UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS

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A. The Source and Nature of Fiduciary Obligations in LLCs

1. Like a corporation, a limited liability company ("LLC") is organized under statute. Unlike corporations, there is no U.S.A. federal statute under which LLCs are organized.

2. As described in greater detail later, common law and Delaware, Florida and most other state LLC statutes provide for two basic fiduciary duties of directors of corporations and of managers and managing members of LLCs:

a. *Duty of care*, of which the elements are:

(1) Good faith;

(2) Care of a prudent person, *i.e.*, care that a person in a like position would reasonably exercise under similar circumstances; and

(3) Reasonable belief that the conduct or action is in the best interest of the LLC; but

(4) Subject to the business judgment rule.

b. *Duty of loyalty*, of which the elements are:

(1) Good faith; and

(2) Refraining from self-dealing, usurping an opportunity of the LLC, and receiving improper benefit, *i.e.*, acting solely or primarily for a personal or non-LLC purpose (but, if each self-interested manager or managing member of the LLC in a particular transaction or matter (a) does not control or dominate management of the LLC and its decision-making process and (b) discloses the self-interest to each other manager or managing member, then the action of management approving that transaction or matter is valid).

The element of good faith, *i.e.*, the duty to act in a manner that management reasonably believes to be in the best interests of the LLC and its owners

(members) is not a separate cause of action from the duties of care and loyalty. Stone v. Ritter, 911 A. 2d 362, 370 (Del. Supr. 2006).

3. *Duty of good faith and fair dealing* arises not from corporate or partnership statute or case law but from the principle of the common law of contracts referenced as the implied contract covenant of good faith and fair dealing ("ICCGFFD"). Fisk Ventures, LLC v. Segal *et al.*, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008)("In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations [among parties to the contract] must be found in the LLC agreement or some other contract [any of an LLC agreement, operating agreement, or other agreement among members of an LLC being referenced in these materials as "LLC Agreement"]."); TravelCenters of Am., LLC v. Brog, 2008 WL 1746987, at *1 (Del. Ch. April 3, 2008)("Limited Liability Companies are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved,'" quoting In re Grupo Dos Chiles, LLC, 2006 WL 668443 (Del. Ch. March 10, 2006); In re Seneca Invs. LLC, 970 A. 2d 259, 261 (Del. Ch. 2008) ("An LLC is primarily a creature of contract, and the parties have wide contractual freedom to structure the company as they sit fit."); 6 Del. C. Section 18-1101(b) (2010) (setting forth the policy of the Delaware LLC Act to "give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."). Although the Florida LLC Act, Chapter 608, Fla. Stat., does not contain an express provision comparable to the policy statement in the Delaware LLC Act, the Florida LLC Act also is a "default statute," including very few mandatory provisions regarding management operations, subjecting most provisions to the LLC Agreement, and permitting substantial freedom of contract of the members regarding the terms governing their relationship with each other and with the LLC.

a. Delaware law.

(1) ICCGFFD is a "judicial convention designed to protect the spirit of the agreement when, without violating an express term of the agreement,

one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain." Bakerman v. Grey Goose, 2006 WL 2987020 (Del. Ch. October 10, 2006), quoting the opinion in Chamison v. Healthtrust. Because ICCGFFD is a tool for contract interpretation by the trier of fact in determining the reasonable intention of the parties to a contract though not expressed in the contract, ICCGFFD is not waivable by the parties to the contract. ICCGFFD precludes "arbitrary or unreasonable conduct" by a contract party having the effect of preventing another party to the contract from receiving the "fruits of the bargain," taking advantage of that party's "position to control" implementation of the contract to frustrate its "overarching purpose." "Only parties to the contract can breach [ICCGFFD]" and, although ICCGFFD is not waivable, parties can avoid application of ICCGFFD by clear, express terms of the contract covering all contingencies prospectively important to them. "Courts should recognize the parties' freedom of choice exercise by contract and should not superimpose an overlay of common law fiduciary duties, or the judicial scrutiny associated with them, where the parties have not contracted for those governance mechanisms in the documents forming their business entity. . . . Use of common law fiduciary duty analysis should be used only 'where the contracting parties can be found to have defaulted into a status relationship by entering into [an LLC Agreement] that is silent on fiduciary duties, or have used language expressing the duties and liabilities of parties consistent with traditional fiduciary relationships in the corporate governance context. . . .When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law fiduciary duty principles analogized from the law of corporate governance. [Citations omitted.]" Steele, Myron T., C.J., Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 Del. J. Corp. L. 1, 4-6, 17, 21, 25 (2007). See also Fisk Ventures LLC v. Segal *et. al.*, *supra,* at *10 ("[B]ecause the implied covenant is *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue."); 23 Williston on Contracts Section 63.21 (4th ed. 2002) ("It is elementary

that one cannot imply a term or promise in a contract which is inconsistent with an express term of the contract itself.") and Section 63:22 (4th ed. 2002)("As a general principle, there can be no breach of the implied promise or covenant of good faith and fair dealing where the contract expressly permits the actions being challenged, and the defendant acts in accordance with the express terms of the contract.")

(2) Nemec v. Shrader, Witkemper v. Shrader, 991 A. 2d 1120 (Del. April 6, 2010) involved exercise by Booz Allen ("Booz") of its right under its Officers Stock Rights Plan (the "Stock Plan") to repurchase or redeem its stock from two of its retired employees, the plaintiffs, at book value, after the plaintiffs' two-year put rights expired, but before, and depriving the plaintiffs of their opportunity to participate in profits from, Booz' sale of its government business division. Citing Dunlap v. State Farm Fire & Cas. Co., 878 A. 2d 434, 441, 442 (Del. 2005)(which cited E.I. DuPont de Nemours & Co. v. Pressman, 679 A. 2d 436, 443 (Del. 1996) and Cincinnati SMSA Ltd. Pshp, v. Cincinnati Bell Cellular Sys. Co., 708 A. 2d 989, 992 (Del. 1998)) and Cont'l Ins. Co. v. Rutledge & Co., 750 A. 2d 1219, 1234, 1234 (Del. Ch. 2000)("The parties' reasonable expectations at the time of contract formation determine the reasonableness of the challenged conduct"), the Supreme Court of the State of Delaware affirmed the Chancellor's dismissal of the complaint, explaining dismissal of the count relating to ICCGFFD as follows:

"[ICCGFFD] involves a 'cautious enterprise,' inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated. '[O]ne generally cannot base a claim for breach of [ICCGFFD] on conduct authorized by the agreement.' We will only imply contract terms when the party asserting [ICCGFFD] proves that *the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.* When conducting this analysis, we must *assess the parties' reasonable expectations at the time of contracting and not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal.* Parties have a right to enter into good and bad contracts, the law enforces both. The plaintiffs lacked 'a reasonable expectation of participating in the benefits' of the Carlyle transaction. [*emphasis supplied*]"

The Court noted the Chancellor's findings that the Stock Plan explicitly authorized the redemption price and timing (distinguishing on its facts Amirsaleh v. Board of Trade of the City of New York, 2008 WL 4182998 (Del. Ch. September 11, 2008) as involving discretionary rights not specified by contract), all parties received the bargain described in the Stock Plan, and "[c]ontractually negotiated put and call rights are intended by both parties to be exercised at the time that is most advantageous to the party invoking the option." Acknowledging the dissenting argument that the redemption, in order not to contravene ICCGFFD, must "further a legitimate interest of the party relying on the contract," the Court observed that, although the redemption would not affect Booz directly, failure to redeem from the plaintiffs under Booz' "absolute contract right" would have adversely affected the working (not retired) stockholders, who then would have a potential claim against the directors for favoring the plaintiffs to the working stockholders. Directors receiving the same *pro rata* benefit as all other stockholders similarly situated, *i.e.*, working stockholders, did not make the redemption an "interested transaction." (The Court cited Aronson v. Lewis, 473 A. 2d 805 (Del. 1984).)

"*Delaware's [ICCGFFD] is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not*, that later adversely affected one party to a contract. Rather the covenant is a *limited and extraordinary legal remedy*. . . These appellants got the benefit of their actual bargain [citing Kuroda v. SPJS Holdings, L.L.C. *et al.*, 971 A. 2d 872, 888 (Del. Ch. April 15, 2009) ("[ICCGFFD] cannot be invoked to override express provisions of a contract.")]. *A party does not act in bad faith by relying on contract provisions for which that party bargained where doing so simply limits advantages to another party.* We cannot reform a contract because enforcement of the contract as written would raise 'moral questions' [citing Steele, Myron T., Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, *supra,* at 6] [*emphasis supplied*]."

The dissent argues that ICCGFFD applies more broadly when the challenged conduct fails to "further a legitimate interest of the party relying on the contract" even if that conduct is expressly authorized by the contract for which the parties bargained, and that, because the Stock Plan did not grant Booz the

redemption right in its "sole discretion," the exercise of that right should be examined under the principles of ICCGFFD, also citing Dunlap, *supra*, for the "arbitrary or unreasonable conduct" standard for invoking ICCGFFD despite express contract provisions authorizing the challenged conduct. Unlike the majority of the Court, the dissent concludes from the facts, examined on a basis favor to the plaintiffs for the purposes of defendants' motion to dismiss, that the Carlyle transaction, as timed in relation to the redemptions, was an "unforeseen circumstance not provided for by the Stock Plan" and regarding which, therefore, the parties could not be expected to have bargained, that the "working stockholders," which the majority stated Booz was justified in protecting and the interests of which the majority conflated with the interests of Booz as a matter of law, were not in fact parties to the Stock Plan ("The majority's *ipse dixit* puts the rabbit in the hat. . . .This attribution of the working stockholders' interest to Booz. . . magically puts a second rabbit into the same hat"), and that Booz, therefore, had no "legitimate interest" served by the redemption.

(3) Similarly, the Delaware Court of Chancery held in Related Westpac LLC *et al.* v. Snowmass LLC et JER *et al.*, C.A. No. 5001-VCS, 2010 WL 2929708 (Del. Ch. July 23, 2010) that, if the LLC Agreement provides clearly that one member has the right to withhold consent in circumstances specified by the LLC Agreement and not to make capital call payments in accordance with that member's own commercial interests, even if those inactions are "unreasonable" and frustrate the purposes of the LLC, fiduciary duties and ICCGFFD do not apply to "impose a contractual reasonableness overlay on a contract that is clearly inconsistent with the parties' bargain. Delaware law respects contractual freedom and requires parties like the operating member [plaintiff] to adhere to the contracts they freely enter." Plaintiff, a member and Operations Manager of two LLCs formed to pursue a land development project in Snowmass, Colorado, sued the defendant member, which was to provide most of the funding for the project, for refusing unconditionally to meet capital calls and consent to major decisions when the funding needs of the project exceeded the agreed upon budget, unless plaintiff gave defendant certain commercial benefits.

The Vice Chancellor dismissed the complaint, finding that, although the LLC Agreement provided that "the defendant member could not unreasonably withhold its consent to certain decisions," the "plain terms" of the LLC Agreement also provided that the defendant member was not subject to a "reasonableness" constrain in withholding its consent to "Material Actions" and "had contractually bargained to remain free to give or deny its consent if that was in its own commercial self-interest." The Vice Chancellor found, "Material Actions are defined [in the LLC Agreement] as anything that would 'require additional Capital Contributions' or 'involve any material change in the budget . . . or any line item therein.' . . . By contrast, the [LLC Agreement makes] clear that [the defendant member] could not 'unreasonably with[o]ld' consent on a range of other matters including taxes, terms of a 'co-list' arrangement, and the removal of . . . the 'Operations Manager' of [plaintiff]. . . . That is, none of the requests for action involve [defendant] reneging on a prior agreement to fund a certain project at a certain level, or to commit a certain level of capital in the future. Nothing in [the Business Plan attached to the complaint] or in the complaint alleges that these requests did not involve Material Actions because they were consistent with approved budgets or annual plans." *The Vice Chancellor's reasoning* that "The words 'not unreasonably withheld' are well known and appear in other sections of the [LLC Agreement]. They do not qualify the defendant member's right to deny consent to major decisions involving a material action," and "the [LLC Agreement] clearly state[s] the sole remedy the operating member has if the defendant member fails to meet a capital call [*i.e.*, to revoke the operating member's contribution or fund the non-contributing member's share]," *citation to and quotation from Fisk Ventures LLC v. Segal et al., supra, and Nemec v. Shrader, supra, and statement that plaintiff's proposed analogy of the facts of this case to "a contractual partner exercising control over joint venture assets by refusing to accede to certain action" is "inapt," indicates that this case involves contract interpretation under contract law rather than business entity law and highlights the significance of careful, consistent, comprehensive contract drafting*

to determinations of applicability or inapplicability of such rules of contract construction as ICCGFFD.

The Vice Chancellor also denied plaintiff's claim for unjust enrichment of defendant and defendant's members for defendant's not funding capital calls, defining "unjust enrichment" as an "unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience" (quoting Shock v. Nash, 732 A. 2d 217, 232 (Del. 1999)), quoting Kurdo, *supra*, at 891 ("[w]hen the complaint alleges an express, enforceable contract that controls the parties' relationship . . . a claim for unjust enrichment will be dismissed."), Ameristar Casinos, Inc. v. Resorts Int'l Holdings, LLC, 2010 WL 1875631, at *13 (Del. Ch. May 11, 2010)("If the defendant did not violate the contract governing the subject of the dispute, then the plaintiff cannot attempt to hold the defendant responsible by softer doctrines, and thereby obtain a better bargain than he got during the contract negotiations."), Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 872 A. 2d 611, 619 (Del. Ch. 2005)("When the complaint alleges an express, enforceable contract that controls the parties' relationship, . . . a claim for unjust enrichment will be dismissed."), *aff'd in part and rev'd on other grounds*, 901 Z. 2d 106 (Del. 2006), and Grunstein v. Silva, 2009 WL 4698541, *6 (Del. Ch. 2009)("[c]ourts will dismiss [a] breach of fiduciary duty claim where [it and a contract claim] overlap completely and arise from the same nucleus of operative facts."). Relying on these authorities, the Vice Chancellor held that, having failed to pursue the "sole remedy" under the LLC Agreement for defendant's failure to make capital contributions, plaintiff "cannot seek out an equitable avenue to remedy his claim" and "Under the [LLC Agreement, defendant] was left free to give consents to Major Decisions involving Major Actions as it chose, in its own commercial interest. That freedom was not qualified by any fiduciary duty of so-called 'reasonableness' and to imply such a duty in these circumstances would nullify the parties' express bargain [citing and quoting Nemec v. Shrader, at 1128]. Under our law dealing with alternative entities such as the LLCs here, this court may not do that. When a fiduciary duty claim is plainly inconsistent with the

contractual bargain struck by parties to an LLC or other alternative entity agreement, the fiduciary duty claim must fall, otherwise 'the primacy of contract law over fiduciary law in maters involving . . . contractual rights and obligations [would be undermined][*citation omitted*]."

(4) These *principles of contract interpretation* were previously applied in favor of the plaintiff *to apply traditional fiduciary duties when not expressly disclaimed by contract*, in the decision in Kelly v. Blum, *et al.,* C.A. No. 4516-VCP, 2010 WL 629850 (Del. Ch. February 24, 2010), in which a separate claim under ICCGFFD was dismissed because not specifically alleged. But *because the LLC Agreement of the manager-managed LLC does not "explicitly" expand, restrict or eliminate traditional fiduciary duties of loyalty and care, managers and controlling members of the LLC owe those duties to the LLC and its members and controlling members owe those duties to minority members (defined by the Vice Chancellor as "the traditional fiduciary duties that directors and controlling shareholders in a corporation would [owe]") as permitted by the Delaware LLC Act, 6 Del. C. Section 18-1101(c),* despite the LLC Agreement's exculpation clause limiting monetary liability of the LLC's managers for breaches of fiduciary duty to "willful" violations of their duty of loyalty or care (which precludes application of the "entire fairness" standard under the duty of loyalty), allegations of facts that the Vice Chancellor found could support a finding that defendants willfully caused the LLC to contract for a non-arm's length, unfair, self-dealing merger with another LLC solely to eliminate ("squeeze out") plaintiff's interest in the LLC were sufficient to allege willful breach of traditional fiduciary duties and survive the motion to dismiss the complaint. *Id.* at n. 70, which reads, "Having been granted great contractual freedom by the LLC Act, drafters of and parties to an LLC agreement should be expected to provide parties and anyone interpreting the agreement with clear and unambiguous provisions when they desire to expand, restrict, or eliminate the operation of traditional fiduciary duties." The Vice Chancellor distinguished Fisk Ventures, LLC v. Segal *et al.*, *supra*, involving an LLC Agreement that, unlike the LLC Agreement involved in Kelly Blum, *et al.*, stated "no member shall have any duty to any

[m]ember of the [LLC] except as expressly set forth herein or in other written agreements." *The significance of the quality of contract drafting is paramount, in determining any modification of traditional fiduciary duties of persons subject to those duties as well as in determining the reasonable expectation and intention of the parties at the time of contracting in applying, or determining that the language of the agreement is sufficiently clear not to apply, ICCGFFD.*. This decision is cited by, among other courts, the U.S. District Court for the Southern District of New York, in Amusement Indus. v, Stern (July 26, 2010) and Armstrong v. Collins, (March 24, 2010).

(5) The opinion of the Delaware Supreme Court in William Penn Partnership et al. v. Saliba, C.A. No. 11 (February 9, 2011) applies the fiduciary duties of managers of an LLC under an LLC Agreement that does not disclaim fiduciary duties in connection with the sale by the LLC of its sole asset in which those managers "acted in their own self interest and contrary to the interests of the other members" of the LLC, and the "entire fairness" defense to their liability, as follows:

"The parties here agree that managers of a Delaware [LLC] *owe traditional fiduciary duties of loyalty and care* to the members of the LLC, *unless the parties expressly modify or eliminate those duties in the [LLC Agreement.]* The [instant LLC Agreement] did not purport to modify or eliminate fiduciary duties and it name [defendants] as the managers of the LLC. Therefore, as fiduciaries the parties here agree that the [managers/defendants] owe fiduciary duties of loyalty and care to the members of [the LLC]. The [defendants] here acted in their own self interest by orchestrating the sale of [the LLC's] sole asset . . . on terms that were favorable to them. *By standing on both of the transaction*—as the seller, through their interest in and status as managers of [the LLC], and the buyer . . . *they bear the burden of demonstrating the entire fairness of the transaction*. . . . The concept of *entire fairness consists of two blended elements: fair dealing and fair price Fair dealing involves analyzing how the transaction was structured, the timing, disclosures, and approvals. Fair price relates to the economic and financial considerations of the transaction.* We examine the transaction as a whole and both aspects of the test must be satisfied; a party does not meet the entire fairness standard simply by showing that the price fell within a reasonable range that would be considered fair. [*Emphasis supplied*]"

The Court held that, "*without full disclosure* to the other members of [the LLC,] it *is impossible to demonstrate [or meet the manager's burden of establishing fair*

dealing or] that the sale was entirely fair, no matter what the price. The [managers/defendants] manipulated the sales process through misrepresentations and repeated material omissions . . . . While fair dealing and fair price are distinct concepts, the burden to establish them is not bifurcated. Rather, this Court must *evaluate a transaction as a whole to determine if the interested party has met his burden of establishing entire fairness*. . . . Merely *showing that the sale price was in the range of fairness . . . does not necessarily satisfy the entire fairness burden when fiduciaries stand on both sides of a transaction and manipulate the sales process*. Here, the [managers/defendants'] manipulation of the sales process denied [the other members/plaintiffs] the benefit of knowing the price as fair bidding process might have brought [*emphasis supplied*]."

(6) *Also highlighting the importance of clear contract drafting,* see Blue Chip Capital Fund v. Tubergen, 906 A. 2d 827 (Del. Ch. August 22, 2006)(interpretation of preferred stock provision of charter); Accipiter Life Sciences Fund v. Helfer, 905 A. 2d 115, 124 (Del. Ch. August 2, 2006)(securities laws violations may also breach ICCGFFD); Kahn v. Portnoy, 2008 WL 5197164 (Del. Ch. December 11, 2008)(if the LLC Agreement provisions exculpating management from fiduciary duties are poorly drafted, then those provisions are not applied when "a director does not act in good faith if the director acts with the substantive belief that her actions are not in the best interest of the corporation. . . This is classic, quintessential bad faith."); Bay Center Apartments Owner, LLC v Emery Bay PKI, LLC, 2009 WL 1124451 (Del. Ch. April 20, 2009) (if the LLC Agreement provisions exculpating management from fiduciary duties are poorly drafted, those provisions are not applied when a manager did not fulfill its implied responsibility to assure that the LLC performed all of its contract obligations). See Altman, "Delaware Alternative Entities," 60 Business Lawyer, 1469, 1475 (August 2005).

b. Although courts of other jurisdictions generally apply the same standards in determining applicability of ICCGFFD (*e.g.*, PurCo Fleet Services, Inc. v. Koenig, (08CA 1677, Colo. Appl. 2010)), courts of other jurisdictions, particularly California, might decide otherwise on the same facts and contract language of Nemec v. Shrader, *supra*, and Related Westpac LLC *et al.* v. Snowmass LLC et JER al, *supra*. See Ruotolo v. Ruotolo, No. CV095026804, 2009 WL 5698124 (Conn. Super. December 29, 2009); Pointer v. Castellani, 918

N.E. 2d 805 (Mass. 2009) (involving termination of a member's employment by the LLC and "freeze-out" allegedly without a "legitimate business purpose"); "Legal Realism, the LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing," 45 Wake Forest Law Review 729 (2010).

c. Traditional fiduciary duty and ICCGFFD, however, generally are *not applied* to persons other than managers and controlling members of an LLC.

(1) They were not applied, in Kuroda v. SPJS Holdings, L.L.C., *et al.*, Civil Action No. 4030-CC, 2010 WL 925853 (Del. Ch. March 16, 2010) to the plaintiff, a "trusted consultant" and investment analyst to an investment manager to an LLC, which LLC was the general partner of an investment fund. The plaintiff, who sought payments allegedly due to him under an LLC Agreement, allegedly had a "central role in the LLC Agreement," exposure to "high-level proprietary and confidential information" regarding the investment manager and the funds, received compensation in his capacity as a non-managing member of the general partner of one of the funds and as a shareholder of the corporation through which plaintiff provided services to the investment manager, resigned abruptly after disagreements with management of the funds, and then established a fund to compete directly with the funds, used the investment strategy and other confidential information of the investment manager, solicited investors in the funds, and disparaged the investment manager, in breach of his consulting agreement. The defendants counterclaimed based upon, among other theories, plaintiff's alleged breach of fiduciary duty and ICCGFFD. Dismissing those counterclaims, Chancellor Chandler reasoned, "[Plaintiff] Kuroda was not a fiduciary to anyone who has alleged any harm—or to anyone on whose behalf parties have alleged harm—and there is no factual or legal basis to which defendants point me that suggests otherwise. Pursuant to the LLC Agreement, Kuroda was a Non-Managing Member of [the general partner of one of the managed funds] who had no control, power, or authority over a single investor's assets or the actions that [the general partner] took. He was neither a manger of [the general partner] nor a controlling member, and he thus has no fiduciary duties [citing and quoting Kelly v. Blum, *et al.*, supra]. No matter how

'central' [plaintiff] Kuroda was to the entire business endeavor, his centrality was governed by contractual duties, not fiduciary ones." Quoting from William Shakespeare's Romeo and Juliet, Act 2, Scene 2, and from Lewis Carroll's Alice's Adventures in Wonderland and Through the Looking Glass 69 (Hugh Haughton ed., Penguin Books 2010)(1865), the Chancellor added, "Among those additional duties defendants seek me to impose are fiduciary ones on an individual who clearly is not a fiduciary. This I cannot do. A rose by any other name may smell as sweet, but calling [plaintiff] Kuroda a fiduciary here would smell of inaccuracy—and imposing upon him ex post some kind of fiduciary duties would reek of injustice. Had defendants wanted everyone to enjoy a rose of fiduciary duty, they should not have planted white roses of contractual obligations and now ask me to paint over them."

(2) Similarly, the court in In re South Canaan Cellular Investments, LLC and South Canaan Cellular Equity, LLC; South Canaan Cellular Investments, LLC and South Canaan Cellular Equity, LLC v. Lackawaxen Telecom, Inc., 427 B.R. 85 (Bankr. E.D. Penn. 2010), citing Kelly v. Blum, *et al.*, *supra*, and Kuroda v. SPJS Holdings, L.L.C., *et al.* (March 16, 2010), *supra*, held that Delaware common law does not impose fiduciary or other related duties on LLC members other than managers and controlling members in the absence of express provisions of the LLC Agreement prescribing such duties and ICCGFFD does not apply unless it is clear in the LLC Agreement that the parties would have agreed to prohibit the alleged wrongdoing (*i.e.*, purchase by a non-controlling, non-manager member of LLC indebtedness) had they considered it when negotiating the LLC Agreement. In any event, the Delaware LLC Act permits a member to engage in transactions with the LLC and to receive confidential information regarding the LLC that the LLC did not object to providing to that member if the LLC Agreement does not permit these actions, and ICCGFFD does not prevent a non-fiduciary from acting in his own best interests. Semble, Entertainment Merchandising Technology, L.L.C. v. Houchin, 720 F. Supp. 2d 792 (N.D. Texas 2010) (the existence of fiduciary duties between members of a Texas LLC is a question of fact, not law).

(3) Also see Christopher's Partner, LLC v. Christopher's of Colonie, LLC, 893 N. Y. S. 2d 689 (App. Div. 3rd Dept. 2010) (provision of LLC Agreement prohibiting members from taking action making it impossible to carry on the LLC's business in the ordinary course does not preclude a member from seizing assets of the LLC in which the member has a security interest for a loan by the member to the LLC, in accordance with the security agreement, because the LLC Agreement permitted loans by members to the LLC and the New York statute gives a member who becomes a creditor of the LLC the same and rights and obligations as a person who is not a member of the LLC. *Cf.*, Cheney v. IPD Analytics, L.L.C., No. 08-23188-CIV, 2009 WL 3806171 (S.D. Fla. August 28, 2009).

(4) But see Mattern & Associates, L.L.C. v. Seidel, 678 F. Supp. 2d 256 (D. Del. 2010) (Pennsylvania law provides for a duty of loyalty by a minority member who is an employee, as an agent, to his employer.

4. Revised Uniform Limited Liability Company Act (2006) ("RULLCA") Section 409 provides for the following duties of managers, or members of a member-managed LLC, to the LLC and, subject to Section 901(b)(the plaintiff member must plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the LLC), to other members of the LLC:

a. Fiduciary duty of care of members of a member-managed LLC, or of managers of any LLC (but not the members of a manager-managed LLC), in the conduct and winding up of the LLC's activities ("Manager Actions"), to act (1) with the care that a person in a like position would reasonably exercise under similar circumstances, (2) in a manner that the managing member or manager reasonably believes to be in the best interests of the LLC, *each subject to* (3) the business judgment rule (discussed below) and (4) the right of the managing member or manager to rely in good faith on opinions, reports, statements or other information provided by another person that the managing member or manager reasonably believes is a competent and reliable source for the information;

b. Fiduciary duty of loyalty of members of a member-managed LLC, or of managers of any LLC (but not the members of a manager-managed LLC), which "includes" the duty to (1) account to the LLC and hold as trustee for it any property, profit or benefit derived by the managing member or manager from Manager Actions, use by the managing member or manager of LLC property or appropriation by the managing member or manager of an LLC opportunity, (2) refrain from dealing with the LLC in Manager Actions as or on behalf of a person having an adverse interest to the LLC (but it is a defense of a managing member or manager, but not of a member, to a claim of conflict of interest under this provision or any comparable claim in equity or at common law that the transaction is "fair" to the LLC), and from competing with the LLC in the conduct of the LLC's activities before its dissolution (in the case of a manager-managed LLC, before completion of winding up of the LLC), *but* (3) all of the members (but not the managers) of any LLC may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

c. Duty of members of any LLC, to discharge the duties under this statute or the LLC Agreement and exercise any rights consistently with ICCGFFD; and

a member of a manager-managed LLC does not have any fiduciary duty to the LLC or to any other member solely by reason of being a member of the LLC. See Katris v. Carroll, 843 N.E. 2d 221 I(Ill. App. 1 Dist. 2005).

5. The Florida LLC Act, in Sections 608.4225 and 608.4226, Fla. Stat. (2006), is similar to Section 409 of RULLCA (2006) except that:

a. Under Section 608.4225(1)(b), "the duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law" and, under Section 608.4225(2) and (4), the information, opinions, reports or statements on which a manager or managing member may rely in discharging the duties thereof are more limited than under RULLCA;

b. Under Section 608.4225(1)(a), the duty of loyalty "is limited to" the duties specified in that provision;

c. Under Section 608.4225(1)(a)3, the duty not to compete continues until dissolution of the LLC (not until completion of winding up of the LLC) for a manager as well as for a managing member;

d. Under Section 608.4225(1)(d), "[a] manager or managing member does not violate a duty or obligation under [the Florida LLC Act] or under the articles of organization or [LLC Agreement] merely because the manager's or managing member's conduct furthers such manager's or managing member's own interest," under Section 608.4225(1)(e), "a manager or managing member may lend money to and transact other business with the [LLC and as] to each loan or transaction, the rights and obligations of the manager or managing member are the same as those of a person who is not a member, subject to other applicable law, and under Section 608.4226, Fla. Stat., the defense to any claim of conflict of interest as a breach of the duty of loyalty is (a) disclosure or knowledge of the relationship or interest by the managers, managing members or committee that authorized the contract or transaction by vote or consent sufficient for the purpose (affirmative vote of a majority of the managers or managing members, or of the committee, having no relationship or interest in the transaction) without counting the vote or consent of each interested member, manager or managing member, or (b) disclosure or knowledge of the relationship or interest by all of the members entitled to vote and their authorization of the contract or transaction by vote or written consent of a majority-in-interest of the members entitled to be counted under this provision, or (c) the contract or transaction being "fair and reasonable" as to the LLC when it is authorized by the managers, managing members, a committee or the members;

e. Under Section 608.4225, Fla. Stat., "each manager and managing member [of the LLC] shall discharge the duties to the [LLC] and its members under [the Florida LLC Act] or under the articles of organization or [LLC Agreement] and exercise any rights consistent with ICCGFFD";

f. Under Section 608.4225, Fla. Stat., "[i]n discharging a manager's or managing member's duties, a manager or managing member may consider such factors as the manager or managing member deems relevant, including he long-term prospects and interests of the [LLC] and its members, and the social, economic, legal, or other effects of any action on the employees, suppliers, customers of the [LLC], the communities and society in which the [LLC] operates, and the economy of the state and the nation";

g. Under Section 608.4225(5), "[a] manager or managing member is not liable for any action taken as a manager or managing member, or any failure to take any action, if the manager or managing member performed he duties of the manager's or managing member's position in compliance with [Section 608.4225]" and

h. Under Section 608.4227(2) and (3), "[a]ny . . . member, managing member, manager or other person acting under the articles of organization or [LLC Agreement] of a [LLC] is not liable to the [LLC] or to any such other member, managing member, or manager for the member's, managing member's, manager's, or other person's good faith reliance on the provisions of the [LLC's] articles of organization or [LLC Agreement]; and . . . [t]he member's, managing member's, manager's, or other person's duties and liabilities may be expanded or restricted by provisions in a [LLC's] articles of organization or [LLC Agreement]" subject to the provisions of Section 608.423, Fla. Stat. restricting provisions of the LLC Agreement, but not of the articles of organization, regarding, among other matters, the duty of care and the duty of loyalty.
See Foster-Thompson, LLC v. Thompson, 2007 WL 1725198 (M.D. Fla. 2007).

6. In the absence of clear statutory or contract provisions to the contrary, judicial authorities in Delaware and elsewhere acknowledge that persons controlling an alternative business entity other than a corporation, such as an LLC, may not use their control position for personal benefit to the detriment of other beneficial owners of the enterprise under theories analogous to the fiduciary duties of directors of corporations. *E.g.*, Kelly v. Blum *et al*., *supra*; Weil v.

Morgan Stanley DW Inc., 877 A.2d 1024, 2005 WL 1774113 (Del. Ch. 2005) (applying California contract law to determine that defendant's sale of plaintiff's brokerage account without plaintiff's consent did not breach any fiduciary duty of defendant, the Vice Chancellor explained, "Typically, fiduciary duties are imposed when someone exercises dominion and control over the assets and property of another such that the controlling person should be prohibited from dealing with those assets and property in a manner that unfairly profits himself."), *aff'd* 894 A. 2d 407 (2005); In re OODC, LLC, 321 B.R. 128 (Bankr. D. Del. 2005) (the court found that a person not an officer, director or majority owner of the LLC nevertheless had actual control over the LLC); In re McCook Metals, L.L.C., 319 B.R. 570 (Bankr. N.D. Ill. 2005) (usurpation of corporate opportunity principles apply to managers of an LLC). *Cf.*, Risk Management Services, L.L.C. v. Moss, 40 So. 2d 176 (La. App. 2010); Chiu v. Chiu, 896 N.Y.S. 2d 132 (App. Div. 2d Dept. 2010); DirectTV Latin America, LLC v. Park 610, LLC, 691 F. Supp. 2d 405 (S.D.N.Y. 2010); One to One Interactive, LLC v. Landrith, 920 N.E. 2d 303 (Mass. App. 2010) (relying on case law regarding fiduciary duty of shareholders of closely held corporations and all members having asserted fiduciary duty claims against one another, thereby precluding denial of the fiduciary duty of the other members); Pointer v. Castellani, *supra;* Cottone v. Selective Surfaces, Inc., 892 N.Y.S. 2d 466 (App. Div. 2d Div. 2009); Mooring Capital Fund, LLC v. Comstock North Carolina, LLC, No. 07 CVS 20852 (N.C. Super. November 13, 2009); Moede v. Pochter, No. 07 C 1726, 2009 WL 4043418 (N.D. Ill. November 20, 2009); Searing v. Grocki, No. X03CV084041080S, 2009 WL 3839295 (Conn. Super. October 21, 2009) (not every member owes a fiduciary duty to every other member of an LLC); Abdalla v. Qadorh-Zidan, 913 N. E. 2d 280 (Indiana App. 2009); In re Yellowstone Mountain Club, LLC, (Credit Suisse v. Official Committee of Unsecured Creditors), 415 B.R. 769 (D. Mont. 2009); Domestic Construction, LLC v. Bank of America, N.A., No. CV07-5357BHS, 2009 WL 2853255 (W.D. Washington September 1, 2009).

7. Even if one LLC member fails to prove damages or have an interest in a successor entity formed by another LLC member when that other member unilaterally dissolved the LCC and used its assets in the new enterprise in breach of fiduciary duty, because the claimant LLC member made no capital contribution to the LLC, the *breaching member may be assessed court costs* in the proceeding and ordered to obtain the release of the claimant from his guaranty of a loan to purchase those assets or indemnify the claimant from that guaranty. Cline v. Grelock, C.A. No. 4046-VCN, 2010 WL 761142 (Del. Ch. March 2, 2010).

8. Insolvent LLCs.

a. Courts have upheld management's acting consistent with a fiduciary duty to creditors of the LLC at the expense of the interests of the owners of the LLC if, in doing so, fiduciary duties to all relevant constituencies were met. Blackmore Partners, L.P. v. Link Energy, LLC, 864 A. 2d 80, 2005 WL 2709639 (Del. Ch. 2004).

b. The Supreme Court of Delaware, however, held in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla *et al.*, 930 A. 2d 92 (Del. 2007) that, under Delaware law, if a corporation enters the "zone of insolvency" or is "insolvent," its directors do not acquire a new direct fiduciary duty to its creditors, but, rather, its directors continue to owe fiduciary duties to the corporation and its shareholders to maximize the value of the corporation. The court noted in *dictum*, however, that a creditor of an insolvent corporation could bring a derivative action for breach of fiduciary duty by a director because the creditors, not the shareholders, of an insolvent corporation are harmed by its directors' breach of their fiduciary duties. The same test probably applies to an insolvent LLC. See In re Wheland Foundry, LLC Reese and Armor v. Livingston Company, 2007 Bankr. LEXIS 3439 (Bankr. E.D. Tenn. October 5, 2007) (applying the Georgia law of formation of the LLC). See also Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A. 2d 168 (Del. Ch. 2006), *aff'd* 931 A. 2d 438 (2007); In re CLK Partners, LLC, Case No. 09-506162010, Bankr. LEXIS 1564 (Bankr. WD La. May 12, 2010) and In re

Hydrogen, L.L.C., 431 B.R. 337 (Bankr. S.D.N.Y. 2010) (no independent cause of action against management exists based on "deepening insolvency"); In re Midway Games, Inc., 428 B.R. 303 (Bankr. Del. 2010); Vichi v. Koninklijke Philips Electronics N.V., Civil Action No. 2578-Vcp, 2009 WL 4345724 (Del. Ch. December 1, 2009).

c. But see JP Morgan Chase Bank v. KB Home, 632 F. Supp. 2d (D. Nev. 2009) (holding that, under Nevada law, managers of an insolvent LLC owe fiduciary duties to its creditors); In re Hydrogen, L.L.C., *supra* (finding that Ohio courts are split regarding the liability of management of LLCs directly to its creditors and aiding and abetting liability, and New York law recognizes a cause of action for aiding and abetting a breach of fiduciary duty); In re Mervyn's Holdings, LLC (Mervyn's LLC v. Lubert-Adler Group IV, LLC), 426 B.R. 488 (Bankr. D. Del. 2010)(California law clearly imposes duties on a controlling LLC member to an insolvent LLC's creditors); Colborne Corporation v. Weinstein, 2010 WL 185416 (Colo. App. January 21, 2010, pet. granted) (under Colorado law, after Sheffield Services Co. v. Trowbridge, 211 P. 3rd 714, 720 (Colo. App. 2009), managers of an insolvent LLC owe to creditors the same fiduciary duty owed by directors and officers of an insolvent corporation, *i.e.*, the limited duty to avoid favoring their own interests over creditors' claims); Acadian Energy Resources, LLC and J. Howard Bass & Associates, Inc. v. Carpenter, *et al.*, Civil Action No. 2:09-00150, 2009 WL 5217679 (S.D. W. Va. December 31, 2009) (West Virginia law recognizes the duty of an LLC manager to the insolvent LLC's creditor); In re Supplemental Spot, LLC (Floyd v. Option One Mortgage Corporation), 409 B.R. 187 (Bankr. S. D. Tex. 2009) (officers of an insolvent Texas corporation have fiduciary duties to its creditors).

d. Some courts (*e.g.*, Colborne Corporation v. Weinstein, supra) limit the duties of management to creditors of an insolvent entity to the duty of loyalty not to favor their interests over those of creditors or engage in self-dealing or preference. See Alexander v. Anstine, 152 P. 3rd 497 (Colo. 2007) and Pinnacle Labs, LLC v. Goldberg, No. 07-C-196-S, 2007 WL 2572275 (W.D. Wis. September 5, 2007).

e. Unlike Delaware corporations, however (involved in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, *et al.*, *supra*, Delaware LLCs are governed by a statute (6 Del. C. Section 18-1001(2010)) expressly limiting derivative provisions to members and assignees on which, therefore, creditors of any LLC may not rely for standing to sue for breach of fiduciary duty to the LLC. CML V, LLC v. Bax *et al.*, 6 A.3d 238, C.A. No. 5373-VCL, 2010 WL 4347927 (Del. Ch. November 3, 2010). The Florida LLC Act, in Section 608.601(1), Fla. Stat., similarly provides, "A person may not commence a proceeding in the right of a domestic or foreign [LLC] unless the person was a member of the [LLC] when the transaction complained of occurred or unless the person became a member through transfer by operation of law from one who was a member at that time." But consider the potential effect of the decision of the Florida Supreme Court in Olmstead, *et al.* v. Federal Trade Commission, 44 So. 3rd 76, 2010 WL 2518106 (Florida June 24, 2010), including its implications for multi-member as well as single-member LLCs formed under Florida law, at least pending the legislative "patch" to Section 608.433, Fla. Stat. expected to be considered by the Florida Legislature in Spring 2011. Pending adoption of that "patch," some experienced Florida business transactions and tax attorneys are converting or reorganizing existing Florida LLCs to LLCs, or forming new LLCs, under the law of Delaware or Wyoming (the first jurisdiction in the U.S.A. to adopt an LLC statute). Contrast Section 608.433, Fla. Stat. (permitting an assignee's charging order for a share of profits and losses and allocation of income, gain, loss, deduction or credit or similar item to which the assignee was entitled, in addition to distributions) with 6 Del. C Section 18-703(a) (2010)(permitting an assignee's charging order only for distributions).

f. Derivative claims would cease to exist upon filing of a bankruptcy petition by or with respect to a corporation. At least one court, applying Georgia law, has held that the same rules apply to distinguishing derivative from direct causes of action for an LLC as for a corporation. In re Wheland Foundry, LLC, Reese and Armor v. Livingston Company, *supra.* But a member of a bankrupt LLC may have standing to claim equitable subordination against other LLC

members based on alleged breach of their fiduciary duties. In re J.S. II, LLC, 389 B.R. 570 (Bankr. N.D. Ill. 2008)(7th Cir.). Also see Davis v. Yageo Corp., 481 F. 3rd 661 (9th Cir. 2007) and One to One Interactive, LLC v. Landrith, *supra*.

B. Identifying and Protecting the Rights of Minority Interest Holders

1. Rights to inspection of books and records and notice.

a. Most state LLC statutes provide for the express procedures and conditions for demands by minority, non-managing members for inspection of books and records of the LLC. For example, Section 410 of RULLCA provides, in relevant part:

(1) On reasonable notice, a member may inspect and copy during regular business hours, at a *reasonable locations* specified by the LLC, any records maintained by the LLC regarding its activities, financial condition and other circumstances, *to the extent the information is material to the member's rights and duties under the LLC Agreement or RULLCA*.

(2) The LLC shall furnish to each member: (a) without demand, any information concerning the LLC's activities, financial condition, and other circumstances which the LLC knows and is *material to proper exercise of the member's rights and duties under the LLC Agreement or RULLCA*, except to the extent the LLC can establish that it *reasonably believes* the member already knows the information; and (b) on demand, any other information concerning the LLC's activities, financial condition, and other circumstances, *except to the extent the demand or information demanded is unreasonable or otherwise improper under the circumstances.*

b. The Florida LLC Act, in Section 608.4101, Fla. Stat. (2002), provides, in relevant part:

(1) "A [Florida LLC] shall provide members and their agents and attorneys access to its records at the [LLC's] principal office or other *reasonable locations* specified in the [LLC Agreement.] The [LLC] shall provide former members and their agents and attorneys access *for proper purposes* to

records pertaining to the period during which they were members. The right of access provides the opportunity to inspect and copy records during ordinary business hours. The [LLC] may impose a *reasonable charge*, limited to the costs of labor and material, for copies of records furnished.[*emphasis supplied*]" (subsection (2))

(2) "A [Florida LLC] shall furnish to a member, and to the legal representative of a deceased member or member under legal disability: (a) [w]ithout demand, information concerning the [LLC's] business or affairs *reasonably required for the proper exercise of the member's rights and performance of the member's duties* under the [LLC Agreement] or the [Act]; and (b) [o]n demand, other information concerning the [LLC's] business or affairs, *except to the extent the demand or the information demanded* is *unreasonable or otherwise improper under the circumstances*. [*emphasis supplied*]"(subsection (3))

c. Delaware law.

(1) 6 Del. C. Section 18-305 in the Delaware LLC Act (2010) provides, in relevant part, that (a) each member of a Delaware LLC "has the right, subject to such *reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense)* as may be set forth in a [LLC Agreement] or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the [LLC] from time to time *upon reasonable demand for any purpose reasonably related to the member's interest as a member of the [LLC]:* (1) [t]rue and full information regarding the *status of the business and financial condition* of the [LLC]; (2) [p]romptly after becoming available, a copy of the [LLC's] federal, state and local income tax returns for each year; (3) [a] current list of the name and last known business, residence or mailing address of each member and manager; (4) [a] copy of any written [LLC Agreement] and certificate of formation and all amendments thereto, together with executed copies of any written powers of attorney pursuant to which the [LLC Agreement] and any certificate and all amendments thereto have been executed; (5) [t]rue and full

information regarding the amount of cash and a description and statement of the agreed value of any other property or services contributed by each member and which each member has agreed to contribute in the future, and the date on which each became a member; and (6) *[o]ther information regarding the affairs of the [LLC] as is just and reasonable.*" Subsection (f) of this statute was amended in 2010 to provide that, in an action to enforce rights under the statute, the Court of Chancery may summarily order the LLC to permit examination by the demanding member of all information described above, and that the time period for the LLC to respond to the demand may be varied from the five business days stated in the statute to "such shorter or longer period of time as is provided for in a [LLC Agreement] but not longer than 30 business days." Under Delaware law, unlike Florida law, the burden of establishing reasonableness of a demand for inspection is on the demanding member, not on the LLC and the LLC Agreement, or managers or members of the LLC, may impose reasonable standards upon disclosure to members.

(2) In a competitive business environment mandating maintenance of confidentiality of an LLC's business records, the Delaware Chancery honored provisions of the LLC Agreement giving its managing members discretion to impose reasonable and appropriate restrictions on inspection by a non-controlling member (sought by that member in connection with the LLC's capital call) in order to safeguard confidential or proprietary information in the business records, including requiring the member to sign and deliver to the LLC a confidentiality agreement, but found the LLC's insistence on inspection only by a principal of the member, rather than by a third-party designee or representative of the member, to be unreasonable. NAMA Holdings, LLC v. World Market Center Venture, LLC, 948 A. 2d 411 (Del. Ch. 2007).

(3) A claim for inspection under Delaware LLC Act, 6 Del. C. Section 18-305 must allege facts sufficient to state a "proper purpose" for the inspection. TravelCenters of America LLC v. Brog, 2008 WL 868107 (Del. Ch. March 31, 2008).

(4) The Delaware Chancery found that a LLC amended its LLC Agreement in a manner that, as implemented, did not any way purport to limit a member's rights to obtain information under Section 18-305(a) but only limited a member's rights to obtain a broader array of information provided under the LLC Agreement before that amendment, and, therefore, that amendment did not require approval or adoption of the amendment "by all of the members or in compliance with any applicable requirements of the [LLC Agreement.]" under Section 18-305(g), in Ross Holding and Management Company, *et al.* v. Advance Realty Group, LLC *et al.* , Case No. 4113-VCN, 2010 WL 3448227 (Del. Ch. September 2, 2010).

(5) The Delaware Chancery honored provisions of a LLC Agreement requiring disclosures to members under specified circumstances, *e.g.*, information in connection with election of the LLC's management that would be required to be disclosed in proxy soliciting materials for an annual meeting of shareholders of an entity subject to the proxy rules of the Securities and Exchange Commission under the federal Securities Exchange Act of 1934, as amended (the "1934 Act"), in TravelCenters of America LLC v. Brog, C.A. No. 3516-CC (Del. Ch. April 4, 2008).

(6) The Delaware Chancery held that a "proper purpose" that was "reasonably related" for a member's demand for inspection of books and records of a Delaware LLC under Section 18-305(a) includes evaluation of that member's interest in the LLC after dilution of without his knowledge before he became a member, in the absence of any limit or standard governing members' rights to inspect books and records imposed by the LLC Agreement or the LLC's members or manager, even if those books and records pre-dated his formally becoming a member so long as he was a member at the time of demand, in Sanders v. Ohmite Holding, LLC, C.A. No. 5145-VCL (February 21, 2011). Examples of "proper purpose" recognized by the court as a basis for inspection, if alleged (even in not proven) were (a) valuing a member's own ownership interest and wrongful dilution, (b) investigating potential wrongdoing, and (c) a "credible basis from which the Court of Chancery can infer there is possible

mismanagement that would warrant further investigation" or possible breach of the duty of loyalty by management.

2. Rights in connection with mergers, consolidations, sales of substantially all of the assets, conversions, and other transactions outside the ordinary course of business of the LLC.

a. Oppression and freeze-out.

(1) Junge v. Bartles, Docket No. 285035, 2009 WL 3365842 (Mich. App. October 20, 2009) involved three equal membership interests members of a Michigan LLC, two of whom purchased the membership interest of the plaintiff but allegedly failed to pay the agreed upon purchase price in full before they formed another entity that took over the business of the LLC with the employees and for the same customers as the LLC. The Court of Appeals found that plaintiff, having accepted in consideration for his membership interest a check and a promise by the other two members to pay additional amounts to him, did not have a cause of action for "conversion" but did have a cause of action for "oppression" under the Michigan LLC Act, which provides for relief, including an equitable remedy (as distinguished from a "money judgment" on which plaintiff would have been entitled to interest) of the plaintiff's proportionate share of the book value of the LLC, for a member that establishes that controlling managers or members engage in "willfully unfair and oppressive conduct," *i.e.*, a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the member as a member.

(2) See, *e.g.*, Kelly v. Blum, *et al.*, *supra*, William Penn Partnership et al. v. Saliba, *supra* (the doctrine of "entire fairness"), One to One Interactive, LLC v. Landrith, *supra,* and Pointer v. Castellani, *supra.*

(3) Subject to certain restrictions and procedures, unless modified, restricted or eliminated by the LLC Agreement, a member of a Florida LLC is entitled to appraisal rights, and to obtain payment of the fair value of that member's membership interest, in connection with the consummation of a merger or conversion of the LLC under the Florida LLC Act, if the member possessed the

right to vote upon the merger or conversion, respectively, under Section 608.4352-608.43595, Fla. Stat. The Delaware LLC Act, 6 Del. C Section 18-101 (2010) *et seq*., includes no such provisions. The LLC Act of the state of formation of each LLC determines the existence of such a provision.

C. Restrictions on Fiduciary Obligations

1. Business Judgment Rule

a. The factors presumed to exist in judicial inquiry regarding management's decisions, which the challenging party has the burden of alleging do not exist, are comparable to those used by courts in reviewing decisions of corporate directors:

(1) Absence of self-dealing, conflict of interest and improper financial benefit;

(2) Independence and good faith of decision makers and control persons; and

(3) Decisions made on an informed basis, after consideration of relevant materials and appropriate deliberations and discussion, include advice of management, lawyers, accountants and investment bankers.

E.g., In re ALH Holding LLC, 675 F. Supp. 2d 462 (D. Del. 2009) ("In addition to any contractual limitations upon fiduciary duties that the members of an LLC might agree upon, the business judgment rule protects directors from spurious claims against their exercise of discretion in an effort to 'promote the full and free exercise of the managerial power granted to Delaware directors.'"); Blackmore Partners, L.P. v. Link Energy, LLC, *supra.*

b. Contrast In re Derivium Capital, LLC (Campbell v. Cathcart), 380 B.R. 407 (Bankr. D.S.C. 2006)(noting that the business judgment rule applies only when there is a reasonable basis to indicate that the transaction was undertaken in good faith and does not apply in cases of self-dealing, fraud or other unconscionable conduct). The rule also does not protect gross negligence or willful misconduct, *e.g.*, In re BHS&B Holdings LLC (Official Committee of

Unsecured Creditors v. Bar Harbour Masters Ltd., 420 B.R. 112 (Bankr. S.D.N.Y. 2009); DCXpress, L.L.C. and Sanders v. Briggs, 2009 WL 3199213 (Ark. App. 3rd Div. 2009).

c. An enhanced standard for applying the rule is used in mergers and acquisitions transactions, beyond the scope of this seminar. See Smith v. Van Gorkom, 488 A. 2d 858 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1985); and Unocal Corp. v. Mesa Petroleum Col., 493 A. 2d 946 (Del. 1985). See William Penn Partnership et al. v. Saliba, *supra* (the doctrine of "entire fairness").

2. Contract restrictions authorized by statute

a. Like ICCGFFD, common law fiduciary duties apply to control persons of LLCs only to the extent that the LLC Agreement does not provide a standard for their conduct or the common law standard would not conflict with an express provision of the LLC Agreement.

b. The Delaware LLC Act, 6 Del. C Sections 18-101 (2010) *et seq*., provides:

(1) The LLC Agreement *may* expand, restrict or eliminate any duties, including fiduciary duties, of a member, manager or other person to the LLC or another member, manager or another party to or bound by the LLC Agreement (each, an "LLC Party") *but cannot eliminate ICCGFFD*;

(2) Unless the LLC Agreement otherwise provides, no member, manager or other person is liable to the LLC or any LLC Party for breach of fiduciary duty in good faith reliance on provisions of the LLC Agreement; and

(3) The LLC Agreement *may* limit or eliminate any or all liabilities for breach of contract and any duties, including fiduciary duties, of a member, manager or other person to the LLC or any LLC Party *but cannot eliminate liability for any act or omission constituting bad faith violation of ICCGFFD.*

See, *e.g.*, Kelly v. Blum, *et al., supra;* In re BHS&B Holdings LLC (Official Committee of Unsecured Creditors v. Bar Harbour Masters Ltd., 420 B.R. 112 (Bankr. S.D.N.Y. 2009), *supra;* Steele, Myron T., C.J., Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, *supra.* Under Delaware law, "a contractual claim will preclude a fiduciary duty claim, so long 'as the duty sought to be enforced arises from the parties' contractual relationship'" exclusively and not from the relationship giving rise to the fiduciary duty related to the same or similar conduct. The court found fiduciary duty claims to stand independently because they arose under defendant's duty of loyalty under the LLC Agreement, whereas the breach of contract claims arose under a different agreement, in PT China LLC v. PT Korea LLC, C. A. No. 4456-VCN, 2010 WL 761145 (Del. Ch. February 26, 2010).

c. Section 110 of RULLCA (2006) states that the LLC Agreement, being "pivotal" to RULLCA according to the commentary, *may* do each of the following:

(1) If not manifestly unreasonable, (a) eliminate the fiduciary duty of loyalty to account or hold as trustee described in paragraph IV.A.4.b(1) above, or to refrain from dealing or competing with the LLC described in paragraph IV.A.4.b(2) above, (b) identify specific types or categories of activities that do not violate the duty of loyalty, (c) alter the duty of care, except to authorize intentional misconduct or knowing violation of law, (d) alter any other fiduciary duty, including eliminating particular aspects of that duty, and (e) prescribe standards by which to measure performance of ICCGFFD;

(2) Specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts;

(3) Eliminate or limit any fiduciary duty that would have pertained to any responsibility of a member of a member-managed LLC to the extent that the LLC Agreement expressly relieves that member of that

responsibility that such member otherwise would have under RULLCA and imposes that responsibility on one or more other members;

(4) Alter or eliminate indemnification provided by RULLCA for a member or manager, or eliminate or limit a member's or manager's liability to the LLC and its members for money damages except for breach of the duty of loyalty, a financial benefit received by the member or manager to which the member or manager is not entitled, a breach of duty under Section 406 (improper distributions), intentional infliction of harm on the LLC or a member, or intentional violation of criminal law.

d. The Florida LLC Act, in Section 608.423, Fla. Stat., provides that the LLC Agreement *may not* do any of the following, in relevant part, among other things:

(1) Unreasonably restrict a right to information or access to records under Section 608.4101, Fla. Stat.;

(2) Eliminate the duty of loyalty under Section 608.4225, Fla. Stat., but *may* (a) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable, and (b) specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(3) Unreasonably reduce the duty of care under Section 608.4225, Fla. Stat.;

(4) Eliminate ICCGFFD under Section 608.4225, Fla. Stat., but *may* determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

D. Securities Law Considerations

1. Membership interests in manager managed LLCs are likely to be, and some member managed LLCs may be, categorized by the courts as "securities"

for the purposes of federal and state ("blue sky") securities laws, whether considered

a. an "investment contract" under Securities and Exchange Commission v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946)(defining, as a matter of law, an "*investment contract*" as "*a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4]solely from the efforts of the promoter or a third party*," which four-element analysis is commonly known as the "*Howey Test*" *(emphasis supplied)*),

b. "stock" under Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985), or

c. a "note" under Reves v. Ernst & Young, 494 U.S. 56 (1990).

The Securities Act of 1933, 15 U.S.C. Section 77b(a)(1), and the 1934 Act, 15 U.S.C. Section 78c(a)(10), define a "security" as, among other instruments, "any note, stock, . . . investment contract, . . . , or, in general, any interest or instrument commonly known as a "security." See Landreth Timber Co. v. Landreth, *supra* at 686 n. 1 to the effect that the definitions of "security" in these federal statutes differ only slightly and generally are treated as identical in meaning.

The U. S. Court of Appeals for Fourth Circuit observed in Robinson v. Glynn LLC, 349 F. 3d 166 (2003) that "[s]ince Howey, however, *the [U.S.] Supreme Court has endorsed relaxation of the requirement that an investor rely only on others' efforts, by omitting the word 'solely' from its restatements of the Howey test [emphasis supplied]*" (citing International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 561 (1979)(quoting United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975)(the "Coop City" case)) and reasoned that *"[w]hat matters more than the form of an investment scheme is the 'economic reality' that it represents [emphasis supplied]*" (citing Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F. 2d 236, 240 n. 4 and 240-41 (4th Cir. 1988)). Also see Burke, George A., Jr., "Limited Liability Companies and

the Federal Securities Laws: Congress Should Amend the Securities Laws to Avoid Coverage, " Vol. 76:749 Indiana Law Journal (2001).

The U.S. Court of Appeals for the Second Circuit similarly applied a facts and circumstances, "case-by-case analysis" of the facts and "economic realities" of the underlying transaction to determine that certain LLC membership interests constituted an "investment contract" and, therefore, "securities" under the Howey Test in U.S. v. Leonard, 529 F. 3d 83, 2008 WL 2357233 (2008), noting, as the court in Robinson v. Glynn LLC, *supra* noted, that the phrase in the Howey Test, "solely from the efforts of" should not be interpreted literally, but rather by considering "whether, under all the circumstance, the scheme was being promoted primarily as an investment or as a means whereby participants could pool their own activities, their money and the promoter's contribution in a meaningful way" so that the distinction lies "between companies that seek the 'passive investor' and situations where there is a 'reasonable expectation . . . of significant investor control.'" Because an LLC is a hybrid vehicle combining elements of the traditional corporation with those of a general partnership with flexibility for federal tax purposes, the Court determined not to apply a "bright-line rule" regarding classification of LLC interests as securities because of "the myriad variations" LLC may take. In Leonard, albeit the LLC's organizational documents purported to give the LLC members significant and active management roles, the Court found that the investors in fact played a "very *passive role [emphasis supplied]*" in the management of the LLC and "exercised little or no control," and, therefore, their LLC interests were "securities," distinguishing on that basis the facts in (a) Robinson v. Glynn LLC, *supra,* (b) Keith v. Black Diamond Advisors, Inc., 48 F. Supp. 2d 3236 (S.D.N.Y 1999)("[I]f at the time of his investment . . .Keith did not *intend to be a passive investor*, as he clearly did not, the . . . interests could not be securities. Furthermore, although *the degree of control he actually exercised was less than he expected to exercise*, that fact *does not convert his interests into securities [emphasis supplied]*") and (c) Great Lakes Chemical Corp. v. Monsanto Co., 96 F. Suppl. 376 (D. Del. 2000)(although the interest holders in an LLC generally

had no authority to manage that LLC, the 100% interest holder had the power to remove any member from the managing board with or without cause and to dissolve the LLC, undiluted "by the presence of other ownership interests"). The Second Circuit summarized the "economic reality" element of the Howey Test as follows: "*The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment*. [*emphasis supplied*]"

2. Even if membership interests in an LLC are determined not to be "equity securities" for the purposes of the federal Securities Exchange Act of 1934, as amended, or the LLC has fewer than 500 holders of record of those interests and $1,000,000 or less in assets, so that the membership interests are not required to be registered under that statute, which would trigger the requirement of filing periodic reports and proxy solicitation materials with the Securities and Exchange Commission ("SEC"), compliance with the anti-fraud disclosure rules of SEC and state blue sky commissioners is required in connection with the offer, purchase or sale of all securities, including compliance with the SEC's Rule 10b-5 promulgated under Section 10(b) of the 1934 Act:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

The U. S. Supreme Court has found a rebuttable presumption of "reliance" on a statement or omission (the securities law stand in for the "cause" element of fraud and other torts) by an investor in the following circumstances:

a. If there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972).

b. Under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public.

The private right of action (*i.e.,* cause of action by a private party rather than by the SEC, the Attorney General or another governmental authority) that the Supreme Court found implied in Section 10(b) and Rule 10b-5, in Superintendent of Insurance of State of New York v. Bankers Life and Casualty Co., 404 U.S. 6, n. 9 (1971), does not extend to aiding and abetting a Section 10(b) violation, see Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). "Section 10(b) does not incorporate common-law fraud into federal law . . . and should not be interpreted to provide a private cause of action against the entire marketplace in which the issuing company operates, *cf.* Blue Chip Stamps et al. v. Manor Drug Stores, 421 U.S. 723 n. 5 [1975]." Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. (2008) (affirming and remanding to the U.S, Circuit Court for the Eighth Circuit, which dismissed the complaint of securities fraud by customers and suppliers of a company that had agreed to arrangements allowing that company to mislead its auditor and issue a misleading financial statement affecting its stock price, but that had no role in preparing or disseminating the financial statement nor made misstatements relied upon by the public nor violated a duty to disclose)

3. Each state blue sky law may impose a different consequence with respect to membership interests determined to be securities under that law, including among others requirements for offerings of membership interests to residents of that state and securities broker/dealer registration requirements for receiving a commission or other compensation for offers and sales of membership interests in that state.

4. See Accipiter Life Sciences Fund v. Helfer, *supra*; Elipas v. Jedynak, No. 07 C 3026, 2010 WL 1286795 (E.D. Ill. March 26, 2010); In re Brisbin (Oliver

Holdings, Inc. v. Brisbin), Bankruptcy No. 08-12236-SSC, Adversary No. 08-AP-937, 2010 WL 276755 (Bankr. D. Ariz. January 19, 2010); J. Stan Developments, LLC v. Lindo, No. 2008-CA-001796, 2009 WL 3878084 (Ky. App. November 20, 2009); Gordon v. Elite Consulting Group L.L.C., No. 08-CV-10772, 2009 WL 4042911 (E.D. Mich. November 19, 2009).