# House Committee on Judiciary

Testimony on House Bill 2261

David S. Walker
Iowa Commissioner on Uniform State Laws and
Dwight D. Opperman Distinguished Professor of Law
February 2, 2012

Mr. Chairman Kinzer and Members of the House Judiciary Committee:

*Introduction*

For the record I am David Walker. I am here today to testify in support of House Bill 2261, which would enact the Revised Uniform Limited Liability Company Act ("RULLCA") and repeal Kansas' present LLC legislation. I am a Professor at Drake University Law School in Des Moines, Iowa, where I teach in the areas of business organizations and transactional law. I am active in the Iowa State Bar Association. I am a past Chair of the Business Law Section and presently serve as a member of its Council. Since 1992 I have been one of Iowa's Commissioners on Uniform State Laws. In that capacity I have had the opportunity to serve on a number of drafting committees. I served on the Drafting Committee for the Model Entity Transactions Act, which you enacted in 2009, for example, and I chaired the Drafting Committee for the Revised Uniform Limited Liability Company Act that you are considering. All of the members of that Committee, and all of the Commissioners, too, viewed RULLCA as a very important undertaking.

Let me give a brief overview of the organization of my testimony today. First, I want to discuss RULLCA and why I would recommend its adoption. Second, because I know that your present LLC Act is modeled after Delaware's LLC Act and that the Kansas Legislature for many decades has followed Delaware corporate law and corporate jurisprudence, and because RULLCA is an alternative to Delaware, I would like to offer some observations about Delaware's LLC Act and why the Uniform Law Commission drafted and approved the Act that is before you. Finally, I would like to comment on a project of the Uniform Law Commission that is almost complete, to which RULLCA or House Bill 2261 is relevant, and in which you may be interested. Then I will be happy to take any questions that you have. Indeed, I am happy and actually very honored to be asked to testify before you today on this bill.

Allow me to make two, brief comments before I turn to the substance of the bill. First, I have read the testimony of Deputy Assistant Secretary of State Ryan Kriegshauser and spoken with him, and I quite understand the concerns he expressed and am supportive of harmonizing business law provisions dealing with the Secretary of State across all business entities. As a member of the Business Law Section Council in Iowa I have

worked with our Secretary of State in that regard, and we are presently examining the Model Registered Agents Act, which would provide uniform treatment for registered agents whatever the nature of the entity. Matters of filing can be dealt with within the structure of RULLCA, and in fact the Drafting Committee intended the various state legislatures and state bar associations to cooperate with their respective Secretary of States' Offices in considering RULLCA and tailoring it to local practice. Second, I understand that the Kansas Bar Association has a strong preference for Kansas' current legislation and that a committee of the Bar has been or is being formed to study the current LLC Act to determine whether and, if so, where revisions might be appropriate. I am an active member of the Iowa Bar, and I have served on similar committees in my state. That work and dialogue with the Legislature is a real public service. I speak to you today only with respect for the work of the Bar and comments it has made to the Committee through its letter of January 20, 2012, to Chairman Kinzer.

*Why Adopt RULLCA*

Limited liability companies are *the* entity of choice for small businesses and other organizations. Almost everywhere—in all but four states according to one recent study—LLCs are formed at two and three *times* the frequency that corporations are formed. It is essential that state legislation preserve and enhance essential attributes of this entity and make available best practices to citizens and businesses in our states. RULLCA is a modern, up-to-date, 3rd-generation limited liability company act drafted by Commissioners from numerous states with participation from advisors representing at least five sections of the American Bar Association and several more official observers. The bill you have was drafted in 2006 and drew upon twenty years of legislation, judicial opinions, and practice; and in a project culminating just last summer, it was further updated and the Uniform Law Commission's business entity statutes—including RULLCA and also the Partnership and Business Entity Transactions Acts that Kansas has adopted—harmonized.

RULLCA thus offers a very up-to-date, well-informed statute, but in doing so, it unambiguously preserves the salient attributes that characterize and define the LLC. It is an entity apart from its members, to be sure, and members have the full shield of limited liability from the debts and obligations, whether in contract, tort, or otherwise, of the LLC. At the same time, an LLC is a creature of contract, and RULLCA broadly preserves and facilitates members and their counsel defining the organization as they want it and tailoring it specifically to their purposes. As stated in section 10 of the bill, the members' operating agreement governs the relations among the members as members and between the members and the LLC; the rights and duties of members and managers; the activities of the company and the conduct of those activities; and the manner in which the agreement may be amended. RULLCA is a "default statute," and its provisions only apply to the extent the operating agreement does not otherwise provide. And what few things the parties cannot do in their operating agreement are stated succinctly in one section. And the default provisions are premised on the expectations and provisions that the Drafting Committee found or concluded that most people would probably choose or prefer most of the time, even while recognizing that they are wholly free to change it.

In addition to RULLCA's being an up-to-date statute which preserves all of the essential, sought-after attributes of the LLC while expressing best practices, a strong reason to consider and favor RULLCA is that its structure—its organization—is very clear and user-friendly. That architecture, incidentally, is mirrored in the Revised Uniform Partnership Act that you have adopted, and it would be familiar to people and certainly to lawyers and judges:

1. Article 1 contains general provisions, e.g., provisions defining terms and dealing with purposes, powers, and name of the LLC; governing law and applicability of supplemental principles of law; office and agent for service of process and change thereof; and three critical provisions dealing with the operating agreement;

2. Article 2 provides for the formation of the LLC; filing, signing, and amending or correcting records; and filing of a biennial report to the Secretary of State;

3. Article 3 contains provisions dealing with the relations of members and managers to persons dealing with the LLC, e.g., agency principles and the key section on liability of LLC members and managers;

4. Article 4 contains provisions dealing with the relations of members to each other and to the LLC, such as becoming a member; sharing of and right to distributions before dissolution; management templates for member-managed and manager-managed LLCs; and standards of conduct and rights to information;

5. Article 5 permits transfer of a member's "transferable interest" but limits the rights of transferees and thereby implements the well-recognized principle of unincorporated business organizations that people get to choose their partners;

6. Article 6 deals with dissociation or withdrawal from the LLC, both rightful and wrongful; and states events causing dissociation and the consequences of dissociation as a member of the LLC;

7. Article 7 deals with dissolution and winding up, including voluntary, judicial and administrative dissolution, and distribution of assets in winding up LLC activities;

8. Article 8 governs foreign limited liability companies;

9. Article 9 governs direct and derivative actions brought by LLC members;

10. Article 10 deals with merger, conversion and domestication, drawing very substantially upon the Uniform Limited Partnership Act (2001), IC Chapter 488;

11. Article 11 contains miscellaneous provisions, including ones dealing with the transition rules and the applicability of the new LLC Act to LLCs formed prior to the effective date.

The accessibility and clarity of legislation, people's ability to find, follow and understand what an Act says, are values I know you do not underestimate.

Summarizing, I have identified what I believe to be three strong reasons for adopting RULLCA: (1) it is a well-drafted, up-to-date statute that has been harmonized with other business entity legislation, including Uniform Acts Kansas has adopted; (2) it preserves all of the essential, sought-after attributes of the LLC and is predicated on contract principles allowing members to tailor and define their deal as they want while providing default terms many would choose, thus freeing organizers and members from the time and expense of drafting every last detail; and (3) its structure and organization are familiar and provisions fairly easy to locate and grasp.

Next, let me look at selected provisions.

- RULLCA offers in Article 1 three consecutive sections dealing with the critically important operating agreement—what its function is, what members can do through it, what they cannot do, who is bound by it—that prompt and facilitate discussion, negotiation, and agreement; and I believe you will find that it does so better than your state's current provisions dealing with the operating agreement.

- RULLCA contains sections that state that members owe the LLC and other members fiduciary duties. That is different from the Kansas LLC Act. The Kansas LLC Act, like Delaware's, explicitly emphasizes freedom of contract, hence contractual duties, and provides only that "to the extent a member, manager or other persons has fiduciary duties," they may be expanded or restricted. In contrast, RULLCA provides that members owe a duty of care and a duty of loyalty to other members and to the LLC and, consistent with decades of case law and other Uniform Acts, explains what those duties entail. The Drafting Committee believed that was only consistent with what people forming a business would expect, and of course, that is what Kansas law as interpreted and applied by the courts holds. In fact, for fiduciary duties in an LLC, the Court of Appeals of Kansas approved the lower court's turning to the Revised Uniform Partnership Act for instruction. Cimarron Feeders v. Bolle, 17 P.3d 957, 964 (Kan. App. 2001).

- RULLCA in section 110 allows parties to alter, expand, restrict, and eliminate aspects of the duty of loyalty, reduce the duty of care within limits, and define what behavior or performance does not violate the duty of loyalty or the implied

contractual obligation of good faith and fair dealing. That is particularly common, for example, in real estate transactions. Again, the premise of the LLC under RULLCA is contractual, but an explicit starting point is that there are fiduciary duties. That is what we believe most people in business would assume. It is the Uniform Act.

- RULLCA, like many LLC statutes, including Kansas, provides for the parties to determine the manner in which the LLC will be managed; and in section 36 of your bill, it provides templates for (1) a member-managed LLC and (2) a manager-managed LLC. These would be instructive to members and managers reading the Act, and in fact an LLC operating manual might be built around the provisions of the Act and turned to by members and managers when questions arise. But RULLCA allows members to vary even these forms and choose other modes of management if they want, or call it a "board" and appoint a "chief executive officer" if they want.

- Section 26 provides that "a member is not an agent of a limited liability company solely by reason of being a member." The member may have actual authority if the operating agreement, or the other members or the manager, gives it to the member; or under well-recognizes principles of apparent authority under common law—which governs corporations in this respect—the member may have apparent authority, for example, because the member has been appointed to a particular position which carries with it known responsibilities. But that is different from having authority to bind the company simply by virtue of the status of member. Some have found that controversial. The ULC did not. Like the Revised Uniform Partnership Act, but different from your LLC Act, RULLCA provides for a "statement of authority" to be created and filed with the Secretary of State in real estate and other transactions. It is a device which can conclusively resolve any question whether a manager or member has authority to enter into a transaction on behalf of the LLC and bind it.

- Section 17 of your bill addresses formation of an LLC. It uses the term "certificate of organization" rather than "articles" because the function of the "certificate" is so limited, and its content so brief. The heart of the LLC is not in the public filing but in the operating agreement. As written section 17 would require two filings if the LLC did not have a member when the filing was made. That was controversial and few liked it; and RULLCA as harmonized last summer, 2011, eliminated the dual-filing requirement. It now provides clearly that a certificate of organization may be filed even though there are no members at the time, but that the LLC is not "formed" until there is at least a member. That enables an attorney, for example, to determine whether an LLC was validly formed and duly organized for purposes of giving a legal opinion, but it doesn't require two filings.

- There are numerous provisions—some familiar, some introduced by RULLCA—that protect the deal. Your current law and RULLCA both provide that a

transferee of a limited liability company interest only obtains the economic rights—the right to receive distributions when, as, and if they are made—but *not* the right to participate in management or demand inspection of documents and records. RULLCA also provides that LLC members may amend the operating agreement even over the protest of a transferee; a dissociated member or transferee cannot "freeze the deal." Further, members may alter or restrict or even eliminate aspects of the duty of loyalty or define what is permissible or sufficient performance, and what they say will be enforceable "unless manifestly unreasonable." The latter term has proved ambiguous for some. It is tightly defined in the Act, or section 10(h) your bill.

- RULLCA contains current, clear provisions dealing with fundamental changes—merger, conversion, or domestication—and these provisions track and mesh with the Model Entity Transactions Act that you have adopted.

- *Series LLCs* is a subject I understand that you are interested in. RULLCA does not provide for series LLCs because a majority of our Drafting Committee members concluded (1) there were two many questions at the time about whether the Internal Revenue Service or United States Bankruptcy Courts or state courts would recognize a "series LLC" as a valid means of insulating certain LLC assets from creditors of the LLC; and (2) it was simpler and safer just to form a separate LLC, just as a corporation would form a subsidiary that would legally be separate from the parent. Nevertheless, some states, including my own and certainly Delaware, provide for series LLCs; and the Uniform Law Commission itself provided for a series to be utilized in the Uniform Statutory Trust Entity Act. The District of Columbia recently adopted RULLCA, and it provided for series LLCs. We did so in Iowa largely because Iowa had provided for series a decade earlier, and as our Bar committee considered the issue, there was testimony from at least one lawyer that he utilized series LLCs and that they were useful. A number of questions continue to exist about series, and the Uniform Law Commission formed a Study Committee on Series. In fact I am a member of it. Clearly use of a series demands strict and careful accounting and record-keeping. But we have learned that some believe that series can serve useful purposes for some clients, quite apart from the context of an investment or mutual fund where series developed. We are also learning that there are different approaches to series LLCs. Delaware regards a series LLC as an entity. That would mean it could sue and be sued, for example, raising questions about its relation to the LLC of which it is a part. The Statutory Trust Entity Act recognizes a series trust but does *not* regard it as an "entity." We have another meeting the end of this month—the 24th—and are hopeful of concluding the Study Committee's work by this summer. The bottom line question is whether to draft provisions or a separate act creating and validating a series.

*Some Observations on Delaware Business Entity Law*

First, Delaware law is developed in the context and for the purpose of sophisticated, often high-end and highly "lawyered" transactions where attention to and negotiation and drafting of every provision are assumed. Of course, there are sophisticated businessmen and women, sophisticated lawyers, and high-end, complex business transactions in Kansas, as there are in Iowa and elsewhere, not just Delaware. But the overwhelming number of LLCs are almost certainly formed *without* lawyers, or without lawyers who do *only* business entity work, or for transactions where the parties don't contemplate or want the expense that negotiation of everything would mean. Most lawyers are not in large law firms but are in firms of ten or fewer, if they're not sole practitioners; and a study of lawyers across the country that a professor conducted during the work of our Drafting Committee indicated that the paradigm LLC had three to five members, if not a single member. The point is that a small business could pretty much take RULLCA as it is—for example, with its fiduciary duties—and find it meets their expectations without having to negotiate and draft more specific *contractual* duties. At the same time, as previously indicated, RULLCA fully allows them to "customize" their deal if they want. In short, lawyers and people can do through RULLCA what they can do under Delaware law.

Second, and as an example, in the matter of fiduciary duties—the expectations that people going into business with one another ordinarily have as they repose trust and confidence in each other in pooling resources and contributing to a business they will own and manage together—the Delaware approach does not reflect Kansas or most states' laws. Delaware's and your LLC Acts do not contain any statement of fiduciary duties. Indeed, the present Chief Justice of the Delaware Supreme Court is of the opinion that the Delaware Legislature has directed the Delaware courts "to engage in a thorough policy analysis of default fiduciary duties" and further directed the courts to determine "whether default fiduciary duties should apply." His own conclusion is "that an economic analysis mandates that the courts reject default fiduciary duties. Instead," he continues, "the courts should analyze LLC agreement by the parties' agreement alone. Default fiduciary duties introduce unnecessary confusion to contracting and add undesired litigation costs without providing any substantial benefit." Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies,* 46 American Business Law Journal 221, 242 (2009). That is definitely *not* the law in Kansas, as your courts have a long, rich history respecting and enforcing fiduciary duties in corporations, partnerships, and limited liability companies. Chief Justice Steele's comments point not only to the difference in approach but also to the assumption that parties will unfailingly go to the time and expense of carefully negotiating all duties and responsibilities and not want to rely on "default provisions" such as those in RULLCA.

Third, and fully disclosing the bias I have through association with RULLCA's development, I believe you would find RULLCA's organization and provisions much more accessible and workable than the Delaware LLC Act and ones modeled after it. In a leading opinion by the Delaware Supreme Court, Elf Atochem North America v.

Jaffari, 727 A.2d 286, 291 (Del. 1999), the Chief Justice of the Court, Norman Veasey, wrote about the Delaware Act, "Although business planners may find comfort in working with the Act in structuring transactions and relationships, it is a somewhat awkward document for this Court to construe and apply in this case. To understand the overall structure and thrust of the Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly. Be that as it may as a problem in mastering the Act as a whole, one returns to the narrow and discrete issues presented in this case."

Fourth, while the Delaware Chancery Court is likely the most sophisticated business court in the United States and opinions of the Delaware Supreme Court rightly command respect, relying upon Delaware courts' interpretations has its costs. In several instances Delaware introduced major upheavals and uncertainty into the law. In the 1970s the Delaware Supreme Court held that a party to a merger where that party held a substantial interest had to show a "business purpose" for the transaction, seemingly apart from its own interests, a position Delaware abandoned a decade later. In the '90s the Delaware Supreme Court interpreting its corporate law held that directors owed a tripartite fiduciary duty—care, loyalty, *and* good faith—each independent; and a decade of litigation unfolded in which the meaning of "good faith" as an independent fiduciary duty was explored and contested. That position was clarified five years ago, when the Delaware Supreme Court held that, in truth, good faith was *not* an independent fiduciary duty but an aspect of the duty of loyalty. Still regarded as a controversial blockbuster is the Delaware Supreme Court's opinion in 1985 in the case of *Smith v. Van Gorkum*, a case defining the duty of care owed by non-self-dealing directors. The *Van Gorkum* case led to widespread enactment of exculpatory legislation for directors by Delaware, with other states following, including in Iowa and Kansas. Even then the Delaware legislation was expressed in terms that spawned extensive litigation. Quite apart from surprises like these and questions they raise about stability and predictability in planning transactions, legislators and lawyers should be aware of the volume of reading that will be required to keep up on Delaware law. Delaware opinions are lengthy and constant. Just last Friday, January 27th, the Chancery Court issued a 75-page opinion exploring fiduciary duties in a Delaware LLC. That will not be the last word.

*The Uniform Business Organizations Code—Something to Consider*

The Uniform Law Commission is a nearly 125-year old organization that is dedicated to the development of uniform *state* laws—enacted by the states and not the federal government—where uniformity is desirable and practicable. States adopt the Acts, and they may customize or tailor the Acts to their preference and local practice. That is understood.

Business and commercial transactions are two such areas where uniformity is desirable and practicable, and the ULC has long been active and its products proven attractive. The Uniform Commercial Code, a joint project with the American Law Institute, is perhaps the ULC's best-known commercial product. In the business area there are Uniform Acts dealing with numerous *unincorporated* entities—partnerships, limited

partnerships, limited liability companies, unincorporated nonprofit associations—and cross-entity transactions. Kansas has adopted the Revised Uniform Partnership Act and the Model Entity Transactions Act; it has an older version of the ULC's limited partnership legislation; and in discussions with the Deputy Assistant Secretary of State I believe you would be interested in Uniform Acts applicable to all business entities insofar as dealings with the Office of the Secretary of State are concerned. The ULC has harmonized all of these Uniform Acts and is organizing them into a Uniform Business Organizations Code. Article 1 of that Code would deal with the Secretary of State and govern names, registered agents, qualification by foreign entities, administrative dissolution and reinstatement, and so forth. It will save everyone time and expense. I am working with the Secretary of State's Office in Iowa and with the Bar in this regard. RULLCA is a part of that Code, as is the Revised Uniform Partnership Act, the Uniform Limited Partnership Act, and the Model or Business Entity Transactions Act. I encourage you, at the appropriate time for you, to investigate the coming Uniform Business Organization Code. It would update at least three business entity acts that you currently have.

In the meantime, I strongly support your consideration of RULLCA, and I thank you for the honor of appearing before you and speaking about this Uniform Act today. I would be pleased to address questions that you have.

David S. Walker