State Law & State Taxation Corner

By Thomas E. Rutledge

Minority Members and Operating Agreements

It is not too broad a generalization to suggest that almost all LLC members fall within one of two categories: those who are members of the control group and those who are not members of the control group.[1] Typically the control group dictates, through counsel that it selected, the terms of the operating agreement, with potential minority participants then invited to accept those terms by joining the company as minority members or, in the alternative, by passing on the opportunity. Alternatively, the minority participants may be invited, and they are certainly always free to insist, upon modifications to the proposed terms. Following are a few thoughts on representing the potential minority in such a situation.

1. **Supermajority or Unanimity Requirement for Organic Transactions.** Many LLC Acts, as a default rule, permit organic transactions such as a merger, conversion or domestication to be approved by a simple majority of the members[2] or even, in certain circumstances, by the managers. These provisions are simply default rules that may be modified in the operating agreement. Raising the threshold ensures that the minority participants have some voice with respect to this means of radically altering the nature of their *inter se* relationship. In the absence of such protections, the minority may find that whatever rights they have negotiated with respect to their participation and particular venture may be lost by the simple mechanism of the majority merging the entity into one that is similar, but without the minority protections.
2. **Unanimity or Supermajority for Amendment of Operating Agreement.** Many LLC Acts permit,

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as a default rule, amendment of the operating agreement by a simple majority of the members.[3] Absent a contractual modification of this threshold, irrespective of the negotiated agreement providing minority protections, such may be promptly lost if the majority determines they should be amended out of the agreement. While there are potential challenges to such an effort by the majority, including the obligation of good faith and fair dealing, it would be unimaginable that the minority participants would want to have to resort to such legal principles and litigation of which they would bear not only the costs but also the initial burden of proof, as a mechanism of enforcing those rights.

3. **Dissenters' Rights.** Only a minority of the LLC Acts provide dissenter rights in the event of an organic transaction.[4] The balance of the Acts, many of which as well provide that a merger or similar organic transaction may be approved by a mere majority of the members, do not contain this protection. Obviously, if it can be negotiated that a merger or similar organic transaction may be undertaken only upon the unanimous approval of the member, dissenter rights are not necessary.[5] Note, however, that it is in no manner required that the dissenter rights provisions model those found in corporate acts such as the Model Business Corporation Act (MBCA) or even LLC Acts, such as that of California, that provide dissenter rights. Rather, the procedures that are to be utilized, as well as the triggering events, will be a matter of contract. As an example of this flexibility, while under corporate law it is the corporation that initiates the judicial action seeking determination of share value, that obligation in an LLC may be reversed, it being the obligation then of the dissatisfied members to initiate the action. It could as well be provided that dissenter rights will not be available if some threshold of the disinterested members has approved the transaction. By way of example, imagine an LLC with ten members, one holding 55 percent and the balance of 45 percent spread among the remaining nine members, each holding a five-percent interest. The operating agreement could provide that dissenter rights will exist in the event of a merger unless the merger transaction receives the approval of at least 89 percent, by percentage interests, of the members. In that instance, if two of the minority members withhold their vote, they representing 10 percent of the total interests in the company, dissenter rights will not be available, it being presumed that the overwhelming approval by a supermajority of the disinterested members confirms that the merger consideration is appropriate. Alternatively, if one-third of the disinterested members do not vote in favor of the transaction, dissenter rights would be available.
4. **Compensatory Payments.** Minority participants should beware of any situation in which the control block has the power, whether by means of distributing cash, by altering guaranteed payments, by the issuance of profits interests or otherwise, to alter the distribution of assets and earnings. Obviously, such provisions provide a mechanism by which those in control may, even without running afoul of the conflict of interest transaction rules (unless written quite broadly into the operating agreement), benefit friends, family and business associates. A provision that allows the compensatory arrangement between the LLC and any manager to be approved by a majority of the managers disinterested with respect to that proposed transaction is, in effect, consent to the managers to, as a group, set their own compensation. Further, a requirement that changes in the compensatory arrangements between the LLC and the managers being subject to the approval of a majority of the members concedes to the control block the ability to sanction siphoning significant amounts of LLC cash for distribution other than to the minority member while at the same time maintaining the allocation of income in the same manner as is provided for in the operating agreement. Arrangements for compensation to be paid a minority participant in the capacity as a manager that are subject to termination by the majority come all too close to "at will" arrangements between the LLC and that minority member/manager. In that context, additional requirements prior to termination, such as a requirement of "for cause," may be sought.
5. **Define the Duty of Loyalty.** While there are LLC Acts that define, and at a rather stringent level, the duty of loyalty that is imposed upon those acting on behalf of an LLC,[6] other states take a

more lenient standard, going so far, in the case of Delaware, as not defining the standard of loyalty in the statute, but leaving it to common law. In the consideration of the duty of loyalty, should the threshold be set at conduct that generates for those in control a benefit for which they have not separately negotiated or, rather, a conduct that is disadvantageous to the minority? Put another way, identifying and clearly delineating what is the duty of loyalty, when does it not apply (is the business opportunity doctrine going to apply in the context of this LLC, and if so, what is the LLC's purpose and scope?) and what should be the assumptions used in its application should all be considered? By defining what those in control may reasonably expect out of the business venture, it is possible to identify issues that are or are not subject to a duty to account.

6. **Limits Upon Conflict of Interest Transactions.** Conflict of interest transactions are, of course, a subset of the duty of loyalty. It may be important to put particular limitations upon related-party transactions. For example, in an LLC with a number of managers, it may be possible for a majority of those managers to approve a transaction between the LLC and a business organization owned by one of the members.[7] Alternatively, the operating agreement could provide that any transaction between the company and a party related to or affiliated with any member must receive the approval of all of the members. While such a limitation admittedly impacts upon the flexibility of management, if for no other reason than a time delay in acquiring consent, if a transaction is truly at market terms and in the best interest of the company, assuming a member is not simply being cantankerous, it must be assumed that the members will approve it.[8]
7. **Define the Duty of Care.** The states have adopted a multitude of formulae by which to describe the duty of care in LLCs.[9] For example, while certain states utilize a prudent man standard, others use a standard of care that is probably more accurately characterized as a standard of culpability, namely wanton or reckless misconduct.[10] Most recently, the Revised Uniform Limited Liability Company Act (2006) adopted a prudent man standard subject to the business judgment rule.[11] The suggestion that the business judgment rule may be properly utilized in the contractual realm of the LLC has been criticized,[12] and most recently criticized by the ABA Committee on LLCs, Partnerships and Unincorporated Business Organizations.[13] Setting aside these debates with respect to what is the *statutory* duty of care, it must be recognized that, while there may be state specific limitations in the form of a "floor" on the duty of care, such may be defined by agreement. The minority participants may seek to negotiate for a standard of care imposed upon those in control of the venture that, while perhaps not holding them liable on the simple negligence threshold that is applicable to paid agents,[14] will hold them to a standard that is not quite so lenient as one requiring wanton or willful misconduct before the managers will be culpable. Further, it should be specified that any standard of liability more relaxed than simple negligence will apply only in the context of discretionary management functions.[15]
8. **Limit Indemnification.** Indemnification provisions always require strict scrutiny. First, does the proposed provision provide for indemnification in a scope broader than the standard of culpability? The net effect of such a provision is to allow a breach of the standard of culpability with no actual exposure of the actor to the consequences of his or her own actions. Furthermore, the types of actions for which indemnification will be available should be carefully scrutinized. For example, while indemnification may be appropriate in cases where there is a nonculpable violation of a duty of care to the other members, it must be questioned whether indemnification is ever appropriate in the context of a duty of loyalty violation. With respect to claims by third parties, it will be appropriate to require a written (and even secured) undertaking to return all funds advanced in the defense of litigation where the actor is ultimately found liable.[16]
9. **Information Rights and Delivery Obligations.** Most LLC Acts recite a list of records that must be maintained by the company and provide that the members will have certain inspection rights of either those documents or the records of the LLC in general. However, these provisions are typically qualified by a requirement that the members' request to review documents be

"reasonable" or for a "proper purpose." It will be the control bloc, or managers appointed by the control bloc, who will typically determine whether a minority member's request to review LLC records is "reasonable."[17] These pressures may be remedied by provisions in the operating agreement detailing records that must either be made available or must be furnished to the minority members on a set schedule. Obvious examples of this information include financial statements in the form of profit and loss statements and a balance sheet, and a comparison of actual results against the budget. Should those mandatory delivery obligations not be satisfied, the minority members should be in a position to bring an action for breach of contract. Further, in order to provide some additional "bite" to that right, the operating agreement should provide that the member/manager who has failed to satisfy that obligation should not be able to satisfy its legal fees out of LLC assets and may be subject to a penalty such as paying the legal fees of the minority members.

In any negotiating situation, the relative power of the two sides will dictate the degree to which potential minority participants may modify the transaction as proposed to them.

10. **Admission of New and Substitute Members.** While a number of LLC Acts require the unanimous approval for the admission of a substitute member, being in this instance the assignee of a member,[18] certain other states allow for the admission of an assignee as a full member upon the majority approval of the incumbent members.[19] Most LLC Acts require, as a default rule, the unanimous approval of the incumbent members for the admission of a new member,[20] although certainly there are states that do not require that such be a unanimous action.[21] With respect to the admission of new members, a minority may want to negotiate for a requirement of unanimous approval of the incumbent members for admission or some other mechanism that precludes dilution of their percentage of the membership interest without the requirement of additional capital that would be required in order to exercise preemptive rights. As to the admission of substitute members, a similar requirement of unanimity or, at a minimum super majority protection is justifiable on a number of bases. For example, the minority participants may be placing particular reliance upon either or both of the expertise or the reliability of the manager. Those characteristics being specific to that manager and not mere commodities such as available capital, the minority members will want a strong voice in determining whether and on what terms the majority position may alter its economic interests in the venture, such as by selling all or a portion of its economic interests, or the substitution of a third party for that controlling member who then has managerial control.

11. **Legal Fees to Minority Members.** The legal costs involved with soliciting and accepting the investment of the minority members, in part, will be paid by the minority members who contribute capital. To that extent, the minority members are underwriting legal expenses incurred on behalf of both the venture and the control block. Simultaneously, the minority members are exclusively bearing the legal and other professional costs incurred in connection with the planned investment. In order to equalize this treatment, the minority members may argue that their expenses involved in joining the venture should be satisfied out of company funds thereby, on a net basis, reducing the burden that they would otherwise bear.

In any negotiating situation, the relative power of the two sides will dictate the degree to which potential minority participants may modify the transaction as proposed to them. Every transaction has a unique dynamic, and requires a unique approach. In any situation, it is doubtful that all of the suggested lines of negotiation would be appropriate, and in any transaction there undoubtedly are going to be other lines of negotiation that need to be explored. What is crucial is that counsel for the minority participants understand the full implications of the transaction that they are entering and that with that appreciation they, as appropriate, seek modification of the transaction to make it as palpable as possible to the minority participants who then may make the business decision of whether or not they will make the investment.

Endnotes

[1] Likely the sole exception to this characterization is the instance of a true 50/50 deal, in which instance each member, with respect to any decision that must be made by either a majority or by unanimous decision, has absolute blocking veto with respect to the other. Further, it should be recognized that, at times, the minority/majority issues will, *vis-à-vis* a particular member, be mixed. Consider, for example, the instance where the minority member, in terms of economic rights, is granted managerial control by reason of designed appointments in the operating agreement on the disproportionate voting rights with respect to classes of membership units, or otherwise, but where certain decisions also will be made based upon capital. In that circumstance, each member is, with respect to certain issues, in a control position, while with respect to others in a minority position.

[2] *See, e.g.*, Ky. Rev. Stat. Ann. §275.350(1); Iowa Code §490A.1203(1)(a), §490A.701(2)(c).

[3] *See, e.g.*, Del. Code Ann. tit. 18 §209(a): Kan. Stat. Ann. §17-7695(a); and Ky. Rev. Stat. Ann. §275.175(2)(a).

[4] *See, e.g.*, Calif. Code §§17600 through 17613; Florida Code §608.4384; New Hampshire Code §304-C:22; Ohio Code §§ 1705.40 et seq.; and Wis. Code §183.1206. Other states are silent as to dissenter rights, while others (*e.g.*, Del. Code Ann. tit. 18, §210; Ky. Rev. Stat. Ann. §275.030(6)) provide that dissenter rights exist only if provided for by contract.

[5] At one time in the development of the corporation, a merger required the unanimous approval of the shareholders. Over time, as that threshold was reduced to a majority, dissenter rights were added as a mechanism for protecting the economic rights of the minority shareholders.

[6] *See, e.g.*, Ky. Rev. Stat. Ann. §275.170(2); Prototype LLC Act §402(b); and ULLCA §409(b).

[7] *See, e.g.*, Ky. Rev. Stat. Ann. §275.170(2).

[8] Setting aside, with respect to this statement, the possibility that a particular member or subset of the members will be engaged in a "strike" against management.

[9] For a survey of these formulae and some of their implications, *see, e.g.*, Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 35 J. Corp. L. 565 (Spring 2007).

[10] *See, e.g.*, Ky. Rev. Stat. Ann. §275.170(1).

[11] RULLCA §409(c).

[12] Thomas E. Rutledge and Elizabeth S. Miller, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 Del J. Corp L. 343 (2005).

[13] *See* James J. Wheaton, *The Report of the RULLCA Review Task Force*, 24 PUBOGRAM 9 (July 2007).

[14] Restatement (3rd) of Agency §8.08 (2006).

[15] The Principles of Corporate Governance, §4.01, utilized the term "business judgment" with respect to activities and decisions to which the relaxed culpability standard of the business judgment rule is available.

[16] *Senior Tour Players 207 Management Company LLC v. Golftown 207 Holding Company LLC*, Del. Ch., 853 A2d 124 (2004) (actor not required to submit an undertaking to repay advanced fees to limited liability company where not required by either the LLC Act in question or the operating agreement). Further, it is worth noting that a right of indemnification does not necessarily bring with it a right of advancement; they are distinct concepts that need to be distinctly addressed in the operating agreement. *See Majkowski v. American Imaging Management Services, LLC*, Del. Ch., 913 A2d 572 (2006).

[17] *See, e.g., NAMA Holdings, LLC v. World Market Center Venture, LLC*, Del. Ch., 2007 Del. Ch. LEXIS 100 (July 20, 2007).

[18] *See, e.g.*, Iowa Code §490A.903.

[19] Ky. Rev. Stat. Ann. §275.265(1).

[20] *See, e.g.*, Kan. Stat. Ann. §17-7686(b)(1); Ky. Rev. Stat. Ann. §275.275(1)(a).

[21] *See, e.g.*, Va. Code Ann. §13.1-1040.