Understanding the World of Minority Rights and Fiduciary Obligations

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I. UNDERSTANDING THE WORLD OF MINORITY RIGHTS AND FIDUCIARY OBLIGATIONS.

In contrast to many other jurisdictions, Arizona has a notably undeveloped body of law regarding fiduciary obligations in a limited liability company ("LLC"). As one commentator has noted:

> Because the Arizona LLC Act does not have an express statutory provision on intra-organization duties, there are various possibilities as to the status of relationships in an Arizona LLC. One possible inference is that the legislature intended for LLCs to be governed solely by the operating agreement and thus, if the articles or operating agreement did not provide for a specific duty, then no such duty exists. Another possible inference is that a duty is implied in the statute and exists in some manner analogous to either the corporations statutes (or the partnership statutes) unless the operating agreement decreases or changes a duty.

6 Ariz. Prac., Corporate Practice § 12:65 (2011-2012 ed.) Given this uncertainty, Arizona practitioners face particular challenges in addressing the fiduciary obligations of LLC members and managers when advising clients in the formation and administration of LLCs. [1]

A. The Source and Nature of Fiduciary Obligations in LLCs

1. Initial Determination – Choice of Law

As noted above, the Arizona Limited Liability Act, A.R.S. §§ 29-601, *et seq.*, (the "Arizona LLC Act") contains no provision expressly delineating the fiduciary duties of LLC members and managers; in this regard, the Arizona LLC Act differs significantly

from the Uniform Limited Liability Company Act (the "Uniform Act"), which spells out at length the fiduciary duties applicable to LLC members and managers, and the LLC statutes of a number of non-Uniform Act States. *See*, Uniform Act, § 409;[2] *also see, e.g.*, Va. Code Ann. § 13.1-1024.1 (manager shall discharge his or its duties as a manager in accordance with the manager's good faith business judgment of the best interests of the limited liability company). Similarly, and again in contrast to many other jurisdictions, the Arizona Courts have not to date had occasion to address the nature and extent of the common law fiduciary duties, if any, applicable to an LLC.

The first level of analysis for an Arizona practitioner, therefore, is to determine the applicable statutory framework. Pursuant to A.R.S. § 29-801, if the LLC at issue was (or is contemplated to be) formed under the law of another State, the law of that State will generally control for purposes of determining the rights and liabilities of the members and managers of the LLC.[3] To the extent the law of another state controls, it will be necessary, at the outset, to perform an appropriate analysis of the applicable statutory and case law authorities. Alternatively, to the extent Arizona law is controlling, it will be necessary to consider, and attempt to rationalize, the varying principles inferable from the Arizona LLC Act and the meager case law that has developed to date.

2. Delaware Approach – Common Law Obligations

While a complete survey of state LLC statutes is beyond the scope of this article, a brief discussion of Delaware law is appropriate, given the national stature of Delaware law in matters of corporate and other entity governance, as well as the common appearance of Delaware entities in Arizona transactions. Like the Arizona LLC Act, the Delaware Limited Liability Company Act (the "Delaware Act") contains no provision expressly imposing fiduciary obligations on members and managers of LLC. However, the absence of such provisions is mitigated in two respects, one statutory and judicial.

First, while, once again, the Delaware Act does not explicitly create or delineate any intra-company fiduciary duties, two provisions of the Act establish (1) that the parties to a limited liability company agreement[4] are subject to a non-waivable contractual covenant of good faith and fair dealing, and (2) that the limited liability company agreement may not "limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." See 6 Del. Code Ann. § 18-1101(c)(e).[5] This express incorporation of the implied

covenant of good faith and fair dealing is of potentially far reaching consequences, as the Delaware Courts, while expressing some reservations regarding its applicability to carefully negotiated agreements, have construed the implied covenant as imposing upon a party an obligation to exercise contractually-granted discretion in a reasonable manner. See *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1206 (Del.1993).

Second, and perhaps more significantly, the Delaware Courts, following applicable principles of corporate law, have made clear that, in the absence of a contrary provision of the limited liability company agreement, the managers of a manager-managed LLC, and the members of a member-managed LLC, owe the members of the company the "traditional fiduciary duties of loyalty and care" owed by a director of a corporation. *William Penn P'ship v. Saliba*, 13 A. 3d 749 (Del. 2011); *see also*, *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, CIV. A. 3658-VCS, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009). As the Court noted in the latter case,

> The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law. See 6 Del. C. § 18-1104; *Robert L. Symonds, Jr. & Matthew J. O'Toole, Delaware Limited Liability Companies § 9.04[B][3] (2007).* The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation.

(citations omitted).

Any apparent ambiguity in the Delaware Act is accordingly resolved by reference to the myriad cases addressing the nature and scope of fiduciary duties owed by corporate directors. See, e.g. *Douzinas v. Am Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149-50 (Del. Ch. 2006); *Metro Comme'n Corp. BVI v. Advanced Mobilecomm Techs, Inc.*, 854 A.2d 121, 153 (Del. Ch. 2004); *VGS, Inc., v. Castiel*, 2000 WL 1277372, at *4-5 (Del. Ch. 2000) , *aff'd* 781 A.2d 696 (2001).

3. Fiduciary Obligations – Conflicting Judicial Decisions Under the Arizona LLC Act

Consistent with the foregoing, the courts construing the Act have enunciated two inconsistent theories as to the existence or non-existence of fiduciary obligations under the Arizona LLC Act.

Two Arizona state cases, both unreported, appear to support the proposition that the absence of express fiduciary obligation provisions in the Arizona LLC Act is not reflective of a legislative determination that no such obligations exist, and that common law principles are fully applicable to LLCs.

In an unreported decision in *Sports Imaging of Arizona, L.L.C. v. 1993 CKC Trust*, 1 CA-CV 05-0205, 2008 WL 4448063 (Ariz. App. 2008), the Arizona Court of Appeals, by analogy to an old, and seldom-applied, line of cases involving closely-held corporations, held that the co-manager of an LLC, and the principles of the co-manager, owed fiduciary duties to the LLC.

Sports Imaging arose out of a failed business relationship between Sports Imaging of Arizona, L.L.C. ("SIA") and The 1993 CKC Trust ("the Trust"); Dr. Culley K. Christensen, the Trustee and a financial beneficiary of the Trust; Jane Christensen (Dr. Christenson's spouse); and Omi-Omni Medical Imaging, P.L.C. ("Omni"), an entity 99% owned by the Trust, pertaining to the ownership and operation of a medical-imaging center.

After an initial venture encountered financial difficulties, SIA was formed to own and operate a specialty medical imaging center, using Omni's existing facility and infrastructure, and focusing on the outpatient MRI market. The co-managers of SIA were Omni and Dr. Pamela Lund, as reflected in a Prospectus, Operating Agreement, and Private Placement Memorandum. The new business was a financial success; disputes arose, however, regarding Omni's obligation to provide services, supplies and personnel to the LLC business, as well as the amount of control to which Omni and Dr. Christensen were entitled. Those disputes escalated to the extent that Omni, through Dr. Christensen, began limiting SIA's use of the Omni facility, effectively locking out SIA during many of its peak hours of operation.

SIA thereupon filed a complaint against Omni, the Christensens and the Trust, alleging, among other things that the defendants "owed fiduciary duties to SIA pursuant to the parties' written agreements. These fiduciary obligations were owed by OMNI as SIA's co-manager, the CKC Trust as a member in SIA, and Dr. Christensen and his wife as principals in those entities." 2008 WL 448063 at *8.

In summary judgment proceedings, the defendants argued that because the Trust and Christensen were never in a contractual relationship with SIA, they could not be individually liable for damages. The trial court, finding that no direct contractual

relationship existed, and there being neither a basis to "pierce the veil" nor facts to support independent individual liability, granted the motion for summary judgment as to the Trust and Christensen individually. *Id.* at *9.

On appeal, the Court of Appeals upheld the jury's verdict against Omni and reversed the judgment dismissing SIA's breach of fiduciary duty claims against the Christensens and the Trust. In so doing, the Court relying on *Mims v. Valley Nat'l Bank*, 14 Ariz. App. 190, 192, 481 P.2d 876, 878 (1971), superseded by statute on other grounds, *Estrada v. Arizona Bank*, 152 Ariz. 386, 732 P.2d 1124 (App. 1987), noted that "shareholders that have the ability to control a corporation owe a fiduciary duty to the corporation and other shareholders," and concluded that

> as a fifteen percent owner of SIA and a ninety-nine percent owner of Omni, which co-managed SIA, the Trust had significant ownership and control over both Omni and SIA, whether that control was exercised or not. Accordingly, even though the express terms of the corporate documents did not create fiduciary duties for the Trust, we agree with SIA that the Trust had the ability to control Omni and SIA and therefore owed a fiduciary duty to SIA.

2008 WL 4448063 at *19. The Court accordingly remanded for a factual determination as to whether the Christensens and the Trust had breached their fiduciary duties. *Id.*

In reaching its decision, the *Sports Imaging* Court, considered and rejected the defendants' argument that the imposition of fiduciary duties was inconsistent with § 409(h)(1) of the Uniform Act, which provides that, in a manager-managed company, "a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member." As the Court noted:

> the Arizona Legislature adopted the Arizona Limited Liability Company Act . . . before the ULLCA was created, and the Arizona Legislature has not adopted the ULLCA for incorporation into Arizona's limited liability statutes. Thus, our analysis is not bound by the ULLCA. Further, to the extent we might utilize the ULLCA to guide our analysis, we conclude that its current language supports SIA's argument more than it does Appellees'. The ULLCA has been revised . . . and the comment to subsection (g)(5) of § 409 of the revised ULLCA informatively advises, "This paragraph merely negates a claim of fiduciary duty that is exclusively status-based and does not immunize misconduct." The comment also provides an example, which states:

> Although a limited liability company is manager-managed, one member who is not a manager owns a controlling interest and effectively, albeit indirectly, controls the company's activities. A member owning a minority interest brings an action for dissolution under Section 701(a)(5)(B) (oppression by "the managers or those members in control of the company"). The court wishes to understand a claim as one alleging a breach of fiduciary duty by the controlling member. Subsection (g)(5) does not preclude that approach. . . .

Id., fn 28.

Sports Imaging thus stands for the twin propositions, that in a *manager-managed* LLC, (1) the managers are subject to fiduciary duties and (2) the members, while not subject to such duties by virtue of their status as such, may be liable for misconduct where they are 'in control' of the company. In citing *Mims*, the Court implicitly adopted the holding of the Arizona Supreme Court in a 1914 case, *Steinfeld v. Nielsen*, 15 Ariz. 424, 444 139 P. 879, 887 (1914), which held, referring to the majority shareholder of a mining company:

> 'Possessing such unlimited power over the mining company, he ought to be held to owe the same standard of conduct towards the stockholders of the company as is due from an officer or director.'

Mims, 14 Ariz. App. at 192, 481 P.2d at 878. While *Mims* was decided prior to the enactment of the present Arizona Corporations Code, the effect of this holding, it would appear, would be to impose on managers and controlling members the standards of conduct enumerated in A.R.S. §§ 10-830 (general standards of conduct), 10-833 (liability for unlawful distributions) and 10-860, *et seq.* (director's conflicting interest transactions). The modern cases make clear, however, that the right to sue a director for breach of duty ordinarily belongs to the corporation, and not the individual shareholders. Thus, the Arizona cases hold that a shareholder may not bring an action for misconduct against the corporation on the theory that the wrongful acts devalued the shareholder's shares. *Albers v. Edelson Tech. Partners L.P.*, 201 Ariz. 47, 52, 31 P.3d 821, 826 (App. 2001), citing *Funk v. Spalding*, 74 Ariz. 219, 223, 246 P.2d 184, 186 (1952). To be entitled to assert a direct claim, under this principle, a shareholder must therefore demonstrate a separate injury growing out of some special circumstance, such as where

> (1) the relationship between the shareholders and a wrongdoer is separate from the shareholders' status as shareholders or their ownership interest in the corporation, (2) the wrongdoer owes a duty to the shareholders for some reason other than their status as shareholders, or (3) the injuries or damages were sustained by individual shareholders rather than by the corporation.

Id.

The *Sports Imaging* Court, while rejecting the particular Uniform Act-based argument discussed above, did not consider the broader argument stemming from the absence of a fiduciary duty provision in the Arizona LLC Act – that the imposition of fiduciary duties was precluded entirely by the Arizona legislature's failure to adopt a provision, whether or not analogous to §409, creating and delineating the fiduciary duties applicable to the members and managers of an LLC.

In a second unreported decision, Division One of the Court of Appeals applied similar reasoning in finding that a member of an LLC was entitled to sue the managers for breach of fiduciary duty. See *Delgadillo v. White*, 1 CA-CV 07-0042, 2008 WL 4095494 (Ariz. App. 2008).

Delgadillo and White formed a limited liability company, Titan Investors I, L.L.C. (Titan I), to invest in real estate. Delgadillo and White managed the company with the aid of Cole, who served as outside legal counsel to another company co-owned by them. *Id*. at *1. In December 2000, Trimark Paseo Point, L.L.C. (Trimark), White's long-time client, contracted to purchase property in Laveen, Arizona from Titan I. Trimark, White and Cole negotiated extension agreements for the close of escrow on the property, one of which called for a two-acre commercial corner (the Commercial Corner) to be held back from the sale. *Id*.

In September 2003, Trimark separately offered to purchase the Commercial Corner for $1.75 per square foot. Delgadillo submitted a counteroffer to purchase the 2 acre parcel for $2.95 per square foot on September 16, 2003 and provided other Titan I members with the opportunity to participate in the purchase. White then submitted an offer to purchase the Commercial Corner at the same $2.95 per square foot price, but without granting the other members of Titan I an opportunity to participate. Trimark accepted the offer and White completed the purchase. *Id.*

Delgadillo subsequently filed suit against White, Cole and their spouses, asserting, *inter alia*, a claim for breach of fiduciary duty. The trial court granted a motion for summary judgment in favor of White and Cole on the breach of fiduciary claim, and Delgadillo appealed. *Id*. at *2.

On appeal, the Court of Appeals, noting that, "under Arizona law, a fiduciary owes a duty of the utmost good faith, loyalty, and full disclosure," stated that, in an LLC context, the "fiduciary duty may derive from the relevant operating agreement or statute." A.R.S. § 29-682(B)(1998). *Id*. at *4. The Court, on the facts, found that fiduciary duties flowed from the organizational documents of the LLC, noting that

> [t]he Private Placement Memorandum and Operating Agreement for Titan I contemplate that managers owe members fiduciary duties. The Operating Agreement additionally afforded Delgadillo the right to inspect the books and vote his membership interests.

Id.

Having thus determined that duties existed by contract, the Court proceeded to a discussion of analogous corporate relationships, explaining,

> [t]o analyze the breach of duties in a limited liability company, we turn to authorities on duties owed in the context of a corporation, an entity analogous to a limited liability company.

Id. On the facts, including that the purchase agreement had been approved at a meeting of the members, the Court found that no evidence existed to support Degadillo's fiduciary duty claim and affirmed the grant of summary judgment.

While the *Delgadillo* Court did not need to reach the issue whether fiduciary duties could be inferred in the absence of a specific provision of the organizational documents, its reliance on corporate law principles, suggests that, like the Court in *Sports Imaging*, it would have found that members and managers of LLCs are subject to common-law duties analogous to those applicable in a corporate context.

Unfortunately (or not), because *Sports Imaging* and *Delgadillo* are unreported decisions, they are not precedent and may not be cited as such. *See* Rule 28(c), Arizona Rules of Civil Appellate Procedure. Their value, if any, lies in the persuasiveness of the Courts' reasoning, balanced against alternative interpretations of the Arizona LLC Act.

The alternative interpretation is illustrated by a pair of federal court decisions, also unreported (but not forbidden to be cited, *see* Rule 32.1, Federal Rules of Appellate

Procedure). The first is *Van Weelden v. Hillcrest Bank*, 2:10-CV-01833-PHX, 2011 WL 772522 (D. Ariz. Feb. 28, 2011), in which the District Court, Judge Teilborg, interpreted the absence of reported Arizona decisions establishing fiduciary duties in an LLC as a determination that no such duties exist.[6]

The plaintiffs in *Van Weelden* were investors in, and members of Quintero Golf and Country Club, LLC, and also purchaser of a subdivision lot in the Quintero Golf and Country Club development. When the LLC defaulted in its financial obligations to the plaintiffs, and failed to complete infrastructure work as promised in the Department of Real Estate subdivision report, the plaintiffs filed suit against the promoter and manager of the LLC, McClung, alleging, among other things, that

> McClung, '[a]s a promoter and the Manager of Quintero, a limited liability company, ... owed a fiduciary duty to Plaintiffs as investors in the company'... and '[a]s a Manager of Quintero ... [McClung] has a duty to manage the corporate affairs of Quintero with the ordinary care a reasonably prudent person would.'

Id. at *6 (internal citations omitted).

The Court dismissed the complaint, finding, among other things, that the allegations of fiduciary duty were insufficient given the absence of an express statement of fiduciary obligations in the Arizona LLC Act:

> Arizona did not adopt the exact language of the Uniform Limited Liability Company Act. One of the key differences, at least as it relates to this case, is that the Arizona Limited Liability Company Act does not impose express fiduciary duties on managers or members of a limited liability company. Therefore, under Arizona law there is no express duty imposed on McClung, which he could have breached to Plaintiffs' detriment.

Id.

The second federal court case is *In re Ratliff*, 2010 WL 6259955 (9th Cir. BAP, 2010), in which the court found, on the facts presented, that no fiduciary relationship existed for purposes of non-dischargeability under Bankruptcy Code § 523.

Ratliff arose from another failed business venture, in the form of an LLC formed by two couples, the Ratliffs and the Campbells, to acquire, operate and sell a parcel if agricultural property, located in Cochise County, Arizona, originally owned by the Ratliffs. After a dispute arose between the parties relating to the sale of the property, the LLC and the Campbells sued the Ratliffs, who then filed bankruptcy. The state court

litigation was removed to bankruptcy court and consolidated with a separate adversary proceeding in which the Campbells sought a determination that the Ratliffs' obligations were non-dischargeable under various sections of the Bankruptcy Code. After trial, the bankruptcy court found that the Ratliffs had breached the operating agreement and converted the Campbells' property while acting in a fiduciary capacity for the members of the LLC, thereby rendering the debt non-dischargeable under § 523(a)(4) (covering debts for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny) (6) (covering debts for willful and malicious injury to the property of another). *Id*. at *5.

On appeal, the Bankruptcy Appellate Panel reversed, finding, *inter alia*, that the bankruptcy court erred as a matter of law in finding that Mr. Ratliff was a fiduciary within the meaning of § 523(a)(4). In reaching its conclusion, the Court first cited applicable bankruptcy authorities holding that, to be classified as a fiduciary under § 523(a)(4), the debtor must have been a trustee in the strict or narrow sense through an express or technical trust imposed before and without reference to the wrongdoing that caused the debt. It then examined relevant Arizona statutes and case law, and found that the requisite trust relationship did not exist. *Id.* at *10.

In reaching its conclusion, the BAP applying the same line of reasoning reflected in *Van Weelden*, emphasized the absence of a statutory declaration of fiduciary duties:

> The [Arizona LLC Act] shows that the Arizona legislature elected not to impose fiduciary duties among and between the LLC's members as individuals or impose a fiduciary duty to other LLC members upon the members who manage the LLC. Accordingly, the statute does not create the basic elements of a trust for § 523(a)(4) purposes; no res is defined, and no fiduciary duties are spelled out. See Terence Thompson, et. al., *6 Ariz. Prac., Corporate Practice § 12:65 (2009–10 ed.)* (noting that the LLC Act is silent on the fiduciary duties of members or managers).

Id. Consistent with that analysis, the BAP found that the bankruptcy court's reliance on Arizona statutory partnership law was misplaced because, "[i]n contrast to partnership law, there is no parallel provision in the [Arizona LLC Act]." *Id*. Likewise, while noting that a director or officer of a corporation owes a fiduciary duty to the corporation and its stockholders under *Mims*, the BAP refused to extend that principle to LLCs, finding that "there is no corresponding case law in the LLC context." *Id*. at *11.

Finally, the BAP found, on the facts, that there was nothing in the company's operating agreement to impose a fiduciary duty on the Ratliffs as to LLC funds, as it did not expressly designate Mr. Ratliff as the managing member, meaning that the Campbells had no less control of the LLC than the Ratliffs:

> Thus, even if an analogy to corporate law were appropriate, it would be inapplicable under these circumstances.

Id.

Van Weelden and *Ratliff* thus stand for the proposition that the exclusion of the Uniform Act's fiduciary duty provision from the Arizona LLC Act evidences a legislative intent that there should be no such duties unless the parties specifically agree. While superficially satisfying, this conclusion is, at least arguably, undercut by a textual analysis of the Arizona LLC Act. Numerous sections of the Arizona LLC Act state default rules, to be effective unless "otherwise provided in an operating agreement," s*ee, e.g.* A.R.S. § 29-785, thereby demonstrating that the Legislature knew how to create rules to be effective in the absence of an operating provision to the contrary. Yet, nowhere in the Act is there any indication that, in the case of fiduciary duties, the drafters intended, by mere silence, to create a rule that would not only create a significant, and inexplicable, disparity between LLCs and other forms of business enterprise, but would potentially insulate managers and controlling members from liability for bad faith misconduct.

Nevertheless, given the current state of the law, there is no controlling authority, and Arizona practitioners must be prepared to address the issue of fiduciary obligations with no background of certainty.

4. Arizona Practice – Alternate Sources of Fiduciary Duties

Given the absence of binding authority in Arizona, practitioners engaged in the formation of LLCs may well find it appropriate to look to other sources other than the Arizona LLC Act to create or delineate fiduciary duties. The particular approach to be taken in a given situation will, of course, vary according to the interests of the client. The following list, while non-exclusive, is intended to provide basic guidance for practitioners in this context:

a) Operating Agreements.

The most obvious alternative source of governing principles is a well-drafted operating agreement. The Arizona LLC Act, by A.R.S. §29-682, specifically

contemplates the use of an operating agreement to establish the rules governing the relationships among the parties to the LLC:

> An operating agreement governs relations among the members and the managers and between the members and managers and the limited liability company and may contain any provision that is not contrary to law and that relates to the business of the limited liability company, the conduct of its affairs, its rights, duties or powers and ***the rights, duties or powers of its members, managers, officers, employees or agents*** . . . . (emphasis added.)

It has been stated, moreover (albeit in one of the unreported cases discussed above), that, under Arizona law operating agreements are to be construed in accordance with ordinary principles of contract interpretation, including (1) that contracts are to be interpreted in accordance with the parties' intent, *In re Ratliff*, 2010 WL 6259955 at *7, citing *Darner Motor Sales, Inc. v. Universal Underwriters Ins. Co.*, 682 P.2d 388, 398 (Ariz.1984) (2) that words in a contract are given their ordinary meaning "unless the circumstances show a different meaning is applicable," *Id.*, citing *Brady v. Black Mountain Inv. Co.*, 459 P.2d 712, 714 (Ariz.1969), and (3) that contracts are to be interpreted in accordance with a "standard of reasonableness." *Id.*, citing *Gesina v. Gen. Elec. Co.*, 780 P.2d 1380, 1386 (App.1989).

With these concepts in mind, and without excluding alternative approaches available to a creative transactional practitioner, the operating agreement can be used in at least two ways to serve as the basis for establishing and defining fiduciary obligations.

First, one readily available way of dealing with the absence of express fiduciary provisions in the Arizona LLC Act is to borrow Arizona law applicable to other forms of business organization. For example, an operating agreement could simply state that, as among the parties, the managers and/or managing or administrative members are governed, as to their conduct in connection with the LLC, by analogous provisions of the Arizona Corporation Law, A.R.S. §§ 10-830 (standards for directors), 10-841 (duties of officers), 10-842 (standards of conduct for officers) or the Arizona Revised Uniform Partnership Act, A.R.S. § 29-1034 (general standards of partner's conduct). Further, or in the alternative, an operating agreement could adopt by reference the standards of conduct applicable to closely-held corporations under *Mims*, 14 Ariz.App. at 192, 481 P.2d at 878. This approach has a number of advantages, including ease of drafting and the existence of a better-developed body of law; it is also consistent with the approach taken

by the Arizona Court of Appeals in *Sports Imaging.* Conversely, however, it would negate the philosophy, apparent in the Arizona LLC Act, that LLCs are a different breed of business entity, and would forfeit the flexibility in the creation of governing rules that is one of the primary benefits afforded to LLCs.

Second, honoring the philosophy of flexibility underlying the Arizona LLC Act, one could incorporate in an operating agreement specifically-drafted provisions that either: (1) create and define fiduciary duties or, subject to discussion in Part C, below, (2) exclude such duties altogether. The principal benefit here, of course, is flexibility, the possible permutations of fiduciary obligations, and corresponding rights, are as varied as the imagination of the drafter of the particular operating agreement. The corresponding disadvantage is that, by bypassing statutory or court-established rules, the parties, by faulty drafting or simply failing to consider particular circumstances, may create opportunities for future disagreement and litigation.

b) Adopt law of another jurisdiction

A second, and equally simple approach, is to adopt the law of a jurisdiction having more fully-developed LLC law. Arizona practitioners, for a variety of reasons, commonly form LLCs under law of other jurisdictions – often Delaware or Nevada. Although the reasons for doing so are often driven by privacy (or similar) considerations, an additional benefit to be derived from the adoption of foreign law is that, under most circumstances, the rules of the particular jurisdiction (either entirely or are supplemented by operating agreement) will control the internal workings of the company. Such choice of law can be easily accomplished by forming the LLC in the desired State, and registering it as a foreign LLC in Arizona; in that event, the general rules of A.R.S. § 29-801 will apply – the law of the place of formation will govern the "internal affairs" of the LLC and the "liability of its members," except that a foreign LLC and its members and managers "have no greater rights and privileges than a domestic limited liability company and its members and managers with respect to transactions and relationships with persons who are not members." Alternatively, a choice of law provision, adopting the law of a chosen jurisdiction, can be inserted in the operating agreement.

The principal benefit of selecting the law of another jurisdiction, once again, is that there will likely be a more fully developed body of law to refer to in the event issues subsequently arise regarding the rights and obligations of the LLC and its members and

managers. There are, however, contrary concerns, including the potential unintended consequences of incorporating the broad array of statutory and judge-made rules applicable to LLCs in a given jurisdiction. At minimum, an Arizona practitioner considering forming an LLC under the laws of another state should fully review both the LLC statue and significant case law of the intended jurisdiction to make sure that the controlling rules are consistent with the interests of his or her client.

B. Identifying and Protecting the Rights of Minority Interest holders

Aside from being the beneficiaries of fiduciary obligations, the minority interest holders (typically members) of an LLC do, or may, have a variety of rights and remedies. Identifying and protecting those rights and remedies, once again, involves both a careful review of the applicable statutory framework and appropriate analysis and attention to the organizational documents of the LLC.

1. Statutory Rights Provided Under the Arizona LLC Act

The Arizona LLC Act grants to the members of an LLC a number of procedural protections. Among other things:

- Inspection of Records. A.R.S. § 29-607 provides that each member of an LLC may inspect and copy the records required to be maintained at the company's known place of business, including, among other things, the articles of organization and operating agreement and all amendments thereto, and tax returns and financial statements for the previous three years, and my further inspect and copy such additional information relating to the company "as is just and reasonable for any purpose reasonably related to the member's interest."

- Unanimous consent to major transactions. A.R.S. § 29-681(C) provides that, except as provided in an operating agreement, the unanimous consent of all members is required to:

> 1. Adopt, amend, amend and restate or revoke an operating agreement or authorize a transaction, agreement or action on behalf of the limited liability company that is unrelated to its purpose or business as stated in an operating agreement or that otherwise violates an operating agreement.
>
> 2. Issue an interest in the limited liability company to any person.

> 3. Approve a plan of merger or consolidation of the limited liability company with or into one or more business entities as defined in § 29-751.
>
> 4. Authorize an amendment to the articles of organization that changes the status of the limited liability company from or to one in which management is vested in a manager or managers to or from one in which management is reserved to the members.

- Judicial dissolution. A.R.S. § 29-785 permits a member of an LLC to seek and obtain an order dissolving the company upon a showing that:

> 1. It is not reasonably practicable to carry on the limited liability company business in conformity with an operating agreement.
>
> 2. Unless otherwise provided in an operating agreement, the members or managers are deadlocked in the management of the limited liability company and irreparable injury to the limited liability company is threatened or being suffered or the business of the limited liability company cannot be conducted to the advantage of the members generally because of the deadlock.
>
> 3. Unless otherwise provided in an operating agreement, the members or managers of the limited liability company have acted or are acting in a manner that is illegal or fraudulent with respect to the business of the limited liability company.
>
> 4. Unless otherwise provided in an operating agreement, substantial assets of the limited liability company are being wasted, misapplied or diverted for purposes not related to the business of the limited liability company.

- Derivative Actions. A.R.S. § 29-831 permits a member to bring an action on behalf of the LLC where either (1) the LLC is manager-managed and the managers have the sole right to bring suit or (2) the LLC is member-managed and the plaintiff lacks authority to cause the LLC to bring suit. That right is significantly qualified, however, in that the plaintiff must (a) have been a member at the time of the underlying transactions, (b) have made demand on the parties with authority to bring suit, which parties have either wrongfully refused to bring suit or failed to respond, and (c) "fairly and adequately

represents the interests of the members, except those members that would be defendants in the action, in enforcing the right of the [LLC]."

While clearly beneficial to minority members, the foregoing statutory provisions are of somewhat limited utility and significance in that, except as to inspection rights under § 29-607 and the right to bring derivative actions and cause the LLC to be dissolved where it is not "reasonably practical" to carry on the business of the LLC, all of the above protections can be overridden by the operating agreement.

Perhaps more importantly, the remedies available to an aggrieved member for misconduct by the controlling parties are both limited and potentially unsatisfactory:

First, unlike the Uniform Act, the Arizona LLC Act contains no provision permitting a member of an LLC to assert a direct claim for breach of duty. Section 901 of the Uniform Act permits direct action by a member against another member, a manager or the LLC "to enforce the member's rights and otherwise protect the member's interests, including rights and interests under the operating agreement or [this Act] or arising independently of the membership relationship," provided that the claimant member "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]." While the cases discussed above suggest that the Arizona Courts will nevertheless permit an aggrieved member to sue under appropriate circumstances, *see Sports Imaging*, 2008 WL 4448063 at *19, the law is less than clear on this point, leaving the member's entitlement to sue as a matter for future litigation.

Second, the statutory remedies – judicial dissolution and derivative actions – are both cumbersome and unsatisfactory in that neither allows the member to obtain what is truly desired – compensation for damages caused by the defendants' misconduct.

Interestingly, however, the LLC judicial dissolution is more favorable to the suing member than the analogous provision of the Arizona corporation statute in one material respect. Under A.R.S. § 10-1430(B), a corporate shareholder may bring an action to dissolve the corporation where, *inter alia*, the parties in control of the corporations are "acting or will act in a manner that is illegal, oppressive or fraudulent." This provision, which is in fact broader than the corresponding sub-section of A.R.S. § 29-785 is, of course, a valuable weapon in the hands of a minority shareholder. However, a companion statutory provision, A.R.S. § 10-1434, significantly limits its value and usefulness by providing that, by notice given within 10 days of the filing of an action to

dissolve a corporation, the corporation may elect to purchase the shares of the dissenting shareholder for "fair value," the price and terms of sale to be decided by a judge, without a jury. The analogous LLC Act provision, as set forth above, does not afford the LLC the right to buyout the interest of the dissenting member, thereby creating a significant incentive to settlement, as the LLC is at risk of forced dissolution, with potentially disastrous business and tax consequences, if it chooses to litigate and loses.

2. Rights Provided in Operating Agreement

The operating agreement, once again, is an open-ended tool; depending on whose interests are being protected, a practitioner may use the operating agreement to expand, contract or eliminate fiduciary obligations. The following is a non-exclusive list of mechanisms by which the interest of a minority holder can be protected in the context of an operating agreement:

- Heightened voting requirements, either supermajority or unanimous, can be required as to specific actions or categories of actions beyond those requiring unanimous consent under § 29-681(C);
- The members can be given the right to remove the manager, or managing member, with or without cause and under various enumerated circumstances (including failure to satisfy business or financial goals);
- The members can be given the right to require a buyout interests under enumerated circumstance at appraised or agreed-upon value;
- Limitation can be placed on the compensation paid to managers and managing members;
- Provisions, analogous to those applicable to director's conflicting interest transactions under A.R.S. §§ 10-860, *et seq.* can be inserted to address transactions involving conflicts of interest on the part of the managers of majority members.
- A mechanism can be established for direct action by a member against another member or manager.

The determination as to what provisions are appropriate will of course vary according to the nature of the relationships among the parties and the specific circumstances of the minority member sought to be protected, As counsel for a potential minority member, the practitioner's role, in part, is to anticipate (to the extent reasonably possible) categories of circumstances under which the client's interests might be

jeopardized, and to either seek to insert appropriate protective mechanisms or advise the client of the consequences of proceeding in their absence. Conversely, as counsel for the majority interest holders, the role of the practitioner, subject to applicable ethical obligations of fairness and honesty, is to insulate the company and majority interest holders from liability based upon claims of disgruntled minority members.

C. Restrictions on Fiduciary Obligations

Given the federal cases discussed above, a reasonable argument can be made that no fiduciary obligations exist in the context of an Arizona LLC. While that conclusion may be excessive, there appears to be nothing in the Arizona LLC Act or the case law that would preclude parties from agreeing, in the context of an operating agreement, that no such obligations will exist; that said, it is likely that some baseline obligations of good faith and fair dealing cannot be waived.

In at least one state, the right of parties to disclaim fiduciary obligations has generated significant controversy. In *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 167-68 (Del. 2002), the Delaware Supreme Court, in dicta, disapproved a series of rulings by the Court of Chancery to the effect that the Delaware Limited Partnership Act, 6 Del. Code Ann. § 17-1101, permitted parties to waive all fiduciary obligations. In response, the Delaware legislature amended both the Limited Partnership Act and the analogous provision of the corresponding provision of the Delaware LLC Act to make explicitly clear that fiduciary duties are, indeed, waivable. *See* 6 Del. Code Ann. § 18-1101; *see also, Scott Gordon Wheeler, LLC Fiduciaries: Where Has All the Good Faith Gone?*, 59 U. Kan. L. Rev. 1063, 1069 (2011). It is thus clear, under current law, that Delaware permits the total elimination of fiduciary obligations in an LLC. Although, once again, there has been no express statement of Arizona law on this point, it is likely that the Arizona Courts, applying the philosophy of maximum flexibility, would follow Delaware and permit parties to eliminate fiduciary duties by an operating agreement provision to that effect.[7]

The issue then arises, what effect such a provision would have on other non-statutory obligations, such as the implied covenant of good faith and fair dealing. As previously noted, Delaware applies a fairly expansive view of the implied covenant, *see Desert Equities, Inc.*, 624 A.2d at 1206; but see also, *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010) (Court will imply contract terms only when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably,

thereby frustrating the fruits of the bargain that the asserting party reasonably expected). Moreover, the Delaware legislature, by statute, has declared the implied covenant to be non-waivable in an LLC context. *See* Del. Code Ann. tit. 6, § 18-1101(c)(e). Permitting the elimination of fiduciary obligation is thus not, as might be assumed, an invitation to bad faith conduct, as the parties to an operating agreement remain obligated to exercise contractually-granted discretion in a reasonable manner. *Desert Equities, Inc.*, 624 A.2d at 1206.

In Arizona, the implied covenant of good faith and fair dealing is implied in every contract. *Rawlings v. Apodaca*, 151 Ariz. 149, 153, 726 P.2d 565, 569 (1986). The Arizona courts, in applying the implied covenant, have held that, while it 'does not create a duty to offer particular terms or to forego available contract remedies,' *Sw. Sav. & Loan Ass'n v. SunAmp Sys., Inc.*, 172 Ariz. 553, 558, 838 P.2d 1314, 1319 (App. 1992), quoting *Villegas v. Transamerica Fin. Serv.*, 147 Ariz. 100, 102, 708 P.2d 781, 783 (App.1985), a party can be found to have breached the implied covenant in exercising a reserved remedy in a manner that exceeds the risks assumed by the other party or violates the other party's 'justified expectations,' *Sw. Sav. & Loan Ass'n*, 172 Ariz. at 559, quoting Restatement (Second) of Contracts, § 205 cmt. a. While formulated differently than the covenant construed by the Delaware Courts, the Arizona covenant serves the same purpose – to fill in the gaps in the parties' agreement and insure that neither party acts in such a manner as to "prevent other parties to the contract from receiving the benefits and entitlements of the agreement." *Wells Fargo Bank v. Arizona Laborers, Teamsters & Cement Masons Local No. 395 Pension Trust Fund*, 201 Ariz. 474, 490, 38 P.3d 12, 28 (2002). Given the overriding policy reflected in the cases recognizing and applying the implied covenant, and given the potential for abuse and overreaching if the covenant were deemed waivable, it appears likely that the Arizona Courts would again follow the approach of Delaware and refuse to permit parties to disclaim their respective obligations of good faith and fair dealing.

D. Securities Law Considerations

Surprisingly, Arizona case law is clear on the question whether membership interests in an LLC constitute "securities." In *Nutek Information Systems, Inc. v. Arizona Corporation Commission*, 194 Ariz. 104, 107, 977 P.2d 826, 828 (1999) the Arizona Court of Appeals was presented with that very question – whether membership interests

in LLCs constitute "securities," so as to bring them within the scope of the Arizona securities laws.

Nutek arose out of a series of transactions involving the promotion and sale of membership interests in LLCs formed to obtain FCC licenses and construct, maintain, and operate five-channel 220 MHz dispatch communications systems. According to the Court's opinion, the promoters, in telephone solicitations and written materials, represented, *inter alia*, that the various LLCs intended to enter into a cooperative operating relationship using compatible systems to form an integrated network. The Securities Division of the Arizona Corporation Commission initiated proceedings by filing a Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist. The notice alleged violations of the registration and anti-fraud provisions of the Arizona Securities Act, A.R.S. §§ 44-1801, *et seq.* The Commission, upon hearing, ruled that the membership interests in the LLCs constituted securities, that the promoters had sold unregistered securities in violation of A.R.S. § 44-1841, failed to register as securities dealers or salesmen in violation of A.R.S. § 44-1842, and committed securities fraud in violation of A.R.S. § 44-1991.

On appeal, as a matter of first impression in Arizona, the *Nutek* Court held that the membership interests in the LLCs were "investment contracts," and thus "securities," under Arizona law. In reaching that conclusion, the Court, noting the broad definition of "security" under Arizona law, applied the three-prong test enunciated by the United States Supreme Court in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946), whereby an investment contract deemed to be a security where "a person (1) invests money (2) in a "common enterprise" and (3) is led to expect profits solely from the efforts of the promoter or a third party," *Nutek*, 194 Ariz. at 108, 977 P.2d at 830, as amplified by the Fifth Circuit opinion in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.1981), which addressed whether ownership interests in a general partnership (joint venture) could be considered securities.

The Court noted that, while the *Williamson* Court stated that general partners and joint venturers normally have enough control over their business entities that the third prong of the Howey test does not apply to them, the burden of establishing that a partnership interest is a security "is not insurmountable." 194 Ariz. at 109, 977 P.2d at 831. Quoting *Williamson,* the Court proceeded to approve the non-exclusive list of

factors considered by the Fifth Circuit to be relevant in determining whether the "expect profits from the efforts of another" aspect of the *Howey* test is satisfied:

> A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Id. The Court further found that the nature of the business enterprise, and the relative sophistication of the investors, may properly be considered in establishing the latter aspect of the test:

> An investor's knowledge of the business being operated provides one of the most reliable indicators of that investor's ability to exercise control over the investment. When the investor does not possess specialized knowledge of the business, he or she is far more likely to expect profits based on the efforts of the promoter or manager. . . . Because investors without specialized knowledge of the business must rely on third parties to manage their investments, they are precisely the vulnerable investors the securities laws are designed to protect.

194 Ariz. at 111, 977 P.2d at 833.

Applying the foregoing criteria, the *Nutek* Court determined that all three prongs of the *Howey/Williamson* test were satisfied, and that the membership interests in question were indeed investment contracts/securities.

The significance of *Nutek is two-fold.* First, as to practitioners engaged in entity formation, at least where the members of an LLC are proposed to include passive investors, it is necessary to give due consideration to the likelihood that the membership interests being issued may be treated as securities. While the specific steps required to be taken are beyond the scope of these materials, practitioners under those circumstances are advised to seek the input of competent securities counsel. Conversely, as to practitioners

advising minority members, the potential availability of securities-based claims is a powerful tool in actual and contemplated litigation with the promoters of the entity.

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[1] An exhaustive survey of the various statutory approaches to fiduciary duties under state LLC statutes, and an argument for an explicit statutory provision under the Maryland Act, which, like the Arizona LLC Act, contains no provision explicitly delineating the fiduciary obligations of LLC members and manager, is set forth in Michael S. Spencer, *Uncertainty for Practitioners and the Judiciary As Well As the Need for A Minimum Standard Demonstrate That Fiduciary Duties Should Be Incorporated into Maryland's LLC Act*, 40 U. Balt. L. Rev. 285, 303 (2010).

[2] Section 409 of the 2006 version of the Uniform Act provides:

> **STANDARDS OF CONDUCT FOR MEMBERS AND MANAGERS**
>
> (a) A member of a member-managed limited liability company owes to the limited liability company and, subject to Section 901(b) [requiring a member asserting a direct claim to "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 limited liability company"], the other members the fiduciary duties of loyalty and care stated in subsections (b) and (c).
>
> (b) The duty of loyalty of a member in a member-managed limited liability company includes the duties:
>
> (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
>
> (A) in the conduct or winding up of the company's activities;
>
> (B) from a use by the member of the company's property; or
>
> (C) from the appropriation of a limited liability company opportunity;
>
> (2) to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a party having an interest adverse to the company; and
>
> (3) to refrain from competing with the company in the conduct of the company's activities before the dissolution of the limited liability company.
>
> (c) Subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. In discharging duties under this subsection, a member may rely in good faith upon opinions, reports, statements, or other information provided by another person that the member reasonably believes is a competent and reliable source for the information.
>
> (d) A member shall discharge the duties under this [act] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.
>
> (e) It is a defense to a claim under subsection (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the limited liability company.
>
> (f) All of the members may authorize or ratify after full disclosure of all material facts a specific act or transaction that otherwise would violate the duty of loyalty.
>
> (g) In a manager-managed limited liability company:

(1) subsections (a), (b), (c) and (e) apply to the manager or managers and not the members;

(2) the duty stated under subsection (b)(3) continues until winding up is completed;

(3) subsection (d) applies both to members and managers;

(4) subsection (f) applies only to members; and

(5) A member of a manager-managed limited liability company does not have any fiduciary duty to the limited liability company or to any other member solely by reason of being a member.

[3] A.R.S. § 29-801 provides:

> Law governing foreign limited liability companies
> A. Subject to the constitution of this state:
> 1. The laws of the state or another jurisdiction under which a foreign limited liability company is organized govern its organization and internal affairs and the liability of its members, except as provided in subsection B.
> 2. A foreign limited liability company shall not be denied registration by reason of any difference between the laws of another jurisdiction under which a foreign limited liability company is organized and the laws of this state.
> B. A foreign limited liability company that has obtained a certificate of registration pursuant to this chapter and its members and managers have no greater rights and privileges than a domestic limited liability company and its members and managers with respect to transactions and relationships with persons who are not members. The certificate of registration does not authorize the foreign limited liability company to exercise any powers or engage in any business that a domestic limited liability company is forbidden to exercise or engage in by the laws of this state.

[4] As used in the Delaware Act, the term "limited liability company agreement" means "any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business."

[5] Delaware Code tit. 6, § 11-1801 provides, in part:

> **Construction and application of chapter and limited liability company agreement.**
>
> (a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.
> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.
> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
> * * * *
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager

> or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

[6] Judge Teilborg qualified his characterization of Arizona law by making it clear that he was basing his decision on the absence of reported case law, not an interpretation of the statute itself:

> It is important to note that the Court is simply stating that Defendant has no duty, because the Arizona courts have not yet determined whether, and how, that duty exists- the Court is not interpreting the Arizona Limited Liability Company Act as expressly creating no duty.

2011 WL 772522 at *9, fn 2.

[7] It has been suggested that the Kansas LLC Act, while identical to the superseded version of the Delaware statute, is properly interpreted as permitting waiver of fiduciary duties:

> Despite the lack of an express invitation for parties to eliminate fiduciary duties in the Kansas LLC act, an examination of the act reveals an intent by the legislature to allow elimination.

Scott Gordon Wheeler, 59 U. Kan. L. Rev. at 1081.

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