

Avoiding Fiduciary Duty Uncertainty

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Duties Imposed by Statute

- Fiduciary duties are expressly imposed on members and managers by statute.
 - Recognized by the Idaho Supreme Court in *Bushi v. Sage Health Care, PLLC*, 203 P.3d 694, 146 Idaho 764 (Idaho 2009)
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Duties Imposed by Statute

- I.C. § 30-6-409 governs the standards of conduct for members and managers of a LLC created before July 1, 2015.
 - I.C. § 30-25-409 governs the standards of conduct for members and managers of a LLC created after July 1, 2015.
 - I.C. § 30-25-409 will govern the standards of conduct for members and managers of all LLCs after July 1, 2017.
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Manager–Managed LLCs

- Managers of a manager–managed LLC owe duties of loyalty and care to the LLC and its members. I.C. § 30–25–409(i)(1)
 - Non–managing members of a manager–managed LLC do not owe duties of loyalty and care to the LLC and its members. I.C. § 30–25–409(i)(1)
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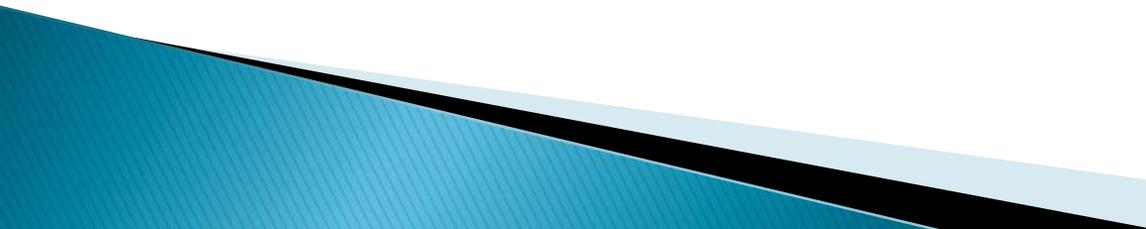


Default Provisions – Duty of Loyalty

Members of a member–managed LLC owe a duty of loyalty to the LLC and its members, including duties

- **APPROPRIATION OF LLC PROPERTY OR OPPORTUNITIES:** To account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
 - In the conduct or winding up of the company's activities and affairs;
 - From a use by the member of the company's property; or
 - From the appropriation of a company opportunity;
- **ADVERSE TRANSACTION**--To refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company; and
- **COMPETITIVE ACTIVITIES.** To refrain from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.

I.C. § 30–25–409(a) and (b)



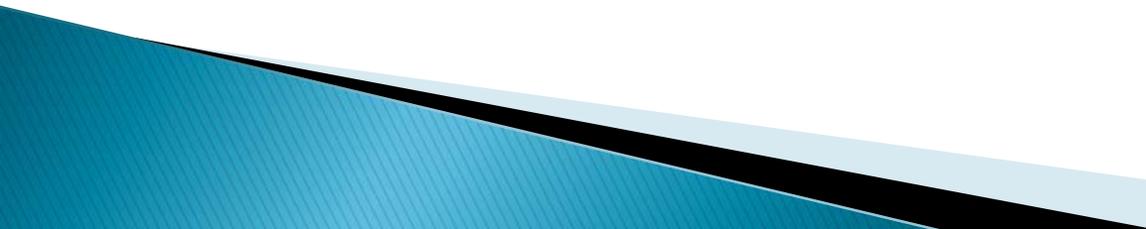


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 - In the conduct or winding up of the company's activities and affairs;
 - From a use by the member of the company's property; or
 - From the appropriation of a ~~limited liability~~ company opportunity;
- To refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company; and
- To refrain from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.

I.C. § 30–25–409(a) and (b)



Default Provisions – Duty of Care

Members of a member–managed LLC owe a duty of care to the LLC and its members

I.C. § 30–25–409(c)

- The duty of care of a member of a member–managed limited liability company in the conduct or winding up of the company's activities and affairs is to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or knowing violation of law.
 - The gross negligence standard is a lower standard of care than the “business judgment” standard previously imposed.

I.C. § 30–6–409(3)

- Subject to the business judgment rule, the duty of care of a member of a member–managed limited liability company in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. In discharging this duty, a member may rely in good faith upon opinions, reports, statements or other information provided by another person that the member reasonably believes is a competent and reliable source for the information.
 - In concept, if not in uniform application, the business judgment rule serves the important function of protecting directors and managers from judicial second–guessing in cases in which an informed business decision has been made in the absence of self–dealing.



Changes to the Duty of Care

refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or knowing violation of law.

versus

act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company.

Much lower standard now



Default Provisions – Good Faith and Fair Dealing

- Members of member–managed and manager–managed LLCs and managers of manager–managed LLCs are required to discharge the duties and obligations under this chapter or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing. I.C. § 30–25–409(d) and (i)(3)
 - Good faith is more of a subjective standard
 - Fair Dealing is more of the objective standard



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Example of how Fiduciary Duties Arise

- ▶ Assume Oil Inc. is a manager of several LLCs organized to explore, develop, and produce crude oil and natural gas in Idaho. Each LLC has different members. Oil Inc. identifies a valuable interest in land and producing properties that it seeks to acquire and is in the process of determining which of the LLCs it will select to undertake the acquisition process. Oil Inc. is aware that this situation presents a conflict of interest.
 - In accordance with its duty of loyalty under I.C. 30-25-409 Oil Inc., as manager of the LLCs, must refrain from competing with, and appropriating an LLC opportunity from, the LLCs, and must act in good faith in its dealings with the LLCs in connection with the acquisition process.

Four Methods through which those with management power in a LLC can proceed with conduct that would otherwise violate fiduciary duties

- ▶ Use operating Agreement to alter or amend Fiduciary Duties.
 - ▶ Use Operating Agreement to define certain conduct as non-violations .
 - ▶ Have all members ratify the conduct after full disclosure.
 - ▶ In the case of self-dealing the conduct might be successfully defended as being or having been fair to the limited liability company.
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Why Limit Express Statutory Duties

- Reduce your client's potential liability.
 - Allow flexibility in structure.
 - Reduce future expenses by addressing potential issues during the honeymoon period
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Defenses to Breach of Duty Claims

- ▶ It is a defense to a claim that a member in a member-managed liability company has acted on behalf of a person having *an adverse interest* to the company that the transaction was fair to the limited liability company. I.C. 30-25-409(g).
- ▶ In addition, all of the members of a member-managed limited liability company or a manager-managed limited liability company may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the *duty of loyalty*. I.C. 30-25-409(f).

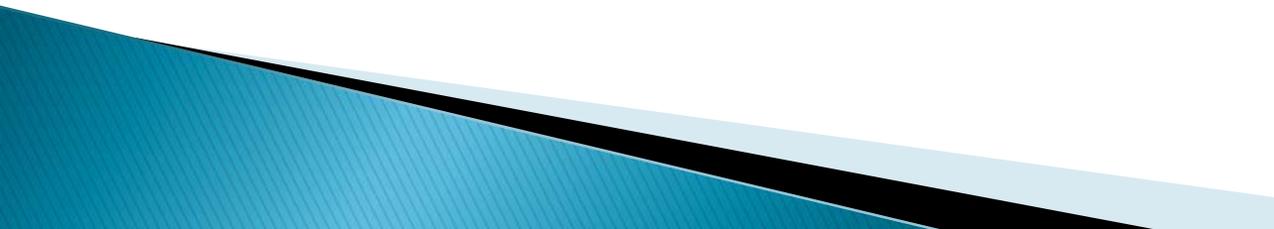


Limiting Fiduciary Duties by Relieving Member Responsibilities

I.C. § 30-25-105(d)(2)

- To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member otherwise would have under this chapter and imposes the responsibility on one (1) or more other members, the agreement also may eliminate or limit any fiduciary duty of the member relieved of the responsibility that would have pertained to the responsibility.

I.C. § 30-6-110(6)

- To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member would otherwise have under this chapter and imposes the responsibility on one (1) or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate or limit any fiduciary duty that would have pertained to the responsibility.
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Ability to Alter or Eliminate the Duty of Loyalty

- An operating agreement may not alter or eliminate the duty of loyalty, except that if not **manifestly unreasonable** an operating agreement may alter or eliminate the duties:
 - To account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
 - In the conduct or winding up of the company's activities and affairs;
 - From a use by the member of the company's property; or
 - From the appropriation of a company opportunity;
 - To refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company; and
 - To refrain from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.
- If not **manifestly unreasonable**, an operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty.

I.C. § 30-25-105(c)(5) and (d)(3)



Example of identifying specific types or categories of activities that do not violate the duty of loyalty.

- ▶ The members of a real estate holding company may currently or in the future want to own commercial real estate individually or with others, and not be required to own such other real estate through the LLC or even with the same members. Thus, an operating agreement for a real estate holding company may identify certain types or categories of activities that do not violate the duty of loyalty, such as:
 - *Other Interests.* A Member may, directly or indirectly, own and/or manage other real estate. Neither the Company nor any other Members shall have any right, by virtue of this Agreement, to share or participate in the ownership or management of such other real estate of the Member or to the income or proceeds derived therefrom.

Another Example of identifying specific types or categories of activities that do not violate the duty of loyalty.

- *Related Transactions.* Each Member and the Affiliates of a Member may, without violating the duty of loyalty, loan monies, lease real and personal property, sell goods and provide services to, and transact other business with, the Company, *provided* that such transactions are on terms commercially fair and reasonable to the Company and no less favorable to the Company than those generally being provided to or available from unrelated third parties.



Ability to Alter or Eliminate the Duty of Care

- An operating agreement may not completely eliminate the duty of care under the 2008 or the 2015 legislation.
 - Under the 2015 legislation, if not **manifestly unreasonable**, an operating agreement may alter the duty of care, but may not authorize conduct involving bad faith, willful or intentional misconduct, or knowing violation of law. I.C. § 30-25-105(d)(3)(C).
 - Under the 2008 legislation, if not **manifestly unreasonable**, an operating agreement may alter the duty of care, except to authorize intentional misconduct or knowing violation of law. I.C. § 30-6-110(4)(c).
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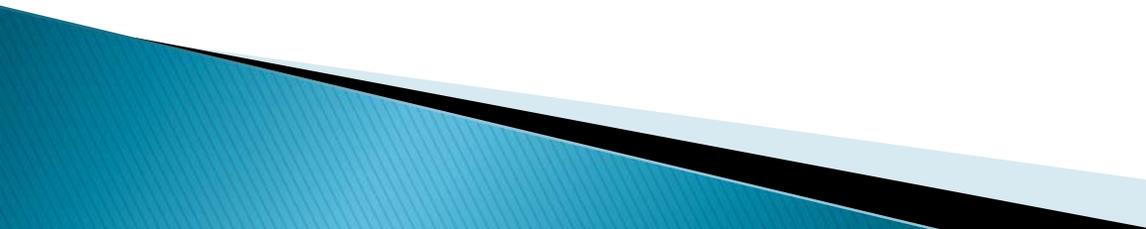


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 - Under the 2008 legislation, if not manifestly unreasonable, an operating agreement may alter the duty of care, except to authorize intentional misconduct or knowing violation of law. I.C. § 30-6-110(4)(c).
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Ability to Alter or Eliminate Other Fiduciary Duties

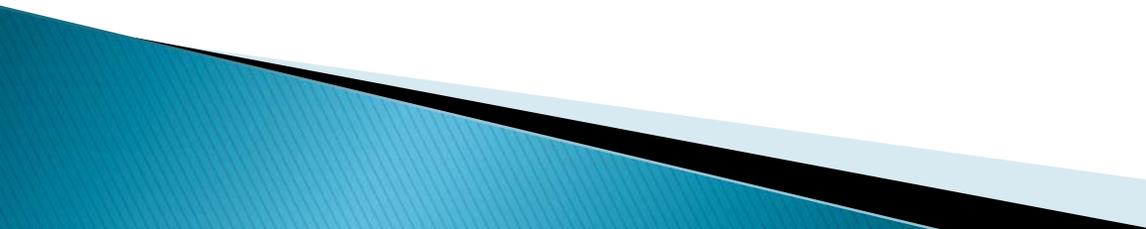
- Under the 2015 legislation, if not **manifestly unreasonable**, an operating agreement may alter or eliminate any other fiduciary duty. I.C. § 30-25-105(d)(3)(D).
 - Under the 2008 legislation, an operating agreement may not eliminate any other fiduciary duty, except if not **manifestly unreasonable**, an operating agreement may alter any other fiduciary duty, including eliminating particular aspects of that duty I.C. § 30-6-110(3)(d) and (4)(d).
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What is Manifestly Unreasonable

- Whether a term is manifestly unreasonable is determined as a matter of law.
- The determination is made as of the time the challenged term became part of the operating agreement.
- The determination is made by considering only circumstances existing at the time the challenged term became part of the operating agreement.
- A term may only be invalidated, if in light of the LLC's purposes, activities, and affairs it is readily apparent that 1) the objective of the term is unreasonable or 2) the term is an unreasonable means to achieve the provision's objective.

I.C. § 30-25-105(e)



Examples of When you would want to alter Fiduciary Duties of Members

- ▶ Members with multiple real estate companies could be permitted to devote time to management of other real estate investments, including properties that might compete in the same marketplace.
- ▶ Health care entities often lease property owned by one of the members. In this instance, the operating agreement should provide that the member may lease the building to the entity without violating the duty to account to the company for the profits derived from the lease.
- ▶ A family LLC could authorize members to use the LLC's vacation cabin for personal purposes.

See Nicole C. Trammel, Fiduciary Duties in Limited Liability Companies, 52 Advocate 20, 21 (2009)

Recommendations

- Do not include overly broad provisions which simply state the parties waive any and all fiduciary duties.
 - Be specific when altering the duties set forth by statute, but include catchall clauses.
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More Examples

- ▶ Sample language for Operating Agreements (not necessarily based on Idaho law)



Example 1 –

18. Fiduciary Duties, Outside Business, Etc.

18.1 Fiduciary Duties.

(a) Standard of Care.

(i) Exculpation. No Manager or officer shall be liable to the Company or any future Member for an act or omission done in good faith to promote the Company's best interests, unless the act or omission constitutes gross negligence, intentional misconduct or a knowing violation of law.

(ii) Justifiable Reliance. Each Manager and officer may rely on the Company's books and records maintained in good faith and on information, opinions, reports or statements received from any person pertaining to matters such Person reasonably believes to be within the Person's expertise or competence.

(b) Competing Activities. The Member may participate in any business or activity, including those that do or may compete with the Company directly or indirectly, without accountability to any Person, including to the Company, and including any accountability for any profit, benefit or compensation received in connection with such actions or relationships, none of which shall be void or voidable by reason of such relationship. The Company recognizes that the Member is or may be engaged in the same or similar businesses as the Company, whether independently or with others, and that neither the continuation and/or development of such business opportunities, nor the failure to disclose any information relating thereto, will give rise to a cause of action or claim by the Company against the competing Member or business, for any of the profits thereof, and the Company shall not have any rights with respect to such other business.



Example 2 – Joint Venture

(a) **Waiver of Fiduciary Duties.** Notwithstanding any other provision of this Agreement or any other applicable provision of law or equity, to the fullest extent permitted by Applicable Law (including Section 18–1101(c) of the Act), no Manager shall have any fiduciary or similar duty, or any liability relating thereto, to the Company or any Member that is not affiliated with such Manager, with respect to or in connection with the Company or the Company Business or affairs; *provided, however,* that, the foregoing shall in no way eliminate or limit the liability of any Manager: (i) for any breach of such Manager’s covenant of good faith and fair dealing (it being understood that each Manager shall owe the same covenant of good faith and fair dealing that a director of a corporation organized under the laws of the State of Delaware would owe to such corporation, except that, any actions taken by such Manager on behalf of a Member that are permitted to be made by such Member pursuant to this Agreement shall not be considered to be a breach of such covenants), (ii) for acts or omissions taken or made not in good faith or that involve willful misconduct, gross negligence or a knowing violation of law or (iii) for any transaction from which such Manager derived an improper direct personal benefit, excluding any indirect benefit derived from such Manager’s equity or other financial interest in a Member.





Example 2 – Joint Venture

(e) **Limitation of Duties; Conflict of Interest.** To the maximum extent permitted by Applicable Law, the Company and each Member hereby waives any claim or cause of action against each Manager and each other Member and their respective Affiliates, employees, agents and representatives for any breach of any fiduciary duty to the Company or its Members by any such Person, including, without limitation, as may result from a conflict of interest between the Company or its Members and such Person or otherwise; *provided, however*, that with respect to actions or omissions of a Person, such waiver shall not apply to a breach of Section 8.6(a), as determined by a final judgment, order or decree of an arbitrator or a court of competent jurisdiction (which is not appealable or with respect to which the time for appeal therefrom has expired and no appeal has been perfected). Each Member acknowledges and agrees that in the event of any such conflict of interest between any Person and the Company, each such Person may, in the absence of bad faith, act in the best interests of such Person or its Affiliates, employees, agents and representatives (subject to the limitations set forth above). No Manager or Member shall be obligated to recommend or take any action in its capacity as a Manager or Member that prefers the interests of the Company or its Members over the interests of such Person or its Affiliates, employees, agents or representatives.





Example 3

12. Standards of Conduct. Whenever the Member is required or permitted to make a decision, take or approve an action, or omit to do any of the foregoing, then the Member shall be entitled to consider only such interests and factors, including its own, as it desires, and shall have no duty or obligation to consider any other interests or factors whatsoever. To the extent that the Member has, at law or in equity, duties (including, without limitation, fiduciary duties) to the Company or any other person bound by the terms of this Agreement, such duties are hereby expressly limited to the implied contractual covenant of good faith and fair dealing. To the fully extent permitted by the Nevada Act and other applicable law, the Member acting in accordance with the Agreement shall not be liable to the Company or any such other person for its good faith reliance on the provisions of this Agreement, or for any act or omission constituting a breach of contract or breach of duties, other than an act or omission that constitutes a bad faith violation of the implied covenant of good faith and fair dealing. The provisions of this Agreement, to the extent that they restrict the duties of the Member otherwise existing at law or in equity, replace such other duties to the greatest extent permitted under applicable law

