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Major Issues in Limited Liability Companies

Meet our presenter

Donald J. Weidner
Mediator and Arbitrator

Upchurch Watson
White & Max
dweidner@uww-adr.com

Major Issues in Limited Liability Companies

DONALD J. ("DON") WEIDNER

Goals for this Hour

Part I. A Brief Overview of LLCs.

Part II. A More Detailed Look at 5 Important Points:

1. The Shield Interacting with the Operating Agreement to Produce a Peculiar Commercial Contract;
2. The Unprecedented Extent to Which Members are "Locked-In" to their LLCs;
3. The Statutory Support for Contractually Restricting or Eliminating the Fiduciary Duties of Members or Managers;
4. The Difficulties Dissatisfied Members Face to Bring Direct and Derivative Claims; and
5. Other Remedies for Dissatisfied Members.

A Brief Overview of LLCs

- The first limited liability company (LLC) statute was Wyoming's in 1977. Since then, the LLC has become the most popular form of business organization in the United States.
- The Revised Uniform Limited Liability Company Act (RULLCA), is the basis of Florida’s 2013 LLC Act, which was amended slightly in 2015.
- Although LLC acts vary among the states, they have much in common. They:
  - borrow heavily from both partnership law and corporate law;
  - offer the equity owners in LLCs, called “members,” “limited liability” analogous to that available in corporations, limited liability partnerships and limited partnerships;
    - that is, members as members are generally not vicariously liable for the torts or contracts of the LLC
      - Unless there is “veil piercing,” as in a corporation
      - Or unless direct liability can be found on the basis of the operating agreement or other contract.

A Brief Overview of LLCs (cont’d)

- Common features among LLC acts (cont’d)
  - require that they be formed by a filing Articles of Organization (“Certificate of Organization” in some states);
  - provide that LLCs can be formed for anything from a sole proprietorship, to an organization that resembles a general partnerships operated its owners, to an organization that involves a level of separation of ownership and control characteristic of a large corporation;
  - authorize LLCs for nonprofit organizations;
    - F.S. § 605.0108(2) provides: “A limited liability company may have any lawful purpose, regardless of whether the company is a for profit company.”
  - avoid requiring traditional corporate formalities and allow great organizational flexibility;
    - For example, there is no requirement to have a board of directors and generally no requirement to have corporate-type of meetings of members. Nevertheless, the members may choose to provide boards or require formal meetings.

A Brief Overview of LLCs (cont'd)

- provide that the LLC is operated pursuant to an "Operating Agreement;"
- generally provides that LLC membership requires unanimous consent, although a member's "financial interest" is freely transferable;
- generally provide that ordinary business matters can be decided by majority vote, with members having agency power to bind the LLC in such matters; and
- make a major distinction between member-managed LLCs and manager-managed LLCs.

➢ Although LLCs are legal entities, they retain more aggregate features than corporations, particularly under federal law.

A Brief Overview of LLCs (cont'd)

- For federal income tax purposes, LLCs can choose to be treated as "pass-through entities."
  - There is no tax at the entity level: the items of income, gain, loss, deduction and credit are "'passed through" to the members for them to report on their individual returns.
  - These rules provide flexibility to the members to allocate tax items as they see fit.
  - They also allow flexibility to adjust basis on sales of interests.
- A single-member LLC can become a "disregarded" entity for federal income tax purposes.

A Brief Overview of LLCs (cont'd)

- For federal diversity jurisdiction purposes, partnerships and LLCs, although they are legal entities, are not treated as corporations. The general federal rule is that an LLC is a citizen of all of the states in which it has individual members—which makes it more difficult for an LLC that is a defendant to remove a state law case to federal court.

- See Silver Crown Investments, LLC v. Team Real Estate Management, LLC, 2018 WL 46979718 (S.D. Fla. 2018) (citations omitted), involving a suit by 13 members of an LLC, all of whom were themselves LLCs:

"For purposes of determining diversity jurisdiction, the citizenship of [an LLC] is the citizenship of each of its members. If a member of an LLC is itself an LLC, the citizenship of the LLC 'must be traced through however many layers of partners or members there may be.' * * * [I]t is the citizenship of an LLCs members—not its managers—that is relevant." (emphasis by the court)

On Formation: The "Shield"

- An LLC is formed when its articles of organization are filed with the Secretary of State and become effective. F.S. § 605.0201(4). The prize is the "shield."

- F.S. § 605.0304 limits the liability of members and managers.

"(1) A debt, obligation, or other liability of [an LLC] is solely the debt, obligation, or other liability of the company. A member or manager is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the company **solely by reason of being or acting as a member or manager.** * * * "

"(2) The failure of [an LLC] to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager of a company for a debt, obligation, or other liability of the company."

"(3) The limitation of liability in this section is in addition to the limitations of liability provided for in s. 605.04093."

  - F.S. § 605.04093: managers and members are "**not personally liable for monetary damages . . . regarding management or policy decisions**," unless there is certain wrongdoing.

On Formation: The "Shield" (cont'd)

- This shield of the LLC is very similar to the shield of a limited liability partnership.
- Its essence is the elimination of the vicarious liability of a member or manager for the contracts and torts of the LLC.
- However, the shield does not absolve a member from liability for his, her, or its own wrongdoing.
- Contrary to suggestions in some opinions. See *Dinuro Investments, LLC v. Camacho*, 141 So.3d 731, 742 (Fla.3d D.C.A. 2014), stating that the LLC Act "specifically provides that members are typically shielded from individual liability *for their involvement with an LLC* unless the terms of the articles of organization or the operating agreement provide otherwise." (emphasis added)
- As we shall see, *Dinuro*'s broad statement about the impact of the shield indicates that it also may consequences inside the LLC that members may not have intended.

The Operating Agreement—Definition and Scope

- The 2013 LLC Act contains extensive provisions on the operating agreement, which is the LLC analog to a partnership agreement.
- F.S. § 605.0102(45): "'Operating agreement' means an agreement, whether referred to as an operating agreement or not, which may be oral, implied, in a record, or in any combination thereof, of the members of a limited liability company, including a sole member, concerning the matters described in s. 605.0105(1). The term includes the operating agreement as amended or restated."
  - With the exception of a promise to contribute to the LLC, "an operating agreement is not subject to a statute of frauds." F.S. § 605.0106(6).

The Operating Agreement—Freedom of Contract to Order One's Affairs (cont'd)

- The definition refers to F.S. § 605.0105(1), which provides that, "except as otherwise provided in subsections (3) and (4) [the LLC Act's mandatory rules], the operating agreement governs the following:
  a) Relations among the members as members and between the members and the [LLC].
  b) The rights and duties under this chapter of a person in the capacity of manager.
  c) The activities and affairs of the company and the conduct of those activities and affairs.
  d) The means and conditions for amending the operating agreement."
- Thus, the 2013 Act gives the parties almost unlimited "freedom of contract" to order their affairs as they see fit in the operating agreement.

The Operating Agreement—Effect on LLC, Members, Managers and Transferees

- In addition to the F.S. § 605.0102(45) definition of the operating agreement and the § 605.0105 designation of the LLC Act's default and mandatory rules, there are two additional statutory rules concerning concerning operating agreements.

- Most fundamentally, F.S.§ 605.0106 generally concerns the effect of the operating agreement on members and on the LLC itself. Perhaps most importantly:

"(1) **[An LLC] is bound** by and may enforce the operating agreement, regardless of whether the company itself has manifested assent to the operating agreement.

"(2) A person who becomes **a member** of [an LLC] is deemed to assent to, **is bound** by, and may enforce the operating agreement, regardless of whether the member executes the operating agreement.

* * *

"(4) **A manager** of [an LLC] **or a transferee is bound** by the operating agreement, regardless of whether the manager or transferee has agreed to the operating agreement."

The Operating Agreement: Not An "Ordinary Commercial Contract"

- If everyone is bound by the operating agreement, bound to whom? May a member sue another member or a manager for breach of the operating agreement?
  - Stated differently, do a member's or a manager's duties under the operating agreement run to the LLC, to the other members, or both?

- The Official Comments to RULLCA Section 801, the source of Florida's Direct Action provision, explain that an operating agreement "typically" presents "different circumstances" than an "ordinary" commercial contract:

"Although in ordinary contractual situations it is axiomatic that each party to a contract has standing to sue for breach of that contract, within [an LLC] different circumstances typically exist. <u>A member does not have a direct claim against a manager or another member merely because the manager or other member has breached the operating agreement.</u> Likewise, a member's violation of this act does not automatically create a direct claim for every other member. <u>To be able to have standing in his, her, or its own right, a member plaintiff must be able to show a harm that occurs independently of the harm caused or threatened to be caused to the [LLC].</u>"

The Operating Agreement: Not An "Ordinary Commercial Contract" (cont'd)

- As this last quote suggests, this perception of the distinctive nature of the operating agreement affects whether a dissatisfied member has a right to bring a direct action or is instead confined to a derivative action.

- To quote from Florida's leading case distinguishing direct from derivative actions, *Dinuro Investments, LLC v. Camacho*, 141 So.3d 731, 738 (Fla.3d D.C.A. 2014):

"Unfortunately, <u>many operating agreements and statutes do not specify who owes a particular duty, and to whom that duty is owed</u>. Indeed, <u>[the Florida LLC Act] subjects all managing members to a duty of loyalty and care that is owed 'to the [LLC] and all of the members of the [LLC]'</u>."

- Indeed, a member's right to enforce the operating agreement is a default rule that can be contracted away.

The Operating Agreement: Not An "Ordinary Commercial Contract" (cont'd)

- *Dinuro* confirms that a member does not owe a direct duty to other members simply by signing the operating agreement:
  - "[U]nlike a typical bilateral contract, where both signing parties owe duties to one another, operating agreements establish a more complicated and nuanced set of contractual rights and duties." Dinuro, 141 So.3d at 741.
    - Quoted with approval in Silver Crown Investments, LLC v. Team Real Estate Management, LLC, 2018 WL 46979718 at *4 (S.D. Fla. 2018).
- *Dinuro* stated a presumption that members are not directly liable to one another for promises they make in the operating agreement.
  - This is very different that the rule in the case of partnership agreements.
- This presumption can be overcome by a provision stating that members shall be directly liable to one another for breaches of its terms.

The Shield and the Operating Agreement (cont'd)

- Nothing prevents an operating agreement from expanding the right of a member to bring a direct action against another member, a manager, or the LLC.
  - An operating agreement may not unreasonably restrict the right of a member to bring a direct action. F.S. § 605.0105(3)(k).
- However, the intent to authorize direct actions by members for breach of the operating agreement must be clearly expressed.
- *Dinuro* rejected numerous arguments that the operating agreement before it authorized direct actions by members:
  - "Conspicuously missing from the operating agreement is any <u>provision stating that the members shall be directly liable to each other for breaches of the terms of the operating agreement</u>. <u>Absent such a stipulation, we presume individual members are not liable for obligations or decisions of the company, as limited liability is one of the paramount reasons for forming an LLC.</u>"

The Shield and the Operating Agreement (cont'd)

- This is a fundamental issue of immense practical importance. The shield can have consequences <u>inside</u> the LLC the members may never have intended. The members may be treated as outsiders by their own LLC.

- In this respect, members in LLCs, just like partners in LLPs, should consider whether they are treated as outsiders in their own operating agreement:
  - "In the long run, it is critical to distinguish between agreements with the partnership and agreements with the other partners. Partners who want the personal liability of other members of limited liability partnerships should bargain for agreements that explicitly impose personal liability. In effect, members of limited liability partnerships should think of themselves as outside creditors of their own partnerships." Robert W. Hillman, Donald J. Weidner and Allan G. Donn, The Revised Uniform Partnership Act 675 (2018-2019 ed.).

The Shield and the Operating Agreement (cont'd)

- Stated differently, members in LLCs who want the personal liability of the other members or managers must explicitly bargain for it. Otherwise, they may be treated as outsiders to their own LLC.

- Compare *Ederer v. Gursky*, 9 N.Y.3d 514, 851 N.Y.S.2d 108, 881 N.E.2d 204 (2007), which reached a different result under New York LLP law than *Dinuro* reached under Florida LLC law.

- In *Ederer v. Gursky,* the New York Court of Appeals held that the liability shield of an LLP did <u>not</u> protect individual partners from the claim of another partner that they had failed to properly account for the value of his interest in the partnership. The partner's claim was based in part upon an earlier withdrawal agreement he had reached with the firm.
  - A dissent in *Ederer v. Gursky* objected that the shield made no distinction between insiders and outsiders.

Members Who Want Out: The Concept of Dissociation

- What if a Founder or other member simply says "I want out and I quit?"
- Under the 2013 LLC Act, as the Florida Revised Uniform Partnership Act ("FRUPA"), the departure of a member, whether by resignation, expulsion, or death, is a "dissociation."
- F.S. § 605.0601(1) provides: "A person has the power to dissociate as a member at any time, rightfully or wrongfully, by withdrawing as a member by express will . . . ."
  - This is a bit of liberalization. Former Chapter 608 did not provide the power to dissociate. A member could have been contractually bound to membership until the LLC was dissolved.
  - Furthermore, the "power to dissociate" is a default rule—it may be modified or eliminated by the operating agreement.
- The question is, what does the dissociation get you? A dissociated member's economic interest in the firm may be trapped in the LLC until it dissolves.

Dissociation from an LLC—No More Buyout

- A member dissociating from an LLC has fewer rights than a partner dissociating from an LLP.
- A partner who dissociates has either the right to dissolve and wind up the partnership (if the partnership was at will) and receive his share of the remaining equity or the right to be bought out of the partnership (if the partnership was for a term or specific undertaking) for the value of his or her interest.
- However, in order to avoid destabilizing a term partnership by requiring it to buy out a partner who left early, § 620.8701(8) provides:
  - "(8). A partner who wrongfully dissociates before the expiration of a definite term or the completion of a particular undertaking is not entitled to payment of any portion of the buyout price until the expiration of the term or completion of the undertaking, *unless* the partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership."

Dissociation from An LLC—No More Buyout (cont'd)

- A member who dissociates gets neither the right to dissolve and cause a winding up nor the right to be bought out.
  - The LLC Act no longer distinguishes between an "at will" company and a "term company."
- Instead, a member who dissociates receives a downgraded interest:
  - The former member is stripped of management and voting rights; and
  - Retains his, her, or its economic interest, but in the capacity of a transferee.
    - The economic interest of a transferee is essentially the right to receive a share of distributions.

Dissociation from An LLC—No More Buyout (cont'd)

- More specifically, if a person is dissociated as a member, "a transferable interest owned by the person in the person's capacity immediately before dissociation as a member is owned by the person *solely as a transferee*." F.S. § 605.0603(c).

- The key here is what the statute no longer states. It no longer includes a right to be bought out.
  - By contrast, the prior LLC Act provided that, upon withdrawal, a member was "entitled to receive . . . the fair value of the withdrawing member's interest in the [LLC] as of the date of resignation based upon the withdrawing member's right to share in distributions from the limited liability company." F.S. § 608.427(2), repealed by the 2013 LLC Act.
  - An even earlier version gave the withdrawing partner "the balance of his or her capital account."

- Nor does a transferee of a member's interest have the right of a transferee of a partner's interest to a judicial determination that it is equitable to wind up the partnership business after the expiration of a fixed term or undertaking or at any time if the partnership is at will. F.S. § 620.8801(6).
  - See F.S. § 605.0702 (grounds for judicial dissolution of an LLC).

Dissociation from An LLC—No Interim Distribution

- Dissociation does not trigger a buyout nor any other interim distribution.
- F.S. § 605.0404(2) provides:

"(2) A person <u>has a right to a distribution before the dissolution and winding up</u> of a [LLC] <u>only if the company decides to make an interim distribution</u>. A person's <u>dissociation does not entitle the person to a distribution</u>."

  - The parties can provide otherwise in their operating agreement, either for a full buyout or for some distribution short of that.

- F.S. § 605.0404(4) provides:

"(4) If a member or transferee becomes entitled to receive a distribution, the member or transferee has the status of and is entitled to all remedies available to a creditor of the [LLC] with respect to the distribution."

Dissociation from An LLC— The Great Demotion

- So what are the consequences of being demoted from a member to a transferee?
- F.S. § 605.0502(1) provides that a transferee is not entitled to:
  "(1) Participate in the management or conduct of the company's activities and affairs; or
  "(2) Except [in the case of a dissolution and winding up], have access to records or other information concerning the company's activities and affairs.
- A transferee is not entitled to the statutory information rights of a member (unless the transfer was the result of the death of a member). F.S. § 605.0410(8).
- F.S. § 605.0502(2) provides that a transferee is entitled to:
  - "receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled.

Effect of Operating Agreement on Transferees, Including Dissociated Members

- F.S. § 605.0107(2) provides that the operating agreement continues to determine the rights of transferees:

"(2) **The obligations** of a [LLC] and its members **to** a person in the person's capacity as a **transferee** or a person dissociated as a member are governed by the operating agreement."

- More specifically, It provides:

"An amendment to the operating agreement made after a person becomes a transferee or is dissociated as a member:

"(a) **Is effective with regard to a** debt, obligation, or other **liability of the [LLC] or its members to** the person in the person's capacity as **a transferee** or person dissociated as a member; and

"(b) Is not effective to the extent the amendment imposes a new debt, obligation, or other liability on the transferee or person dissociated as a member." Id.

Effect of Operating Agreement on Transferees, Including Dissociated Members (cont'd)

- F.S. § 605.0107(2) "clarifies" that an amendment to the operating agreement binds a transferee, even if it changes the firm's obligations to the transferee, "with the limitation that the amendment cannot impose a new debt or other obligation on the transferee." Conti & Marks, supra. Pt. 1.
- The Florida Bar Drafting Committee Commented: "The law of unincorporated business organizations is only beginning to grapple in a modern way with the tension between the rights of an organization's owners to carry on their activities as they see fit (or have agreed) and the rights of (dissociated) owners who are 'locked in' as transferees of their own interests."

The *Bauer* Model for Limited Rights of Transferees

- LLC Act approves the way the “tension” was resolved by the majority opinion in *Bauer v. Bloomfield Company/Holden Joint Venture,* 849 P. 2d 1365 (Alaska 1993).
- The Holdens were two of six partners in a partnership. They took out an <u>unrelated loan</u> of $800,000 from Bauer and secured it with an assignment to Bauer of “all of their right, title and interest” in the partnership. <u>The other four partners consented to the assignment.</u>
- The Holdens defaulted on their loan and Bauer gave notice to the partnership that he was exercising his right to receive all distributions to which the Holdens would have been entitled. <u>For a while, the partnership made monthly payments to Bauer.</u>
- In January, 1989, the <u>partners stopped making payments. They unanimously decided, instead, to pay an $877,000 “commission” to one of the other partners</u> in the amount of 5% of the increased gross rental income on lease extensions that partner obtained from the state. <u>That payment wiped out the profits that would have gone to Bauer</u>, $207,567.

The *Bauer* Model for Limited Rights of Transferees (cont'd)

- Bauer sued the partnership and all the partners other than their transferors.
- Majority agreed with the court below that <u>the assignment made with the consent of all the partners did not make assignee Bauer a "de facto" partner</u>.
- "<u>Therefore, he was not entitled to complain about a decision made with the consent of all the partners.</u>"
  - Even a change in policy that ended distributions. As an assignee, Bauer was <u>not entitled "to interfere in the management</u> or administration of the partnership business or affairs, <u>or to require any information or account of partnership transactions or inspect the partnership books</u>."
- Because all the partners agree that the commission should be paid, there were no profits left to distribute to the Holdens, and hence to Bauer, until the commission was fully paid.
- .

The *Bauer* Model for Limited Rights of Transferees (cont'd)

- "We are unwilling to hold that partners owe a duty of good faith and fair dealing to assignees. To do so would undermine the clear intent of the [partnership act]."
- "Partners should be able to manage their partnership without regard for the concerns of an assignee, who may have little interest in the partnership venture."
- Court cited Bromberg & Ribstein on Partnership § 3:61:
  - "The U.P.A. rules . . . balance the interests of assignees, assignors, and nonassigning partners in a way that is suited to the very closely held business. Although the assignee's impotence obviously limits the market value of the partners' interest, the partners need to be protected from interference by unwanted strangers."
- DISSENT in *Bauer* said the crucial question is whether the decision to pay the commission was made in good faith. Without asking that question, the majority leaves the assignee with no remedy.

The *Bauer* Model for Limited Rights of Transferees (cont'd)

- The DISSENT continued: "It is a well-settled principle of contract law that an assignee steps into the shoes of an assignor as to the rights assigned. Today, the court summarily dismisses this principle in a footnote and leaves the assignee barefoot."
  - "Requiring the partners to make decisions regarding distributions in good faith does not interfere with management, it merely requires that the partners fulfill their existing contractual duties in good faith."
- The statute was not designed to allow the withholding of distributions "for whatever outrageous motive or reason. The court's opinion essentially leaves the assignee of a partnership interest without remedy to enforce his right."
- When the partnership was formed, "a contractual relationship arose among the partners. This court has held that a covenant of good faith and fair dealing is implied in all contracts."
  - The basis for imposing this covenant "is a hybrid of social policy and an effort to further the expectations of the contracting parties that the promises will be executed in good faith."

The *Bauer* Model for Limited Rights of Transferees (cont'd)

- One element of the contract is the Holdens' right to receive their share of profits when a distribution is made. As an element of the partnership contract, this right is accompanied by the duty [obligation] of the parties to deal fairly and in good faith.
- "<u>The partnership has a right to decide not to make a distribution, but in making this decision, the partnership must act in good faith.</u>"
- Under the law of assignments, Bauer steps into the shoes of the Holdens. Accompanying their contractual right to distributions is the partnership's obligation to make decisions concerning distributions in good faith.
- <u>Good faith involves a question of fact. "If there is a dispute as to why someone did what he did, there is a question of fact for the jury." The burden is on the assignees to establish that a genuine issue of fact existed as to whether the 5% commission was paid "in good faith."</u>

The *Bauer* Model for Limited Rights of Transferees (cont'd)

- The RULLCA legislative history, Comment b to § 112 of Re-ULLCA (2006), adopts the *Bauer* majority:
  - "If the law categorically favors the owners, there is a serious risk of expropriation and other abuse. On the other hand, if the law grants former owners and other transferees the right to seek judicial protection, that specter can 'freeze the deal' as of the moment an owner leaves the enterprise or a third party obtains an economic interest.
  - * * *
  - "The *Bauer* majority is consistent with the limited but long-standing case law in this area (all of it pertaining to partnerships rather than LLCs). This subsection follows the Bauer majority and other cases by expressly subjecting transferees and dissociated members to operating agreement amendments made after the transfer or dissociation.
  - "**The issue of whether, in extreme and sufficiently harsh circumstances, transferees might be able to claim some type of duty or obligation to protect against expropriation is a question for other law.**"

The *Bauer* Model: for Limited Rights of Transferees (cont'd)

- The *Bauer* dissent noted that part of the "balance" of the interests under the UPA was in UPA § 32(b), which provided that a court shall decree dissolution, on the application of the purchaser of a partner's interest: "At any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued."
- FRUPA § 620.8801(6) provides similar relief for a transferee, although it is not automatic:
  - "A partnership is dissolved, and its business must be wound up * * *

    "(6) on application by a transferee of a partner's transferable interest, a judicial determination that it is equitable to wind up the partnership business: * * *

    (ii) at any time, if the partnership was a partnership at will at the time of the transfer or entry of the charging order that gave rise to the transfer."
- As noted earlier, there is no similar provision benefitting a transferee under the current LLC law, which has eliminated the category of an "at will" LLC.

Dissociation from An LLC—Florida Eliminates "Oppression" Offset to Loss of the Buyout

- Florida's 2013 LLC Act is based on <u>RULLCA, which eliminated the right of a dissociating member to be bought out.</u>
- However, <u>when it did so, it added the rule that judicial dissolution is available if "the mangers or those in control of the company . . . have acted in a manner that is *oppressive*</u> and directly harmful to the applicant."
- The RULLCA drafters stated that this provision reflected "case law developments around the country and was "<u>*necessary* given the perpetual duration of an LLC formed under this Act . . .and this Act's elimination of the 'put right' provided by" the original Uniform LLC Act</u>."
- In short, the RULLCA drafters concluded that, if members are going to be locked in to a perpetual entity and be denied a buyout right, it is "necessary" to give them judicial protection against oppressive behavior.
- However, when Florida adopted <u>RULLCA rule, it deleted the rule that oppression is a ground for judicial dissolution</u>.

The Operating Agreement—Default and Mandatory Rules

- Much of the LLC Act consists of default rules that apply in the absence of a provable agreement to the contrary. The statute provides a default--or "off the rack"-- operating agreement. F.S. § 605.0105(2).
  - Technically, a pre-formation agreement is not an operating agreement because there are not yet "members" of an LLC.
- However, some of the rules in the LLC Act are mandatory rules that the parties are not free to contract away.
- F.S. § 605.0105 (3) lists the Act's mandatory (or "nonwaivable") rules with the introductory declaration: "An operating agreement may not . . . . "
- For example, the operating agreement may not:
  - "Vary the grounds for dissolution specified in s. 605.0702." (including judicial dissolution at the request of a member or a manager)
  - "Unreasonably restrict the right of a member to maintain an action under §. 605.0801-605.0806." (the provisions allowing a member to bring a direct or a derivative action against the firm, another member or a manager)
  - "Unreasonably restrict the duties and rights stated in s. 605.0410" (concerning member access to books and records)

The Operating Agreement: Altering or Eliminating Fiduciary Duties

- The mandatory provisions concerning the duty of loyalty, the duty of care, and other fiduciary duties, are in §§ 605.0105(3)(e) and (f) and § 605.0105(4).
- In short, <u>the operating agreement may "alter or eliminate"</u> the three fundamental aspects of <u>the duty of loyalty</u> stated in F.S. § 605.04091(2)(a)-(c) <u>or "any other fiduciary duty," if not "manifestly unreasonable."</u>
  - Eliminating the duty of loyalty is controversial, and case law suggests it can be only accomplished with great care.
- However, the operating agreement may not: "Relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or a knowing violation of law." F.S. § 605.0105(3)(g).
- F.S. § 605.0105(3)(p) also has a non-Uniform rule prohibiting an operating agreement from indemnifying a member or manager "in cases involving certain misconduct (including bad faith, willful or intentional misconduct, a knowing violation of law, or breach of fiduciary duties or the obligation of good faith and fair dealing." Louis T.M. Conti and Gregory M. Marks, Florida's New Revised LLC Act, Part I, 87 Fla. B. J. (Sept/Oct. 2013).

The Fiduciary Duties of Loyalty and Care

- F.S. § 605.04091, setting out the "Standards of Conduct for Members and Managers," applies to members in member-managed LLCs and managers in manager-managed LLCs. It states that the duties of loyalty and care are fiduciary duties.

  "(1) Each manager of a manager-managed [LLC] and member of a member-managed [LLC] owes fiduciary duties of loyalty and care to the [LLC] and members of the [LLC]."

  "(2) The duty of loyalty includes" three components in subsections 2(a)-(c):
  - To account for any benefit derived in the conduct or winding up of the LLC activities, from a use of LLC property, or from the appropriation of an LLC opportunity.
  - To refrain from dealing as or on behalf of an adverse party.
  - To refrain from competing with the LLC prior to its dissolution.
- These duties were "un-cabined" in 2015. These are not the only fiduciary duties.

Self-Interest and Conflict of Interest Transactions

- F.S. § 605.04091(5) provides that a manager or member "does not violate a duty or obligation under this chapter or under the operating agreement solely because the manager's or member's conduct furthers the manager's or member's own interest."
  - RULLCA eliminated this provision and adopted a "fairness" rule as a "different approach." Florida has both.
- F.S. § 605.04092(3) is the core of the "Conflict of interest transactions" rule:

"If a transaction is fair to the [LLC] at the time it is authorized . . . , the fact that a member or manager . . . is directly or indirectly a party to the transaction . . . or has a direct or indirect material financial interest . . . in the transaction . . . is not ground for equitable relief and does not give rise to an award of damages or other sanctions."

- F.S. § 605.04092(4) provides that the person challenging the validity of an "interested transaction" has the burden of proving a lack of fairness in certain situations (ex., if it has been approved by a majority of disinterested managers or members).

The Duty of Care

- F.S. § 605.04091(3):

  "The duty of care in the conduct or winding up of the company's activities and affairs is to refrain from engaging in <u>grossly negligent</u> or reckless conduct, willful or intentional misconduct, or a knowing violation of law."

- F.S. § 605.04091(6): In discharging his, her, or its duties, a member or manager is entitled to rely on various opinions, reports, statements and or other information provided by others.

- See also F.S. § 605.04096, giving managers and members broad freedom from liability for money damages for policy decisions or actions or failures to act, unless there was violation of criminal law, improper benefit derived, or other wrongdoing.

Fiduciary Duties and Freedom of Contract (cont'd)

- At the same time the legislature un-cabined the "Standards of Conduct" provision, it added permission to contract away "any other fiduciary duty," and reinforced that rule with amendments to § 605.0111, "Rules of construction and supplemental rules of law":

"(1) It is the intent of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements . . . ."

"(2) To the extent that, at law or in equity, a member, manager, or other person has duties, including fiduciary duties . . . [those duties] may be restricted, expanded, or eliminated . . . by the operating agreement, to the extent allowed by s. 605.0105."

"(3) Unless displaced by particular provisions of this chapter, the principles of law and equity, including the common law principles relating to the fiduciary duties of loyalty and care, supplement this chapter."

- See also 605.04091(5): "A manager . . . or a member . . . does not violate a duty or obligation under this chapter or under the operating agreement solely because the manager's or member's conduct furthers the manager's or member's own interest."

Restricting or Eliminating Fiduciary Duties

- Except to the extent provided in F.S. § 605.1005(3), the statutory duties of loyalty and care are default rules.
- F.S. § 605.0105(3) states that an operating agreement may not:

“(e) Eliminate the duty of loyalty or the duty of care under s. 605.04091, except as otherwise provided in subsection (4).”

- F.S. § 605.0105(4)(c) states:

“(c) If not manifestly unreasonable the operating agreement may:

“1. Alter or eliminate the [three] aspects of the duty of loyalty under s. 605.04091(2);

“2. Identify specific types or categories of activities that do not violate the duty of loyalty;

“3. Alter the duty of care, but may not authorize willful or intentional misconduct or a knowing violation of law; and

“4. Alter or eliminate any other fiduciary duty.” [added to the 2013 LLC Act in 2015]

Restricting or Eliminating Fiduciary Duties (cont'd)

- F.S. § 605.0105(5) provides that courts, not juries, get to decide what is "manifestly unreasonable:"

"(5) <u>The court shall decide as a matter of law whether a term of an operating agreement is manifestly unreasonable</u> under paragraph 3(f) [dealing with the obligation of good faith and fair dealing] or paragraph (4)(c) [dealing with the duties of loyalty, care, and "any other fiduciary duty"] . The court:

"(a) <u>Shall make its determination</u> as of the time the challenged term became part of the operating agreement and shall consider only circumstances existing at that time; and

"(b) <u>May invalidate the term only if</u>, in light of the purposes, activities, and affairs of the [LLC], <u>it is readily apparent that</u>:

"1. The <u>objective</u> of the term <u>is unreasonable</u>; or

"2. The term is an <u>unreasonable means</u> to achieve the provision's objective."

Removing Contractual Restrictions on the Duty of Loyalty

- Recall that an operating agreement can be written or oral, or a combination of both.
- Thus, presumably, it could be argued that there was an oral agreement to amend or remove written restrictions on the duty of loyalty in an operating agreement.
  - Although amending the operating agreement requires unanimous consent of the members (unless the operating agreement provides otherwise)
- It would be difficult to argue that a provision was amended orally or by implication if the operating agreement provided that it may only be amended by a record.
  - F.S. § 605.0102(59): "'Record,' if used as a noun, means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form."
- Unclear the impact of F.S. § 605.0105(3)(g), which provides that an operating agreement may not: "Relieve or exonerate a person from liability for conduct involving bad faith, willful or intentional misconduct, or a knowing violation of law."

The Obligation of Good Faith and Fair Dealing

- F.S. § 605.04091(d):

  "A manager of a manager-managed [LLC] and a member of a member-managed [LLC] shall discharge their duties and obligations under this chapter or under the operating agreement and exercise any rights consistently with the <u>obligation of good faith and fair dealing</u>."

- RULLCA refers to the obligation of GFFD as "contractual." The Florida LLC Act does not use the word "contractual," but it does not classify this "obligation" as a fiduciary duty.

- F.S. § 605.0105(3)(f) states that <u>the operating agreement may not</u>:

  "(f) <u>Eliminate the obligation of good faith and fair dealing</u> under s. 605.04091, <u>but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured if the standards are not manifestly unreasonable</u>."

- This GFFD provision has no cross-reference the F.S. § 605.0105(4) rule that permits the elimination of fiduciary duties, if not manifestly unreasonable.

The Obligation of Good Faith and Fair Dealing (cont'd)

- Particularly in situations in which statutory fiduciary duties have been contracted away, there is greater pressure on the content of the "implied covenant" of GFFD.
- The general understanding of the covenant of GFFD is that it is a "gap filler," intended to fill in the gaps in an agreement.
  - Usually, the gaps will be filled in with normal business practice.
- The statutory concept is that courts should not use the "rubric" of GFFD as a basis for independent duties
  - Hence, GFFD is an "obligation," not a "duty".

The Obligation of Good Faith and Fair Dealing (cont'd)

- Even more specifically, the idea is that the covenant of GFFD should not be applied to deny a party the benefit of a provision of a written agreement.
- See Official Comment to RULLCA § 409(d), defining the contractual obligation of GFFD:

"Courts should not use the contractual obligation to change *ex post facto* the parties' or this act's allocation of risk and power. To the contrary, the obligation should be used only to <u>protect</u> agreed-upon arrangements <u>from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangement was made</u>."

Direct versus Derivative Actions

- One of the most frequently litigated questions involving LLCs is whether a claim by a dissatisfied member of an LLC is a <u>direct</u> claim <u>or</u> a <u>derivative</u> claim.
- Many members attempt to bring a direct claim against another member, a manager, or the firm itself.
  - For example, saying a manager is breaching a duty to the member.
- The dissatisfied member who is a <u>direct</u> claimant proceeds on the theory that he, she, or it, has been directly injured and is entitled to receive a remedy.
- With great frequency, <u>courts tell dissatisfied members that they lack "standing" to bring their direct claim</u> because it is, in substance, a derivative claim, not a direct claim.
- The claim is derivative when it presents an injury to the firm. The appropriate remedy, therefore, goes to the firm rather than to an individual member.

Derivative Action by a Member—Demand Required Unless Demand Futility

- F.S. § 605.0802 authorizes a Derivative Action by a Member:

"A member may maintain a derivative action to enforce a right of a [LLC] if:

(1) The member first makes a demand on the other members in a member-managed [LLC] or the managers of a manager-managed [LLC] requesting that the managers or other members cause the company to take suitable action to enforce the right, and the managers or other members do not take the action within a reasonable time, not to exceed 90 days; or

(2) A demand under subsection (1) would be futile, or irreparable injury would result to the company by waiting for the other members or the managers to take action to enforce the right in accordance with subsection (1)."

- RULLCA does not have an outside 90-day time limit
- Neither Florida's prior LLC statute nor its corporate statute provided futility as a basis for excusing a demand.

Derivative Action by a Member—Demand Required Unless Demand Futility (cont'd)

- The Florida Bar Drafting Committee commented:

"[T]he majority believed that the RULLCA formulation of permitting a derivative action to be commenced based on demand futility, is more appropriate for many closely held LLCs in Florida. <u>Many, if not most, of the derivative actions in Florida are brought by minority owners of LLC interests against a majority owner who also happens to be in control of the LLC, and in those instances, it is almost always going to be the case that the member or manager in control will refuse or ignore the demand</u> for the company to bring the action, thereby further delaying the opportunity to seek redress in the courts."

S. Cohn and S. Ames, Fla. Bus. L. Ann. p. 318 (2017-18):

"Under Delaware law, <u>to excuse a demand based on futility</u> the shareholder must allege <u>particularized facts</u> creating a <u>reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was a valid exercise of a business judgment</u>."

Derivative Action by A Member: LLC Gets a Chance to Exercise Its Business Judgment

- In short, the LLC Act recognizes that the LLC is the principal party in interest in a derivative action and has a right to exercise its business judgment:

"That is why the statute requires a demand (unless futility exists) to allow the LLC to determine whether it will take remedial action and provides for the LLC to make a motion to dismiss if it believes that the derivative action as filed should not proceed. *Even if a claim has legal merit, there might be adequate grounds for a complaint's dismissal*. An LLC is not required to pursue or allow a derivative action to pursue every possible claim it might have. The nature of the claim, the amount involved, indemnification provisions, potential litigation costs and likelihood of success are all factors to be considered." Cohn & Ames, supra. at 320

Derivative Action by a Member—Proper Plaintiff

- To sue derivatively on behalf of the firm, a plaintiff faces many obstacles.
- F.S. § 605.0803 provides for the Proper Plaintiff in a Derivative Action:

"A derivative action to enforce a right of a limited liability company may be maintained <u>only by a person that is a member at the time the action is commenced and</u>:

1) Was a member when the conduct giving rise to the action occurred; or
2) Whose status as a member devolved on the person by operation of law or pursuant to the terms of the operating agreement from a person who was a member at the time of the conduct."

- The Florida Bar Drafting Committee commented: "The New Act removes the requirement from RULLCA that a plaintiff must remain a member of the [LLC] while the action continues."

Derivative Action by a Member—Special Litigation Committee

- F.S. § 605.0804(1): provides that the company may respond to a derivative action by appointing a Special Litigation Committee (SLC) to intervene in a derivative action.

"(1) If [an LLC] is named as or made a party in a derivative proceeding, the company may appoint a [SLC] to investigate the claims asserted in the derivative action and determine whether pursuing the action is in the best interest of the company. If a company appoints [an SLC], on motion, except for good cause shown, the court may stay any derivative action for the time reasonably necessary to permit the committee to make its investigation. This subsection does not prevent the court from:

(a) Enforcing a person's rights under the company's operating agreement or this chapter, including the persons rights to information under s. 605.0410; or

(b) Exercising its equitable or other powers, including granting extraordinary relief in the form of a temporary restraining order or preliminary injunction."

Derivative Action by a Member—Special Litigation Committee (cont'd)

- Uniform Law Commission Comment: "Although special litigation committees are best known in the corporate field, they are no more inherently corporate than derivative litigation or the notion that an organization is a person distinct from its members. <u>An 'SLC' can serve as an ADR mechanism, help protect an agreed upon arrangement from strike suits, protect the interests of members who are neither plaintiffs nor defendants (if any), and bring to any judicial decision the benefits of a specially tailored business judgment</u>."

- Cohen & Ames supra at 323: "If the LLC's decision is to reject the demand, and the member then files a derivative complaint, the LLC has the right to file a motion to dismiss if its rejection was based upon an investigation by a [SLC] that met the qualifications of independence set forth in §. 607.0804(3). Alternatively, if the LLC had rejected the demand without such internal investigation, after the complaint is filed it might then undertake an investigation through [an SLC] that could, depending on the findings, become the basis for a motion to dismiss. The LLC is entitled to a stay of the proceedings until its investigation has been completed. In its motion to dismiss, the LLC will have the burden of proof regarding the independence and the reasonableness of the committee's investigation."

Derivative Action by a Member—Requirements and Appointment of Special Litigation Committee Member(s)

- F.S. § 605.0804(2): "[An SLC] must be composed of <u>one or more disinterested</u> and <u>independent</u> individuals, <u>who *may* be members</u>."

- F.S. § 605.0804(3) provides that <u>an SLC may be appointed</u>:

"(a) <u>In a member-managed [LLC], by the consent of the members who are not named as parties in the derivative action, who are otherwise disinterested and independent, and who hold a majority of the current percentage or other interest in the profits owned by all of the members</u> of the company who are not named as parties in the derivative action and who are otherwise disinterested and independent;

"(b) <u>In a manager-managed [LLC], by a majority of the managers not named as parties in the derivative action and who are otherwise disinterested and independent</u>; or

"(c) <u>Upon motion by the [LLC]</u>, consisting of a panel of one or more disinterested and independent persons."

Derivative Action by a Member—Requirements and Appointment of Special Litigation Committee Member(s) (cont'd)

- The Florida Bar Drafting Committee noted that this provision added "independence standards" to who get to choose the SLC:

- "Under the New Act, [an SLC] may only be appointed by the consent of member or managers that are not parties to the proceeding and that are otherwise disinterested. In addition, in a member-managed company the appointing members must then hold a majority of the then current percentage or other interest in the profits of the company . . . . The New Act also allows a court to appoint a panel of disinterested and independent persons to constitute the special litigation committee."

* * *

"The Drafting Committee believes that requiring a [SLC] member to be independent and disinterested also allows a court the ability to evaluate each committee member as disinterested and independent at the outset of an investigation. It also avoids any unnecessary delays that are inherent in waiting until the end of a [SLC] investigation when the committee has ineligible participants."

Derivative Action by a Member—Determination of Special Litigation Committee (cont'd)

- F.S. § 605.0804(4): "After appropriate investigation, [an SLC] shall determine what action is in the best interest of the limited liability company, including continuing, dismissing, or settling the derivative action or taking another action that the special litigation committee deems appropriate."

- When a motion is made to enforce the determination of the SLC:

"If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court *may* enforce the determination of the committee. Otherwise, the court shall dissolve any stay of derivative action entered . . . and allow the derivative action to continue under the control of the plaintiff." F.S. § 605.0804(5)

  - By contrast, RULLCA provides the court "shall enforce" the SLC's determination.

Direct Action by a Member

- F.S. § 605.0801, new with the 2013 LLC Act, is a "comprehensive direct action by member provision." It authorizes a direct action by a member as follows:

"(1) Subject to subsection (2), a member may maintain a direct action against another member, a manager, or the limited liability company to enforce ***the member's*** rights and otherwise protect the member's interests, including rights and interests under the operating agreement or this chapter or arising independently of the membership relationship.

(2) A member maintaining a direct action under this section 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]***."

  - From Re-RULLCA (2006) § 901 Direct Action by Member.

Florida's Leading Case on Direct Actions: *Dinuro*

- *Dinuro Investments, LLC v. Camacho*, 141 So.3d 731, 739 (Fla. 3d D.C.A. 2014) is Florida's leading case on the requirements to bring a direct action.
- Dinuro Investments, LLC and two other LLCs were equal members of San Remo, a real estate LLC that became overextended on loans to Bank. Bank agreed to loan modifications on the condition that all three members contribute additional money. The other two did, Dinuro did not, and the loans went into default. The other two members formed a new entity, which Dinuro declined to join, that purchased the Bank's notes from San Remo and sued to foreclose on the San Remo properties. San Remo did not respond to the foreclosure action, and a default was entered against it.
- As a result, the new entity owned by the other two members wound up with all of San Remo's properties and San Remo and Dinuro wound up with nothing.
- When Dinuro sued the other two members, the trial court said it had no standing to bring its claims because they were derivative, not direct.

Dinuro—The Basic rules

- On appeal, after extensive review of "nearly fifty years of apparently divergent case law," the 3rd DCA summarized the requirements to bring a direct action in Florida:

"[A]n action may be brought directly only if (1) there is a direct harm to the shareholder or member such that the alleged injury does not flow subsequently from an initial harm to the company **and** (2) there is a special injury to the shareholder or member that is separate and distinct from those sustained by the other shareholders or members.

* * *

"We also find that there is an exception to this rule under Florida law. A shareholder or member need not satisfy this two-pronged test when there is a separate duty owed by the defendant(s) to the individual plaintiff under contractual or statutory mandates."

  - Id. at 739-740.

Dinuro—Direct Harm

- The "direct harm" test appears to be applied by a majority of courts nationally.
- It distinguishes direct actions from derivative actions by considering "whether the harm from the alleged wrongdoing flows first to the company and only damages the shareholders or members due to the loss in value of their respective ownership interests in the company, or whether the harm flows 'directly' to the shareholder or member in a way that is not secondary to the company's loss." Id. at 735.
- Thus, a member cannot bring a direct action "for damages against management on the theory their alleged wrongdoing decreased the value of his or her stock (e.g., by reducing corporate assets and net worth)." Id. at 735-36.
- See *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004): "The analysis must be based solely on the following questions: Who suffered the alleged harm—the [LLC] or the suing [member] individually—and who would receive the benefit of the recovery or other remedy?"

Dinuro—Direct Harm (cont'd)

- *Dinuro* continued with its own and arguably more restrictive statement of the direct harm test: "Thus, the examining court must compare the individual's harm to the company's harm. Under this test, <u>a [member] can only bring a direct suit if the damages are unrelated to the damages sustained by the company and if the company would have no right to recover in its own action</u>." Id. at 736. (citing *Tooley*)

- It affirmed the trial court conclusion that Dinuro had no direct injury—his harm was from the total devaluation of San Remo.

- The Third DCA lauded the direct harm test for its simplicity:
  - "This approach likely provides the greatest simplicity in application, as the courts need only look to whether the alleged wrongful conduct devalued the company as a whole or was directed specifically towards the individual plaintiff." Id. at 736.

Dinuro—Direct Harm (cont'd)

- On the other hand, the court noted that the direct harm test can benefit a wrongdoing member:

"One downside to this approach, however, is that it <u>potentially allows a wrongdoer to devalue the company for personal gain without fear of personal repercussions</u>. Claims alleging that a majority member has embezzled assets from the company to the detriment of minority members, for example, would only be cognizable as derivative actions, and any recovery for such an action would go to the company. <u>The wrongdoer would then receive a proportionate share of the return of the embezzled funds so that he is made whole despite being the very party causing the harm.</u> In other words, *a strict 'direct harm' approach may be especially harsh in small company settings because minority members will not be able to recover personal money that is taken by an oppressive majority*." Id. at 736

Dinuro—Special Injury

- Because *Dinuro* concluded there was no direct harm, it found no need to consider whether there was also “special injury.”

- Nevertheless, it said the special injury test:

“require[s] a plaintiff to demonstrate that he has sustained a loss that is substantially different from those losses sustained by other shareholders or members before he can maintain an individual or direct suit.”

- It noted that not all jurisdictions use this test, which can be “nebulous:”
  - “[T]his test can be much more difficult to apply, as the ‘special’ nature of the injury can be a nebulous inquiry that is often not readily apparent.” Id. at 737.

Dinuro—Separate “Duty Owed” by Contract or Statute

- A plaintiff may assert a direct action when there is a special duty owed <u>even if the harm otherwise flows to the company</u>. *Harrington v. Batchelor*, 781 So.2d 1133, 1135 (Fla. 3d DCA 2001).
- Therefore, because Dinuro failed to establish a direct action on the basis of direct harm and special injury, the court was required to decide whether Dinuro had standing to assert a separate contractual or statutory duty owed to it.
- The “duty owed” test “simply examines the <u>statutory</u> **and** <u>contractual</u> terms to determine whether the duty at issue was <u>owed to the individual member</u> or shareholder <u>by a particular manager or member</u>, *or* <u>**whether those duties were owed to the company generally**</u>.” Id. at 737.
- We have already discussed *Dinuro*’s presumption that there is not direct duty owed on the basis of the operating agreement.
- *Dinuro* said Dinuro abandoned his fiduciary duty claim early in the litigation, it did not discuss whether there was a separate duty owed under the statutory fiduciary duties.

Direct Harm and Special Injury After *Dinuro*

- Recall that Florida's direct action provision, enacted after *Dinuro* arose, states only one test: "whether the member "can plead and prove an . . . injury that is not solely the result of an injury suffered . . . by the [LLC]."
  - Arguably changing the law of *Dinuro.* Clearly looking to developments in other states.

- Nevertheless, Florida cases subsequent to *Dinuro* suggest that <u>conduct directed toward or that uniquely influences a dissatisfied member offers the greatest promise of a direct action, even if the injury seems derivative of a more fundamental wrong to the entity.</u>

- For example, in *Strazzulla v. Riverside Banking Co.*, 175 So.3d 879 (Fla. 4th DCA 2015), individual shareholders alleged that, <u>in a conversation they had following a shareholders' meeting, two directors misrepresented to them the nature of the firm's assets. As a result, they declined to participate in an expiring buyback program and remained shareholders while the value of their holdings was virtually wiped out</u> in the financial crisis.

Direct Harm and Special Injury After *Dinuro* (cont'd)

- *Strazzulla* (cont'd)
- <u>Trial Court</u>: Derivative, not direct. The <u>injury emanated from the mismanagement resulting in high-risk CDOs being purchased, rather than fraud on the plaintiffs', whose injuries were "common to all other shareholders.</u>"
- 4th DCA: Reversed. Though it is "murky" when a direct action may be brought, <u>*Dinuro*'s requirements of direct harm and special injury were satisfied. The plaintiffs' injury was "distinct from any injury suffered by other shareholders, who did not receive these same representations." Their direct action for misrepresentation was in addition to any derivative action for mismanagement.</u>
  - Note: Their situation presented both direct and derivative claims.

Direct Harm and Special Injury After *Dinuro* (cont'd)

- Similarly, direct and derivative claims were both found to have been involved in *Triton II, LLC v. Randazzo*, 2018 WL 4932342 (S.D. Fla. 2018), an LLC invested $3 million in a corporation in exchange for a 30% interest in it. The LLC sued the two promoters of the corporation, who were also its only other shareholders, for: a) inducing its investment in the corporation with false and misleading statements; and b) subsequently misusing the funds. The court said the claims premised on false and misleading statements to induce the investment involve direct injuries to the LLC. However, the LLC lacked standing to assert the claims premised on actions allegedly taken after the investment in the corporation. The loss of value to the LLC because of the subsequent actions "is functionally indistinguishable from the loss to [the corporation] and the other members. Indeed, the fact that [plaintiff and the two defendants] are the only members of [the corporation] does not permit [the LLC] to assert a claim directly that otherwise could be asserted only derivatively."
- What policy goal was achieved by denying a derivative suit when all three shareholders were parties to the proceeding?

Purposes of Limitations on Direct Actions

- The requirement that some suits be brought derivatively has been criticized as inappropriate in the context of a closely-held LLC.
- Direct actions are denied, and derivative actions are required, for a number of reasons:

1. To prevent multiple suits over the same cause of action.
2. To fairly distribute a recovery among interested members—to avoid giving an unfair advantage to the member who brings the direct action.
3. To avoid prejudice to firm creditors.
4. To preserve the role of the firm and its managers and members in resolving claims of the firm in accordance with their best business judgment.

- What was accomplished by denying standing in *Dinuro* and other cases in which all members (or shareholders) were a party to the suit?

Separate "Duty Owed" in Contract After *Dinuro*

- In *Rahal v. Mussel Beach Restaurant, Inc.*, 2018 WL 456212 (S.D. Fla. 2018), the plaintiff sued a restaurant corporation in which she invested and against its other two shareholders, who had a majority stake in it. She alleged that <u>she paid $700,000 for a 49% interest in the corporation on condition that the money would be used to grow the business by leasing adjacent space and adding additional seating</u>.
  - The defendants moved for summary judgment on her claim for breach of fiduciary duty, arguing that it failed as a matter of law because she did not bring it in a derivative capacity. The court denied the motion, citing *Strazzulla,* and saying that, even without direct harm and a special injury, a direct action can be brought "as an exception to the two-prong test where there is a separate statutory or contractual duty owed by the wrongdoer to the individual shareholder."
  - The plaintiff had identified sufficient evidence in the record that "a <u>reasonable jury could find that Defendants owed plaintiff a separate contractual duty</u>, and therefore, Defendants fail to show that Plaintiff was required to bring her claim In a derivative capacity."

Separate "Duty Owed" Under Statute After *Dinuro*

- *Fritz v. Fritz*, 219 So.3d 234 (Fla. 3d DCA 2017), has been the leading Florida case applying *Dinuro* to breach of fiduciary duty claims. Four brothers owned a family corporation that operated a nursery on land owned by two limited partnerships the brothers also owned. Plaintiff sued his three brothers for violating their fiduciary duties by charging the corporation excessive fees and by transferring property received in settlement of limited partnerships' claims to an LLC the three owned separately.

- Held, the plaintiff had shown neither direct harm and special injury nor a separate duty. <u>Even if a separate duty is alleged as the basis for a direct action, the plaintiff must show an injury "separate and distinct" from that suffered by other members.</u> Citing its own extremely broad language in *Dinuro*, the policy is to protect "individuals from the obligations arising out of their relationship to the company, while also allowing the parties greater freedom to contractually set their respective obligations."

Separate "Duty Owed" Under Statute After *Dinuro* (cont'd)

- Most recently, *Silver Crown Investments, LLC v. Team Real Estate Management, LLC*, 2018 WL 4679718 (S.D. Fla. 2018), said that "the express terms" of the 2013 LLC Act's direct action rule "seem to do away with the separate statutory duty exception articulated in *Dinuro.* Accordingly, only if there is a contract—like an LLC's operating agreement—allowing plaintiff members to bring direct claims against other members or managers, can a plaintiff bring a direct action without needing to satisfy the two-prong test [of direct harm and special injury]." Id. at *5.

Various Ways to Dissociate another Member

1. <u>Dissociation/Expulsion Pursuant to the Operating Agreement.</u>

- A person is dissociated as a member when "an event stated in the operating agreement as causing the person's dissociation occurs." F.S. § 605.602(2).
- A person is dissociated as a member when "the person is expelled as a member pursuant to the operating agreement." F.S. § 605.602(4).
  - The operating agreement may provide for expulsion with or without cause.
- There are many situations that seem right for an automatic dissociation under the operating agreement, such as a failure to make a capital call, a failure to continue to live in the area in which the firm does its business, or a failure to maintain the necessary license to do business as part of a personal services firm.
- However, it may be preferable to address these situations by a provision in the operating agreement that gives the other members or the firm discretion to expel an offending member.

Various Ways to Dissociate another Member (cont'd)

2. <u>Expulsion by Unanimous Consent of the Other Members.</u>

➢ Even if there is no provision in the operating agreement providing for expulsion, a member "is expelled as a member by the unanimous consent of the other members" in any of three unusual situations:

- It is unlawful to carry on the LLC's activities and affairs with the person as a member.
- The person's entire transferable interest has been transferred other than for security purposes or pursuant to a charging order that has not been foreclosed.
- The person is an entity in dissolution or whose charter or right to do business has been revoked.

See F.S. § 605.0602(5).

Various Ways to Dissociate another Member (cont'd)

3. <u>Judicial Expulsion/Dissociation.</u>

- Even in the absence of an expulsion provision in the operating agreement, F.S. § 605.0602(6) provides grounds for judicial expulsion:

(6) On application by the company or a member in a direct action . . . the person is expelled as a member by judicial order because the person:

a) <u>Has engaged . . . in **wrongful conduct** that has affected adversely and materially . . . the company's activities and affairs</u>;
b) <u>Has committed **willfully or persistently** . . . **a material breach** of the operating agreement or a duty or obligation under § 605.04091 [Standards of Conduct for Members and Managers]</u>; or
c) <u>Has engaged in . . . conduct relating to the company's activities and affairs which makes it **not reasonably practicable** to carry on . . . with the person as a member.</u>"

Consequences of Expulsion

- A person expelled by judicial order before completion of the winding up dissociates wrongfully. F.S. § 605.0601(2)(b)(3).
  - However, expulsion pursuant to the operating agreement, or on the unanimous consent of the other members, are not listed as events that causes dissociation wrongfully. See F.S. § 605.0601(2).

- As with other "dissociations," <u>judicial expulsion does not eliminate a member's interest in the LLC. Rather, it simply restricts it to the right to receive distributions</u>. The expelled member is stripped of any management rights or correlative fiduciary duties.
  - In effect the member is not "expelled" in the sense of being cut off from the firm. The members interest is demoted, not terminated. The member retains an economic interest with no continuing right to manage.

Expulsion Does Not Extinguish Economc Interest

- In *Froonjian v. Ultimate Combatant, LLC*, 169 So.3d 151 (Fla. 4th DCA 2015), held that a majority of the members had a right to expel a minority member but did not have the right to divide its interest among themselves.
- His interest was personal property, said the court, and was protected either through the “fair value” provisions governing withdrawals or his right to share in the surplus if the LLC dissolved.
- Now that the right to “fair value” has been removed from the statute, it appears that there is no requirement for a continuing LLC or its members to buy out the expelled member. Rather, the expelled member simply has the rights of a transferee to receive distributions. 169 So.3d 151 (Fla. 4th DCA 2015).

Removal as Manager v. Removal as Member

- *Froonjian* is remarkable, and in error, to the extent it states that, in the absence of a provision in the articles or in the operating agreement, the majority has a right to expel for any reason.
- The court relied on *Kertesz v. Spa Floral, LLC*, 994 So.2d 473 (Fla. 3d DCA 2008), which addressed the right of the majority to remove the founder as a managing member.
- Froonjian failed to distinguish between removing a person from a management position and removing the person as a member.

Expulsion—Forced Buyout of a "Toxic" Member

- *All Saints University of Medicine v. Chilana*, 2015 WL 11254290 (N.J. Super. Ct. App. Div. 2016), held that, <u>even in the absence of statutory support, the court has the general equitable power to order, not merely a dissociation, but also a forced sale of the interest of a member who has breached fiduciary duties</u>.
- Approving the trial court statements:
  - "Perpetuating the toxic relationship of [the plaintiff] and [the defendant]—even the recast relationship of a full LLC Member . . . versus dissociated member with ongoing economic interest . . . is neither practicable, feasible nor equitable."
  - "It would be grossly inequitable to permit [the defendant] to reap the benefits of a continuing economic interest in an entity he was content to see destroyed."
  - A contrary holding "would grant an undeserved windfall to [the defendant], and reward him for his effort to bring about [the enterprise's] undoing, at the expense of the party who gave the [enterprise] a chance of viability."
- Held: <u>His interest was worth zero and that was the buyout price.</u>

Judicial Dissolution of LLCs

- F.S. § 605.0702(b) provides that a circuit court may dissolve an LLC:

"(b) <u>In a proceeding by a manager or member</u> if it is established that:

- The conduct of all or substantially all of the company's activities and affairs is unlawful.
- It is <u>not reasonably practicable to carry on the company's activities and affairs</u> in conformity with the articles of organization and the operating agreement.
- The managers or members in control of the company have acted . . . in a manner that is <u>illegal or fraudulent</u>;
- The limited liability company's <u>assets are being misappropriated or wasted</u>, causing injury to the limited liability company, or in a proceeding by a member, causing injury to one or more of its members;
- The managers or the members . . . are deadlocked in the management of the company's activities and affairs, the members are unable to break the deadlock, and irreparable injury to the limited liability company is threatened or being suffered."

Judicial Dissolution of LLCs (cont'd)

- Florida's LLC Act omitted RULLCA § 701(a)(5)(B), stating that, on application by a member, a court may order dissolution "on the grounds that the managers ***or*** those members in control of the company . . . have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant."
- "While there was strong sentiment in favor of adopting the RULLCA oppression provision from a number of Drafting Committee members, the majority decided otherwise. Oppression as a basis for judicial dissolution is not in Existing Law, and no other Florida business entity statute permits oppression as a basis for judicial dissolution. Therefore, the Drafting Committee concluded that the oppression matter should be deferred until a 'harmonization' effort is undertaken by the Business Law Section to more carefully consider whether oppression should be adopted as a basis for seeking judicial dissolution in the corporation, LLC, and partnership statutes simultaneously." – Drafting Committee White Paper.

Judicial Dissolution Not Readily Granted

- *Kertesz v. Spa Floral, LLC*, 994 So.2d 473 (Fla. 3d DCA 2008), indicated that dissolution will not be granted simply because a minority member makes plausible allegations that the firm or its managers have embarked on a financially damaging course. The court denied dissolution to the founder of an LLC who was ousted from his position as the managing member by a recently-added majority of members. He claimed that the firm's biggest client would leave because of his ouster, reflecting at the very least a deadlock of the firm and a waste of its assets.
- The court said that his removal as manager ended any deadlock and that he could not bring an action for waste. The court was loathe to interfere with "the business judgment of the majority," who had "more at risk and therefore a greater incentive to try to make a decision in the best interest of the LLC."
- Even if in the long run the change in management proves to be "improvident," that "does not of itself give rise to a cause of action against the majority who voted for it or the LLC."

Dissolution is an Extreme Remedy—Buyouts as Fallbacks

- Dissolution is an extreme remedy—it is in effect a death-sentence for the LLC. Therefore, F.S. § 605.0703(4)(a)-(c) provides that, in any proceeding for a judicial dissolution, the court may:

  a) Appoint a receiver or custodian;
  b) <u>Order a purchase of a petitioning member's interest "pursuant to § 605.0706;"</u> [providing for a reactive buyout by the firm or by other members] [see next slide] <u>or</u>
  c) <u>Order such other remedy the court deems appropriate.</u>

The buyout is presumably an "other remedy" the court can choose to award to a plaintiff.

Dissolution is an Extreme Remedy—Buyouts as Fallbacks (cont'd)

- F.S. § 605.0706 gives the LLC and the other members a reactive right to buy out a member or manager who sues for dissolution.
  - The buyout price is "the fair value of the interest."
  - If the parties cannot agree on fair value, the court shall stay the proceedings and determine it.
  - The court then "shall enter an order directing the purchase."

- On the challenges facing dissatisfied members who seek judicial relief, see Donald J. Weidner, *Dissatisfied Members in Florida LLCs: Remedies*, 18 Fla. St. Univ. Bus. Rev. 1 (2019) (forthcoming). Available at https://ssrn.com/abstract=3254537

Dissolution for Oppression

- The omitted RULLCA § 701 specifically provides both

1. a right against oppression for minority members in an LLC and
2. flexible remedies for violations of that right.

An important question is whether courts will provide similar protections to LLCs operating under statutes that do not explicitly provide such a remedy. "Courts appear to be heading in that direction but there are very few cases."

- RULLCA § 404(b) on "**Sharing of a Right to Distributions Before Dissolution**:"
  - " A person has a right to a distribution before the dissolution and winding up of a limited liability company only if the company decides to make an interim distribution."

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