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Proposed Revisions to the LLC Act

2010 SPRING CONVENETION OF THE UTAH STATE BAR

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Policies

- “Business Friendly”
 - Favor toward entity, management & owners
 - Freedom of contract
- Uniformity
 - Structure
 - Content

Utah Revised Limited Liability Company Act

- Utah enacted first LLC act in 1991
- Revised LLC Act was enacted in 2001
- Not viewed favorably nationally
 - Not “Business Friendly”
 - “Frankenstein Statute”

URLLCA is a Hodgepodge of other Statutes

- Utah Revised Business Corporations Act
- Utah Revised Uniform Limited Partnership Act
- Utah Professional Corporation Act
- Utah Revised Nonprofit Corporation Act
- The Prototype Act
- The Uniform Limited Liability Company Act
- LLC Statutes of California, Colorado, Connecticut, Delaware, Mississippi, North Carolina, New York, Virginia, and Washington

Perceived Defects (Utah Act)

- Overall Structure – Frankenstein effect
- No allowance of oral operating agreements
- Inadequate asset protection
- Subordination of creditor-member claims
- Subordination of creditor claims for costs and expenses of winding up
- Undue extension of statutory apparent authority
- Inflexible in delegation of authority
- Confusing use of term “capital account”
- Default provision for allocation of “profits” and “loss” may conflict with Internal Revenue Code and Treasury Regulations
- Conflicting requirements to terminate a series

Overall Structure

- Many state LLC Acts are based on RUPA
 - Uniform LLC Act
 - ABA Prototype Act
- Utah Act
 - Uneven flow
 - Not easily comparable with other state acts

No Oral Operating Agreements

- The Utah Act requires that operating agreements must be in writing
- An oral operating agreement is nullified and the default provisions of Utah Act apply
- Can result in unexpected business results
 - No oral “profits interest”
 - Voting, allocations and distributions based on capital

Inadequate Asset Protection

- Foreclosure vs. Charging Order
- Charging Order
 - a lien on a debtor-member's LLC interest
 - operates like a garnishment and requires the LLC to pay over amount that would otherwise go to debtor-member to creditor until the debt is satisfied
 - When the judgment creditor is satisfied in full, the rights to receive distributions from the LLC are fully restored to the debtor-member

Subordination of Creditor-Members

- Utah Act penalizes member-creditors
 - by subordinating their creditor interests behind non-member-creditors in liquidation
- Utah Act penalizes service providers
 - by subordinating non-member-creditors such as accountants, attorneys, and employees who provide services during the winding up period of an LLC

Subordination of Creditor-Members

A member may become a creditor of an LLC in a number of ways:

- Lend money (secured or unsecured) to LLC;
- Provide services to LLC for remuneration;
- Sell goods to LLC on credit;
- Right to receive indemnification payments
- Right to reimbursement for expenses paid by member on behalf of LLC
- Lease real or personal property to LLC

Subordination of Creditor-Members

- Asset distributed in winding up in the following order and priority:
 - First, to pay or satisfy the liabilities of creditors other than members, in the order of priority established by law;
 - Second, to pay or satisfy the liabilities to members in their capacity as creditors;
 - Third, to pay or satisfy the expenses or costs of winding up the LLC;
 - Thereafter, to the members.
- Utah Act prohibits the alteration of the super priority rights granted to non-member-creditors without such non-member-creditor's consent

Undue Extension of Apparent Authority

- Generally: the Uniform Partnership Act of 1914 codified a particular type of apparent authority based on position, providing that:

“[t]he act of every partner ... for apparently carrying on in the usual way the business of the partnership binds the partnership.”

- Third Party Reliance: Third parties dealing with general or limited partnerships know by the entity’s legal name and the status of the partner whether the person has the power to bind the partnership.
- As applied to LLCs:
 - Member-managed LLC: each member, as a member, has apparent authority.
 - Manager-managed LLC: only managers have statutory apparent authority, and members, as members, have no statutory agency authority

Undue Extension of Apparent Authority

- **Problem** – What if the members do not want every manager in a manager-managed LLC or every member in a member-managed LLC to have apparent authority?
 - For example, Board of Managers
- The Utah Act provides:

“an act of a manager ... binds the company unless the manager had no authority to act for the company in the particular matter and the lack of authority was expressly described in the articles of organization or the person with whom the manager was dealing knew or otherwise had notice that the manager lacked authority.” § 48-2c-802(2)(c) (emphasis added)

Undue Extension of Apparent Authority

- Any limitation on a manager's (or member's) authority must be **expressly** set forth in the articles of organization to be effective against third parties.
- Limitations set forth only in the operating agreement will only be effective against third parties with knowledge of such lack of authority.

Inflexible in Delegation of Authority

- Delegation of Authority only permitted if comply with:
 - Must be in writing
 - Scope and Duration must be in writing
 - Power to revoke at any time shall be retained by member or manager
 - Delegation shall not include any power of substitution
 - Delegation by a member or manager does not cause such member/manager to cease to be such
- Problem: Corporate management structure with officers would not traditionally comply with delegation requirements.

Confusing Use of Term “Capital Account”

- The Utah Act uses “capital accounts” to determine:
 - Voting rights (§ 48-2c-803.1)
 - Profit and loss allocations (§ 48-2c-906)
 - Non-liquidating distribution rights (§ 48-2c-1001)
 - Liquidating distribution rights (§ 48-2c-1308(2))
- A member’s “capital account” is determined differently under the Utah Act than under the Internal Revenue Code and related Treasury Regulations
- Problem areas:
 - 704(c) – property contributed with built-in gain
 - 752 – basis for debt resulting in negative capital accounts
 - Regulatory Allocations (e.g. loss limitations, minimum gain chargeback rules, qualified income offset, etc.)

Default Allocations of Profits and Losses

- Default rule allocates profits and losses based on “capital accounts”
- Default rule will conflict with tax rules under certain circumstances
- Certain statutes are silent as to how profits and losses are allocated
 - Corporate statute (including S-Corps)
 - Revised Uniform LLC Act
 - Revised Prototype LLC Act
- Each of these acts contain distribution provisions but lets the Internal Revenue Code determine how profits/losses are allocated

Conflicting Requirement to Terminate Series

- Delaware came up with the concept of a “Series” LLC in 1995
- “Series” LLCs was added to the Utah Act in 2006
- Language for the Utah Act was taken from the Delaware Act
- §48-2c-613(3) corresponds to §18-215(k)(3) – BUT certain changes were made to facilitate numbering.
- These changes changed the meaning resulting in conflicting terms

Conflicting Requirement to Terminate Series

UTAH ACT §48-2c-613(3)

(c) unless otherwise provided in the operating agreement, the affirmative vote or written consent of:

(i)(A) the members of the limited liability company associated with the series; or

(B) if there is more than one class or group of members associated with the series, by each class or group of members associated with the series; ***and***

(ii) (A) members associated with the series who own more than 2/3 of the then-current percentage or other interest in the profits of the series owned by all of the members associated with the series; or

(B) the members in each class or group of the series, as appropriate;

(Emphasis added)

DELAWARE ACT §215(k)

(3) Unless otherwise provided in the limited liability company agreement, upon the affirmative vote or written consent of the members of the limited liability company associated with such series or, if there is more than 1 class or group of members associated with such series, then by each class or group of members associated with such series, ***in either case, by*** members associated with such series who own more than two-thirds of the then-current percentage or other interest in the profits of the series of the limited liability company owned by all of the members associated with such series or by the members in each class or group of such series, as appropriate;

(Emphasis added)

No Perpetual Term

- Prior to “check-the-box” many LLC statutes had a maximum term so as to lack the corporate characteristic of “continuity of life”
- “Check-the-Box” regulations were adopted in 1996
- Delaware and other states started permitting perpetual life LLCs starting in 1997
- Utah still does not permit perpetual LLCs – maximum term is 99 years (*see* §48-2c-404(4)(c) and (5))

Conversion of Domestic LLCs to Foreign Entities

- §48-2c-1401 through §48-2c-1406 deal with “conversions”
- An entity may convert to a domestic LLC by: [§48-2c-1401(2)]
 - Complying with requirements of §48-2c-1404
 - If involving a foreign entity – laws governing such foreign entity must permit conversion
 - Timely filing of any document required by jurisdiction governing foreign entity
 - Requisite approval of conversion and new operating agreement
 - Filing articles of conversion with the Division
- The requirements to convert a domestic LLC to a foreign entity are not clearly set forth.
- The Utah Act only provides that a conversion of domestic LLC into a foreign entity must be: [§48-2c-1406(4)]
 - Permitted by statute governing the foreign entity
 - Conversion approved in accordance with foreign statute
 - “accompanied” by any filing in the foreign jurisdiction – (This makes no sense – what is being accompanied?)

Revised Uniform LLC Act

- Proposed by National Conference of Commissioners on Uniform State Laws (“NCCUSL”)
- The first “Uniform Limited Liability Company Act” proposed in 1995
- The Revised Uniform Act was proposed in December of 2006
- Adopted by only two States:
 - Iowa
 - Idaho
- Proposed by Senator Hillyard during Utah 2010 Legislative Session (SB0065) as part of the “Unincorporated Business Entities Act”

Revised Uniform LLC Act

Distinctive Features

- Architecture is based on the Revised Uniform Partnership Act (“RUPA”)
- Shelf Registration – permits filing LLC charter without any LLC members
 - Requires second filing once have at least one member
 - LLC not “officially” formed until have at least one member
- Rules regarding operating agreements:
 - Permits oral operating agreements
 - Reverses hierarchy of governing documents – operating agreement is supreme not certificate of formation
 - Certificate of formation merely evidences existence of LLC

Revised Uniform LLC Act

Distinctive Features (continued)

- Transferee rights:
 - Person who ceases to be a member – has no “pay out” right
 - No right to become member, has no governance rights, and virtually no information rights
 - Members may alter operating agreement and affect the transferee’s rights without the consent of the transferees
 - Transferee has no right to seek dissolution – locked in

Revised Uniform LLC Act

Distinctive Features (continued)

- Fiduciary Duties:
 - “Un-Cabining”
 - RUPA pioneered idea of codifying all partner fiduciary duties to protect against judicial second guessing
 - Revised Uniform Act codified major duties but list not exhaustive
 - Duty of Loyalty
 - Self Interest
 - Good Faith and Fair Dealing
 - Duty of Care – replaces “gross negligence” with “ordinary care” subject to “business judgment rule”
 - Business judgment rule not codified – Iowa codified in its version
 - Limitations on ability to waiver and modify duties
 - Fully disclosure and disinterested consent
 - “not manifestly unreasonable” standard

Revised Uniform LLC Act

Distinctive Features (continued)

- Eliminates statutory apparent authority by position
 - Provides for filing of a “Statement of Authority”
- No default provision of allocation of profits and losses
- Charging order is NOT the exclusive remedy – foreclosure available
- Judicial dissolution for oppression
 - A member may bring action to dissolve on grounds that the managers or control members “have acted or are acting in a manner that is oppressive and was, is or will be directly harmful to the applicant”
 - Permits court order remedies other than dissolution
- No Series LLCs
 - Iowa added
- Professional LLCs not included
 - Iowa added

Revised Uniform LLC Act

Concerns Raised by Senator Valentine

- Agreed that the Utah Act has deficiencies that need to be dealt with
- From a “policy” standpoint wants the Utah Act to be “business friendly”
- Prefers the Revised Prototype Act to the Revised Uniform Act
- Certain of his concerns regarding the Revised LLC Act:
 - Oral operating agreements – may increase litigation/less certainty
 - §803(b) – owning income-producing real or personal property in the state constitutes transacting business in the state (compare to Utah Act 48-2c-1602(2)(h) – “owning, without more, real or personal property” does not constitute transacting business in state)
 - Changing fiduciary duty standard from “gross negligence” to “reasonable care”
 - Appears not to permit §754 election – concern over ordering of liquidating distributions (I don’t see this)
 - Shelf registration
 - Lack of constructive notice/does away with statutory apparent authority
 - Fiduciary duties to minority members (*see* the Revised Uniform Act comment to subsection (g)(5) of §409)

Revised Prototype LLC Act

- ABA’s Committee on LLCs, Partnerships and Unincorporated Entities (“LPUE”) published the first “Prototype Limited Liability Company Act” in November 1992
- LPUE released the Revised Prototype Act in January 2009
 - Intended to be an “evergreen” project

Revised Prototype LLC Act

Distinctive Features

- Architecture is based on RUPA
- Permits oral operating agreements - imposes writing requirements with respect to:
 - Capital contribution obligations
 - Expansion, restriction or elimination of fiduciary duties
 - Limitation or expansion of liability for breach of contract or duties
- Item including in certificate of formation (other than those required) do not constitute constructive notice of any fact
- Eliminates statutory apparent authority by position

Revised Prototype LLC Act

Distinctive Features (continued)

- Removes management provisions – leaves management structure, authority and duties entirely up to the operating agreement
- Charging order is exclusive remedy – no foreclosure
- Judicial dissolution for oppression
 - Substantially the same as the Revised Uniform Act
- No default provision for allocation of profits and losses

Delaware Limited Liability Company Act

- Business Friendly
 - Policy to give “maximum effect to the principal of freedom of contract and to the enforceability of the limited liability company agreement” §18-1101(b)
- Forum of choice for many sophisticated investors (*e.g.*, Venture Funds)
- Delaware Advantages:
 - Helpful and business friendly Secretary of State
 - Experienced Court of Chancery
 - Quick legislative resolutions following unfavorable court rulings
 - Large body of case law – greater predictability
 - The “9/11” Rule – Emergency Filings (2 day extension)
- Delaware Disadvantages
 - Additional costs
 - Annual fee - \$250
 - Annual Agent fee – approx. \$375 (some agents as low as \$100)
 - Venue – Delaware is always an available forum (cannot be waived)

Delaware LLC Act

Distinctive Features

- Broad flexibility – freedom of contract (§18-1101(b))
- Fiduciary duties may be eliminated
- Series LLCs
- Charging Order – exclusive remedy
- Contains a default provision for the allocation of profits and losses based on agreed value of contributions (§18-503) will conflict with the Internal Revenue Code and Treasury Regulations

Areas of Comparison

- Oral Operating Agreements
- Management Structures and Apparent Authority
- Charging Orders
- Profit Allocation Provisions
- Default Distribution Provisions
- Fiduciary Duties

Oral Operating Agreements

- What constitutes as an operating agreement?
- Default Statute vs. business deal
- What provisions (if any) must be in writing
 - Utah Act
 - Requires OA to be in writing
 - Whatever isn't in written OA is covered by default statute
 - Revised Uniform Act – nothing required
 - Revised Prototype Act
 - Capital contribution obligations
 - Expansion, restriction or elimination of fiduciary duties
 - Limitation or expansion of liability for breach of contract or duties
 - Delaware
 - Agreement to non-exclusive juris of courts of, or arbitration in, a specific juris or the exclusive juris of courts of, or arbitration in, Delaware

Oral Operating Agreement

- Statutes of Fraud
 - Requires a writing for:
 - Obligations other than those to be performed within 1 year of making
 - Agreements relating to the sale or transfer of property
- Commentators
 - Some have argued that the statutory recognition of oral operating agreements when combined with stated policy to give “maximum effect” to the enforcement of operating agreements gives inference that the Statutes of Fraud should be overridden.
 - Other argue that nothing in the Act suggests an attempt to override the Statutes of Fraud

Oral Operating Agreements

- Utah Statutes of Fraud
 - § 25-5-4 of the Utah Code
 - Courts have interpreted “one-year clause” as applying only to contracts that are literally incapable of being performed within one year
 - Zion's Serv. Corp., 366 P.2d at 985
 - Question: If one provision of an agreement falls within but doesn't satisfy Statute of Fraud, is the entire agreement unenforceable?
 - Some states permit provision-by-provision application others do not

Oral Operating Agreement

- Olsen v. Halvorsen
 - Case before the Delaware Chancery Court
 - Facts:
 - Olsen, Halvorsen and Ott formed series of companies to operate a pair of hedge funds
 - Draft operating contained a 6 years earn-out for departing partners – was never signed
 - Halvorsen and Ott (representing 77.5%) expelled Olsen
 - Olsen was paid capital account balance and remainder of salary
 - Olsen demanded earn-out as set forth in unexecuted operating agreement
 - Olsen brought suit – court granted summary judgment to defendants
 - Held that the Statutes of Fraud does apply to those aspects of an oral operating agreement that are not susceptible to performance within a single year.
 - Court applied a provision-by-provision approach

Oral Operating Agreement

- Example:
 - A, B and C meet with their accountant and decide to form an LLC in which each will be an equal member (i.e., 1/3).
 - A and B will be providing services and will receive “profits interests”.
 - C will contribute real property having no basis and an agreed upon fair market value of \$1,000,000.
 - They have their accountant form the LLC and on his advice do not enter into a written operating agreement.
 - They operating the LLC for 5 years allocating profits and making distributions 1/3 to each, and making decisions based on majority vote (i.e., 2 out of 3).
 - In year 6, a dispute arises – what happens now?

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Questions ?