

# Litigating Fiduciary Duty Claims

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AMERICAN **BAR** ASSOCIATION

Litigation Section

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Printed in the United States of America.

26 25 24 23 22      5 4 3 2 1

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Chapter 5

# Fiduciary Duties in the Context of the Limited Liability Company

By Dale Schian, Dominick San Angelo, and Kortney Otten

## I. Introduction

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The ubiquity of the limited liability company as an entity form throughout the United States in the last several decades has often been described as a “much heralded development in corporate law.”<sup>1</sup> This entity form, first made available in the state of Wyoming in 1977, offered the benefit of a limitation on personal liability (much like a corporation) for its “members,” while enabling its members to treat the income generated from their interest as a pass-through for taxation purposes (much like a partnership). The limited liability company (LLC) statutes adopted throughout the United States thus created a hybrid entity that offers flexibility for the members and other participants in the entity to customize their relationships by contract. The LLC statutes established entities that “are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.’”<sup>2</sup> All 50 states and the District of Columbia have enacted LLC legislation.

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1. See, e.g., Rachel Maizes, *Limited Liability Companies: A Critique*, 70(3) ST. JOHN’S L. REV. art. 3 (1996), available at <https://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=1618&context=lawreview>.

2. *TravelCenters of Am., LLC v. Brog*, 2008 WL 1746987, at \*1 (Del. Ch. Apr. 3, 2008) (quoting *In re Grupo Dos Chiles, LLC*, 2006 WL 668443, at \*2 (Del. Ch. Mar. 10, 2006));

The LLC entity form affords novelty and flexibility that create its own set of issues for determining whether certain actors within the entity are bound by fiduciary duties, and to whom. This chapter explores some of these unique issues in the LLC context, including the source of the fiduciary duty; a discussion of who owes fiduciary duties; to whom such duties are owed; how the duties differ in the context of “member-managed” versus “manager-managed” LLCs; and the extent to which statutory, common law, and the contractual agreements bind the LLC and its participants.

## II. Fiduciary Duties

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Fiduciary duties consist of the duty of loyalty and the duty of care. The duty of loyalty requires the fiduciary to act with undivided loyalty to the LLC. It mandates that the best interests of the company take precedence over any personal interests or individual advantages possessed by an officer, director, or member that are not shared by the company generally. Failure by such actors to fulfill a duty of loyalty usually includes some form of self-dealing or misuse of corporate office for personal gain.<sup>3</sup> Corporate decisions that confer a benefit (indirectly or directly) upon a participating director, officer, or member can implicate the duty of loyalty.

The duty of care requires fiduciaries of the LLC to act in good faith and exercise reasonable care in carrying out their obligations in dealing with the LLC’s operations and activities. It requires that the fiduciary act with a degree of care that an ordinarily prudent person in a similar situation would use.<sup>4</sup>

## III. Applicable Source of the Duty

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An LLC possesses characteristics typically associated with both corporations and partnerships. The fiduciary duties of participants in an LLC arise from three sources: the authorizing statute, the common law, and the agreement of the parties. Whether a fiduciary relationship exists

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*see also* CML V, LLC v. Bax, 6 A.3d 238, 250 (Del. Ch. 2010), *aff’d*, 28 A.3d 1037 (Del. 2011), as corrected (Sept. 6, 2011).

3. *In re* BH S & B Holdings LLC, 420 B.R. 112, 150 (Bankr. S.D.N.Y. 2009), *aff’d as modified*, 807 F. Supp. 2d 199 (S.D.N.Y. 2011) (internal citations omitted).

4. *In re* Sols. Liquidation LLC, 608 B.R. 384, 407 (Bankr. D. Del. 2019).

among the various parties is generally a question of fact.<sup>5</sup> Even where no duty exists, it is possible that, through a course of dealing or contract, a duty arises when an actor accepts responsibility for and takes actions that generate reliance on the part of the beneficiary.<sup>6</sup>

## A. By Statute

The creation and formation of LLCs is governed by statute. State statutes vary substantially across the nation. When efforts began in 1992 to draft a uniform act, called the Uniform Limited Liability Company Act (ULLCA), nearly every state had already adopted legislation authorizing LLCs.<sup>7</sup> In 1996, the ULLCA was finally completed, but only six states adopted it. The ULLCA sought to codify fiduciary duties consistent with the approach taken in the Revised Uniform Partnership Act.

The ULLCA was substantially revised in 2006 and ten states adopted it. The 2006 revision recognized that the approach taken in 1996 was *too* reliant on the concept of good faith and fair dealing. The 2006 revision also sought to more fully define fiduciary duties using a “reasonableness under the circumstances standard” and defined that duty by reference to the well-known business judgment rule.

Efforts to harmonize the 2006 ULLCA with other uniform acts on unincorporated associations led to the current version of the revised 2013 ULLCA.<sup>8</sup> It has been adopted in nine states and the District of Columbia. Section 409 of the 2013 ULLCA deviates from the 2006 ULLCA in that it no longer expressly recognizes the business judgment rule that is a prominent measure of fiduciary duty for directors in the corporate context. The standard of reasonableness based on similar circumstances and references to fiduciary duty have also been removed. Instead, section 409(c) defines the duty of care as refraining “from

5. See *Gemstar Ltd. v. Ernst & Young*, 917 P.2d 222, 233 (1996).

6. See *Spinella v. Apriva LLC*, No. CV 2015-053104, 2016 WL 8939205, at \*4 (Ariz. Super. Ct. Feb. 29, 2016) (citing *Lloyd v. State Farm Mut. Auto Ins. Co.*, 860 P.2d 1304 (Ariz. Ct. App. 1992)); see also *In re Sky Harbor Hotel Properties, LLC*, 443 P.3d 21, 23 (Ariz. 2019) (describing the “fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act”) (quoting RESTATEMENT (SECOND) OF AGENCY § 1 (Am. Law. Inst. 1958)).

7. Unif. Ltd. Liab. Co. Act (2006) (last amended 2013), Prefatory Note to ULLCA (2006), 6C U.L.A. 4 (2016). Unless otherwise indicated references in this chapter to the “uniform act” or “ULLCA” refer to the Uniform Limited Liability Company Act (2006) (last amended 2013).

8. 6C U.L.A. 1 (2016) (Harmonized) (last amended 2013) (“ULLCA (2013)”); *id.* at 7 (Prefatory Note to 2011 and 2013 Harmonization Amendments).

engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or knowing violation of law.”<sup>9</sup> The comment to section 409(c) states that “eliminating the label ‘fiduciary’ is merely semantics; no change in law is intended.”<sup>10</sup>

Because some state statutes predate the uniform acts, they often rely on common-law or agency principals to establish and define the scope of fiduciary duties. Even the approach to address fiduciary duties in the 1996 ULLCA changed in the 2006 version, and then again in 2013. The purpose of the 2013 revision was “to harmonize, to the extent possible, all uniform acts pertaining to unincorporated associations.”<sup>11</sup> Additional judicial development will be necessary to know if the different formulations and descriptions of the duties owed make a meaningful difference in the standard of conduct required for those who act for and on behalf of LLCs.

## B. At Common Law

Many, but not all, state LLC statutes address the fiduciary duties owed by managers, members, and other parties to the LLC and to each other. Courts have analyzed the extent to which fiduciary duties apply at common law to LLCs in states without statutory provisions, and have generally held that such duties exist.<sup>12</sup> Courts have looked to the law of agency, contracts, and other areas of common law to conclude that fiduciary duties are present in the context of the LLC. The law continues to evolve in that area and states continue to amend their statutes to address fiduciary duties.

In 1992, Arizona adopted the pre-ULLCA version of the LLC act, which did not address fiduciary duties at all. The LLC act did however, provide that the principals of agency law applied to LLCs. The Arizona Supreme Court recently held that the Arizona LLC Act necessarily imposes fiduciary duties on members, managers, and the LLC because it incorporates the law of agency, which includes principals of fiduciary duty.<sup>13</sup> The court also determined that LLCs and their members *cannot* eliminate the implied covenant of good faith and fair dealing, which is present in every contract.<sup>14</sup>

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9. 6C U.L.A. 107.

10. *Id.* at 109 (comment subsection (c)).

11. *Id.* at 7 (Prefatory Note to 2011 and 2013 Harmonization Amendments).

12. *E.g.*, *Executive Ctr. v. Meieran*, 823 F. Supp. 2d 883 (E.D. Wis. 2011).

13. *In re Sky Harbor Hotel Properties, LLC*, 443 P.3d 21, 22–23 (Ariz. 2019).

14. *Id.* at 24.

Delaware courts have relied on contract law, equitable conduct, and prior common law to find fiduciary duties in an LLC member context.<sup>15</sup> The Delaware LLC Act does not explicitly articulate that managers of Delaware LLCs owe common law fiduciary duties of care and loyalty in the same way that directors and officers do in the corporation context. Rather, Delaware law allows parties to an LLC agreement to restrict or expand fiduciary duties to the LLC or its members or managers. However, because there is an ability to *restrict* fiduciary duties, many contend that such fiduciary duties *must* exist for there to be something to restrict or eliminate by contract.<sup>16</sup> And although the LLC act does not expressly provide for fiduciary duties, Delaware courts have determined that *default equitable* fiduciary duties exist in an LLC context and are implicit in Delaware's LLC Act.<sup>17</sup> Even if an LLC agreement

disclaims all statutory fiduciary duties of the directors, the directors' duties are limited to (i) those expressly set forth in the agreement and (ii) those that a court deems to arise under the implied covenant of good faith and fair dealing (which adheres to every contract and, by statute, cannot be waived or modified).<sup>18</sup>

Like Delaware, Florida relied on those same principles before amending and instating the Florida Revised LLC Act in 2015. Florida's Revised LLC Act now includes and addresses fiduciary duties that were previously lacking.<sup>19</sup> It specifically incorporates fiduciary duties of

15. See *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1214 (Del. 2012) and *Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839, 861 (Del. Ch.), *judgment entered sub nom. Auriga Capital Corp. v. Gatz Properties, LLC* (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

16. *Fiduciary Duties of Managers of LLCs: The Status of the Debate in Delaware*, American Bar Association (Feb. 28, 2012), available at [https://www.americanbar.org/groups/business\\_law/publications/blt/2012/02/02\\_lazarus/](https://www.americanbar.org/groups/business_law/publications/blt/2012/02/02_lazarus/).

17. See *Auriga Capital Corp.*, 40 A.3d 839; and see *McWhinney Centerra Lifestyle Ctr. LLC v. Poag & McEwen Lifestyle Centers-Centerra LLC*, 2021 WL 126572 (Colo. App. Jan. 14, 2021).

18. Gail Weinstein, Steven J. Steinman, Brian T. Mangino, Randi Lally & Maxwell Yim, *Fried Frank Discusses the Obligations of LLC Directors and Managers*, THE CLS BLUE SKY BLOG (June 20, 2018), <https://clsbluesky.law.columbia.edu/2018/06/20/fried-frank-discusses-the-obligations-of-llc-directors-and-managers/>.

19. Louis T.M. Conti, *Un-Cabined Fiduciary Duties in Florida LLCs: The Common Law and Equity Opens the Door to Expanded Liability and the Manifestly Unreasonable Standard*, 91(8) FLA. BAR J. (Sept./Oct. 2017), <https://www.floridabar.org/the-florida-bar-journal/un-cabined-fiduciary-duties-in-florida-llcs-the-common-law-and-equity-opens-the-door-to-expanded-liability-and-the-manifestly-unreasonable-standard/>.

loyalty and care in the LLC context, relating to managers, members, and the LLC. Florida also applies a duty of good faith and fair dealing in the LLC context, which, like other states have found, cannot be waived.<sup>20</sup> Unlike other states, Florida's LLC Act expressly limits or prohibits all together the ways in which the fiduciary duties may be altered or eliminated.

Wisconsin's Limited Liability Company Law (WLLCL) does not expressly mention fiduciary duties, but it does provide that common law principles of agency apply to the members and/or managers of the LLC. Wisconsin courts have construed that provision to apply fiduciary duties in connection with LLCs. In doing so, Wisconsin courts have found that the WLLCL did *not* abrogate common law claims and defenses and that members and managers owe common law fiduciary duties to other members and the LLC.<sup>21</sup>

In summary, because LLCs are created by statute, it is appropriate to look "first, foremost, and primarily" to the statute to define fiduciary duties.<sup>22</sup> Yet, many states' LLC acts are ambiguous or incomplete when addressing fiduciary duties. Because of this ambiguity and incompleteness, many courts have looked to other states' LLC acts and drawn on other areas of law to fill in gaps where the applicable act is silent. The result is a growing body of case law that defines the contours of the fiduciary duties owed in various circumstances at common law.

### C. By Agreement

Fiduciary duty obligations can also arise by agreement from a company's operating agreement.<sup>23</sup> One of the significant advantages of the LLC form over other entity forms is the flexibility of defining the relationships among the LLC's participants by contract. Most state statutes provide that, unless prohibited by law or superseded by a provision in an LLC's charter documents, an LLC may reduce or enlarge the fiduciary duties of certain actors through the company's operating agreement, or other agreement of the parties.

For imposition of fiduciary duties, the three versions of the ULLCA have been largely consistent concerning what is permissible to include in an operating agreement.<sup>24</sup> The differences between state statutes,

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20. See FLA. STAT. § 605.04091 and Jeramie J. Fortenberry, *Florida LLC Law* (July 6, 2020), [https://www.fortenberrylaw.com/llc-law/florida/#\\_Toc44947663](https://www.fortenberrylaw.com/llc-law/florida/#_Toc44947663).

21. *Marx v. Morris*, 925 N.W.2d 112, 124 (Wisc. 2019).

22. *800 S. Wells Commercial LLC v. Cadden*, 103 N.E. 3d 875, 885 (Ill. Ct. App. 2018).

23. ULLCA (2013) § 105.

24. ULLCA (1996) § 103(b)(2)-(4); ULLCA (2006) § 110(c)(4)-(5), (9), (d), ULLCA (2013) § 105(c)(5)-(7), (11), (d).

state common laws, relevant state case law, and adopted ULLCA versions all determine what may be accomplished in an operating agreement in relation to expanding or eliminating fiduciary duties for an LLC's members, managers, or the LLC itself.

## 1. Expansions and Limitations on Fiduciary Duties by Agreement

Generally, an LLC can, by contract through its operating agreement, expand or limit the fiduciary duties of various actors within the LLC. Pursuant to the multiple versions of ULLA, operating agreements can define the standards of performance related to the fiduciary duties of members or managers as long as those standards are “not manifestly unreasonable.”<sup>25</sup> For example, an operating agreement could enlarge the scope of the fiduciary duty to impose the same fiduciary duties owed by officers and directors to a corporation.<sup>26</sup> Conversely, an operating agreement may allow managers to engage in self-interested transactions.<sup>27</sup> In many states, an LLC can limit fiduciary duties of managers and other persons in its operating agreement with exculpatory provisions.<sup>28</sup> Further, an operating agreement can limit affirmative duties to take certain actions that would typically be required for a manager or other person to fulfill fiduciary duties, such as removal of the duty to provide information or the books and records of the LLC to its members.<sup>29</sup> Even Florida law, which is more restrictive in terms of the allowance of the elimination or modification of fiduciary duties than are other jurisdictions, permits *some* alteration of these duties within specified limits.

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25. *Id.*

26. *See* *Strebel v. Wimberly*, 371 S.W.3d 267, 271 (Tex. Ct. App. 2012) (analyzing an operating agreement that provided that “the Managers shall have fiduciary duties to the Company and the Members equivalent to the fiduciary duties of directors of Delaware corporations” and applying substantive Delaware corporate law to determine whether there was a breach of fiduciary duty by the Manager).

27. *See, e.g.,* *Synectic Ventures I, LLC v. EVI Corp.*, 294 P.3d 478, 485–86 (Or. 2012) (observing that Oregon law permits self-interested transactions that are authorized by operating agreement or that are approved by members).

28. *E.g.,* *Kelly v. Blum*, 2010 WL 629850 (Del. Ch. 2010) (discussing 6 Del. C. § 18-1101(e)).

29. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 664 (Del. Ch. 2012); *see also* J. William Callison & Maureen A. Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice*, LTD. LIABILITY CO., FIDUCIARY DUTIES § 8:7 n.45 (2020 ed.) (collecting cases).

## 2. Limitations (and Limitations on Limitations) on Fiduciary Duties Imposed by Law

Many jurisdictions provide that the covenant of good faith and fair dealing is imposed by law and part of every contract. The ULLCA has consistently prohibited attempts to eliminate the covenant from operating agreements.<sup>30</sup> Courts generally will give effect to an operating agreement's language that establishes, limits, or sometimes eliminates fiduciary duties. Delaware and other states permit the complete elimination of fiduciary duties, but not the implied contractual covenant of good faith and fair dealing.<sup>31</sup>

Although parties have the legal right to make whatever contracts they desire, they cannot contract for illegal purposes or against public policy.<sup>32</sup> The majority of the courts that have analyzed fiduciary duties in the LLC context have found that parties cannot contract around the covenant of good faith and fair dealing and that the attempt to do so is against public policy or contrary to law. Generally, a contract that cannot be performed without violating applicable law is illegal and void, and thus unenforceable.<sup>33</sup> Thus, while most states permit the elimination or modification of fiduciary duties as applicable to LLCs and its members or managers, some restrictions and prohibitions uniformly remain across the states in that regard.

## IV. The Individuals Who May Have Fiduciary Duties

The roles of shareholders, partners, officers, and directors are more easily defined in corporations and partnerships than in the LLC context. LLCs are creatures of customization by contract, coupled with a myriad of choices afforded to parties to alter their roles and relationships

30. ULLCA (1996) § 103(b)(4); ULLCA (2006) § 110(c)(5); ULLCA (2013) § 105(c)(6).

31. *See, e.g.*, TM2008 Investments, Inc. v. Procon Capital Corp., 323 P.3d 704, 708 (Ariz. Ct. App. 2014); Feeley v. NHAOCG, LLC, 62 A.3d 649, 664 (Del. Ch. 2012).

32. ULLCA (1996) §§ 103(b)(3), 409(c); ULLCA (2006) § 110(d)(3); ULLCA (2013) § 105(c)(7).

33. E & S Insulation Co. of Arizona v. E. L. Jones Const. Co., 591 P.2d 560, 562 (Ariz. Ct. App. 1979); *see also* Mountain States Bolt, Nut & Screw Co. v. Best-Way Transp., 568 P.2d 431 (Ariz. Ct. App. 1977) (“If the acts to be performed under the contract are themselves illegal or contrary to public policy, or if the legislature has clearly demonstrated its intent to prohibit maintenance of a cause of action, then recovery should be denied.”).

as members and managers. This contributes to the unique flexibility of LLCs, but makes defining the roles and relationships among members, managers, officers, and other role players in the LLC more complex. Because of that, it is difficult to make generalized statements of the law for actors within the LLC. This is especially true with respect to fiduciary duties of these actors in the LLC context. Moreover, state statutes vary across the nation. And, many states, like Delaware, have more case law to draw from to address these issues, versus other states that have had less opportunity to deal with LLC roles and fiduciary duties and thus little case law or analysis to look to for clarification.

### A. Officers

Officers of an LLC sometimes owe fiduciary duties in the same way as they would in a corporation.<sup>34</sup> Yet, when the officers are supervised by the LLC's manager(s), some courts have held that such officers may not have fiduciary duties.<sup>35</sup> In an Illinois case, an LLC brought suit against its officer (a vice president) for breaching its fiduciary duty to its members and the LLC by diverting corporate opportunities, improperly transferring assets, and improperly allocating expenses.<sup>36</sup> Because the LLC was expressly a manager-managed LLC, the court determined that where activities are exclusively controlled by an LLC's manager, the duties owed to the company reside in the manager, and *not* in the officer. It held that an officer does not owe any fiduciary duties to an LLC (or its members) simply by being an officer of the LLC.

### B. Managers in a Manager-Managed LLC

When an LLC is not managed by its members, but elects to have its affairs directed by one or more managers, managers are analogous to directors and officers in a corporation and tend to have similar fiduciary duties. Although the scope of the fiduciary duties may be enlarged or limited by an operating agreement, it will be subject to the covenant of good faith and fair dealing, as discussed earlier.<sup>37</sup>

Without a contrary provision in the operating agreement, the manager of an LLC owes duties of loyalty and care to the members of the

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34. See *In re BH S & B Holdings LLC*, 420 B.R. 112 (Bankr. S.D.N.Y. 2009).

35. 800 S. Wells Commercial LLC v. Cadden, 103 N.E.3d 875, 886 (Ill. Ct. App. 2018).

36. *Id.*

37. *Supra* Section III(c)(ii).

LLC.<sup>38</sup> Many states that have adopted statutory provisions about managerial duties “require managers to act in *good faith* and with such care as an ordinarily prudent person would exercise in similar circumstances (i.e., a *reasonableness standard*).”<sup>39</sup>

### C. Controlling Members

Controlling members hold an ownership interest that permits them to make decisions for the company, even where those decisions may be contrary to the wishes of other members and where a decision may be detrimental to the interests of the company or other members. Most courts treat controlling members the same as controlling shareholders<sup>40</sup> in a corporation.<sup>41</sup> This differs from a passive LLC member, who has an ownership interest but does not actively participate in or control the company’s decisions or its operations.

Controlling members are generally found to owe fiduciary duties to the LLC and minority members of the LLC in the same vein as managers of an LLC do.<sup>42</sup> Delaware courts have held that members who control an LLC owe fiduciary duties to the LLC *and* noncontrolling members.<sup>43</sup> Managing members<sup>44</sup> of an LLC owe fiduciary duties to the LLC and its member investors, thus, a managing member must act with the utmost good faith and loyalty in managing the LLC.<sup>45</sup>

38. Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at \*8 (Del. Ch. Apr. 20, 2009).

39. Callison & Sullivan, *supra* note 29, § 8:7.

40. A controlling shareholder is a shareholder who owns the largest number of a corporation’s shares or one who has control over the company’s affairs for reasons other than share ownership percentage. *See, e.g.*, Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1113 (Del. 1994).

41. *See* Kelly v. Blum, CA. No. 4516-VCP, 2010 WL 629850, at \*12 (Del. Ch. Feb. 24, 2010).

42. Glidepath Ltd. v. Beumer Corp., No. CV 12220-VCL, 2019 WL 855660, at \*18 (Del. Ch. Feb. 21, 2019), *judgment entered* (Del. Ch. 2019) (“Buyer owed fiduciary duties as a controlling member.”); Kelly v. Blum, 2010 WL 629850 (Del. Ch. 2010).

43. *See* Klein v. Wasserman, 2019 WL 2296027 (Del. Ch. 2019) (control can be established through ownership or through showing of actual control over LLC’s business and affairs through general control or specific control); Glidepath Ltd. v. Beumer Corp., 2019 WL 855660 (Del. Ch. 2019) (LLC controller owes fiduciary duties); Cancan Dev. v. Manno, 2015 WL 3400789 (Del. Ch. 2015); *In re* Atlas Energy Resources, 2010 WL 4273122 (Del. Ch. 2010) (controlling members in member-managed LLC owe minority members the traditional fiduciary duties that controlling shareholder owes to minority shareholders).

44. A managing-member is a member who is designated to make decisions for the company regardless of their ownership interest percentage in the LLC.

45. 51 AM. JUR. 2D LIMITED LIABILITY COMPANIES § 11 (Nov. 2020 update).

## D. Members

Generally, absent an agreement, members of an LLC do not owe fiduciary duties to each other solely by virtue of being a member.<sup>46</sup> Yet, in Arizona and some other states, members will be found to have fiduciary duties to the LLC and the other members if the LLC is member managed.<sup>47</sup>

In a manager-managed LLC, neither common law nor the law of corporations or partnerships expressly imposes a fiduciary duty on members of an LLC without a duty being imposed through an operating agreement.<sup>48</sup> The caveat here is that this general statement assumes the member is passive and not controlling, and that the member has not undertaken to act on behalf of the LLC. As discussed earlier, a controlling member has fiduciary duties to noncontrolling members.<sup>49</sup> Further, a member who controls or acts on behalf of the LLC may have fiduciary duties to the other members.<sup>50</sup>

## E. The LLC

The LLC itself does not generally have fiduciary duties to its members, but this is an evolving area of law.<sup>51</sup> Note that an LLC can have fiduciary duties to members of other LLCs, if, for example, the LLC is the manager or controlling member of another LLC.<sup>52</sup>

46. *In re Tsiaoushis*, 2007 WL 2156162 (E.D. Va. 2007) (nonmanaging members of manager-managed LLCs owe no fiduciary duties).

47. ARIZ. REV. STAT. § 29-3409.

48. *TM2008 Investments, Inc. v. Procon Capital Corp.*, 323 P.3d 704, 708 (Ariz. Ct. App. 2014).

49. Controlling members are prohibited, for example, from engaging in oppressive conduct. *See* ULLCA § 701(5)(b); *see also* *Sports Imaging of Arizona, L.L.C. v. 1993 CKC Tr.*, No. 1 CA-CV 05-0205, 2008 WL 4448063, at \*19 (Ariz. Ct. App. Sept. 30, 2008).

50. *Evergreen W. Bus. Ctr., LLC v. Emmert*, 296 P.3d 545, 552 (Or. 2012), *rev'd on other grounds*, 323 P.3d 250 (Or. 2014) (en banc) (finding that a member had “entered into a relationship of confidence with the company that required him to act ‘in good faith and with due regard to the interests of the one reposing the confidence’”) (quoting *Starkweather v. Shaffer*, 497 P.2d 358 (Or. 1972) (en banc)).

51. *See Khoobehi Properties, LLC v. Baronne Development No. 2, L.L.C.*, 16-506 (La. Ct. App. 5th Cir. 3/29/17), *writ denied*, 2017-0893, 227 So. 3d 288 (La. 9/29/17) (LLC was not liable for breach of fiduciary duty for not disclosing material information to member before member sold interest).

52. Generally, courts will differentiate between parties who serve in multiple capacities, such as a member and a creditor. *See, e.g.,* *Bootheel Ethanol Investments, L.L.C. v. Semo Ethanol Co-op.*, 2009 WL 398506 (E.D. Mo. 2009) (no fiduciary duties owed by member who failed to make capital contributions with respect to nonpayment of LLC’s debt to other member allegedly resulting); *In re South Canaan Cellular Investments, LLC*, 427 B.R.

## V. To Whom Is a Fiduciary Duty Owed?

### A. To the Limited Liability Company

More case law is developing that indicates fiduciary duties *are* owed to the LLC itself, either by managers, members, or both. North Carolina has found that an LLC manager's obligation to discharge his duties in good faith, with the care an ordinary prudent person in a like position would exercise under similar circumstances, and in the manner the manager reasonably believes to be in the best interests of the LLC, is owed by the manager *to the company*, rather than to other members.<sup>53</sup>

In *Flippo v. CSC Assocs.*,<sup>54</sup> the Virginia Supreme Court affirmed that a member of an LLC was directly liable for a breach of fiduciary duty *to the LLC*.<sup>55</sup> *Flippo* involved a claim for breach of fiduciary duty against the member-manager of an LLC for conveying assets to another business entity for the member-manager's personal benefit.

### B. To the Limited Liability Company's Members

Whether members owe fiduciary duties to each other appears to be expanding with the implementation of new state statutes and supplemental case law. As discussed, many states impose equitable fiduciary duties among members that can be altered based on agreement, and, whether a member owes fiduciary duties to other members will normally depend on the type of LLC involved—including whether the LLC is member or manager managed, and whether the LLC member has any control or management responsibilities. Passive members will generally not owe fiduciary duties to other members. However, when members *are* found to owe each other a fiduciary duty, they are the typical fiduciary duties discussed herein: the duty of loyalty and of care.

Members may enforce these rights on behalf of the LLC itself. The ULLCA has consistently recognized the right of members to maintain actions at law and in equity to enforce their rights under the operating

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85 (Bankr. E.D. Pa. 2010) (member could become LLC creditor and could use information provided by LLC); *Christopher's Partner, LLC v. Christopher's of Colonie, LLC*, 69 A.D.3d 1275, 893 N.Y.S. 2d 689 (3d Dep't 2010) (member as secured creditor).

53. *Kaplan v. O.K. Technologies, L.L.C.*, 675 S.E.2d 133 (N.C. Ct. App. 2009), *review denied*, 690 S.E.2d 699 (N.C. 2010).

54. 547 S.E. 2d 216 (Va. 2001).

55. *Id.* at 219.

agreement and to assert derivative rights on behalf of the LLC.<sup>56</sup> The 1996 ULLCA recognized the right to bring derivative actions, but did not protect against unreasonable restrictions in operating agreements until the 2006 version of ULLCA was enacted.<sup>57</sup> The 2013 amended version of ULLCA carried forward the preservation of derivative actions in operating agreements.<sup>58</sup> The act prohibits eliminating or unreasonably restricting the right to bring such claims.

Nevertheless, the right to bring an action on behalf of the LLC may not provide the remedy the member seeks. In *Gowin v. Granite Depot*,<sup>59</sup> the Virginia Supreme Court permitted a member to bring a derivative action against the manager for a breach of his fiduciary duty to the LLC. Although it was acknowledged that one reason for action was to terminate the interest of the other member, the court found the action did not have any impact on the LLC and denied recovery.

### C. To the Limited Liability Company's Creditors

As discussed in more detail in Chapter 12, at times, fiduciary duties may be owed to creditors. This is particularly so when an entity is *insolvent*. Some states have held that managers of insolvent LLCs have fiduciary duties to creditors of the LLC.<sup>60</sup> The Delaware court in *Gheewalla* held that when a corporation is insolvent, “creditors become the principal constituency injured by any fiduciary breaches that diminish the firm’s value.”<sup>61</sup>

That said, it is not always clear that a creditor could bring an action to enforce its rights. Some courts have held that creditors cannot bring a direct action against managers breaching a fiduciary duty owed to a creditor.<sup>62</sup> And other courts, such as the Delaware court in *CML*,

56. ULLCA (1996) §§ 1101–1104; ULLCA (2006) §§ 901–906; ULLCA (2013) §§ 801–806.

57. ULLCA (2006) § 110(a)(9).

58. ULLCA (2013) § 105(c)(11).

59. 634 S.E.2d 714 (Va. 2006).

60. *In re Senior Cottages of America, LLC*, 482 F.3d 997 (8th Cir. 2007) (fact that fiduciary duties might also run to creditors does not prevent bankruptcy trustee from making claim on LLC’s behalf); *In re McCook Metals, L.L.C.*, 319 B.R. 570 (Bankr. N.D. Ill. 2005) (managers of insolvent LLCs owe fiduciary duties to LLC creditors; manager usurped LLC opportunity by acquiring asset into another LLC); *JPMorgan Chase Bank, N.A. v. KB Home*, 632 F. Supp. 2d 1013 (D. Nev. 2009) (Nevada law would extend corporate insolvency exception to LLCs so that managers have fiduciary duties to creditors).

61. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 102 (Del. 2007).

62. *In re Mooney*, 2007 BNH 29, 2007 WL 2403774 (Bankr. D. N.H. 2007) (although managers of insolvent LLC have similar fiduciary duties as officers and directors of an

have held that derivative claims *cannot* be brought by creditors in the context of an LLC.<sup>63</sup> “Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections.”<sup>64</sup> To limit creditors to their bargained-for rights and deny them a *new* right to sue derivatively on behalf of an insolvent entity tracks the LLC act’s contractarian environment.<sup>65</sup>

All versions of the ULLCA have taken a fairly restrictive approach to third parties, including creditors, interfering with the operation and management of LLCs. Although derivative actions are authorized in all three versions of the act, each limits the “proper plaintiff” to “a member of the company when the action is commenced.”<sup>66</sup> The statutory language, the policy of defining relationships by agreement of the parties, and the philosophy of encouraging parties to know their partners, and *not* compelling members to admit outsiders, suggests that creditors who are not parties to the operating agreement are unlikely to be permitted to assert rights and urge duties owed to the LLC by its managers and members.

## VI. Conclusion

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The LLC entity form offers flexibility in the fiduciary duty realm. The ability of members to control which fiduciary duties and to whom they are owed is a significant advantage of the LLC form to a savvy drafter at the inception of the entity. Although state statutes and courts nationally have tended to find fiduciary duties in the LLC context, there is still much opportunity to control those duties by expanding, limiting, or eliminating them through the operating agreement. When creating an LLC, the drafter of an operating agreement should carefully consider the LLC’s members and what fiduciary duties are appropriate, if any. Additionally, the drafter should consider the LLC’s state statutes, recent court decisions, and the latest version of the ULLCA in order to have a full understanding of how fiduciary duties may be determined should an issue arise down the road with the LLC or its members.

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insolvent corporation, creditors cannot bring direct action against managers).

63. CML V, LLC v. Bax, 6 A.3d 238, 250 (Del. Ch. 2010), *aff’d*, 28 A.3d 1037 (Del. 2011), as corrected (Sept. 6, 2011).

64. *Id.*

65. *Id.*

66. ULLCA (1996) § 1102; ULLCA (2006) § 903; ULLCA (2013) § 803.