

**Presentation to the Annual Meeting of the  
Iowa State Bar Association  
June 18, 2008**

**What You Need to Know About  
the New Iowa Limited Liability Company Act  
By  
David Walker**

**A Short History of LLC Legislation**

- Foreign Countries' Legislation
- Wyoming Legislation 1977
- IRS Revenue Ruling 1988
- A Firestorm of LLC Legislation across the U.S. 1988-95
- Iowa Limited Liability Company Act (1992)
- Uniform Limited Liability Company Act (1995)
- Revised Uniform Limited Liability Company Act (2006)

**Revised Uniform Limited Liability Company Act (2006)**

- A product of the National Conference of Commissioners on Uniform State Laws
- To draft a “second generation” (or perhaps 3<sup>rd</sup>) limited liability company act
- Project commenced in 2003, and Final Act approved by the Conference in 2006
- Adopted in Idaho and Iowa and under serious consideration in Arkansas, Indiana, Maine, New Jersey, New York, Pennsylvania, and Vermont

**Why Undertake a New Uniform Act?**

- In 2003 15 years had passed since IRS Rev. Rul.
- Six years had passed since IRS abandoned the *Kintner* Regs and adopted “Check the Box.”
- With 15 years of experience with and practice under state legislation, there was opportunity to draw on the best provisions and practices—
- Thus providing guidance to courts, the Bar, and the public; facilitating planning; and lowering transaction costs; and
- Keeping Iowa business and commercial law current, up-to-date, and competitive.

## **Dramatis Personae**

- National Conference of Commissioners on Uniform State Laws Drafting Committee and C-Reporters, Carter Bishop and Dan Kleinberger
- ABA Advisor and Section Advisors, e.g., PUBO, Corporate Laws, Real Property, Taxation, Negotiated Acquisitions
- Official Observers (including Marc Ward)
- ISBA Business Law Section LLC Committee & Council
- ISBA Board of Governors

## **Something Old, Something New**

- The Iowa Revised Uniform Limited Liability Company Act draws on the architecture and language of RUPA, *IC 486A*, and the Uniform Limited Partnership Act, *IC 488*
- The entity remains an unincorporated, limited liability entity driven by private contract, not public statutes, and Revised ULLCA is largely “default legislation.”
- “Articles of Organization” become “Certificate of Organization,” reflecting limited purpose
- Management structure not required to be stated in the Certificate of Organization

## **Architecture That Is Familiar**

- Article 1 contains general provisions, including definitions; provisions addressing knowledge and notice, purpose, duration, governing law, and service of process; and three critical sections on the operating agreement;
- Article 2 deals with formation & public filings;
- Article 3 addresses relations of members and managers to persons dealing with the LLC;
- Article 4 addresses becoming a member, contributions, sharing of distributions, *default* management structures, and duties inter se;
- Article 5 embodies the core principle of unincorporated business law, “pick your partner,” and deals with transfers of interest, including rights of transferees and creditors;
- Article 6 addresses member’s dissociation, and its causes and consequences;
- Article 7 governs dissolution and winding up;
- Article 8 deals with foreign LLCs;
- Article 9 governs action by members, i.e., direct and derivative litigation;
- Article 10 governs fundamental changes or organic transactions—mergers, conversions, and domestications;
- Article 11 governs professional LLCs;
- Article 12 of the Iowa Revised ULLCA continues, in Iowa, to provide for and govern “series limited liability companies”—something the Uniform Act did not do;
- Article 13, finally, contains miscellaneous provisions, including:
  - The effective date, January 1, 2009;
  - The all-inclusive date, January 1, 2011.

## Priority Issues and Innovations

- The Operating Agreement
- “Uncabining” Fiduciary Duties & What Members Can Do to Define, Restrict or Eliminate
- Being Precise about the Obligation of Good Faith and Fair Dealing
- Duty of Care and the Business Judgment Rule
- Dealing with Self-Dealing and Conflicts
- Judicial Remedy for Oppressive Conduct
- Addressing “Statutory Apparent Authority”
- Providing for Statements of Authority by Position
- Templates for Management Structure
- Dealing with So-Called “Shelf LLCs”
- Direct and Derivative Litigation and Special Litigation Committees
- Keeping LLC law Distinct from Corporate Law

### “Operating Agreement” Means:

“[t]he agreement, whether or not referred to as an operating agreement and whether oral, in a record, implied, or in any combination thereof, of all the members of a limited liability company, including a sole member, concerning the matters described in section 489.110, subsection 1. The term includes the agreement as amended or restated.” IC 489.102, subsection 15.

### The Operating Agreement

- The Act contains three sections in Article 1 that address:
- The scope, function, and limitations of the operating agreement—§ 489.110;
- The effect of the operating agreement on the LLC and persons becoming members, and “preformation agreements”—§ 489.111; and
- The effect on 3<sup>rd</sup> parties and the relationship of the operating agreement to records filed on behalf of the LLC--§ 489.112.

### Substantive Improvements in the Operating Agreement Provisions

- Broadly defines “operating agreement” and, in keeping with majority view, states it can be oral;
- Makes clear that the agreement governs the parties’ relations, *subject to stated exceptions*, and that ULLCA represents default legislation;
- Delineates the extent to which the parties can vary provisions of the Act, § 489.110(3), e.g., the duty to refrain from competing with the LLC, “if not manifestly unreasonable;”

- Defines “manifestly unreasonable” and makes clear the question is for the court to decide--§ 489.110(8);
- Authorizes “shield” and indemnification provisions;
- Provides the LLC itself is bound by and may enforce the agreement;
- Clearly states that a person becoming a member assents to the operating agreement;
- Authorizes a “preformation agreement,” which will become the operating agreement;
- Authorizes a “private statute of frauds” clause barring amendments or modifications not in writing, § 489.111(4);
- Allows amendment to be conditioned on non-member’s approval;
- Makes clear the operating agreement governs transferees and dissociated members;
- If there is conflict between the operating agreement and a public filing, the operating agreement prevails as to members, managers, dissociated members, and transferees; and the public filing governs as to other persons who have reasonably relied upon it.

### **Management**

- The Act provides templates for member-managed LLCs and manager-managed LLCs, § 489.407;
- The Act presumes an LLC is member-managed, unless expressly provided otherwise in the operating agreement, with equal rights of members to participate in management provided on a *per capite, not a per capital, basis*, and differences as to ordinary matters being resolved by a majority of the members;
- Management provisions are default provisions.

### **Authority of Members**

- Unlike partners, who have statutory apparent authority merely by virtue of partner status, IC 486A.301, the Iowa Revised ULLCA *eliminates* statutory apparent authority, IC 489.301;
- An LLC member is *not* an agent “solely by reason of being a member;”
- “Other law” may impose liability on the LLC because of the person’s conduct.

### **Statements of Authority**

- The Act improves upon or enhances RUPA’s provisions authorizing a “statement of authority”—IC 489.302;
- Allows a “statement of authority” by position, not person, for real estate transactions and/or other commercial transactions;
- Will allow the LLC to provide evidence of authority to enter transactions without having to disclose the entirety of the operating agreement.

## **Fiduciary Duties**

- § 489.409: “A member of a member-managed limited liability company owes to the company and, subject to section 489.901, subsection 2, the other members the fiduciary duties of loyalty and care stated in subsections 2 and 3.”
- Similar to RUPA and ULPA, but
- “Uncabined”—the word “only” has been eliminated from section 1, and section 2 provides that the duty of loyalty “includes,” not “is limited to,” the duties stated
- Why RUPA and ULPA “cabined in” fiduciary duties
- Why Revised ULLCA took a different approach

## **Fiduciary Duties: More on “Uncabining”**

- Risk to transactional planning--
- But a number of states, including California and Illinois, had taken that step in their partnership or LLC legislation, and
- The Revised ULLCA clarifies and increases the power of parties to define, restrict, and even eliminate aspects of “fiduciary duties” in the operating agreement under § 489.110; and further,
- The Revised ULLCA defines and confines the meaning of “manifestly unreasonable” and makes it a question for the court to decide.

## **Conflicts of Interest & Self-Dealing**

- RUPA, ULPA, and the Iowa Revised ULLCA provide that the duty of loyalty requires that a partner or member “refrain from dealing with [the entity] . . . as or on behalf of a party having an interest adverse to the [entity],” e.g., IC 489.409(2)(b);
- Compare the current Iowa LLC Act, 490A.708 [Business Transactions of Managers with the LLC];
- RUPA and ULPA, *but not the Iowa Revised ULLCA*, provide that “a partner does not violate a duty or obligation under this Act or under the partnership agreement merely because the partner’s conduct furthers the partner’s own self-interest;”

## **Conflicts of Interest and the New Act**

- The operating agreement may “restrict or eliminate the duty, *if not manifestly unreasonable*, under IC 489.110(4);
- The operating agreement “may 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 persons after full disclosure of all material facts”—489.110(5);
- “It is a defense to a claim under [489.409(2)(b)], and any comparable claim . . . that the transaction was fair to the limited liability company.”—IC 489.409(5).

## **The Duty of Care**

- A major issue in the drafting or revision project because the language used in RUPA and ULPA, namely, limiting the duty “to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law,” was viewed by many as unsuitable in a Post-Enron Era.
- The Iowa LLC Act (1992) utilizes an “ordinary care” standard—does negligence mean liability?
- Corporate law fixes duties by position, e.g., directors and officers; differentiates the standard of conduct from the standard of liability; and recognizes the business judgment rule.

## **The Duty of Care under the New Act**

- The duty of care is stated in terms of ordinary care in IC 489.409(3), similar to existing Iowa law in 490A.706, BUT
- Is explicitly made “[s]ubject to the business judgment rule,” AND
- The business judgment rule is defined and articulated in IC 489.409(7), stating when the duty of care is satisfied;
- The focus is on the process of decision, not the content of the decision made.

## **The Obligation of Good Faith & Fair Dealing**

- A contractual concept protecting reasonable expectations flowing from express provisions in a contract, and not a fiduciary duty;
- But confusion has arisen, and while RUPA and ULPA require duties to be discharged “consistently with the obligation of good faith and fair dealing,” they don’t make clear it’s the *contractual* obligation of good faith;
- The Revised ULLCA makes it clear—489.409(4).

## **Direct and Derivative Litigation**

- Current Iowa law in IC 490A.410 does not draw a distinction between direct and derivative actions by members;
- Article 9 of the Iowa Revised ULLCA does;
- Duties under section 409 are owed to the LLC and to members, “subject to IC 489.901;”
- Under section 901, a direct action requires “an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the limited liability company;”
- Where there is actual or threatened injury to the LLC, the action is derivative and demand is required.

### **Special Litigation Committees**

- The Uniform Act in section 905 contains a default provision authorizing an LLC to appoint a special litigation committee, comprised of disinterested and independent persons, to investigate in good faith, consistently with the duty of care, whether a derivative claim is in the best interests of the LLC and if not, recommend dismissal, which a court must grant if the requirements are met;
- Iowa did not adopt this section;
- Consequences of not doing so: An LLC may do so anyway because it is a contractual entity, but counsel, the members or managers and the courts will not be guided or limited by the Uniform Act's language.

### **Judicial Remedy for Oppression**

- LLCs have indefinite duration, unless otherwise provided, and there is no “put” or buy-out right for dissociating members [so always include a buy-sell agreement];
- While not inviting courts to “rewrite the deal,” the Act provides a remedy for oppressive conduct, similar to other business law—IC 489.701(1)(e);
- “Oppression” is not defined and is left to courts, which generally define it in terms of a member's known reasonable expectations and frustration thereof by those in control;
- The Act authorizes members and transferees to seek judicial dissolution and authorizes a remedy other than dissolution, e.g., a court-ordered buy-out, which courts have commonly ordered.