

Limitation of Fiduciary Duties for LLC Members

By Marshall P. Horowitz and Gregg R. Sultan

Reprinted and/or posted with the permission of Daily Journal Corp. (2010).

Given the current economic climate, non-controlling members of limited liability companies (LLCs) increasingly are scrutinizing the actions of LLC managing members and managers more rigorously than in the past. Managers and managing members of LLCs typically owe duties of care and loyalty (called fiduciary duties) to the LLC and its members. Many states permit modification by contract of the fiduciary duties of members and managers. Delaware's Limited Liability Company Act, for example, allows members and managers to limit or even eliminate fiduciary duties in the contracts that govern their relationships, typically called operating agreements or limited liability company agreements. This provides a great deal of latitude to the manager and managing members of a Delaware LLC, who may, for example, wish to eliminate all fiduciary duties if the company is engaged in a narrow business (i.e., manufacture of one particular type of beverage product) and the managing members wish to be able to engage in other ventures outside of the company that are generally competitive with it, but are not likely to adversely affect the company's business (other beverages).

A recent ruling by the Delaware court in *Kelly v. Blum* provided further clarity to state law in this area. The court held that because the company's operating agreement was silent as to the duties controlling members owed to minority members, the controlling members owed traditional fiduciary duties to the company, including refraining from entering

into a transaction that would harm the minority member's interests. *Kelly* thus clarified the law in Delaware by requiring explicit language in the LLC operating agreement reducing or eliminating fiduciary duties, but noting that such explicit language limiting or eliminating fiduciary duties would be enforceable. In the absence of such language, traditional fiduciary duties from managers and managing members to the LLC and its members will apply.

In California, the situation is more ambiguous. Limited liability companies in California are governed by the Beverly-Killea Limited Liability Company Act ("LLC Act"). Section 17005(d) of the LLC Act states that the "fiduciary duties of a manager to the limited liability company and to the members of the limited liability company may only be modified in a written operating agreement with the informed consent of the members." Unfortunately, there has yet to be a case that clarifies how a court interprets the language of this statute.

Section 17005(d) contains three key components. The first component—the absence of the phrase "or eliminated"—has generated a variety of opinions. Some commentators have interpreted the absence of this phrase to mean "that an LLC Agreement may narrow fiduciary duties to some extent, but not cancel them entirely." Others have argued that the "statute does not contain any limitations on the ability to modify fiduciary duties," and that "[r]ead alone, this would appear to permit LLC members to waive any or all of the fiduciary

duties of a manager of an LLC.” This ambiguity can put the manager and managing members of an LLC in a dilemma. A prudent reading and interpretation of the statute that applies a commonsense meaning of the word “modify” would be that the fiduciary duties of a manager and the managing members of a California LLC may not be eliminated, but may be modified or limited. If there is a compelling reason, however, to eliminate fiduciary duties and there is no equally important countervailing consideration, the manager and managing members should consider organizing the LLC under the laws of Delaware instead of California. If there is a reason why the LLC should be organized in California (i.e., a prospective non-controlling member with a significant amount of capital to invest requires it), the members of the LLC need to consider various practical circumstances and drafting options in the operating agreement to ensure that the company and its manager and members can still accomplish their goals even though fiduciary duties will remain at least to some extent. Often times, the analysis is complicated by which party has more leverage in the negotiation.

Another significant, albeit unresolved, issue regarding the absence of the phrase “or eliminated” is the relationship between Sections 17005(d) and 17153 of the LLC Act, which states that “[t]he fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership.” By analogizing the fiduciary duties of LLC members to those of partners in a partnership, Section 17153 seems to suggest that “an LLC member’s ability to waive the fiduciary duties of a manager is limited in the same way that a partner’s ability to waive the fiduciary duties of another partner are limited by *California Corporations Code Section 16103*.” Since Section 16103 has been interpreted to allow only the modification, but not the complete

waiver or elimination, of fiduciary duties in the partnership context, by analogy it is likely that a California court would be unlikely to allow the complete waiver or elimination of fiduciary duties in the LLC context. So again, it would be advisable to proceed cautiously and not attempt to eliminate or completely waive an LLC manager’s fiduciary duties in an operating agreement, but rather try to limit them.

Lastly, Section 17005(d) imposes an informed consent standard, which may make modifying the fiduciary duty of an LLC manager more difficult in California than in Delaware, where “maximum effect will be given to principles of freedom of contract and the freely negotiated provisions of an LLC operating agreement...” This is because Delaware permits modification of an LLC manager or managing members’ fiduciary duties by the terms of the operating agreement alone, but California imposes an additional requirement to obtain the informed consent of the non-controlling members of the LLC. Indeed, another issue that may arise regarding the informed consent standard is “[w]hether consent will be considered informed if obtained with respect to conduct generally described in the operating agreement far in advance of a competitive transaction,” or if it must be “based on specific disclosure of relevant facts...” For example, if the operating agreement indicates that the LLC manager may engage in “competitive activities,” is that sufficient to meet the requirement of having obtained the informed consent of the other members with respect to specific acts of competition, or should the manager obtain the other members’ informed consent in connection with each such act? A careful and cautious reading of the statute would indicate the latter.

Given the current unresolved state of how California’s laws regarding fiduciary duties of LLC members and managers will be interpreted by the California courts, LLC managers or

members seeking to modify or minimize fiduciary duties should do so in a tailored and considered fashion. Unless and until there is precedent in California case law permitting the express and complete waiver of all fiduciary duties, it would be prudent for California LLC managers and members not to attempt to eliminate or completely waive fiduciary duties in the company's operating agreement. Rather, they should carefully consider the extent to which the manager's fiduciary duties will be limited and then draft precise language into the operating agreement. In the exercise of caution, it would also be prudent for LLC managers and managing members to provide complete disclosure to all other LLC members of the relevant facts and circumstances related to specific transactions that may adversely affect any of such members' interests, advise such members to seek the advice of their own legal counsel, and then obtain such members written acknowledgement that they have consulted with counsel.

Because of the uncertainty surrounding this area, individuals structuring a business as an LLC, who have compelling reasons to limit the fiduciary duties of its managers, should strongly consider seeking the advice of experienced legal counsel familiar with these issues who can provide guidance during the drafting of the company's operating agreement and in making any revisions to it as the company grows and seeks new investors and members.



Marshall P. Horowitz
213.929.2519
mhorowitz@swlaw.com

Marshall is a partner at Snell & Wilmer's Los Angeles office. His practice focuses on advising both U.S. and international clients on a broad range of transactional matters. He serves as primary outside counsel to a variety of companies and entrepreneurs. He also has extensive experience in the formation and ongoing representation of private equity funds.



Gregg R. Sultan
213.929.2555
gsultan@swlaw.com

Gregg is an associate at Snell & Wilmer's Los Angeles office. His practice is concentrated in general transactional matters, including M&A, trademark, copyright, entertainment, franchising, new media and technology transactions.

Snell & Wilmer
L.L.P.
LAW OFFICES

www.swlaw.com