifestly unreasonable,” even if it merely alters rather than eliminates the duty. For example, would reducing the standard to gross negligence be manifestly unreasonable even if this were only an alteration and although it was the ULLCA default standard?

3. Good Faith and Fair Dealing

RULLCA provides that the parties may “prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.”¹³⁷ This restriction is puzzling given the general nature and function of the good faith obligation. The obligation of good faith and fair dealing is best viewed as a way to interpret long-term contracts, including those for business associations like limited liability companies.¹³⁸ Thus, good faith “standards” necessarily arise out of the contract as a whole rather than out of a specific provision for the good faith obligation. RULLCA’s awkward formulation may lead a court to apply some version of the good faith obligation that is not based on the contract whenever the parties have not addressed the good faith obligation explicitly.

4. Other Fiduciary Duties

RULLCA section 110(c)(4) explicitly prohibits eliminating “any other fiduciary duty,” other than the duties of care or loyalty. Section 110(d)(4), however, allows the operating agreement to “alter any other fiduciary duty, including eliminating particular aspects of that duty” (emphasis added). There is a basic policy issue of why these “other” duties may only be altered but not eliminated.¹³⁹ There is also the same practical issue with the duty of care discussed above in Part VI.D.2 of where to find the uncertain border between “alter” and “eliminate.” The problem is even more complex here, because when the RULLCA drafters “uncabined” fiduciary duties, as discussed in Part VI.A, they did not indicate what duties had been left out of the “cabin.” If the

137. *Id.* § 110(d)(5).

138. See Ribstein, *Limited Partnerships*, *supra* note 122, at 937–38 (discussing good faith duty in the limited partnership context).

139. Indeed, the PUBO Task Force, *supra* note 118, has suggested that this provision be modified to add the power to eliminate.

parties do not even know what the duties are, it is not clear how they can know when an agreement merely alters a duty without eliminating it.

5. Remedies

RULLCA section 110(c)(9) provides that the agreement may not “unreasonably restrict the right of a member to maintain an action under [Article] 9,” which relates to members’ direct and derivative actions. There was no such restriction in ULLCA. The RULLCA restriction raises several questions about the enforceability of remedy limitations. These questions are particularly important given the strong arguments against even a default derivative remedy in the LLC, discussed below in Part VIII.

First, the term “unreasonably” is ambiguous. In particular, it is not clear how “unreasonably” relates to the “manifestly unreasonable” standard defined in section 110(h). Does the omission of “manifestly” mean that the restriction is invalid even if it is seemingly reasonable? Do any of the other delineations of the “manifestly unreasonable” standard apply to simple unreasonableness? In other words, must the court evaluate simple unreasonableness as of the time of the agreement, or examine the agreement’s objectives separately from how the agreement achieves the objectives, as with “manifestly unreasonable”? These issues may matter because the absence of a remedy may look very different at the time of the agreement than it does at the time of litigation. Also, a court may decide that a judicial remedy is vitally important irrespective of the agreement’s other enforcement mechanisms, rendering unreasonable the agreement’s objective of eliminating litigation.

Second, it is not clear how, if at all, this provision restricts arbitration and choice of forum clauses. The problems with derivative suits in the LLC context noted above and discussed below in Part VIII mean the parties may want to provide for alternative remedies. There is ample authority for permitting arbitration to supplant litigation in LLC agreements.¹⁴⁰ Indeed, the comment to RULLCA section 110(c)(9) notes that “[a]rbitration and forum selection provisions are commonplace in business agreements, and this

140. See *Elf Atochem N.A.*, 727 A.2d at 294 (holding that LLC members contracted away derivative remedy under clause providing for “[n]o action at law or in equity based upon any claim arising out of or related to this Agreement,” except an action to compel arbitration or to enforce an arbitration award); *Douzinis v. American Bureau of Shipping, Inc.*, 888 A.2d 1146 (Del. Ch. 2006) (relying on *Elf Atochem* to apply arbitration provision to manager’s alleged breach of fiduciary duty to minority members); *Williams v. Litton*, 865 So. 2d 838 (La. App. 2003) (arbitration provision not invalid as attempt to supersede LLC statute).

paragraph's restrictions do not reflect any special hostility to or skepticism of such provisions."¹⁴¹ The comment and the black letter law, however, create uncertainty as to RULLCA's position on these agreements. Moreover, if the statute significantly restricts arbitration, it may contravene the Federal Arbitration Act, which requires courts in most cases to enforce arbitration clauses.¹⁴²

RULLCA section 110(c)(7) provides that the operating agreement may not vary the court's power to decree dissolution under section 701(a)(4) and (5), which includes the controversial ground of "oppressive" conduct discussed in Part VII below.¹⁴³ Also, the comment to section 110(g)(4) says that subsection's bar on limiting damage claims for "intentional infliction of harm on the company or a member" means that "an exculpatory provision cannot shield against a member's claim of oppression."¹⁴⁴ Limiting the members' ability to restrict judicial dissolution and associated relief is consistent with case law.¹⁴⁵ It arguably makes sense to preserve some sort of judicial safety valve for such problems as unlawfulness, deadlock, and fraud; however, arbitration is arguably a viable alternative to the judicial oppression remedy, just as it is for conventional lawsuits. There is case law support for enforcing arbitration in lieu of judicial dissolution.¹⁴⁶

6. Review and Evaluation

RULLCA's provisions restricting the operating agreement arguably are its most troubling ones. The balance of costs and benefits is far from clear. Though restrictions on contracting theoretically might reduce some problems by giving parties fewer ways to cheat,¹⁴⁷ limiting contracting restrictions may also increase the parties' costs by giving them fewer tools to deal with potential problems and by inviting malfeasance by disgruntled members.

141. RULLCA § 110 (c) cmt.

142. See Federal Arbitration Act, 9 U.S.C. § 9 (2000).

143. RULLCA § 110(c)(7).

144. *Id.* § 110(g)(4) & cmt.

145. See RIBSTEIN & KEATINGE, *supra* note 16, § 11:5, n.21.

146. See, e.g., Willie Gary LLC v. James & Jackson LLC, No. 1781, 2006 Del. Ch. LEXIS 3, at 38 (Del. Ch. Jan. 10, 2006) (stating that parties could "contract to have an arbitrator hear claims for dissolution," but interpreting arbitration provision in the agreement as not precluding party from seeking judicial dissolution), *aff'd* 906 A.2d 76 (Del. 2006); Terex Corp. v. STV USA, Inc., No. 1614-N, 2005 Del. Ch. LEXIS 159, at 2-3 (Del. Ch. Oct. 20, 2005) (interpreting arbitration provision as precluding judicial action for dissolution).

147. See Kleinberger & Bishop, *supra* note 20.

The costs and benefits of restricting contracts arguably depend on whether the statute is likely to be used by sophisticated or by unsophisticated parties. The problem with RULLCA's restrictions on contracting is that they disserve all the parties who might conceivably use the statute. RULLCA denies sophisticated planners many of the tools they might use to create a durable deal and minimize the risk of litigation. At the same time, unsophisticated parties may face even more hazards in having to navigate the RULLCA maze than they would face in a world of unconstrained contracting. For example, they will have to figure out whether the agreement eliminates or merely alters the duty of care, if its restriction is "manifestly unreasonable," what other fiduciary duty actions the agreement might allow despite elimination of loyalty and care duties, whether an agreement that eliminates a damage suit nevertheless permits a suit for a breach of duty, and how all this relates to the general obligations of good faith and fair dealing. The function of a business association statute should be to enhance effective contracting, not to make it all but impossible.

The limitations on the agreement discussed in this section cast doubt on the effect of many seemingly reasonable agreements. Consider, for example, section 110(d)(2)-type agreements that "identify specific types or categories of activities that do not violate the duty of loyalty," or an agreement that substitutes specific procedural protections for general fiduciary duties.¹⁴⁸ Might a party nevertheless sue successfully for breach of some unspecified "other" duty? Also, could a court find that the elimination was "manifestly unreasonable" despite the substitution? The availability of these arguments complicates and increases the costs of trying and settling fiduciary claims.

VII. THE OPPRESSION REMEDY

As noted in Part VI.D.5, RULLCA provides for judicial dissolution on the new ground that the managers or members in control "have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant."¹⁴⁹ This is consistent with some state statutes.¹⁵⁰ Nevertheless, the oppression remedy raises several important issues in the LLC context. First, the oppression remedy is drawn from the close corporation setting, and therefore represents a retreat from the idea that LLCs offer an escape from the problems of close corporations. Courts and legislators initially devised this

148. RULLCA § 110(d)(2).

149. *Id.* § 701(a)(5)(B).

150. See RIBSTEIN & KEATINGE, *supra* note 16, § 11:5, n.23.

remedy to give owners a way out of closely held corporations in the absence of any specific contractual or statutory exit mechanism.¹⁵¹ The remedy was always awkward because it necessarily involves a court creating an agreement for the parties. Early LLC statutes made these makeshift agreements unnecessary by providing a default mechanism for exit at will. Most LLC statutes, however, now restrict dissociation at will,¹⁵² arguably necessitating some sort of judicial escape mechanism.

Second, even if an oppression-type remedy is justified for LLCs, it does not follow that LLC statutes should invite courts to apply the same standards as in close corporations.¹⁵³ Given the variation in LLC statutes and the importance of the operating agreement in the LLC context, the parties to LLCs are more likely to have contracted for or selected their preferred exit mechanism than those in close corporations. Accordingly, there is more need for LLCs than for close corporations to clarify the relationship between the oppression remedy and the parties' contract. The statute might clarify that courts can dissolve only for breach of a specific contractual or statutory duty rather than suggesting that oppression provides an independent ground of relief. Indeed, there is already some judicial recognition that oppression is not a distinct breach of duty under RULLCA or other law.¹⁵⁴ Without this clarification, the oppression remedy could be an open-ended invitation to litigation and judicial rewriting of contracts.

Third, RULLCA muddies the distinction between the remedy and the duty. A comment to RULLCA section 409(g)(5), which provides that “[a] member does not have any fiduciary duty to the company or to any other member solely by reason of being a member,” states:

This paragraph merely negates a claim of fiduciary duty that is exclusively status-based and does not immunize misconduct. Example: Although a limited liability company is manager-managed, one member who is not a manager owns a controlling interest and effectively, albeit indirectly, controls the company's activities. A member owning a minority interest brings an action for dissolution under Section 701(a)(5)(B) (oppression by “the managers or those members in control of the company”). The court wishes to

151. See Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 426 (1995).

152. See RIBSTEIN & KEATINGE, *supra* note 16, § 11:2–3.

153. See *id.* § 11:15.

154. See *Kasten v. MOA Investments*, 731 N.W.2d 383 (Wis. Ct. App. 2007) (holding that minority oppression was not a basis of cause of action, but only a ground for dissolution).

understand a claim as one alleging a breach of fiduciary duty by the controlling member. Subsection (g)(5) does not preclude that approach.¹⁵⁵

This unfortunately implies that the oppression remedy provides a distinct duty and then attempts to reconcile this duty with non-managing members' lack of a duty under section 409(g)(5).

Fourth, the RULLCA comment quoted immediately above raises the problem of attempting to find a fiduciary duty on the part of a member *qua* member. Contrary to the comment, there is no fiduciary duty without delegation of open-ended management power.¹⁵⁶ A non-controlling member's wrongful exercise of a veto power accordingly would not be a breach of a fiduciary duty, but rather would be a breach of a specific obligation under the operating agreement interpreted in the light of the obligation of good faith and fair dealing. This approach is consistent with the black letter of RULLCA section 409(g)(5), and the comment creates confusion by implying otherwise. Moreover, the comment misleadingly implies that section 409(g)(5) bars an oppression remedy in the event of bad faith conduct by a non-controlling member.

VIII. DERIVATIVE SUITS

RULLCA Article 9, like ULLCA, provides for derivative suits in LLCs. This is common in LLC statutes, but still controversial. The corporate-type derivative suit procedure is questionable for LLCs and particularly for member-managed firms.¹⁵⁷ Each member probably has some power to sue and could be authorized by either a vote of the disinterested members, or simply by a failure by one or a majority of co-members to object to the suit after notice.¹⁵⁸ The poor fit of the derivative suit in this context is indicated by the many LLC cases that have struggled to find some basis for authorizing a direct remedy.¹⁵⁹ Even most centrally managed LLCs are closely held and the members participate actively in management, allocating merely ministerial duties to managers. Indeed, the RULLCA management provisions discussed above in Part V recognize the fluidity of the LLC in rejecting clear distinctions between member-managed and manager-managed LLCs for

155. RULLCA § 409(g)(5) & cmt.

156. *See* Ribstein, *supra* note 105, at 217.

157. *See* RIBSTEIN & KEATINGE, *supra* note 16, § 10:3.

158. *See id.* § 10:2.

159. *See id.* § 10:4 & n.19.

agency purposes. In contrast to the typical corporation, the members of a manager-managed LLC may have the direct power to authorize a suit, as well as remedies such as removal of managers which corporate shareholders do not have. Accordingly, there is little justification for the extraordinary corporate-type remedy of empowering a single volunteer owner to sue on behalf of the firm without seeking affirmative authorization from other members or managers.

Even if RULLCA correctly preserves the default rule authorizing derivative suits,¹⁶⁰ there are two additional problems. First, as discussed above in Part VI.D.5, the statute wrongly leaves in doubt the enforceability of operating agreement provisions waiving the remedy, including arbitration and choice of forum provisions. The need to preserve the parties' ability to provide for these alternative remedies is particularly important given the doubts about the appropriateness of the derivative remedy for LLCs.

Second, RULLCA not only preserves the corporate-type derivative remedy, but marches briskly in the direction of further "corporatizing" it by providing in section 905 for a special litigation committee. The same considerations that make derivative suits questionable for most LLCs make the extra burden and formality of a special litigation committee even more dubious. While RULLCA merely authorizes rather than compels these committees, the authorization suggests that this formal procedure is appropriate for LLCs. Courts might take this suggestion and hold that a majority's refusal to sue on behalf of the LLC without appointing such a committee was wrongful.

CONCLUSION

The new RULLCA provisions raise serious problems that legislators and lawyers should consider carefully before deciding whether to adopt RULLCA in their state or to advise a client to form an LLC under a RULLCA-based statute. These particularly include the following:

- An unworkable and confusing provision on shelf registration;
- Failure to clarify the law on series LLCs;
- Awkward and convoluted new provisions on the operating agreement;
- A questionable default rule on distributions-in-kind;
- Eliminating LLC rules on agency power of members and managers;

160. Note that even without a statutory derivative remedy, the operating agreement still could provide for one.

- Opening the door to uncertain new fiduciary duties;
- Creating significant uncertainty about the members' ability to contract regarding fiduciary duties and remedies;
- Adding a questionable new basis for judicial dissolution; and
- Further corporatizing the derivative remedy by adding a provision for special litigation committees.

In deciding whether to adopt RULLCA, legislators should keep in mind that there is little need for a uniform law in this area. All of the arguments against a uniform LLC law made in reference to ULLCA¹⁶¹ apply even more strongly here. In particular, firms can readily solve most potential problems of multiple state laws by choosing a single statute to govern their affairs. Even to the extent that there is some benefit to uniformity, as with respect to the small number of issues covered in the LLC statute to which the “internal affairs” choice of law rule does not apply, the states have achieved and continue to achieve this benefit on their own without NCCUSL’s help. Moreover, ULLCA actually decreased the level of uniformity that would have existed in its absence, and RULLCA threatens to do the same.¹⁶² Given the controversial nature of many of RULLCA’s changes and the fact that LLC law has matured over the twelve years since ULLCA, there is even less reason to think that RULLCA will achieve uniformity than there was for ULLCA.

It follows that legislators should adopt RULLCA provisions only if they conclude that the provisions are appropriate for their states, not because they think that the need for uniformity overrides any concerns they might have. In other words, legislators should adopt RULLCA only if they think that RULLCA is a suitable model. The above analysis suggests strongly that it is not. Moreover, given the institutional problems with crafting uniform laws,¹⁶³ there is no reason to expect that RULLCA would be a better model than many of the sophisticated state LLC statutes that state legislators and bar committees have produced over the last twenty years. Even if legislators conclude that some of RULLCA’s provisions are clearly superior to existing law, they should not adopt RULLCA unless they are satisfied that the benefits of RULLCA exceed the costs of creating uncertainty by abandoning prior case law and precedents.

161. *See generally* Ribstein, *Critique*, *supra* note 7 (arguing against adoption of ULLCA on the grounds that adoption will not result in greater uniformity).

162. *See* Kobayashi & Ribstein, *supra* note 9, at 6.

163. *See id.* at 6–8; Ribstein, *Critique*, *supra* note 7, at 322.

Practicing lawyers face a serious dilemma when advising clients to form under RULLCA. In particular, RULLCA's agency provisions may threaten the security of transactions with third parties, and the provisions on waiver may subvert even well-crafted operating agreements. With respect to waiver, contracting parties obviously expect that a court will enforce their agreements. While this does not necessarily mean that the law should make all agreements fully enforceable, it does mean that clients rely on their lawyers to inform them of significant risks of non-enforceability. RULLCA creates myriad escape hatches from the agreement.¹⁶⁴ Even if a lawyer conscientiously believes that RULLCA is appropriate for the parties' relationship, she should consider the need to disclose to clients the significant risks RULLCA presents. Indeed, failure to disclose these risks may constitute legal malpractice.¹⁶⁵

Finally, RULLCA holds lessons for uniform lawmaking generally. The defects in RULLCA cannot be attributed to any individual shortcomings of the skilled, hardworking, and experienced lawyers who contributed to the project over several years. Rather, the defects are hardwired into the process of drafting uniform laws.¹⁶⁶ Given the risks of poor policy choices, uniform lawmaking is a questionable endeavor and should only be undertaken where a uniform state law is likely to be useful. The limited liability company does not fall under this category.

164. *See supra* Part VI.D.

165. *See generally* Thomas E. Rutledge & Allan W. Vestal, *Making The Obvious Choice Malpractice: LLPs and the Lawyer Liability Time Bomb in Kentucky's 2005 Tax Modernization*, 94 KY. L.J. 17, 34 (2005) (discussing the risk of malpractice in advising clients in choosing the LLP form in Kentucky without consideration and disclosure of tax risks).

166. *See* Kobayashi & Ribstein, *supra* note 9, at 6–8.