A CRITIQUE OF THE UNIFORM LIMITED LIABILITY COMPANY ACT*

Larry E. Ribstein**

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** George Mason University Foundation Professor of Law, George Mason University School of Law. Portions of this Article have also been published in LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, 1995 Supplement. Funding was provided by the George Mason University Law and Economics Center.

Since the limited liability company (LLC) burst on the scene in 1988, forty-eight jurisdictions have passed LLC statutes.[1] The stat

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1. ALA. CODE §§ 10-12-1 to -61 (Supp. 1993); ALASKA STAT. §§ 10.50.010–.995 (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); CAL. CORP. CODE §§ 17000–17705 (West Supp. 1995); COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); CONN. GEN. STAT. ANN. §§ 34-100 to -242 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993); D.C. CODE ANN. §§ 29-1301 to -1375 (Supp. 1995); FLA. STAT. §§ 608.401–.514 (1993); GA. CODE ANN. §§ 14-11-100 to -1109 (1994 & Supp. 1995); IDAHO CODE §§ 53-601 to -672 (1994 & Supp. 1995); ILL. ANN. STAT. ch. 805, para. 180 (Smith-Hurd Supp. 1995); IND. CODE ANN. §§ 23-18-1-1 to -13-1 (West 1994); IOWA CODE ANN. §§ 490A.100–.1601 (West Supp. 1995); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1993); KY. REV. STAT. ANN. §§ 275.001–.455 (Michie/Bobbs-Merrill Supp. 1994); LA. REV.

utes are remarkable both in their diversity and in their evolution of LLC provisions over a short time.[2] The National Conference of Commissioners on Uniform State Laws (NCCUSL) now seeks to end both the diversity and the evolution of the LLC form with its promulgation of the Uniform Limited Liability Company Act (ULLCA).[3]

State legislators and bar committees must decide whether to amend their statutes to adopt ULLCA. They might choose to do so either because they hope ULLCA will become a uniform law or they wish to emulate what they believe is a carefully drafted, well-reasoned proposal.

This Article argues against both of these reasons for adopting ULLCA. Parts I and II show that LLC statutes do not have to look alike and, even if some types of provisions should be uniform, adopting ULLCA is not the best way to achieve this goal. LLC statutes already have become quite uniform on the issues where uniformity is most efficient,[4] and adopting ULLCA's often quirky provi

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STAT. ANN. §§ 12:1301–:1369 (West 1994); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (1993 & Supp. 1994); ME. REV. STAT. ANN. tit. 31, §§ 601-762 (West Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101–.5200 (West Supp. 1995); MINN. STAT. ANN. §§ 322B.01–.960 (West 1995); MISS. CODE ANN. §§ 79-29-101 to -1201 (Supp. 1994); MO. ANN. STAT. §§ 347.010–.187 (Vernon Supp. 1994); MONT. CODE ANN. §§ 35-8-101 to -1307 (1994); NEB. REV. STAT. §§ 21-2601 to -2653 (Supp. 1994); NEV. REV. STAT. ANN. §§ 86.010–.571 (Michie 1994); N.H. REV. STAT. §§ 304-C:1 to :85 (Supp. 1994); N.J. STAT. ANN. §§ 42:2B-1 to -70 (West Supp. 1995); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1994); N.Y. LTD. LIAB. CO. LAW §§ 101–1403 (McKinney Supp. 1995); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993 & Supp. 1994); N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1993); OHIO REV. CODE ANN. §§ 1705.01–.58 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2000–2060 (West Supp. 1995); OR. REV. STAT. ANN. §§ 63.001–.990 (Supp. 1994); 15 PA. CONS. STAT. ANN. §§ 8901–8998 (Supp. 1995); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992 & Supp. 1994); S.C. CODE ANN. §§ 33-43-101 to -1409 (Supp. 1995); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1995); TENN. CODE ANN. §§ 48-246-101 to -602, 48-248-101 to -606 (Supp. 1994); TEX. REV. CIV. STAT. ANN. Art. 1528n, arts. 1.01–11.07 (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to -158 (1994 & Supp. 1994); VA. CODE ANN. §§ 13.1-1000 to -1123 (Michie 1993 & Supp. 1995); WASH. REV. CODE ANN. §§ 25.15.005–.902 (West Supp. 1995); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1994); WIS. STAT. ANN. §§ 183.0102–.1305 (West Supp. 1994); WYO. STAT. §§ 17-15-101 to -143 (1989 & Supp. 1995).

2. For a study of the evolution of the Limited Liability Company (LLC) statutes, see Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369 (1995).

3. Although the UNIF. LTD. LIAB. CO. ACT (ULLCA) (1995), *reprinted in* 25 STETSON L. REV. 463 (1995), was officially promulgated in August, 1994, it has since been revised — repeatedly and substantially. Unless otherwise noted, all references are to the August 11, 1995, version.

4. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, ECON. INQ. (forth-

sions will not help achieve additional uniformity. Parts III and IV then analyze ULLCA in detail. These Parts show that much of ULLCA suffers from poor drafting and questionable policy choices. Accordingly, legislatures should not discard their current statutes on the theory that ULLCA is a better product.

I. ADOPTING ULLCA TO ACHIEVE UNIFORMITY

The Prefatory Note to ULLCA rationalizes NCCUSL's effort as follows:

> Practitioners and entrepreneurs struggle to understand the law governing limited liability companies organized in their own State and to understand the burgeoning law of other States. Simple questions concerning where to organize are increasingly complex. Since most state limited liability company acts are in their infancy, little if any interpretative case law exists. Even when case law develops, it will have limited precedential value because of the diversity of the state acts.
>
> Accordingly, uniform legislation in this area of the law appeared to have become urgent.[5]

The Commissioners then add: "The adoption of ULLCA will provide much needed consistency among the States, with flexible default rules, and multistate recognition of limited liability on the part of company owners."[6]

These concerns about non-uniformity fail to demonstrate that uniformity is "urgent." Section A of this Part shows that there is, in fact, little need for LLC statutes to be uniform. Moreover, Section B shows that uniformity in this area, far from being desirable, could be costly. The Commissioners' additional concerns about "flexible default rules"[7] and "multistate recognition of limited liability"[8] are irrelevant to ULLCA. The states already have achieved "multistate recognition of limited liability"[9] without NCCUSL's help, free contracting is a reason *not* to have uniformity, and, as Part IV shows,

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coming 1995 or 1996) (manuscript at 11, on file with the *Stetson Law Review*).

5. ULLCA Prefatory Note.

6. *Id.*

7. *Id*.

8. *Id*.

9. *Id*.

the need for flexibility is reason *not* to adopt ULLCA.

A. Benefits of Uniformity

The supposed benefits of uniform LLC statutes include ensuring that a single law applies to any given LLC, reducing the costs of those who deal with and invest in LLCs of determining the applicable law, facilitating the development of a body of case law and customs that would increase the certainty and predictability of LLC law, reducing the possibility of a "race to the bottom" for LLCs, and ensuring favorable tax treatment. This section analyzes each of these supposed benefits of uniform LLC law and finds them to be largely illusory.

1. Application of Different State Laws to the Same Firm

Uniform laws can reduce several kinds of costs associated with the potential application of different state laws to the same firm. Most importantly, firms face costs of complying with different laws in each jurisdiction in which they do business. This reduction usually is not significant, since firms generally can comply with all laws by complying with the most stringent, and since inconsistency costs can be eliminated only in the rare instance of ubiquitous adoption and uniform interpretation of statutes.

In the case of the law relating to the internal governance of firms such as LLCs, uniformity is unnecessary to eliminate inconsistency costs as long as each firm is subject to a single law. This might have been a problem when only a few states had LLC statutes, since courts do not necessarily enforce contractual choice of law in non-corporate firms.[10] But almost all states have LLC statutes that provide for application of the law of the state of formation.[11] Therefore ULLCA is unnecessary to eliminate legal incon

10. *See* Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245 (1993).

11. ALA. CODE § 10-12-46(a) (Supp. 1993); ALASKA STAT. § 10.50.600 (Supp. 1994); ARIZ. REV. STAT. ANN. § 29-801 (Supp. 1994); ARK. CODE ANN. § 4-32-1001 (Michie Supp. 1993); CAL. CORP. CODE § 17450 (West Supp. 1995); COLO. REV. STAT. ANN. § 7-80-901 (West Supp. 1994); CONN. GEN. STAT. ANN. § 34-222 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-901(a)(1) (1993); GA. CODE ANN. § 14-11-701(a) (1994); IDAHO CODE § 53-650 (1994); ILL. ANN. STAT. ch. 805, para. 180/45-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-11-1(a) (West 1994); IOWA CODE ANN. § 490A.1401 (West Supp. 1995); KAN. STAT. ANN. § 17-7636(a) (Supp. 1993); LA. REV. STAT. ANN. § 12:1342 (West 1994); ME. REV.

sistency for LLCs.

2. *Costs of Learning Which Rule Applies*

The ULLCA drafters emphasize the difficulties of learning about all of the different LLC laws.[12] In evaluating this argument, it is important to distinguish two types of costs — those of firms and their lawyers who are looking for the "best" statute for their firm or client, and those of members and third parties who are investing in or loaning money to existing LLCs. Having many LLC statutes could increase some firms' costs in shopping for LLC statutes because it forces them to hire experts who can evaluate the differences between LLC statutes. This cost is not significant because most LLCs operate intrastate and may not want to incur the costs of operating in their home state as a foreign LLC. In any event, the relevant question is whether the added costs of diversity outweigh the benefits of having a choice of statutes. Life was simpler but not necessarily better when there was only one telephone company. Having many LLC statutes offers significant benefits in terms of innovation and variety of statutory forms.[13] Although the failure to have a single standard may make generalists unhappy as they lose business to specialists who keep track of the nuances of LLC law (and, indeed,

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STAT. ANN. tit. 31, § 711(1)(a) (West Supp. 1994); MD. CODE ANN., CORPS. & ASS'NS § 4A-1001(a)(1) (1993); MICH. COMP. LAWS ANN. § 450.5001 (West Supp. 1995); MINN. STAT. ANN. § 322B.90 (West 1995); MISS. CODE ANN. § 79-29-1001 (Supp. 1994); MO. ANN. STAT. § 347.151(1) (Vernon Supp. 1994); NEB. REV. STAT. § 21-2637 (Supp. 1994); N.H. REV. STAT. ANN. § 304-C:62(I)(a) (Supp. 1994); N.J. STAT. ANN. § 42:2B-52 (West Supp. 1995); N.Y. LTD. LIAB. CO. LAW § 801(a) (McKinney Supp. 1995); N.C. GEN. STAT. § 57C-7-01 (1993); N.D. CENT. CODE § 10-32-135(1) (Supp. 1993); OHIO REV. CODE ANN. § 1705.53 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, § 2042(A)(1) (West Supp. 1995); OR. REV. STAT. ANN. § 63.714(1) (Supp. 1994); R.I. GEN. LAWS § 7-16-48(a)(1) (1992); S.C. CODE ANN. § 33-43-1001 (Supp. 1995); S.D. CODIFIED LAWS ANN. § 47-34-45 (Supp. 1995); TENN. CODE ANN. § 48-246-101(1) (Supp. 1994); TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 7.01 (West Supp. 1995); VA. CODE ANN. § 13.1-1051 (Michie 1993); WASH. REV. CODE ANN. § 25.15.310(1)(a) (West Supp. 1995); W. VA. CODE § 31-1A-48(1) (Supp. 1994); WIS. STAT. ANN. § 183.1001(1) (West Supp. 1994); *see infra* text accompanying notes 386–88 (discussing ULLCA §§ 1001–1009). *See generally* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 13.03 (1992 & June 1995 Supp.).

12. *See supra* text accompanying notes 5–9. Other participants in the ULLCA drafting process have also cited the reduction of information costs as an important reason for uniformity in this area. *See* James W. Reynolds & Steven G. Frost, *Articles of Organization's Default Rules Discussed*, 1 J. LTD. LIAB. COS. 43, 43 (1994).

13. *See infra* Part I(B)(2).

gives generalists an incentive to back a uniform law), it would not necessarily make firms better off or otherwise improve overall social welfare.

The information costs of diverse laws in connection with dealing with existing LLCs depend on the type of transaction. Uniformity produces little savings for purchasers of ownership interests in existing firms, since the purchasers are mainly interested in negotiating and learning the terms of an often complex customized agreement. As long as the agreement controls in most respects, new members have relatively little need to find out which statutory default terms apply. Finding out whether the agreement conforms with the mandatory terms of the statute is likely to add little to the total cost of researching the deal. Moreover, ULLCA substitutes complex mandatory terms for the simple non-uniform default rules that would otherwise apply.[14]

Diverse laws can be more of a problem for casual creditors, who may have to incur substantial costs in dealing with LLCs subject to many different state laws. Creditors would want to know information such as the extent of the owners' personal liability and of creditor-protection provisions relating to capitalization and distributions. Rather than incurring these costs in each transaction, creditors may apply a risk discount to the price of any transaction with LLCs. But while LLCs therefore might prefer uniformity, they do not need ULLCA, since LLC statutes have spontaneously evolved a high level of uniformity with respect to creditor-oriented provisions.[15] ULLCA would, in fact, destroy this uniformity and increase creditors' information costs by adding an idiosyncratic provision with regard to the most important creditor-oriented rule — the members' personal liability.[16]

3. *Availability of Interpretive Materials*

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14. *See* ULLCA § 103(b) (listing mandatory rules); *infra* text accompanying notes 226–29 (discussing problems of drafting fiduciary duty provisions in light of mandatory rules).

15. *See* Kobayashi & Ribstein, *supra* note 4; *infra* Part I(C).

16. *See* ULLCA § 303 and *infra* text accompanying notes 160–68 (discussing § 303).

ULLCA's drafters were also concerned that non-uniformity would reduce the supply of available judicial precedents.[17] Judicial precedents, form contracts, business practices and legal advice do help in interpreting and applying a statutory standard form[18] and, in turn, can reduce the costs of drafting agreements,[19] uncertainty about potential outcomes under agreements, and the frequency and cost of litigation. A uniform LLC law might help produce these interpretive materials by making relevant judicial precedents and other interpretive materials from all jurisdictions that have adopted the law. But a uniform statute is of little help in solving many of the interpretation problems that arise in business associations. Straightforward formalities need little interpretation, and general fiduciary standards are inherently contextual in nature.[20] Even if uniformity is important, the statute need not supply it. Lawyers can bridge relatively minor differences between statutes by supplying standard form operating agreements and other materials that fit many different types of statutes. Finally, an idiosyncratic uniform law might even *reduce* the supply of interpretive materials. ULLCA includes several rules which are not yet included in business association statutes, and so have generated no case law.[21] In other cases ULLCA adopts the minority rule among LLC statutes.[22]

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17. *See supra* text accompanying note 5.

18. *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995). For a fuller discussion of this issue as it relates to LLCs, see Ribstein, *supra* note 2.

19. One lawyer commented:

> [A]s standard forms get published by the legal text and form houses that the income allocation will begin to become formalized where a standard form is used[.] Right now, because of the flexibility and the delphic specificity of the existing LLC statutes, everybody rolls their own in the operating agreements. There do[ ] not seem to be any formula answers that can be generated for a client for a few hundred dollars in legal fees.

E-mail message from Gordon Buck to LNET-LLC (Sept. 1, 1994).

20. *See* Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 52–53 (1993).

21. *See, e.g.,* ULLCA §§ 103 (providing new rules for nature and effect of operating agreement); 203 (providing new rule for effect of articles); 303 (providing new rule for opting out of limited liability); 404 (providing new list of acts that require unanimous consent); 408 (providing new rules for members' information rights); 603 (providing new rules for effect of member dissociation); 701–702 (providing new rules for member buyout); 802 (providing new rules for continuation of LLC after dissolution).

22. *See infra* text following note 55.

4. Defects in Jurisdictional Competition

A uniform law might be useful because the states lack adequate incentives to draft efficient LLC laws. One reason may be that LLC laws will suffer from a "race to the bottom" because legislators pass statutes that serve particular interest groups rather than general social welfare. Whether this is likely to happen relates to information costs. As long as the parties to firms, or parties dealing with firms, can cheaply determine what rules apply, they can avoid statutes they do not like or reflect the costs of different rules in their contract price. There is unlikely to be a liquid market in LLC interests as there is for corporations that would efficiently capitalize the costs associated with the chartering statute.[23] LLC members might be misled into choosing the wrong statute by their lawyers, upon whom the members necessarily rely for expert analysis of different LLC statutes. As a result, legislatures may tailor their statutes to lawyers' rather than investors' interests by, for example, emphasizing complex litigation-maximizing rules. Legislators also might favor owners at the expense of casual creditors who may not be as able as owners to analyze the statutes under which debtor firms are organized.[24]

A uniform law also might be necessary because, rather than a race to the bottom, there may be no race at all. Since LLCs are inherently closely held, owners may not be willing to incur the costs of interstate organization.[25] Accordingly, legislators would have no interest in competing for LLC business.[26] This depends on whether firms' benefits from shopping for LLC law exceed the costs of organizing outside their home state. The factors that relate to this cost-benefit analysis include variations in quality of LLC statutes, trans-

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23. As to the role of capital markets in corporate chartering, see Ralph Winter, GOVERNMENT AND THE CORPORATION (1978); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980).

24. *See supra* text accompanying notes 15–16. On the other hand, sophisticated creditors, such as banks, readily can evaluate the applicable LLC rules and may be able to exert pressure on legislatures to enact rules that favor them.

25. *See* Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 376–78 (1992) (arguing that close corporations are relatively immobile).

26. Note that, if no such market develops because LLCs are relatively immobile, it also follows that there is little chance of multiple state laws applying to LLCs — an important argument favoring uniformity. *See supra* Part I(A)(1).

action costs of interstate organization, and fees charged by the states.[27] In other words, firms might pay high foreign-state costs to get a much better statute, and low foreign state costs to get a slightly better statute.

Whatever legislators' theoretical incentives to develop LLC law, in fact the competition has been quite robust. Forty-seven states and the District of Columbia passed LLC statutes within only six years after the tax ruling that made LLCs feasible.[28] These statutes evolved both toward efficient terms,[29] and toward uniformity with respect to the types of provisions for which uniformity is efficient.[30] This may be because lawyers have incentives to participate in drafting LLC statutes in order to increase the local market for formation of LLCs and to earn reputational benefits from being associated with the development of an expertly drafted law.[31]

In any event, ULLCA and other uniform laws do not solve problems associated with limited jurisdictional competition. The NCCUSL drafters, like state legislators, have their own incentives to draft statutes that favor certain interest groups, including lawyers who would like the litigation fallout from a complex statute.[32] Moreover, state legislators will not necessarily abandon any perverse incentives they might have when exposed to the sunlight of a NCCUSL proposal. Indeed, interest groups might use NCCUSL to accomplish their ends.[33] Thus, a uniform law could be at least as interest-group-oriented as any state statute[34] while even further weakening the jurisdictional competition that could provide some market discipline.

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27. *See* Ribstein, *supra* note 2.

28. Rev. Rul. 88-76, 1988-2 C.B. 360. See *supra* note 1 for a list of state LLC statutes.

29. *See* Ribstein, *supra* note 2.

30. *See* Kobayashi & Ribstein, *supra* note 4.

31. *See* Ribstein, *supra* note 2, at 400–01.

32. *See* Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. (forthcoming 1996) (manuscript on file with author) [hereinafter *Economic Analysis*]; Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws, and LLCs*, COLO. L. REV. (forthcoming 1995) (manuscript at 9–10, on file with author) [hereinafter *Model Laws*].

33. *See* articles cited *supra* note 32.

34. Indeed, there is ample evidence of interest group influence on ULLCA. *See Model Laws*, *supra* note 32 (manuscript at 17–22).

5. Tax-Induced Uniformity

A final argument for a uniform LLC statute is that it can help in characterizing the LLC for purposes of federal tax classification. It is often uncertain whether an LLC will be characterized as a partnership for tax purposes unless the firm has gone to the expense of obtaining a private letter ruling.[35] A firm may be able to minimize the uncertainty by forming under a statute which is designed to comply with, or is the subject of, an IRS revenue ruling. ULLCA has, in fact, been drafted so as to include some of these tax characteristics.[36] But it would be just as easy for the firm to form pursuant to a state statute that has similar provisions, or to adapt its own agreement to the ruling, particularly now that the IRS has issued a comprehensive revenue ruling on LLCs.[37] Moreover, the changeable nature of tax law is itself a strong argument *against* uniformity because state laws cannot easily both remain uniform and adjust quickly to changes in tax law.[38]

B. Costs of Uniformity

This section discusses some potential costs of uniform laws: increasing the costs of exit from mandatory rules, and reducing innovation and diversity.

1. Exit from Mandatory Rules

Mandatory rules, such as those restricting waivers of fiduciary duties, can preclude both efficient and inefficient contracts. One way to sort out efficient and inefficient mandatory rules is to let firms choose among statutes that vary regarding mandatory rules. Uniform laws, of course, remove this choice.[39] On the other hand, non-

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35. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 465 (1992).

36. *See* ULLCA § 801 (providing for pro rata rule on continuation consistent with Rev. Proc. 95-10, 1995-3 I.R.B. 20, discussed *infra* note 303 and accompanying text).

37. *See* Rev. Proc. 95-10, 1995-3 I.R.B. 20. Indeed, it is not clear how ULLCA fits with this ruling on such matters as identifying the difference, which is important to the ruling, between member-managed and manager-managed LLCs. See *infra* text accompanying notes 234–35 for a discussion of "manager" in ULLCA.

38. Also, as discussed *infra* text accompanying notes 44–45, evolution of state statutes can itself induce desirable changes in tax law.

39. *See Model Laws*, *supra* note 32 (manuscript at 5–6).

uniformity could lead to a "race to the bottom" which is won by inefficient permissive statutes. Thus, the argument about permitting exit from mandatory rules essentially reduces to one about the efficiency of jurisdictional competition.[40]

2. *Reducing Innovation and Experimentation*

Persuading legislatures to focus on a single uniform law proposal deters further innovations in, and experimentation with, the LLC form. Although this is generally true for uniform laws,[41]it may be particularly a problem for LLCs. First, the LLC form is still evolving. The LLC is the first form to combine the management and financial flexibility of a partnership with full corporate-type limited liability. Accordingly, there is no accepted wisdom about what rules should apply to such a business. For example, it is not clear whether the statute should provide by default that owners vote and share income and distributions per capita, as in a general partnership, or pro rata by ownership interests as in a corporation.[42] This suggests that the best rule will emerge from the collective wisdom and experience of lawyers and legislatures in fifty states as lawyers and their clients learn from the actual operation of LLCs. LLC statutes have, in fact, evolved from predominantly pro rata to predominantly per capita rules.[43]

State legislative innovation and experimentation is also important for LLCs because LLC statutes interact with federal tax law. In particular, questions remain concerning which LLCs will be characterized as partnerships for tax purposes, and, if so, whether the same rules that apply to partnerships will be applied to LLCs.[44] Although changes in state law do not directly change tax classification, they can provoke a reexamination of the tax classification rules. Accordingly, whether tax classification rules evolve and become more flexible may depend importantly on whether the underlying state rules are evolving. For example, state statutes have loosened the vote required for transfer of management rights and con-

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40. *See supra* Part I(A)(4).

41. *See Model Laws*, *supra* note 32.

42. *See infra* text following note 186 (discussing pre-dissolution distribution).

43. *See* Ribstein, *supra* note 2, at 419–22.

44. For a review of tax classification and operation issues, see RIBSTEIN & KEATINGE, *supra* note 11, Chapters 16 & 17.

tinuation of the firm after member dissociation. Although there may once have been a question about whether non-unanimous consent to transfer of management rights or to continuation of the firm would mean that the firm has corporate-type free transferability or continuity of life for tax purposes, it is now clear that majority-in-interest voting on these issues is non-corporate.[45] Had state development been frozen into uniformity at an early date there would have been no occasion for the federal rule to change.

Whether uniformity impedes desirable innovation and experimentation depends on state legislators' willingness and ability to innovate in the absence of uniform law proposals. The rapid proliferation of diverse LLC statutes clearly shows that state legislatures are willing to experiment, perhaps in response to pressure from politically powerful bar groups. Conversely, uniform lawmakers may be particularly averse to innovation if they try to maximize adoptions by seeking a middle-of-the-road position that will be accepted by the least innovative legislatures.[46]

3. Need for State Variation

Uniformity may be costly if different types of statutory provisions are best suited to different states. For example, farm or ranching states might want to accommodate active management by owners[47] while states with an active real estate investment industry might prefer rules that accommodate management by sophisticated managers as is typical in real estate investment firms. These different statutes could be used by firms throughout the country. Conversely, ULLCA would encourage a one-size-fits-all regime.

C. Method of Achieving Uniformity

45. *See* Rev. Proc. 95-10, §§ 5.01, 5.02, 1995-3 I.R.B. 20, 23.

46. *See Economic Analysis, supra* note 32 (noting criticism of NCCUSL as being overly conservative).

47. *See* Kenneth D. Esch & Pamela L. Spaccarotella, *Limited Liability Companies as an Alternative Choice of Entity for Farming and Ranching Operations in the State of Nebraska*, 28 CREIGHTON L. REV. 19, 35 (1994).

Even if uniform LLC law were desirable, there is an additional question whether ULLCA is the best way of achieving a uniform state law. Where uniformity is efficient, it has emerged spontaneously in LLC statutes,[48] partly because several states have adopted all or part of the ABA's Prototype Limited Liability Company Act (Prototype).[49] ULLCA might encourage beneficial uniformity to emerge where it would not do so spontaneously because it provides state legislators with a focal point around which to coordinate their efforts,[50] or might discourage a "herd" effect in which state legislators blindly adopt prior inefficient statutes without doing independent analysis.[51] ULLCA as an "official" uniform law may be a more potent focal point for uniformity than the "unofficial" Prototype and, unlike those of model-type laws, NCCUSL's procedures are designed to create proposals that maximize state adoptions.[52]

On the other hand, ULLCA could *decrease* uniformity if it causes states to move away from spontaneous uniformity to adopt ULLCA's more idiosyncratic provisions,[53] or causes the states to move toward uniform adoption of less efficient provisions than they adopted prior to ULLCA. The evolution of LLC statutes so far has led not only to efficient uniformity[54] but also to substantively efficient provisions.[55] This suggests that to increase efficient uniformity NCCUSL should build on existing spontaneous uniformity. Nevertheless, Table I shows that ULLCA's drafters often have adopted idiosyncratic provisions and ignored the product of six years of state legislative efforts.

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48. *See supra* note 4 and accompanying text.

49. PROTOTYPE LTD. LIAB. CO. ACT (Am. Bar Ass'n 1992) [hereinafter PROTOTYPE ACT]; *see Model Laws, supra* note 32 (manuscript at 29–33).

50. *See Model Laws*, *supra* note 32 (manuscript at 6).

51. For theoretical treatments of herd behavior, see Abhijit Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797 (1992); Sushil Bikhchandani et al., *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades*, 100 J. POL. ECON. 992 (1992); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990). For an application of this theory to judicial lawmaking, see Jason Johnston, Notes on the Economic Theory of Legal Evolution, mimeo, Vanderbilt University (1993).

52. *See Model Laws, supra* note 32 (manuscript at 4, 6).

53. *Id.* (manuscript at 27–29).

54. *See supra* note 4 and accompanying text.

55. *See* Ribstein, *supra* note 2, at 412–28 (tracing evolution of LLC statutes).

D. Comparing ULLCA and the UPA

ULLCA appears to follow in the path of a well-regarded precedent — the Uniform Partnership Act. If partnership law should be uniform,[56] why not the law relating to a partnership-like form, the LLC?

There are two important distinctions between LLCs and partnerships regarding uniformity. First, when the Uniform Partnership Act was promulgated in 1914, partnership was already an old form. There was substantial consensus about what partnership law should

56. It is no longer clear that even partnership law should be uniform, or that the REVISED UNIF. PARTNERSHIP ACT (1994) (RUPA), 6 U.L.A. 280 (Supp. 1995), is any more appropriate than ULLCA. *See* Ribstein, *supra* note 20, at 79–82.

look like[57] and a recent comprehensive codification in the English Partnership Law[58] from which to draw. This sharply contrasts with the lack of consensus, and therefore the need for further innovation,[59] in LLC law.

A second important difference between LLC and partnership law is that there is traditionally no analogue to the corporate internal affairs rule for partnerships.[60] Thus, partners could not contractually select the law of a single state to govern their partnership. Accordingly, a uniform partnership law might eliminate troublesome choice of law problems. At the same time, partners' inability to select the state of organization meant that, even without a uniform law, there would be no corporate-type jurisdictional competition in partnership law. By contrast, every LLC statute adopts some analogue to a corporate-type "internal affairs" rule.[61]

E. Summary

The efficiency justifications for uniform laws do not apply to LLCs as long as virtually all states have statutes ensuring that the law of the organization state applies to most aspects of the LLC. At the same time, uniformity in LLC law would prevent valuable innovation, experimentation, and variation and would foreclose exit from inefficient mandatory rules. LLCs do not need a uniform law.

II. ULLCA AS A MODEL LAW

Even if there is no need for ULLCA as *uniform* law, it still could be useful as a *model* for state law.[62] A business association statute presents a complex and interrelated set of policy issues that may be beyond the competence of generalist, often part-time, state legislators with minimal resources.[63] In some non-commercial states there

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57. Indeed, many of the elements of partnership were in place at least 70 years before the UPA was adopted. *See generally* JOSEPH STORY, PARTNERSHIP (1st ed. 1846).

58. Partnership Act of 1890, 53 & 54 Vict., ch. 39 (Eng.).

59. *See supra* text accompanying notes 41–46.

60. *See* Ribstein, *supra* note 10, at 245–46.

61. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 13.03.

62. *See Model Laws, supra* note 32 (manuscript at 11–12) (discussing difference between uniform and model laws).

63. Indeed, our data indicate that part-time legislators do tend more than full-time legislators to adopt uniform laws. *See Economic Analysis, supra* note 32.

may even be few expert lawyers willing and able to take the lead in proposing specific legislation.

But state legislators who need help on LLC law need not rely on ULLCA. They could look to the Prototype Limited Liability Company Act or other LLC statutes. For example, the Delaware act has been produced by a national leader in business legislation which stakes its long-standing reputation on its legislative products. To be sure, NCCUSL also has a hundred-year reputation to protect, and is usually able to attract advisors to help its drafting committees and to elicit wide commentary for its proposals. Yet the generalists who usually staff a NCCUSL drafting committee[64] are no match for the expert lawyers who work on Delaware's business laws.

The ULLCA drafters tout participation by a "blue ribbon panel of national experts and other interested and affected parties and organizations."[65] The experts are not identified, and neither their fields of expertise nor the extent of their participation are described. Assuming that some distinguished experts devoted significant time to the project, the final project inevitably reflects the interests of these advisors and their clients.[66] Even wholly disinterested and undoubtedly sophisticated advisors bring their particular real estate, tax, probate or other perspectives to the table. Also, the final product must be approved by the Commissioners as a whole, who may have little familiarity with the statute. Finally, the overall process of attempting to compromise various interests through drafting, voting, and redrafting can introduce unnecessary complexity.[67]

Even the most sophisticated and disinterested experts and the best designed drafting and approval process cannot produce the perfect statute. In a project which involves the complexity of a business association statute there will always be glitches that can be minimized only by a process that involves extensive vetting and

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64. *See Model Laws*, *supra* note 32 (manuscript at 12) (discussing NCCUSL's reliance on generalists rather than experts).

65. ULLCA Prefatory Note.

66. *See Model Laws, supra* note 32 (manuscript at 13) (discussing influence of these groups on ULLCA).

67. *Id.* (manuscript at 22) (discussing convoluted and confusing drafting resulting from ULLCA adoption process). For an example, see *infra* text accompanying notes 290–303 (discussing the intricate and confusing term/at-will compromise in the section 801 dissolution provisions).

commentary. It is worth comparing in this respect ULLCA's preparation with that of NCCUSL's mostly contemporaneous project, the Revised Uniform Partnership Act (RUPA). Although RUPA dealt with a type of business association about which much more was known, it was drafted over a six-year period, producing many very widely publicized drafts[68] and several publications.[69] Eighty years before RUPA, the Uniform Partnership Act was drafted over a twelve-year period under two of the most distinguished academics of the day.[70] The ULLCA final product is at a stage of development comparable to that of relatively early and deeply flawed drafts of RUPA.[71]

In the final analysis, even drafting by the finest experts in a perfect process cannot replace the much greater information and understanding that is likely to emerge from the decentralized process of jurisdictional competition. Given the extent to which the process of ULLCA's drafting falls short of this ideal, there is no reason to assume that ULLCA would be the best model for LLC legislation.

III. EVALUATING ULLCA: UNDERLYING PRINCIPLES

The remainder of this Article shows in detail why ULLCA is unsuitable for use as a model LLC statute. This Part begins by discussing some underlying considerations for evaluating ULLCA. Part IV then presents a section-by-section critique of ULLCA.

In general, the statute should minimize the transaction costs of parties to LLCs. The ULLCA drafters intend ULLCA to be "a flexible act with a comprehensive set of default rules designed to substitute as the essence of the bargain for small entrepreneurs and oth-

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68. For example, the drafts were published each year in supplements to ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP (1990–1994 Supps.).

69. *See, e.g.,* BROMBERG & RIBSTEIN, *supra* note 68, 1992 Special Release; Larry E. Ribstein, *A Mid-term Assessment of the Revised Uniform Partnership Act*, 46 BUS. LAW. 111 (1990) [hereinafter *Mid-Term*]; Ribstein, *supra* note 20; Donald J. Weidner, *Three Policy Decisions Animate Revision of the Uniform Partnership Act*, 46 BUS. LAW. 427 (1991); Donald J. Weidner, *The Revised Uniform Partnership Act Midstream*, 21 U. TOL. L. REV. 825 (1990).

70. *See* UNIF. PARTNERSHIP ACT, Commissioners' Prefatory Note, 6 U.L.A. 5 (1969).

71. An early draft of RUPA had, for example, seriously misguided provisions on partnership formation which were criticized in *Mid-Term*, *supra* note 69, at 113. These provisions were removed from subsequent drafts.

ers."[72] Section A, below, concurs with the need to have default, rather than mandatory rules. But even if ULLCA actually conformed with this view, which it unfortunately does not, simply having default rules is not enough. As discussed in Section B, the default rules should be designed for relatively small firms. Section C discusses the need for an integrated, coherent statute, while Section D discusses the need to avoid excessive litigation.

A. To What Extent Should the Act Be Mandatory?

Although the ULLCA drafters thought they produced a "flexible" act characterized by "default rules,"[73] what they actually produced is something very different. The Act contains numerous rules regarding such matters as formalities and creditor protection which cannot be waived because they affect persons other than managers, members and transferees.[74] It also provides for fiduciary duties and information rights which the members have only limited power to waive.[75]

Are these limitations on contracting justified? Mandatory rules in LLC statutes may protect members from co-members and managers or protect creditors and other third parties from owners and managers. However, mandatory rules also can be costly by, among other things, foreclosing efficient arrangements. Accordingly, mandatory rules should be examined carefully to determine whether, and how well, they perform these functions.

With respect to protecting members from co-members and managers, it is far from clear why parties to LLCs need to be protected from the entire broad category of contracts waiving fiduciary duties and related judicial dissolution and expulsion rights.[76] LLC members as a group are at least as sophisticated as others whose contracts traditionally are enforced. To the extent LLCs are used as vehicles to prey on the unsuspecting, the law can respond with a specific remedy. On the other hand, generally restricting waivers in the LLC statute will not only prevent the occasional unconscionable contract, but also will preclude or make more costly a wide range of

72. ULLCA Prefatory Note.
73. *Id*.; *see supra* text accompanying note 6.
74. ULLCA § 103(b)(7).
75. *Id.* § 103(b)(1)–(6).
76. *Id*.

efficient deals.

Contracts solely among members and managers clearly should not bind those who are not members or managers. However, creditors and others can contract with the LLC, perhaps by consenting to rules in effect at the time they deal with the firm. The costs of requiring even casual creditors to check statutes and articles of organization each time they deal with an LLC arguably justifies making many of the statutory rules that affect third parties non-waivable absent explicit third-party consent. But it does not follow that the Act should include all of these rules in the first place. In particular, elaborate remedies against excessive distributions are unnecessary.[77] Moreover, open-ended formal requirements create intolerable uncertainty as to whether omission of the formality subjects firms to damages to particular creditors or threatens the members' liability shield.

B. For Whom Should LLC Statutes Be Drafted?

The drafters say the rules should suit "small entrepreneurs and others" and that:

> [t]he Committee also recognized that small entrepreneurs without the benefit of counsel should also have access to the Act. To that end, the great bulk of the Act sets forth default rules designed to operate a limited liability company without sophisticated agreements and to recognize that members may also modify the default rules by oral agreements defined in part by their own conduct.[78]

The drafters seem to have concluded that the Act would accommodate "small entrepreneurs" as long as firms easily could modify statutory default rules. Unfortunately, as noted in Section A and discussed throughout this Article, the Act does not really provide this sort of easy exit from its rules. Moreover, as discussed below,[79] permitting modification by oral agreement is not necessarily efficient for relatively small, or any other, LLCs.

But even if the Act perfectly provided for drafting around its defaults, the drafters have to decide for whom to draft the *default*

77. *See infra* text accompanying notes 193–200 (discussing ULLCA §§ 406–407).
78. ULLCA Prefatory Note.
79. *See infra* text accompanying notes 90–93.

rules. Should these rules suit "small entrepreneurs" or "others"? If the statute should be designed for smaller, more informal firms but the defaults mainly suit sophisticated, carefully designed firms, the statute's intended clientele must either incur drafting costs that would not be imposed by a better-designed statute, or suffer the unexpected consequences of the default rule.

One way to identify the statute's appropriate clientele is to ask who is most likely to use the statute and design the statute accordingly. This approach arguably would minimize transaction costs by minimizing the number of contracts that vary the statutory defaults. Given the LLC's birth as a tax vehicle, one might conclude that most users will be sophisticated firms with customized agreements. On the other hand, if the LLC is simply a type of partnership with limited liability then the statute should be designed accordingly.

Of course, either prediction may be wrong. More importantly, even if the drafters correctly anticipate their market, they cannot design "off-the-rack" statutory rules that will fit even a significant fraction of the more sophisticated LLCs. Accordingly, most sophisticated LLCs will draft customized agreements even if the statute is designed for them. Conversely, if the rules suit more sophisticated firms, small, informal firms will have to carefully waive the statutory defaults when they might have needed no agreement, or a very simple agreement, under a general partnership-type statute. Alternatively, such firms might go without an agreement and incur high litigation costs when disputes arise.

Legislators can, therefore, minimize transaction costs by drafting default rules that suit relatively small, unsophisticated firms because unsuitable defaults are more burdensome for such firms than for more sophisticated firms. Instead, ULLCA's drafters have tried to give such firms exactly what they do *not* need — a statute that encourages them to make their own agreements. If this were the appropriate goal, it would have been much simpler for the drafters to go all the way and provide no statute at all. But, as discussed in Part IV, ULLCA manages to find an unhappy middle: a statute with the sort of complex, convoluted rules that are unsuited to very small, informal firms and would be avoided by larger firms by customized agreements.

C. To What Extent Should the Act Draw from Other Statutes?

ULLCA, like most LLC statutes, borrows provisions from other business association statutes. This has both advantages and disadvantages.[80] The main advantage is that linking LLCs and other standard forms would provide LLC law with cases and other interpretive materials associated with the linked forms. This is particularly important for a new standard form, for which there are as yet no cases.[81]

On the other hand, before drafters decide to link the LLC statute with other standard forms, they should have an overall concept of how the components of the LLC form interrelate. A business association statute should be "coherent" in the sense that its terms should be designed to work together.[82] As discussed in more detail throughout Part IV, many of the provisions ULLCA borrows from other statutory standard forms do not pass this test. LLCs differ from limited partnerships with regard to the default rule of member management and limited liability for all members; from general partnerships in terms of the alternative centralized management default and limited liability of all members; and from corporations because of the decentralized management default and the greater informality allowed by LLC statutes. Because of these differences, provisions borrowed from these other statutory forms may not fit well with the other provisions in the LLC statute.

In any event, some provisions of ULLCA reflect the worst of both possible worlds. ULLCA borrows several provisions from the Revised Uniform Partnership Act which has been adopted in only a few states[83] and which has given rise to no case law. In this way,

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80. *See* Larry E. Ribstein, *Linking Statutory Forms*, LAW & CONTEMP. PROBS. (forthcoming 1995) (manuscript at 16–22, on file with the author).

81. Note, however, that providing interpretive materials is a justification for *uniformity*. *See supra* § I(A)(3). Even if some linkage is appropriate, it is highly questionable whether these materials are so important that they justify the combined high costs of *both* uniformity *and* linkage.

82. *See* Ribstein, *supra* note 2, at 381–82.

83. Statutes based closely on the 1993 version of RUPA were adopted in Montana (MT. CODE ANN. §§ 35-10-101 to 35-10-644 (Supp. 1994)) and Wyoming (WYO. ST. ANN. §§ 17-21-101 to 17-21-1003 (Michie 1994)). A statute based partly on an earlier version of RUPA was adopted in Texas. TEX. REV. CIV. STAT. ANN. Art. 6132b, arts. 1.01–10.04 (West Supp. 1995). Statutes based on the latest version of RUPA were adopted in Connecticut, 1995 Conn. Acts 341 (Reg. Sess.) (Effective July 1, 1997); Florida, 1995 Fla. Sess. Law Serv. 242 (West) (to be codified at FLA. STAT. §§ 620.81001–.8908); North Dakota, N.D. CENT. CODE §§ 45-13-01 to -21-08 (Supp. 1995), and West Virginia, W. VA. CODE §§ 47B-1-1 to -10-05 (Supp. 1995).

ULLCA gets the disadvantages of unsuitable provisions without any of the advantages of linking with established forms.

D. Certainty and Litigation Costs

Parties to a business association should readily be able to determine what their rights are without detailed legal advice and protracted litigation. This means, among other things, that the Act should leave the parties to their agreements rather than letting the courts settle every dispute, and that the statutory language should be as clear as possible. Indeed, the main function of a business association statute is to give firms that organize under it more certainty than they would get from the general common law of agency or analogous application of rules from other business association statutes. Yet as shown in Part IV, ULLCA includes much open-ended and elliptical "black letter law," with the blanks filled in, to uncertain effect, by the commentary.

Sometimes the need for certainty may outweigh other considerations. For example, while oral agreements may suit the informality of small firms,[84] they may also impose high costs by raising the possibility that every dispute may have an oral agreement or course of conduct lurking in the background to be proved or disproved.

IV. SECTION-BY-SECTION ANALYSIS OF ULLCA

This Part critically analyzes the more important sections of ULLCA. The purpose of this Part is to provide a guide for legislatures and bar committees that are considering whether to adopt ULLCA.

Sections 101(13), 103: The Operating Agreement

Section 103 provides for the effect of the "operating agreement."[85]

1. What Is an Operating Agreement?

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84. *See* ULLCA Prefatory Note (noting that the Act provides "access" to small entrepreneurs in part because "members may also modify the default rules by oral agreements defined in part by their own conduct").

85. *Id*. § 103. "Operating agreement" is defined in section 101(13).

ULLCA must address the basic policy question of what kinds of agreements should be deemed to waive the statutory provisions. The answer, arguably, is *any* agreement (or, perhaps, as discussed below, any *written* agreement) that is (1) agreed to by *all* of the members, and (2) that relates to the LLC. This is the definition provided for in the Prototype Act.[86]

The ULLCA operating agreement provisions make conflicting statements about the nature of the operating agreement. Section 101(13) *defines* the operating agreement as "concerning the relations among the members, managers, and limited liability company."[87] However, section 103 says more broadly that the operating agreement "regulate[s] the affairs of the company and the conduct of its business, and . . . govern[s] relations among the members, managers, and company."[88] These sections suggest that a provision concerning relations with those who are not members of managers, such as member liability, may or may not be part of what ULLCA defines as an "operating agreement."

The ULLCA provisions on the operating agreement are also incomplete because they do not explicitly answer several questions which have arisen under state statutory definitions of the operating agreement, including whether the definition includes several agreements on specific points made at different times, or agreements made by fewer than all of the members.[89]

2. Should Default Provisions Be Waivable by Oral Operating Agreements?

ULLCA provides that the operating agreement "need not be in writing."[90] In the informal type of firm for which LLC statutes should be drafted[91] a requirement of a written operating agreement might often frustrate the members' legitimate expectations. But there is also much to be said for reducing potential litigation by providing that at least some important statutory defaults, including

86. PROTOTYPE ACT, *supra* note 49, § 102(k).
87. ULLCA § 101(13).
88. *Id*. § 103(a).
89. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 4.16.
90. ULLCA § 103(a).
91. *See supra* Part III(B).

allocation of financial rights, voting requirements, and dissolution causes, can be varied only by written agreement. Note in this respect that an "oral operating agreement" could include something as ephemeral as a course of conduct.[92]

Whatever the best *default* rule as to the enforceability of oral operating agreements, the parties to an LLC should be able to agree that the agreement cannot be amended except by a writing. This approach would avoid frustrating members' expectations in informal firms, while allowing more formal firms to minimize the potential uncertainty and litigation expense of oral operating agreements. ULLCA section 103 apparently would permit waivers of the default provisions on operating agreements by not listing itself as a provision which cannot be waived.[93]

3. Are the Limits on Contracting in Section 103 Justified?

Section 103 provides that the operating agreement rather than the Act controls except for the matters listed in subsection (b), which include certain fiduciary duties. Mandatory rules are criticized generally above[94] and in more detail below.[95]

One type of mandatory rule is worth discussing separately — waivers relating to those who are not members, managers or transferees.[96] LLCs clearly ought to be able to make enforceable agreements with those outside the LLC, even if these agreements waive the default provisions of the Act.[97] The relevant ULLCA provisions are not as straightforward as this proposition. ULLCA provides that an operating agreement cannot "restrict rights of a person, other than a manager, member, and transferee of a member's distributional interest, under this [Act]."[98] First, it is not clear what

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92. *See* ULLCA Prefatory Note and § 103 cmt.; *see also id*. § 411 cmt. (stating that continuation of the LLC after expiration of an agreed term constitutes an agreement to continue as an at-will firm).

93. *Id*. § 103(b). The drafters state that the agreement can provide that all amendments must be in writing. *See id*. § 103 cmt.

94. *See supra* Part III(A).

95. *See infra* text accompanying notes 217–20, 226–29 (discussing waiver of fiduciary duties in ULLCA §§ 408 and 409).

96. ULLCA § 103(b)(7).

97. *See supra* text accompanying note 77.

98. ULLCA § 103(b)(7).

the Act means by "restrict."[99] Any definition of rights is a restriction. Presumably, however, "restrict" means to take away rights that those outside the LLC would have under the Act unmodified by the operating agreement. Second, does this provision mean that the operating agreement is not enforceable against one who is not a manager or member even if that person *is* a party to the agreement? If so, this is wrong.[100]

Perhaps this provision means only that an "operating agreement" cannot restrict rights of those outside the LLC, but that an agreement that is not an "operating agreement" may do so. Since the Act defines "operating agreement" to include only agreements "concerning the relations among the members, managers, and the limited liability company,"[101] maybe an agreement which concerns relations with those outside the LLC is not an "operating agreement" the effect of which is limited under 103(b). Yet that is wrong, too, since there is no reason why an agreement should not be an "operating agreement" merely because it *affects* persons other than members or managers. The Act should have defined the operating agreement according to its parties — i.e., as one "among" the members — rather than solely according to its subject matter.

Section 104: Supplemental Principles

Section 104 says that, "[u]nless displaced by particular provisions of this [Act], the principles of law and equity supplement this [Act]."[102] The comment to this section indicates that such principles "include, but are not limited to"[103] those listed in UCC section 1-103, including fraud and agency, and section 1-205 on course of dealing and usage of trade. But course of dealing and usage of trade are part

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99. This is discussed further, *infra* at notes 138–39.

100. Prior to the February 28, 1995 draft, ULLCA section 103(b)(7) provided that an operating agreement may not "restrict rights of third parties under this [Act], *other than managers, members or their transferees.*" ULLCA § 103(b)(7) (January 20, 1995 draft). The February 28 draft eliminated the second clause, thereby suggesting that the Act only restricted waivers that purported to bind non-parties to the agreement. By the August 11, 1995 version the provision included the original second clause but not the original first clause. It is not clear how or whether this last change affects the meaning of the provision.

101. ULLCA § 101(13), discussed *supra* text accompanying notes 89–90.

102. *Id*. § 104(a).

103. *Id*. § 104 cmt.

of the contract rather than "supplemental principles." At the same time, "law" could be interpreted to include other *statutory* law, including partnership and corporate statutes. Thus, the "black letter" creates a potentially open-ended linkage with other law which may not be suitable for LLCs.[104] It is not clear whether the comment should be interpreted to close such linkages since it does not expressly preclude them and, if so, whether it would be effective to limit the "black letter."

Section 105: Name

Section 105 requires the LLC's name to include certain terms which indicate that it is an LLC, and, except in certain circumstances, to be "distinguishable upon the records of the [Secretary of State]"[105] (or other equivalent agency).

This provision is unclear in several important respects. First, the "name" of the LLC, although restricted, is not *defined*. If "name" includes only what is set forth in the articles of organization, then it is not clear why the terms identifying the firm as an LLC are necessary. If the term includes what the firm calls itself in advertising, correspondence, and other contexts, what is the firm's "name" under the statute when this varies in different uses?

Second, what is the penalty for violation of the section? If "name" includes advertising and other uses, and if a violation includes *any* use of a name different from that in the articles, is the penalty loss of LLC status, damages to anyone who deals with the LLC under the non-complying name, damages to a relying creditor, or none of the above?

Section 201: LLC as Entity

Section 201 says that "[a] limited liability company is a legal entity distinct from its members."[106] But whether a firm is an "entity" depends on whether a court or legislature chooses to endow it with the legal characteristics of an entity, not on whether it is one in some Platonic sense. Thus, even a partnership, the archetypal non-

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104. *See supra* Part III(B).
105. ULLCA § 105(b).
106. *Id*. § 201.

"entity," often is treated like one in many contexts.[107] For an example of this confusion between causes and consequences it is necessary to look no further than the comment to this section, which says:

> A limited liability company is legally distinct from its members who are not normally liable for the debts, obligations, and liabilities of the company. See Section 303. Accordingly, members are not proper parties to suits against the company unless an object of the proceeding is to enforce members' rights against the company or to enforce their liability to the company.[108]

In fact, ULLCA provides that members may be liable to third parties for LLC debts when they so agree.[109] It is not clear whether the comment means that because an LLC is an "entity," members are never proper parties to suits against the LLC, even when their agreed liability would contradict "entity" status. ULLCA might have usefully reduced the potential confusion created by the entity and aggregate concepts if it had simply provided that an LLC is an "entity" unless the context otherwise requires.

Section 202: Organization

Section 202 provides that one or more persons may form an LLC by filing articles of organization.[110] This raises two issues: (1) whether one-person LLCs should be permitted, and (2) what are the consequences of failing to file articles.

1. Should One-Member LLCs Be Permitted?

Partnerships must have two members,[111] and this requirement has been carried over to many LLC statutes.[112] This makes sense, since LLC statutes typically include many partnership-type rules, including those concerning allocation of management rights, allocation of financial rights, transfer of interests, and the consequences of

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107. *See* BROMBERG & RIBSTEIN, *supra* note 68, § 1.03.

108. ULLCA § 201 cmt.

109. *Id*. § 303; *see infra* text accompanying notes 163–68 (discussing ULLCA § 303).

110. ULLCA § 202(a). The definition of "limited liability company" in *id*. § 101(9) does not specify that an LLC must have any minimum number of members.

111. *See* UPA § 6; RUPA §§ 101(4), 202.

112. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 4-45 (tabulating statutory provisions).

member dissociation. As in the partnership statute, these rules assume the existence of two or more members. Accordingly, one-member LLCs may raise problems in interpreting and applying the statute.

On the other hand, the comment says the one-member rule gives "flexibility . . . to enable sole proprietors to obtain the benefit of a liability shield."[113] Indeed, it makes sense to give sole proprietorships the same access to LLCs that they have to the corporate form. Moreover, a rule requiring two members could cause problems for unwary firms if a member dies or if contractual or formality questions are raised about the status of purported members.

But this "flexibility" comes at a cost. One-member firms may not be characterized as partnerships for tax purposes,[114] and may have difficulty seeking the protection of the bankruptcy law.[115] While there is a strong argument against drafting a statute specifically to comply with tax characterization factors, that argument is based on balancing non-tax transaction costs considering that firms do not need to comply with all of the tax characterization factors to be taxed as partnerships.[116] As discussed immediately above, transaction cost considerations weigh *against* one-member firms. Moreover, ULLCA's drafters are inconsistent regarding tax-compliant terms, since they adopt rules on continuity of the LLC solely for tax reasons.[117]

In any event, even if ULLCA's rule permitting one-member LLCs is not clearly wrong, reasonable legislators could reach a contrary conclusion. Accordingly, there is no reason why this rule should be uniform, or why states should use it as a model.

2. *Effect of Failing to File Articles*

113. ULLCA § 202 cmt.

114. *See* Rev. Proc. 95-10, § 4.01, 1995-3 I.R.B. 20, 21–22 (providing that a one-member LLC cannot seek a ruling that it is a partnership for tax purposes).

115. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 14.04 (discussing question whether one-member LLC is an "association" under bankruptcy law).

116. *See supra* text accompanying notes 35–38, 44–45.

117. *See infra* text accompanying notes 300–03 (discussing ULLCA § 801).

ULLCA provides that "the existence of a limited liability company begins when the articles of organization are filed."[118] But there is no reason why, before filing, the members and third parties should not be bound by any agreements they have made, including an express or implied agreement to be governed by the Act.[119] This is the rule in limited partnerships.[120] The comment says that "[u]ntil the articles are filed, a firm is not organized under this Act and is not a `limited liability company' as defined in Section 101(9)."[121] However, it also says that members may nevertheless agree to be bound by the Act, and that third parties may express "a contractual intent to extend a limited liability shield to the members of the would-be limited liability company."[122] Indeed, there is nothing in the ULLCA, as there is in several statutes, that imposes liability on members who assume or purport to be acting as an LLC without complying with formalities.[123] Under this approach, filing is important only if there is no contract among members or third parties that accomplishes the effect of the filing.[124]

Section 203: Articles of Organization

Section 203 provides for the contents and effect of the articles of organization. While most of the content requirements of the articles are similar to those in most other LLC statutes, ULLCA includes idiosyncratic provisions on term LLCs and the effect of the articles.

1. Specifying a Term

118. ULLCA § 202(b).

119. *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80 (1991).

120. *See* BROMBERG & RIBSTEIN, *supra* note 68, § 12.04.

121. ULLCA § 202 cmt.

122. *Id*.

123. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 4.15 (discussing these provisions); *see also id*. at 4-68 (tabulating state statutory provisions).

124. Because an "operating agreement" may not restrict rights of those who are not members or managers under ULLCA section 103(b)(7), *see supra* text accompanying notes 96–101, an agreement with persons outside the LLC might not restrict their rights under section 202 to disregard the liability shield prior to formation or to hold members liable as partners. On the other hand, the "operating agreement" restriction may not apply because this is not a "limited liability company."

ULLCA requires the LLC to state in the articles "whether the company is to be a term company and, if so, the term specified."[125] The specification of a "term" is significant, since a "term company" may not dissolve on dissociation of a member,[126] and may or may not dissolve on expiration of a term.[127] Yet it may not be clear whether, or for what purposes, an LLC is a "term company." A "term company" is defined as one whose "members have agreed to remain members until the expiration of a term specified in the articles of organization."[128] Otherwise the LLC is an "at-will company."[129] The drafters say that specifying an "undertaking of an uncertain business duration is not sufficient" *unless* the undertaking is one that may extend beyond a specified term.[130] This surprising qualification has no basis either in the "black letter," or in partnership law, which equates time period and undertaking durations.[131] Nor does it make any sense, since the members may know the firm's mission without knowing how long it will take.[132] Nevertheless, if the members forget to include the magic words of an arbitrary period of years, their term may not be enforced by a court that applies the comment rather than the black letter. This is hardly the "flexibility" for "small entrepreneurs" the drafters promised.[133]

2. *What Is the Effect of the Articles?*

ULLCA provides that, where the articles and operating agreement are inconsistent, the operating agreement controls as to "managers, members, and members' transferees"[134] while the articles control as to other types of persons "who reasonably rely on the articles

125. ULLCA § 203(a)(5).

126. *Id.* § 801, discussed *infra* at notes 290–303.

127. See ULLCA § 411, discussed *infra* at notes 245–46.

128. ULLCA § 101(19).

129. *Id.* § 101(2).

130. *Id*. § 203 cmt.

131. UPA § 31(1)(a); RUPA § 602(b)(2).

132. It might make sense to require the term to be stated as a particular period of years *if* the only effect of the specification were on third parties, since third parties may not easily be able to determine when an undertaking has been completed. Yet ULLCA neither explicitly provides that the "term" affects third parties (*see* § 804, discussed *infra* text accompanying notes 358–63) nor limits the effect to third parties.

133. *See* ULLCA Prefatory Note; *supra* text accompanying note 5.

134. ULLCA § 203(c)(1).

to their detriment."[135]

These provisions are questionable from a policy standpoint. The provision applying to managers, members, and transferees oddly seems to say that an oral operating agreement, or even course of conduct that is construed as an operating agreement, would control over formal, written, filed articles. Most parties to LLCs probably would not expect this result.

The provision on persons other than managers, members and their transferees[136] is also dubious in several respects. First, it is not clear whether ULLCA would enforce articles on which such third parties rely despite knowing of contrary provisions in a more recent written operating agreement. This may not be *reasonable* reliance. Yet if the "reasonableness" qualification makes the operating agreement enforceable, this would seem to negate the express provision to make the articles control as to third parties. Moreover, it is not clear how third parties can "reasonably rely" on the articles where the statute makes the operating agreement control.

Second, ULLCA provides that the articles may not "vary the nonwaivable provisions of Section 103(b)."[137] The latter section does not "have" any unwaivable provisions, but rather provides that the operating agreement may not waive or vary certain provisions of the act, or "restrict rights of persons other than a manager, member, and transferee of a member's distributional interest."[138] Assuming ULLCA is saying that the articles cannot do what the operating agreement cannot do, it raises the same questions about the meaning of "restrict" as does the provision on the effect of the operating agreement.[139]

Finally, ULLCA provides that the articles have other effects, including binding the firm in real property transactions[140] and liability for false statements, discussed next. In sum, the complexity of this section could trap the informal firms for which the statute should be designed.

Section 209: Liability for False Statements

135. *Id.* § 203(c)(2).
136. *Id*.
137. *Id*. § 203(c).
138. *Id*. § 103(b)(7).
139. *See supra* text accompanying notes 96–101 (discussing ULLCA § 103).
140. ULLCA § 301(c), discussed *infra* at notes 153–59.

ULLCA provides that one who suffers loss in reliance on a false statement in a filed document can recover damages from one who signed the document knowing it was false.[141] This provision is confusing because it is not clear when there can be a false statement in a filed document. Most statements in filed documents are necessarily "true" by reason of having been stated in the document. For example, the name of an LLC is probably what is set forth in the articles. If the firm transacts business under a different name, the misrepresentation, if any, is that name, and not the one in the articles. Also, as discussed immediately above, ULLCA provides that the articles control as to third parties where there is an inconsistency between the articles and the operating agreement. Again, the articles are true for such statements even if they are contradicted by other evidence.

Where the articles are not controlling — i.e., as to a non-mandatory disclosure where the articles neither "restrict" third parties' rights nor are inconsistent with the operating agreement[142] — the special statutory liability for such falsity is excessive because LLCs and their members are in any event liable for fraud, including fraud in filed documents. The section may go beyond fraud in giving a remedy to third parties for immaterial misstatements on which they unreasonably relied. In other words, a third party could recover on proving a false statement which she believed and acted on — a contention that may be impossible to disprove. But there is no apparent justification for relaxing the usual elements of a fraud cause of action for misstatements in a filed document. This open-ended damage remedy could have the perverse effect of unduly discouraging LLCs from using the articles to provide information about the firm to third parties.

A final problem with the liability for false statements is the way it relates to the effect of the articles in ULLCA section 203. In some cases, as where the articles are inconsistent with the operating agreement, section 203 makes the articles, in effect, controlling and, therefore, not false.[143] In other situations the articles may be "false" and trigger an open-ended action for damages. It is not clear why

141. ULLCA § 209.

142. *See supra* text accompanying notes 135–39.

143. ULLCA § 203(c)(2) (articles controlling as to third parties who reasonably rely on them).

these similar actions should have such different consequences.

Section 301: Agency Power

Section 301 provides for the authority of members and managers in LLCs that are[144] and are not[145] managed by managers, as well as for the authority to bind in real property transfers.[146]

1. When Is a Manager's Act Binding?

ULLCA says that only managers, and not members, are agents of a manager-managed LLC and can bind the firm by acts in the ordinary course of business.[147] Unfortunately, there is no precise guidance on who is a "manager." While this is generally a problem in LLC statutes,[148] ULLCA does not help, circularly defining a "manager" as one who is authorized under section 301.[149]

It is also not clear whether the operating agreement can restrict a manager's authority to act without member consent. Section 301(b)(2) provides that acts outside the ordinary course bind the LLC if they are authorized under the section which provides for the members' voting rights. This section permits a manager to decide "any matter relating to the business of the company" except in certain cases requiring unanimous member consent,[150] subject to contrary provision in the operating agreement.[151] Is a manager's act that would be authorized under the voting rights provision therefore binding even if the operating agreement limits the manager's actual authority? If so, the firm could be bound by an act outside the ordinary course, where the third party should be on notice of a lack of authority, even where the members attempted to limit the manager's authority. If the act is not binding solely because of a provision in the operating agreement, this would contradict the rule which provides that the operating agreement cannot restrict third

144. *Id*. § 301(b).
145. *Id*. § 301(a).
146. *Id*. § 301(c).
147. *Id*. § 301(b).
148. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 8.03.
149. *See* ULLCA § 101(10).
150. *See id*. § 404(b)(2), (c), discussed *infra* text accompanying notes 181–84.
151. The members' voting rights are not among the non-waivable rights listed in ULLCA section 103(b).

party rights.[152]

2. When Does a Member Effectively Transfer Real Property?

A member may sign and deliver a real property conveyance that is conclusive against a bona fide purchaser without knowledge of the lack of authority, unless the articles restrict the member's authority.[153] This raises several questions. First, if the articles do restrict the member's authority, this could restrict a relying third party's rights contrary to section 203.[154] Second, it is not clear when a third party is deemed to have "knowledge" of the lack of authority. ULLCA unhelpfully defines "knowledge" as "actual knowledge."[155] Does a third party have such "knowledge" if she knows of a restriction on authority in the operating agreement? Apparently not, in light of prohibitions on restricting third party rights.[156] Does a third party have such knowledge when the member's act is not "apparently . . . ordinary,"[157] as where the member is transferring all of the LLC's property?

Apart from these questions, the rule on real property conveyances is questionable policy. Subsection 301(a) is explicitly subject to subsection 301(c), which implies that the ordinary rules of authority do not apply to real property transfers, many of which are sufficiently unusual to be outside a member's usual authority. If this is the rule, it differs from the rule which applies to other business associations. As such, it would surprise any informal LLC — the sort of firm for which the statute should be designed[158] — that did not receive competent legal advice about the terms of ULLCA. The possibility of surprise is increased because section 203, which tells LLC members what to put in the articles, does not cross-reference authority limitations under subsection 301(c).[159]

Section 303: Liability of Members

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152. *Id*. § 103(b)(7).
153. *Id*. § 301(c).
154. *See supra* text accompanying notes 135–36.
155. ULLCA § 102(a).
156. *See* ULLCA §§ 103(b)(7) and 203(c)(2), discussed *supra* text and accompanying notes 96–101 and 135–36.
157. ULLCA § 301(a).
158. *See supra* Part III(B).
159. *See* ULLCA § 203.

Section 303 provides that LLC members and managers are not liable solely by reason of being or acting as such.[160] This is similar to provisions in virtually all LLC statutes. However, the section includes other unusual and questionable rules regarding the effect of failure to observe formalities and of member consent to liability.

1. Significance of Failure to Follow Formalities

ULLCA provides that "[t]he failure of a limited liability company to observe the usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or managers for liabilities of the company."[161] This provision poses more questions than answers. What are "usual" formalities and requirements? Are they different from "unusual" formalities? If the LLC's failure to follow formalities is not "a ground" for imposing liability, does that nevertheless mean it can still be taken into account in piercing the veil? If the failure to comply with statutory requirements has no effect at all, what is the purpose of including such requirements in the statute? The simpler and more direct way to protect firms from veil-piercing liability based on failure to comply with formalities is to eliminate useless requirements from the statute and to specify the consequences of failing to comply with included requirements.[162]

2. What Is the Effect of the Filing Requirement for Personal Liability?

Members may be liable "in their capacity as members for all or specified" LLC debts if the articles so provide with the members' consent.[163] This provision is arguably useful to the extent that it helps some members contract for liability without having to contract separately with each creditor, and to avoid the corporate tax characteristic of limited liability.[164] Such an LLC would be similar to

160. *Id*. § 303(a).
161. *Id*. § 303(b).
162. *See supra* text following note 77.
163. ULLCA § 303(c).
164. As to the usefulness of this provision in avoiding corporate-type limited liability, see RIBSTEIN & KEATINGE, *supra* note 11, at 16-32 (Supp. 1995).

a limited partnership, except that the guaranteeing members would not necessarily be managers and would not necessarily be liable for all of the firm's debts.

The main problem with subsection 303(c) is that it might inappropriately extend to impose constraints on member guarantees. An analogous New York provision explicitly provides that it does not apply to member guarantees.[165] ULLCA does not include this qualification. Because the filing is required for liability of members "in their capacity as members,"[166] it could be interpreted as applying to members' guarantees of the LLC's liabilities. Significantly, this language is broader than that in subsection (a), which relieves members from liability "solely by reason of being" members.[167]

To the extent that this subsection applies to member guarantees it is unnecessary and perverse. Authorizing guarantees is unnecessary because subsection (a) only removes members' liabilities that are imposed "solely by reason of" their acting as or being members — that is, not including liability imposed by contract or otherwise.[168] The provision is perverse if it conditions effectiveness of member guarantees on a certificate of disclosure. While guarantees may be relevant credit information, any such benefit from requiring disclosure is outweighed by the costs to unwary creditors who may be outmaneuvered by members or more sophisticated creditors who know about ULLCA's idiosyncratic disclosure requirement.

Section 402: Liability for Contributions

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165. N.Y. LTD. LIAB. CO. LAW § 609(b) (McKinney Supp. 1995). At least two LLC statutes make the members' liability limitation subject to a provision in the articles. *See* IOWA CODE ANN. § 490A.601 (West Supp. 1995); TENN. CODE ANN. § 48-217-101 (Supp. 1994). Another statute provides that members can agree to be liable by a provision in the "regulations" (which are equivalent to an operating agreement). TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 4.03 (West Supp. 1995).

166. ULLCA § 303(c).

167. *Id*. § 303(a). It is not clear whether a contract with creditors would be binding without the disclosure. Since the agreement with the creditor is arguably not an "operating agreement" (*see supra* text accompanying note 101), and in any event does not "restrict" creditor rights under ULLCA section 103(b)(7), section 303(c) does not clearly invalidate noncomplying agreements even if it applies to guarantees.

168. ULLCA § 303(a).

Section 402 provides for members' liability for contribution obligations and for compromise of these obligations.

1. Enforceability of Oral Contribution Obligations

This section permits enforcement of oral contribution obligations: "Given the informality of some [limited liability] companies, a writing requirement may frustrate reasonable expectations of members based on a clear oral agreement."[169] Yet the drafters also should have considered the litigation costs that might result from claims that members had orally agreed to make contributions.[170] Although the appropriate balance between enforcing expectations and minimizing litigation may not be clear, the fact that the vast majority of the states require a writing is evidence of the appropriate rule.[171] In any event, rejecting the clear majority rule is not the simplest path to the uniformity NCCUSL supposedly seeks.

2. Compromise of Contribution Obligations

Members can vote to compromise member contribution obligations, but compromised contributions can be enforced by creditors who relied on the initial obligation.[172] While many LLC acts so provide,[173] they are wrong. To be sure, creditors may rely on contribution obligations, but it is more likely that they will rely either on general assets, profitability or guarantees. Creditor reliance is particularly unlikely since ULLCA does not require contributions to be

169. *Id*. § 402 cmt.

170. *See supra* text accompanying note 84.

171. Only eleven states enforce oral contribution obligations, of which eight require some record of contributions. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 5-24 to 5-25 (tabulating state provisions).

172. ULLCA § 402(b).

173. ARIZ. REV. STAT. ANN. § 29-702(C) (Supp. 1994); COLO. REV. STAT. ANN. § 7-80-502(2) (West Supp. 1994); DEL. CODE ANN. tit. 6, § 18-502(b) (1993); FLA. STAT. § 608.435(3) (1993); IOWA CODE ANN. § 490A.801(3) (West Supp. 1995); KAN. STAT. ANN. § 17-7619 (Supp. 1993); MD. CODE ANN., CORPS. & ASS'NS, § 4A-502(B) (1993 & Supp. 1994); MINN. STAT. ANN. § 322B.42 (West 1995); NEV. REV. STAT. ANN. § 86.391(3) (Michie 1994); OKLA. STAT. ANN. tit. 18, § 2024(B) (West Supp. 1995); R.I. GEN. LAWS § 7-16-25(d) (1992 & Supp. 1994); TEX. REV. CIV. STAT. ANN. Art. 1528n, art. 5.02(D) (West Supp. 1995); UTAH CODE ANN. § 48-26-133(3) (Supp. 1994); VA. CODE ANN. § 13.1-1027(C) (Michie 1993 & Supp. 1994); W. VA. CODE § 31-1A-32(c) (Supp. 1994); WYO. STAT. § 17-15-121 (1989 & Supp. 1995); *see* RIBSTEIN & KEATINGE, *supra* note 11, at 5-26 (tabulating state provisions).

disclosed in the articles,[174] does not require keeping records of contributions,[175] and permits contributions in any form, including by obligations to perform services[176] which provide no security to creditors of insolvent LLCs. In the unusual case in which creditors do rely on a particular contribution obligation, they can contract for the protection this section would unnecessarily provide to all creditors. This rule costs LLCs financial flexibility with very little offsetting benefit to most creditors. Moreover, ULLCA apparently does not even let LLCs contract with its creditors to avoid the rule.[177]

This type of provision is borrowed from limited partnership statutes, a holdover from the early days of limited partnership in which limited liability was exceptional and mistrusted, and surrounded by other provisions which bolstered creditor reliance on contributions by restricting their form and requiring certificate disclosure.[178] There is no justification for continuing to include such provisions in LLC statutes.

Section 403: Indemnification

Section 403 provides, among other things, for reimbursement of members or managers by the LLC "for liabilities incurred by the member or manager in the ordinary course of the business of the company or for the preservation of its business or property."[179] Unfortunately, "ordinary course" might include all apparently authorized acts even if these have not been actually authorized by the members. Moreover, the comment adds an unsatisfactory gloss that the member or manager is not entitled to indemnification for "tortious conduct against a third party."[180] This comment leaves unclear whether, for example, a non-negligent act, such as an act for which a statute imposes strict liability, which is in the "ordinary course," is non-indemnifiable merely because it might be classified

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174. ULLCA § 203.
175. *Id.* § 408.
176. *Id.* § 401.
177. *See id.* § 103(b)(7). Note that, under this provision, even an agreement varying the unanimity requirement for compromise of contribution obligations under *id*. § 404(b)(c)(5) may not be enforceable as to third parties.
178. *See* REVISED UNIF. LTD. PARTNERSHIP ACT (1985) (RULPA) § 502(b), 6 U.L.A. 407 (Supp. 1995).
179. ULLCA § 403(a).
180. *Id*. § 403 cmt.

as "tortious."

Section 404: Management

Subsections (a) and (b) provide, subject to subsection (c), for management by member-managed and manager-managed LLCs by majority vote of the members and managers, respectively.[181] Subsection (c) provides that certain matters, including amendments to the operating agreement and articles, must be decided by unanimous vote of the members.[182]

1. Is a Unanimity Rule for Certain Matters Appropriate?

The unanimity rule empowers each partner not only to protect himself from harmful transactions, but also to insist on a large share of the gain from beneficial transactions. Even if members do not behave opportunistically, the cost of obtaining unanimous consent rises rapidly with the number of members. Moreover, a unanimity rule may not be very important in protecting members from harm where, as in a partnership or LLC, a member who disagrees with the firm's policies can dissociate.[183] Perhaps the costs of dissociating combined with the potential for harm to individual members from extraordinary new transactions justifies a veto power in partnerships, where the members are subject to personal liability. But the potentially serious problems caused by a unanimity rule may not be warranted where members have limited liability, as in an LLC.[184]

The strongest argument for a unanimity rule in an LLC is that the default rule should be designed for the more intimate, informal firm in which partnership-like management rules have the greatest benefits for members and impose the lowest decisionmaking costs. Even if this argument is persuasive, the unanimity rule would not necessarily be appropriate in manager-managed firms. The members' decision to centralize management decisions indicates that the firm is not the sort of intimate firm in which the veto power is appropriate and that the costs of obtaining unanimity may be high.

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181. *Id*. § 404(a), (b).
182. *Id.* § 404(c).
183. *Id*. §§ 601–603.
184. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 8-5 to 8-8.

At best, the ULLCA approach is debatable enough that it should not be *uniform*.

Moreover, even if some matters should be decided unanimously, not everybody will agree about subsection (c)'s list of matters that must be approved unanimously. Matters such as compromise of contribution obligations, interim distributions and redemption of property subject to a charging order could be considered ordinary financing decisions best entrusted to the managers and a majority of members. To be sure, as discussed immediately below, members could vary the rules in their operating agreement. However, default rules are important because of the costs of negotiating and drafting detailed agreements. Indeed, that is why business association statutes are necessary in the first place.

2. When Are These Rules Varied by Contrary Agreement?

The rules prescribed by this section can be waived by an oral operating agreement.[185] A strong argument can be made that a default rule of this importance should be waived only by written agreement. Although the statutory default rules should be designed for informal firms, it does not necessarily follow that rules regarding waiver of defaults also should accommodate informality. The drafters should consider the potential litigation costs of oral agreements about matters where disputes are sure to arise.

Section 405: Sharing of and Right to Pre-Dissolution Distributions

Section 405 provides that any distributions prior to dissolution shall be made equally, and that members have no right to receive or obligation to accept distributions in kind.[186] The section raises issues about the appropriate default sharing ratio and about how the default provision can be waived.

1. Should Distributions Be Shared Per Capita or Pro Rata?

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185. *See* ULLCA § 103 (permitting oral operating agreement to vary terms, and not including section 404 among provisions that may not be varied by operating agreement).

186. *Id*. § 405(a), (b).

There are good arguments both for and against a default rule that allocates financial rights equally among the members rather than pro rata according to members' financial contributions as is the corporate rule. The argument for the per capita approach is that informal firms may not have sufficient records from which members' current financial shares readily can be determined. As a result, such firms risk litigation concerning the validity of every distribution. On the other hand, a per capita rule is probably inconsistent with the parties' expectations in a limited liability firm, in which the members' contributions are mostly financial. Thus, while the ULLCA rule is not wrong, it is not so clearly right that it ought to be the uniform rule.

2. Should the Default Rule Be Waivable by Oral Agreement?

The distributions rule can be waived by oral operating agreement.[187] This raises the same concerns and potential problems as waivers of management and voting rules under ULLCA section 404[188] — i.e., the appropriate balance between accommodating the expectations of members of informal firms and avoiding excessive litigation costs.[189] Both the Prototype Act[190] and RULPA[191] require written waivers of this default.

Enforcing oral waivers of the unanimity rule may add complications. The comment points out that the members must unanimously consent to interim distributions under subsection 404(c), and therefore could block equal distributions that inappropriately reflect members' contributions.[192] Yet it may not be clear when the unanimity rule has been informally amended.

Sections 406–407: Limits on and Liability for Distributions

187. *Id*. § 103.
188. *See supra* text accompanying note 185.
189. *See supra* text accompanying note 189.
190. PROTOTYPE ACT, *supra* note 49, § 601.
191. RULPA § 504.
192. ULLCA § 405 cmt.

Sections 406 and 407 provide, respectively, for limitations on distributions[193] and for liability for wrongful distributions.[194] Such provisions give little more to creditors than they would get under fraudulent conveyance law. For this small benefit, these provisions impose a costly extra level of legality on LLCs. ULLCA section 406 requires firms to make determinations on the basis of "reasonable"[195] accounting practices that the distribution meets both "balance sheet"[196] and "equity insolvency"[197] tests, with special rules for purchase or redemption of member interests.[198] Such formalities ensure that even small, informal LLCs will need legal and accounting advice in arranging day-to-day finances. These provisions were not included in the Prototype Act.[199] Moreover, the fact that they have not been included in most limited liability partnership statutes[200] suggests that state legislatures are now ready to accept limited liability without these restrictions.

Section 408: Information Right

Section 408 provides for access to the LLC's books and for other member information rights.[201] As discussed in the following subsections, ULLCA's open-ended language invites extensive litigation on disclosure, an issue that can be raised in connection with any dispute. Even worse, ULLCA does not give the parties adequate freedom to fashion their own agreements on this important issue.

1. Books and Records

ULLCA provides for access to, but not the keeping of, records.[202]

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193. *Id*. § 406.
194. *Id*. § 407.
195. *Id*. § 406(b).
196. *Id*. § 406 cmt.
197. *Id*.
198. *Id*. § 406(c).
199. PROTOTYPE ACT, *supra* note 49, § 603 cmt.
200. LLP statutes that include such provisions are COLO. REV. STAT. § 7-60-146 to -147 (West Supp. 1995); MINN. STAT. ANN. § 323.14 Subd. 5 (West 1995); and N.D. CENT. CODE § 45-22-10 (Supp. 1995).
201. ULLCA § 408.
202. *Id*. § 408(a).

This is consistent with both the UPA[203] and RUPA[204] rules. As noted by the comment, such a rule arguably fits the most informal firms for which the act should be designed[205] because such firms may be caught by surprise by a recordkeeping requirement.[206] Moreover, under a statute that requires the firm to keep books,[207] it is not clear what the penalty for failing to keep required books is, or should be. However, because LLCs may be centrally managed, the partnership analogy may not be appropriate for LLCs. In a manager-managed LLC, unlike the "standard form" partnership, members who do not directly participate in management normally would want a way to monitor managers' performance. Indeed, records are so basic to managers' disclosure duties that courts are likely to imply an agreement or statutory requirement of recordkeeping obligations by managers. Accordingly, the statute should delineate the default recordkeeping duty in order to minimize the cost of litigating the issue.

2. Where Do Members Have Access to Books and Records?

ULLCA gives members access to books and records "at the company's principal office or other reasonable locations specified in the operating agreement."[208] This raises several issues. First, since operating agreements may be oral, members may have difficulty determining where the records are supposed to be kept under the operating agreement. Indeed, simply putting the records in a particular place might constitute the operating agreement provision on location if no one objects. Once again, the potential litigation costs of oral agreements may outweigh the benefits even for informal firms.[209]

Second, it is not clear when an operating agreement provision on location will be enforced. The location must be "reasonable."[210] While it is easy to see how managers who are free to decide could put the records in an inconvenient place, how can a place to which the members have agreed be "unreasonable"? This requirement is

203. UPA § 19; *see* BROMBERG & RIBSTEIN, *supra* note 68, § 6.05.
204. RUPA § 403.
205. *See supra* Part III(B).
206. ULLCA § 408 cmt.
207. *See id*. § 404.
208. *Id*. § 408(a).
209. *See supra* text accompanying notes 90–93.
210. ULLCA § 408(a).

particularly confusing in light of other ULLCA provisions. Does "reasonable" differ from the obligation to discharge duties in "good faith" under ULLCA subsection 409(d), or from the rule in section 103 that the operating agreement cannot "unreasonably" restrict access to records?[211] Can the agreement "reasonably" restrict access to an "unreasonable" place? If so, would not such an agreement be enforceable, since section 103 purports to list all of ULLCA's restrictions on waiver?

3. What Information Does the LLC Have to Provide Without Demand?

The LLC must furnish "without demand, information concerning the company's business or affairs reasonably required for the proper exercise of the member's rights and performance of the member's duties under the operating agreement or this [Act]."[212] Once again, the Act has provided an open-ended standard rather than a clear default rule. Does the "reasonably required" standard mean all information that is "relevant" to the members' financial or management rights, only such "relevant" information that is also "material," or something else? No case law exists on this issue. The law generally does not impose open-ended disclosure duties for the sound reason that such a rule would invite litigation and protective overdisclosure by managers.[213] For all of these reasons, it is curious that the ULLCA drafters did not follow the UPA and RUPA approach of requiring demand regardless of the type of information.[214]

4. What Information Can Members Demand?

ULLCA entitles members "on demand, [to] other information concerning the company's business or affairs, except to the extent the demand or the information demanded is unreasonable or otherwise improper under the circumstances."[215] Once again, ULLCA adopts a vague standard. When is information "unreasonable"? Does "unreasonable" differ from "otherwise improper"? From the bad faith

211. *See id.* § 103(b)(1).
212. ULLCA § 408(b)(1).
213. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 9-12.
214. UPA § 20; RUPA § 403(c).
215. ULLCA § 408(b)(2).

conduct proscribed by ULLCA subsection 409(d)? Also, if the *information* is "reasonable," how could the *demand* be "unreasonable"? Although a demand might be unreasonable if the member insists on having the information in the middle of the night, the section seems to refer to what may be demanded rather than when it must be provided. Moreover, any victory based solely on *when* a member demanded "reasonable" information is bound to be pyrrhic.

In addition to being inherently unclear, this provision also relates uncertainly to members' rights to information without demand. How can "reasonable" information that must be furnished on demand under subsection 408(b)(2) not be "reasonably required" and therefore subject to a duty to furnish without demand under subsection 408(b)(1)? When should members "demand" information instead of suing because it has not already been disclosed?

5. What Are a Member's Rights to Production of the Operating Agreement?

ULLCA provides that "[a] member has the right upon written demand given to the limited liability company to obtain at the company's expense a copy of any written operating agreement."[216] Although the section could be read to grant a member the right to have an oral agreement reduced to writing, it probably means only that a member has a right to a copy of any operating agreement that is already a "record."

6. When Can Disclosure Duties Be Waived?

The above questions are made particularly serious by the limits on members' rights to contract around disclosure duties. The operating agreement may not "unreasonably restrict a [member's or former member's] right to information or access to records under section 408."[217] Not only is "unreasonably" inherently unclear but also, as already noted,[218] it is confusing in conjunction with the reasonableness requirement for location[219] and the good faith re-

216. *Id*. § 408(c).
217. *Id*. § 103(b)(1).
218. *See supra* text accompanying notes 210–11.
219. ULLCA § 408.

quirement.[220] More fundamentally, it is not clear why the parties cannot make any agreement they want on this issue, subject to usual good faith rules of construction. Surely some LLCs would want to escape the potential litigation inherent in ULLCA's open-ended "reasonableness" default rules on disclosure. But if they try to do so, they only get tangled further in the additional issue of whether their agreement was "unreasonable."

Section 409: Fiduciary Duties

Section 409 provides for rules similar to those in RUPA[221] defining the fiduciary duties in an LLC as the duties of loyalty and due care.[222] These rules apply to members of member-managed firms and to managers and managing members of manager-managed firms. In general, this section is an invitation to extensive litigation because of its vague standards and because it attempts the impossible — the full specification of duties that inevitably vary from case to case. This was equally a problem in RUPA.[223] The attempt to transplant these duties to ULLCA creates even more problems.

1. Adoption of RUPA Rules

My criticisms elsewhere of the RUPA fiduciary duty rules[224] apply equally to the same rules in ULLCA. Like RUPA, ULLCA subsection 409(b) confusingly provides for separate components of the duty of loyalty in addition to the general duty to account for benefits of which these are a part; subsection (d) wrongly provides for the basic contract good faith obligation in the fiduciary duty section; and subsection (e) casts doubt on the rest of the section by letting members act selfishly;[225] and ULLCA section 103 severely limits

220. *Id*. § 409(d).

221. RUPA § 404.

222. ULLCA § 409(a).

223. *See* Ribstein, *supra* note 20, at 52–54.

224. *Id*. at 52–62. For additional criticism of the mandatory nature of ULLCA's fiduciary duty rules, see *supra* § III(A).

225. The comments attempt to explain ULLCA section 409(e) by stating that "a member does not violate the obligation of good faith under subsection (d) merely because the member's conduct furthers that member's own interest," giving examples of voting in the member's own interest. ULLCA § 409 cmt. This would be clear even without subsection (e) because the good faith obligation does not impose a duty of selflessness. Yet subsection (e) is obviously not limited to the good faith obligation.

firms' ability to contract around these highly questionable default rules.

One aspect of the RUPA rules adopted in ULLCA deserves special mention because of the way it interrelates with other ULLCA rules. Under ULLCA, the operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable, and may "specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty."[226] There is, however, no provision elsewhere in ULLCA explicitly permitting member authorization of self-dealing transactions in the absence of a provision in the operating agreement. The comment says that "Subsection [103](b)(2)(ii) preserves the common law right of the members to authorize future or ratify past violations of the duty of loyalty provided there has been a full disclosure of all material facts."[227] Yet this "common law right" is far from clear. The LLC is not a "common law" organization. By contrast, the UPA requires partners to account for only those benefits derived "without the consent" of the other partners.[228] ULLCA subsection 409(b)(1) uses almost the same language as the UPA but deletes the consent language. This strongly implies that ULLCA does not permit authorization by member vote.

If the members cannot authorize a specific transaction that would otherwise constitute self-dealing, this would be a real hardship for the typical informal firms — for which the Act should be designed[229] — that do not include such detail in their operating agreements. Indeed, members of such firms may be surprised by the existence of the rule only after the issue is litigated. This is particularly a problem since it may be difficult to determine whether the conduct in fact would violate the duty of loyalty in the absence of consent.

In the end, courts probably will resolve this issue by holding that member consent removes any fiduciary breach regardless of what the Act says. The Act should make this clear.

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226. ULLCA § 103(b)(2)(ii).
227. *Id*. § 103 cmt.
228. UPA § 21.
229. *See supra* Part III(B).

2. Erroneous Linkage with RUPA

Even if the RUPA rules applied in ULLCA were fine for partnerships, they would not necessarily suit LLCs. For example, the limited liability of LLC members suggests that the extra incentive of a duty of care may be appropriate to protect against improvident transactions.[230] Although the RUPA duty of care as set forth in ULLCA subsection 409(c) may be appropriate for LLCs, the use of the same language in both statutes erroneously suggests that the courts should apply this duty the same way in both contexts. This may cause the creation of inappropriate precedents for both LLCs and partnerships.

3. What Are Members' Duties in a Manager-Managed Firm?

ULLCA adapts RUPA fiduciary duty rules to the special circumstances of manager-managed LLCs.[231] A member in a manager-managed LLC has no duties "solely by reason of being a member."[232] Assuming it is clear who is a "member" and who a "manager," there is a question whether a control group of members should be freed from fiduciary duties to the minority. Although ULLCA apparently provides for judicial dissolution in this situation,[233] members arguably should have some remedy short of dissolution. Moreover, it is not clear why members of member-managed LLCs should have fiduciary duties even if they do not participate in management, while non-managing members of manager-managed LLCs have no fiduciary duties even if they participate in control.

More seriously, because the relationship between members and managers in LLCs is an evolving concept, it is even more difficult to make precise statements about fiduciary duties in LLCs than in the relatively simply partnership context. When is a person a "member" and when a "manager" for fiduciary duty purposes, particularly in informal LLCs where functions may be blurred? ULLCA defines "manager" unhelpfully as one who is "vested with authority under

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230. *See* Claire Moore Dickerson, *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 417 (1995) (discussing the roles of limited liability and other factors in comparing fiduciary duties in LLCs and partnerships); Ribstein, *supra* note 80 (criticizing "linkage" of LLC and partnership law).

231. ULLCA § 409(h).

232. *Id*. § 409(h)(1).

233. *See id*. § 801(b)(5)(v), discussed *infra* text accompanying note 334.

section 301."[234] This is circular, since section 301 simply vests with authority one who is a "manager."[235] Moreover, under section 409, even a non-managing member

> who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act].[236]

When is a "member" who is not a "manager" under section 301 nevertheless exercising the rights of a manager under section 409? And when is he doing so "pursuant to the operating agreement"[237] if the agreement is oral or does not explicitly forbid the action? Does the member's fiduciary duty turn on whether he is usurping authority?[238] Finally, ULLCA relieves a manager of liability "to the extent of the managerial authority delegated to the members by the operating agreement."[239] Does this mean that managers are relieved of liability when they *act* as long as the operating agreement has *delegated* authority to the members?

Section 410: Remedies

Section 410 provides that a "member may maintain an action" to enforce the member's rights against the LLC or another member "with or without an accounting."[240] This section's main problems concern its interrelation with the members' management rights and the derivative remedy.

Section 410 apparently allows individual member suits for

234. ULLCA § 101(10).
235. *Id*. § 301.
236. *Id*. § 409(h)(3).
237. *Id*.
238. *See* Dickerson, *supra* note 230, at 438 (criticizing ULLCA's "formalistic" distinctions between members and managers while ignoring the existence of actual control). The relationship between managers' powers and their fiduciary duties is an important and difficult issue in corporate law. *See* Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989). The recent case of Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994), suggests that directors are sharply limited in how they may sell control of the corporation — an act which exceeds their usual power under the corporate statute.
239. ULLCA § 409(h)(4).
240. *Id*. § 410.

breach of fiduciary duty to the LLC without either co-member consent or demand on managers.[241] ULLCA Article 11 permits derivative suits only if members or managers with authority refuse to do so.[242] Courts will have to make the difficult determination whether a member is suing derivatively under Article 11 or directly under section 410. Although the drafters provide that a "member pursues only that member's claim,"[243] the member's fiduciary rights under section 409 also are enforceable under this section. This apparently would permit members to sue individually on derivative-type claims for damage to the LLC.[244]

Section 411: Continuation of Term LLC

Section 411 provides that if a term LLC is continued after expiration of its term, or an LLC's business is continued without winding up, it does so as an at-will LLC.[245] This section raises several questions which are discussed below in connection with section 801.[246]

Sections 501–504: Transferees and Creditors of Members

Sections 501 to 504 provide for transfer of LLC interests[247] in terms similar to those which apply to partnership interests. This application of partnership law generally makes sense from an organizational standpoint, and helps ensure that LLCs have the part-

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241. *Id*.

242. *Id*. § 1101; *see infra* text accompanying notes 389–405 (discussing Article 11).

243. ULLCA § 410 cmt.

244. *Id*. § 410(a)(2) (providing for actions enforcing "the member's rights under this [Act]"; *id*. § 409(a) (providing that members owe duties of loyalty and care to the company "and its other members").

245. Curiously, *id*. § 411(b) refers only to "continuation" without specifying the kind of continuation to which it is referring. The title of the section indicates that both subsections refer to continuation of a term LLC. The drafters should have made this explicit.

246. *See infra* text accompanying notes 343–54.

247. ULLCA sections 501 to 504 distinguish between LLC members and transferees of "distributional interests," defined as members' interests in "distributions." *Id*. § 101(6). A "distribution" is defined as "a transfer of money, property, or other benefit from a limited liability company to a member in the member's capacity as a member or to a transferee of the member's distributional interest." *Id*. § 101(5). This is broad enough to include all of a member's financial rights, which can be "transferred in whole or in part." *Id*. § 501(b).

nership tax characterization feature of restricted transferability.[248] The sections are also generally similar to those in most LLC statutes.[249] Indeed, the existing uniformity of these provisions is one reason why ULLCA is unnecessary.

Section 601: Dissociation Events

This section specifies the events that cause a member's dissociation.[250] The dissociation triggers either a buyout or dissolution and winding-up.[251] Most notably, this section provides that a member dissociates on transfer of all of his distributional interest[252] and that a member who transfers "substantially all" of his interest may be expelled by unanimous member vote.[253] This appears to be a compromise between providing for expulsion or providing for automatic termination as a result of a transfer.[254] However, it is an unsatisfactory compromise, since it will inevitably trigger litigation over whether the member has transferred "substantially all" of the interest. In the closely held firm for which the statute should be drafted, members might be concerned about any dilution of the incentives of a co-manager, and so arguably should have at least a default expulsion power in this situation. On the other hand, giving such a power to the majority could invite opportunistic expulsions. In any event, the rule should be clear-cut.

Section 602: Power to Dissociate

This section provides that a member has a power to dissociate at any time, although the dissociation may be wrongful.[255]

1. Should There Be a Default Power to Dissociate?

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248. Rev. Proc. 95-10, 1995-3 I.R.B. 20.
249. *See generally* RIBSTEIN & KEATINGE, *supra* note 11, ch. 7.
250. ULLCA § 601.
251. *See id*. §§ 603, 701 and 801, discussed *infra* text accompanying notes 265–72, 273–75, 290–354.
252. ULLCA § 601(3).
253. *Id*. § 601(5)(ii).
254. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 7.05 (discussing these alternatives).
255. ULLCA § 602(a).

The most important question concerning the member's power to dissociate is whether the statute should provide for this default right. Since the main consequence of the power to dissociate is the member's buyout right, this issue is discussed below with respect to the provision concerning that right, ULLCA section 603.[256]

2. Should Dissociation Be Wrongful if Not in Breach of Operating Agreement but Prior to Expiration of a Term?

A member's dissociation is wrongful if it is in breach of the operating agreement or prior to expiration of the duration of a term LLC.[257] A wrongfully dissociating member is liable for damages caused by the dissociation.[258] This default damage remedy is a mistake. Unlike in a partnership, on which this rule is based,[259] the member's premature departure does not necessarily impose significant burdens on the other members — it does not generally cause dissolution,[260] does not generally require the firm to find other debt guarantees because the members have limited liability and, at least in a manager-managed LLC, does not generally require replacement of the member's services.[261] Moreover, any risk that prematurely buying out the member will disrupt the firm's business is minimized by the fact that a term LLC can delay buyout until completion of its term[262] and has the option to prohibit dissociation altogether.[263] Thus, there will probably be no real damage from the member's

256. *See infra* text accompanying notes 265–72.

257. ULLCA § 602(b). A term LLC is one that is so designated in the articles. *See id*. § 101(19). Note that if the operating agreement provides for a term but the articles do not, the firm is apparently not a term LLC, despite the fact that section 203(c)(1) provides that the agreement generally controls among the members if the two are inconsistent. Although the dissociation prior to expiration of the specified term is wrongful whether or not it explicitly violates the operating agreement, there would appear to be no reason under section 103 why the operating agreement could not make dissociation prior to expiration of the term non-wrongful.

258. *Id*. § 602(c).

259. *See* UPA § 38(2); RUPA § 602.

260. A member's premature dissociation other than for involuntary events such as bankruptcy or death does not cause the dissolution of a term LLC. ULLCA § 801(b)(3).

261. If the departure breaches an employment agreement, there would be a cause of action for this breach, and therefore no need for a LLC statutory provision.

262. ULLCA §§ 603(a)(2)(ii), 701(a)(2).

263. *See id.* § 602(a) (providing that power to dissociate is subject to contrary provision in the operating agreement). Note that, under this provision, it may not be clear if the operating agreement should be interpreted as prohibiting withdrawal altogether or making withdrawal wrongful under certain circumstances.

departure. Yet this section invites the firm and the court to search for damages.

3. Should Dissociation by Member Bankruptcy Be Wrongful?

ULLCA provides that dissociation is wrongful if "the member is dissociated by becoming a debtor in bankruptcy."[264] Even if damages ought to be imposed on some wrongfully dissociating members, such damages should not be imposed on the creditors of a bankrupt member.

Section 603: Effect of Dissociation

This section is partly a switching provision: On dissociation, the firm either dissolves, in which case Article 8 applies,[265] or the firm continues and purchases the member's interest under Article 7.[266] In a term LLC, the purchase occurs only on expiration of the stated duration.[267] The section also specifies the effect of dissociation on members' management and fiduciary rights and obligations.[268]

1. Should Members Have a Default Put?

One of the more controversial aspects of this section is that a member has a default right at any time to be cashed out of the firm. The obligation to buy out members could impose significant burdens on the sort of closely held firm for which the statute should be designed. Perhaps such a right is justifiable in a partnership, since it relieves partners of having to continue to expose their personal wealth to business risk in order to keep their financial interest in the firm. But LLC members do not have this problem. Accordingly, it is worth asking whether the statute should assume that LLC members would want to provide for a buyout right.

The strongest justification for the buyout right is that even in an LLC, illiquid minority members may be subject to potential oppression by majority members. Such problems have given rise to special remedies in close corporations which have triggered much

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264. *Id.* § 602(b)(2)(iii).
265. *Id*. § 603(a).
266. *Id*. § 603(a)(i).
267. *Id*. § 603(a)(2)(ii).
268. *Id*. § 603(b).

litigation and unsatisfactory judicial lawmaking.[269] These remedies invite courts to guess that close corporation shareholders want to be treated like partners, contrary to their decision to incorporate.[270] The same problems would arise under LLC statutes that do not provide for a default buyout right. If the statute provides for such a right by default, the majority would have to make the absence of a buyout right clear to the minority by specifying it in the operating agreement. This would eliminate judicial guesswork about whether or not the members agreed to the absence of a buyout.

2. Other Consequences of Dissociation

ULLCA subsection 603(b) necessitates separating out the subparts of the duty of loyalty and determining when duties relate to pre-dissociation matters and which post-dissociation matters relate to winding up.[271] These difficulties are added to the difficulties of interpreting the fiduciary duty provision.[272] This is another respect in which ULLCA is a litigator's dream.

Section 701: Purchase Right

ULLCA section 701 provides rules for the purchase of a dissociating member's "distributional interest."[273] Although a default buyout right arguably makes sense for informal LLCs,[274] this section's rules governing the buyout provide the sort of detailed formality that is appropriate for a more sophisticated firm. If the firm is operated informally there is a strong possibility that members and managers will miss the specified thirty-day and 120-day

269. *See* Larry E. Ribstein, *The Closely Held Firm: A View from the United States*, 19 MELB. L. REV. 950 (1995) (discussing the need for LLC statutes in light of these problems). On the other hand, tax considerations relating to gift tax valuation militate against a default buyout right. For a discussion of tax and non-tax aspects of the default dissociation right, see Larry E. Ribstein, *Statutory and Planning Consideration for Withdrawal from an LLC*, 1 J. LTD. LIAB. CO. 64 (1994).

270. *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

271. ULLCA § 603(b); *see* Ribstein, *supra* note 20, at 147–53 (discussing problems of applying analogous RUPA provision).

272. *See* ULLCA § 409 (providing for basic fiduciary duty); *supra* text accompanying notes 221–39 (discussing § 409).

273. This is defined in ULLCA § 101(6) as "all of a member's interest in distributions by the limited liability company."

274. *See supra* text accompanying note 269.

deadlines.[275] These rules are appropriate only for a formal, heavily lawyered, corporate appraisal proceeding, not the informal firm for which the statute should be designed.

Section 702: Court Action to Fix Price

Section 702 provides rules for the court determination of the buyout price — i.e., "fair value."[276] Most importantly, it provides that the court should consider

> among other relevant evidence the going concern value of the company, any agreement among some or all of the members fixing the price or specifying a formula for determining value of distributional interests for any other purpose, the recommendations of any appraiser appointed by the court, and any legal constraints on the company's ability to purchase the interest.[277]

1. Vagueness of "Fair Value" Standard

The drafters emphasize the open-endedness of the "fair value" standard used for determining the buyout price:

> Under this broad standard, a court is free to determine the fair value of a distributional interest on a fair market, liquidation, or any other method deemed appropriate under the circumstances. A fair market value standard is not used because it is too narrow, often inappropriate, and assumes a fact not contemplated by this section — a willing buyer and a willing seller.[278]

While any judicially determined buyout price is bound to involve some uncertainty, there is no reason to maximize the need for costly lawyering as ULLCA does. The fact that there is no actual willing buyer and willing seller is no reason why the court cannot be instructed to determine a hypothetical market price based on a willing buyer/willing seller standard. Indeed, RUPA requires just such a

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275. *See* ULLCA § 701(b), (d).
276. *See id*. § 701(a).
277. *Id*. § 702(a)(1).
278. *Id*. § 702 cmt.

determination.[279] If there is some policy reason why this would not be appropriate, the statute should clarify deviations from the market standard. For example, the statute could explicitly eliminate any "minority discount" by providing that value should be determined on the basis of the member's pro rata share of the value of the firm.[280] This would deter oppression of minority holders and eliminate the need for open-ended special remedies.[281] As phrased, the section creates unnecessary potential for litigation on many issues, as indicated in the following subsections.

2. *What Factors May the Court Consider?*

ULLCA section 702 provides that "the court shall . . . determine the fair value of the interest, considering among other relevant evidence . . . ."[282] This sets no limit on the factors the court may consider, exacerbating the open-endedness problem discussed immediately above. Also, "the court shall" language implies that the court *must* consider at least the factors set forth in the section. Does "considering" mean that the court must take all of these factors into account, or that the court can apply a zero weight to some factors? If the latter, under what circumstances may the court do so?

3. *Relevance of Agreement*

The language providing that the price or formula in an agreement is merely a factor to be taken into account in fixing the price[283] apparently does not refer to the buyout price in an operating agreement. Such a price would control under subsection 701(c)[284] and under section 103 which does not list sections 701 and 702 as non-

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279. RUPA § 701(a), (b).

280. *See id.* § 701(b).

281. *See infra* text accompanying notes 334–42.

282. ULLCA § 702(a)(1). The factors include:

> the going concern value of the company, any agreement among some or all of the members fixing the price or specifying a formula for determining value of distributional interests for any other purpose, the recommendations of any appraiser appointed by the court, and any legal constraints on the company's ability to purchase the interest.

Id.

283. *See supra* note 282.

284. "[T]he price and terms so fixed [in the operating agreement] . . . govern[s] the purchase unless the purchaser defaults." ULLCA § 701(c).

waivable provisions.[285] Rather, the reference to an agreed price or formula refers only to agreements *other than* the operating agreement,[286] or to provisions other than those fixing the buyout price. But then the agreement may be unenforceable as to the dissociated member or wholly irrelevant to the buyout price. These would be problems particularly if, as discussed immediately above, the court *must* take the agreement into account.

4. Difference from Partnership Standard

ULLCA section 702 applies a different standard from RUPA,[287] which itself differs from the UPA.[288] Thus, cases under one Act cannot be used under the others. There is no apparent reason why ULLCA departs in this respect from RUPA while questionably borrowing RUPA language in many other respects. This indicates that, contrary to one of the fundamental drafting principles discussed in Part III,[289] ULLCA's drafters lacked a coherent theory that would help determine when to link the LLC with other forms.

Section 801: Dissolution

Section 801 specifies the events which result in a dissolution of the LLC, including agreed events, judicial decree, and member dissociation, depending on whether the firm is "term" or "at will,"[290] as discussed below.

1. Dissolution at Will

A "term" LLC, defined as one whose articles so provide,[291] dissolves on a member's dissociation only if the dissociation is caused by bankruptcy or death (or the equivalent of a non-individual member) and only if that member is either a manager or a member of a

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285. *See id*. § 103(b) (listing non-waivable provisions).

286. ULLCA subsection 702(a)(1) refers to "any agreement between *some or all* of the members fixing the price." *Id*. (emphasis added). Under the default rule, a price fixed in the operating agreement would require the consent of *all* the members. *See id*. §§ 103(a), 404(c).

287. See *supra* text accompanying notes 279–80.

288. *See* Ribstein, *supra* note 20, at 66.

289. *See supra* Part III(C).

290. ULLCA § 801(b).

291. *Id*. § 101(19).

member-managed LLC.[292] At-will LLCs, which ULLCA defines as those which are not "term,"[293] dissolve on dissociation of a member in a member-managed LLC or of a manager in a manager-managed LLC.[294]

Dissolution at will should not be the default rule for any type of LLC. Dissolution at will is highly questionable even in general partnerships because of the disruption it causes and the leverage it gives each member to extract concessions from co-partners who want to continue the firm.[295] However, at least in a general partnership the liquidation power is supported to some extent by the potential harm to minority members resulting from their continuing personal liability for partnership debts. An LLC member's buyout right adequately addresses minority members' need for exit.[296] Indeed, ULLCA also provides minority members with the protection of a default veto power.[297] Adding a default dissolution power to the minority's other rights radically tips the balance of power in their favor.

It is no answer that firms can vary dissolution at will in their operating agreement or include the appropriate articles provision to make their firms term partnerships. The Act should provide rules for informal firms that may not have such agreements or provide for such formalities. For the reasons discussed immediately above, few informal firms will be likely to want the rules ULLCA provides. Yet they will be forced to incur the costs of drafting around the Act. Worse, they probably will not have a formal agreement or special articles provisions,[298] or even if they do they may run into the unexpected consequences of specifying a term.[299] Firms are least likely to agree on dissolution, which is a remote event from the perspective of drafting operating agreements or initial articles. As a result, members' expectations will be frustrated, or courts will try to sort out what the parties really wanted, as they now do in close corporation

292. *Id*. § 801(b)(3).

293. *Id*. § 101(2).

294. *Id*. § 801(b)(3).

295. *See* Ribstein, *supra* note 20, at 72; Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987).

296. *See* ULLCA § 701.

297. *See* ULLCA § 404, discussed *supra* text accompanying notes 183–84.

298. It is particularly likely that they will not have an *effective* term election in their articles given the specificity of the required election. *See supra* text accompanying notes 128–33 (discussing ULLCA § 203).

299. *See infra* text accompanying notes 343–54 (discussing ULLCA § 801).

dissolution cases.

In the final analysis, ULLCA's position on dissolution at will reflects an unsatisfactory compromise of tax and transaction cost considerations. The statute undoubtedly provides for dissolution at will because this is an important partnership tax characteristic.[300] However, perhaps because they recognized the hardships of dissolution at will, the drafters have provided an exception for "term" LLCs.[301] The problems of "term" LLCs are discussed below.[302] The drafters' recognition of the problems of dissolution at will are further reflected in their 1995 addition of an exception to dissolution at will for member dissociation from manager-managed firms. This rule responds to the IRS's December Revenue Procedure which provides that non-dissolution after member dissociation from a manager-managed firm does not amount to corporate-type continuity of life for purposes of obtaining a private ruling.[303] This distinction makes no sense as a default rule apart from tax considerations. It is based on an inappropriate analogy to limited partnerships in which the significant difference between general and limited partners based on limited liability should matter, given the existence of a power to liquidate the firm at will. In an LLC, by contrast, both managing and non-managing members have limited liability. The governance and liquidity benefits to members from dissolution at will *increase* when members are excluded from management, while the costs to the firm depend on the duration of the firm, not the form of governance. Although a centralized-management exception to dissolution at will increases continuity, it is an inappropriate default rule because it may confuse members of informal LLCs. Without costly legal advice, such firms are likely to think that continuity depends solely on whether the firm is at will.

2. *When Does the Firm Continue Following Member Dissociation?*

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300. *See* Rev. Proc. 95-10, 1995-3 I.R.B. 20.

301. ULLCA § 801(b)(3).

302. *See supra* text accompanying notes 343–54 (discussing ULLCA § 801).

303. *See* Rev. Proc. 95-10, § 5.01(1), 1995-3 I.R.B. 20, 23. The drafters explicitly acknowledged the tax derivation of the provision by stating that the January amendment to the dissolution provisions "harmonize[s] the Act with new and important Internal Revenue Service announcements." ULLCA Prefatory Note.

An at-will LLC dissolves on member dissociation unless the business

> is continued by the agreement of:
>
> (A) the remaining members that would be entitled to receive a majority of any distributions that would be made to them assuming the business of the company were dissolved and wound up on the date of the dissociation; and
>
> (B) the remaining members that would be entitled to receive a majority of any future distributions that would be made to them assuming the business of the company were continued after the date of the dissociation.[304]

ULLCA defines "future distributions" as used in this section to mean

> the total distributions that, as of the date of dissociation, are reasonably estimated to be made to the remaining members if the company were continued until the projected date of its termination, reduced by the amount of distributions that would have been made to the remaining members if the business of the company were dissolved and wound up on the date of dissociation.[305]

Finally, ULLCA defines "distribution" as a "transfer of money, property, or other benefit from a limited liability company to a member in the member's capacity as a member."[306] It therefore "includes all sources of a member's distributions including the member's capital contributions, undistributed profits, and residual interest in the assets of the company . . . ."[307]

The drafters explain their adoption of a rule based on members' interests as follows:

> Decision-making under this Act is normally by a majority in number of the members or managers for ordinary matters and unanimity for specified extraordinary matters. See Section 404(a) to (c). The majority of members holding requisite distributions rights varies this rule and is used only in subsection (b)(3)(i) . . . .

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304. ULLCA § 801(b)(3)(i).
305. *Id.* § 801(a).
306. *Id.* § 101(5).
307. *Id*. § 101 cmt.

> Under this Act, distributions are shared on a per capita basis . . . . Therefore, under the default rule, a majority in number would also be a majority of members holding requisite distributions rights unless the company has in excess of one hundred members.[308]

Although the comments say that majority-of-distributions in effect means per capita voting in the absence of contrary agreement because distributions are shared per capita,[309] this is wrong. The drafters refer to the rule that applies only to *interim* distributions.[310] But on winding up, members are entitled among other things to return of their *contributions*[311] which may vary from member to member even in a default LLC. Determination of member contributions may be difficult in an informal firm that does not keep clear, current records — the sort of firm for which the statutory default rule should be designed. It will be even harder to guess at shares of "future distributions," which may include both interim and final distributions of capital, and harder still to apply complex distribution formulas in agreements that do not vary the default voting rule.

The drafters initially provided for a "majority-in-interest" voting rule which, like a similar late addition to the Revised Uniform Partnership Act,[312] was explicitly intended to conform with tax rules.[313] The drafters changed this rule after it was criticized in an earlier draft of this Article.[314] The old rule, as unsatisfactory as it was, at least had the virtue of aligning with tax law, RUPA, and some LLC

308. *Id*. § 801 cmt.

309. *Id*.

310. *Id.* (referring to ULLCA § 405).

311. *Id.* § 806(b).

312. *See* RUPA § 801.

313. *See* Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993) (providing that corporate-type "continuity of life does not exist" if a general partner withdraws, causing dissolution, and the remaining partners agree to continue the partnership); Rev. Proc. 94-46, 1994-28 I.R.B. 129 (providing a safe harbor definition of "majority in interest" as majority of profit interests and of capital interests); Rev. Proc. 95-10, § 5.01, 1995-3 I.R.B. 20, 23 (specifying conditions under which an LLC may obtain ruling that relates to its classification as a partnership for federal tax purposes). The drafters made clear their intention to align with tax rules in the comment to ULLCA section 801 (January 20, 1995 draft).

314. *See* Larry E. Ribstein, A Critique of the Uniform Limited Liability Company Act (Jan. 29, 1995) (unpublished manuscript, on file with the *Stetson Law Review*). This draft was sent to the ULLCA Reporter, Carter Bishop. It is not clear why the change was made.

statutes.[315] As discussed above, the new rule does not solve the main problem of the majority-in-interest rule of relying on computation of member interests. Moreover, it is even more unsatisfactory because it is not only confusing in itself, but also completely idiosyncratic and so less likely to attract a body of interpretive materials.

3. Who May Apply for Judicial Dissolution?

ULLCA provides for separate grounds for judicial dissolution upon application by a "member or a dissociated member"[316] or "transferee."[317] The member's or dissociated member's very broad rights are discussed in the next subsection. A transferee of an interest in a term LLC can sue for dissolution at any time in an at-will LLC, and after the expiration of the term of a term LLC merely by showing that this is "equitable."[318] As broad as this ground is, the comment says that a transferee who is a dissociated member's successor has the even broader rights of a member.[319] The black letter does not so provide, and indeed indicates the contrary by referring to a "dissociated member" without mentioning "successors."[320] Some statutes explicitly provide that the successor is an assignee.[321] This should be the result under all statutes.[322] Otherwise, members would be forced to share management rights with new parties, contrary to the default rule in all LLC statutes providing new members

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315. *See* N.M. STAT. ANN. § 53-19-39 (Michie Supp. 1994); N.Y. LTD. LIAB. CO. LAW § 102(o) (McKinney Supp. 1995); S.C. CODE ANN. § 33-43-901(C) (Supp. 1995); VA. CODE ANN. § 13.1-1046(3) (Michie 1993 & Supp. 1995).

316. ULLCA § 801(b)(5).

317. *Id*. § 801(b)(6).

318. *See id*. § 801(b)(6)(i).

319. *Id*. § 801 cmt.; *see also id*. § 601 cmt.

320. *See infra* text accompanying notes 323–25.

321. *See* ALASKA STAT. § 10.50.385 (Supp. 1994); ARK. CODE ANN. § 4-32-707 (Michie Supp. 1993); COLO. REV. STAT. ANN. § 7-80-704 (West Supp. 1994); GA. CODE ANN. § 14-11-506 (1994); IDAHO CODE § 53-639 (1994); KY. REV. STAT. ANN. § 275.299 (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. § 12:1333 (West 1994); ME. REV. STAT. ANN. tit. 31, § 688 (West Supp. 1994); MO. ANN. STAT. § 347.117(1) (Vernon Supp. 1994); N.M. STAT. ANN. § 53-19-33(A) (Michie Supp. 1994); WASH. REV. CODE § 25.15.250(3)(b) (West Supp. 1995); WIS. STAT. ANN. § 183.0704(2) (West Supp. 1994). Other statutes include language similar to that in RUPA section 705 which provides that the executor or other successor may exercise all of the member's rights for the purpose of settling the member's estate but does not explicitly provide for transfer of financial rights or that the estate is an assignee. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 7-40 (tabulating statutes).

322. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 7.09.

can be admitted only upon member consent.[323] Moreover, the estate or other successor cannot be viewed as merely a continuation of the member's interest, since ULLCA provides that a member's death causes dissociation,[324] and that an event of dissociation terminates a member's power to participate in management except in winding up the LLC.[325]

The commentary on successor's rights apparently was part of the flurry of activity in response to the IRS' late-December rule that non-dissolution on dissociation of a member from a manager-managed LLC does not amount to corporate-type continuity of life for purposes of seeking a private ruling.[326] In catching up to the tax law, the drafters suddenly created a potential glitch for successors. Prior to the change, in the absence of contrary agreement, death caused dissolution and winding up.[327] After the change, death does not always cause dissolution, which means that the estate of a non-managing member who dies during an unexpired term would not be entitled to be paid until after expiration of the term.[328] Thus, the estate would be trapped in the firm, at the mercy of the other members and seemingly without even a dissociated member's right to sue for judicial dissolution during this period.[329] These consequences resulted from the spiraling complexity of trying to compromise the general transaction-cost need for continuity and the tax need for dissolution by providing limited exceptions for term and manager-managed LLCs. The drafters at least should have explicitly empowered the successor to sue for judicial dissolution rather than attempting to change the law through commentary.

4. When May a Member Apply for Judicial Dissolution?

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323. *See, e.g.*, ULLCA §§ 404(c)(7) (requiring unanimous member consent to admission of new member); 503(a) (requiring member consent to transfer of management rights); *see also* RIBSTEIN & KEATINGE, *supra* note 11, § 7.04.

324. ULLCA § 601(8)(i).

325. *Id*. §§ 603(b)(1), 803(c). Indeed, it follows from this analysis that a dissociated member also should be viewed as no more than a transferee who should not have broad dissolution rights.

326. Rev. Proc. 95-10, 1995-3 I.R.B. 20; *see supra* text accompanying note 303.

327. ULLCA §§ 601(7)(i), 801(3) (January 20, 1995 draft).

328. *See* ULLCA § 701(a)(2) (LLC must purchase interest at value at end of specified term).

329. *See id*. § 801(b)(5). Note that, even if death does cause a dissolution, a successor apparently would have no right to compel dissolution under *id*. § 801(b)(5)(iv) if the company failed to complete a buyout.

ULLCA provides for circumstances which justify a judicial decree of dissolution.[330] Some of these circumstances are discussed below. Subsection 801(b) provides for dissolution when "the economic purpose of the company is likely to be unreasonably frustrated."[331] The drafters explain that a "court has the discretion to dissolve a company under subsection (b)(5)(i) when the company has a very poor financial record that is not likely to improve. In this instance, dissolution is an alternative to placing the company in bankruptcy."[332] But an internal remedy for the members is not an "alternative" to administering the firm's debts in bankruptcy, and bankruptcy has nothing to do with a solvent firm that is able to pay its debts but whose "purpose" is "frustrated." Although the drafters think the section applies only to a company with "a very poor financial record," the black letter does not say this. Disappointed members may claim that the "economic purpose" of an otherwise viable firm has been or probably will be "frustrated." The other members may oppose dissolution by arguing that the firm may be "frustrated," but not "unreasonably" so. The analogous provision in the UPA for judicial dissolution if the "[t]he business of the partnership can only be carried on at a loss,"[333] more clearly focuses on poor finances and is at least minimally justified in a context in which partners are personally liable for these losses.

The most troublesome ground for judicial dissolution is that which provides for dissolution when "the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent or unfairly prejudicial to the petitioner."[334] This ground brings into the LLC the whole unsatisfactory body of "oppression" law from close corporations. These open-ended remedies give courts wide latitude to rewrite operating agreements to give members exit remedies and other rights they were never intended to have.[335] Indeed, one of the most important

330. *Id*. § 801(b)(5).

331. *Id*. § 801(b)(5)(i).

332. *Id*. § 801 cmt.

333. UPA § 32(e); *see* BROMBERG & RIBSTEIN, *supra* note 68, § 7.06(d).

334. ULLCA § 801(b)(5)(v).

335. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs,* 38 STAN. L. REV. 271 (1986); Dale A. Oesterle, *LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, U. COLO. L. REV. (forthcoming 1995) (manuscript on file with author).

characteristics of the LLC form is that, unlike the more awkward close corporation form, LLC statutes make such remedies unnecessary by giving members a default right to dissolve or have their interests purchased at fair value,[336] ameliorating the problems the close corporation oppression remedies were intended to address.[337] This remedy is particularly unnecessary when combined with the additional ground of dissolution where "it is not otherwise reasonably practicable to carry on the company's business in conformity with the articles of organization and the operating agreement"[338] (which is the sole ground provided for limited partnerships[339]), the members' power to veto major decisions,[340] and the members' and managers' basic fiduciary duties.[341] Finally, it is important to keep in mind that these causes apply irrespective of contrary provisions in the operating agreement — that is, even if the parties explicitly have agreed that the firm should continue for a certain time or until a certain event.[342]

5. When Does a "Term" LLC Dissolve?

A term LLC may be continued as an at-will company after expiration of a specified term, including by members' or managers' continuation of the business without any winding up.[343] Unfortunately, ULLCA nowhere provides that a term LLC dissolves on expiration of its term if it is not continued. In fact, a provision to that effect[344] was deleted from later drafts. Although the comments to section 411 say that a term LLC "will generally dissolve upon expiration of its

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336. ULLCA §§ 602, 603, 701. One writer argues that judicial oppression remedies are necessary even under such LLC statutes because the parties may draft around the default put without adequately planning for oppression scenarios. *See* Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 466–74 (1995). But applying an oppression remedy in this situation is even more likely to frustrate the parties' expectations than where the oppression remedy merely operates against the background of default corporate rules.

337. *See* Ribstein, *supra* note 269.

338. ULLCA § 801(b)(5)(iii).

339. RULPA § 802. It is not clear the extent to which this cause supplements the UPA causes. *See* Ribstein, *supra* note 80.

340. ULLCA § 404(c).

341. *Id.* § 409.

342. *Id.* § 103(b)(6).

343. *Id.* § 411.

344. ULLCA § 801(7) (January 20, 1995 draft).

term," this is contradicted by the black letter of the dissolution section which not only fails to include expiration of the term as a dissolution cause, but also provides that a transferee of a member's interest may apply for a judicial dissolution after the expiration of the term.[345] On the other hand, ULLCA provides for dissolution on "an event specified in the operating agreement,"[346] which may or may not include the expiration of an agreed term or undertaking.

Assuming that a term LLC does generally dissolve on expiration of its term, the members could provide in the operating agreement for a continuation after expiration, in which case the term specified in the articles would be, in effect, a minimum rather than a maximum. This raises several additional questions. First, it is not clear when the operating agreement will override the articles as to third parties.[347]

Second, it may not be clear when the operating agreement has been amended to permit continuation. If a term LLC is continued after expiration of the term, including by continuation of the LLC's business by members or managers (depending on whether the LLC is manager-managed), the LLC becomes at will.[348] That provision leaves some doubt about what vote is necessary for continuation. The comments assert that continuation is an ordinary business matter which can be decided by a simple majority vote.[349] The same comment also says that a continuation after expiration of the term in effect amends the operating agreement to provide for continuation as an at-will LLC.[350] Yet if this is an amendment, it would seem to require a unanimous vote.[351] Unanimity is also required for continuation after dissolution[352] which, as discussed above,[353] may or may not occur on expiration of the term.

The confusion confronting a term LLC may be particularly hard on informal LLCs which provide for a term in order to have conti-

345. ULLCA § 801(b)(6)(i).

346. *Id.* § 801(b)(1).

347. *See id*. §§ 103(b)(7) (operating agreement does not restrict rights of third parties); 203(c)(2) (articles rather than inconsistent operating agreement controls as to third parties who rely on articles to their detriment).

348. *Id*. § 411(b).

349. *Id*. § 411 cmt.

350. *Id.*

351. *See id*. § 404(c)(1).

352. *Id*. § 802(b).

353. *See supra* text accompanying notes 344–46.

nuity, only to find that the term actually causes dissolution.

All of these problems would disappear if the ULLCA simply did not provide for term LLCs. The drafters obviously inserted the term as a compromise that ameliorates the effect of dissolution at will. From a policy standpoint, the default rule should not provide for dissolution at will in any situation.[354] If dissolution at will is deemed to be necessary to preserve partnership-like non-continuity for tax purposes, then the Act should eliminate the intolerable confusion discussed in this subsection and provide for a simple default rule of dissolution at will.

Section 802: Continuation of LLC After Dissolution

ULLCA permits the members unanimously to agree to continue the LLC before completing winding up.[355] Even the dissociating member must consent to the continuation, and the waiver of dissolution does not affect the rights of creditors who relied on the dissolution or a member's post-dissolution authority.[356] In effect, then, dissolution alters the firm's internal and external contracts, and this alteration can be reversed only through adequate consent by members and notice to third parties. Since the section provides adequate safeguards for dissociating members and creditors affected by the dissolution, it does not raise serious policy issues.[357] However, the usefulness of the section is seriously impaired by the notice and consent requirements: the validity of the continuation is threatened by any member who claims oral dissent from the continuation or any creditor who relied on the dissolution. Accordingly, the members who wish to continue might be better off forming a new business association rather than using the odd procedure provided for in this section.

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354. *See supra* text accompanying notes 295–99.

355. ULLCA § 802(b).

356. *Id*.

357. For criticism of a version of RUPA section 802, on which ULLCA section 802 is based, which originally did not adequately protect dissociating members or third parties who might be injured by the waiver, see Ribstein, *supra* note 20, at 72.

Section 804: Member's or Manager's Power and Liability as Agent After Dissolution

An LLC is bound by acts after dissolution that are appropriate for winding up or "would have bound the company under Section 301 before dissolution, if the other party to the transaction did not have notice of the dissolution."[358] It is unclear when a third party will be deemed to have notice of dissolution. ULLCA provides that one has notice when he "(1) knows of the fact; (2) has received a notification of the fact; or (3) has reason to know the fact exists from all of the facts known to the person at the time in question."[359] Among other possible questions is whether a third party has "notice" of dissolution after the expiration of a term specified in the articles.[360] Although ULLCA section 804 is based on RUPA,[361] RUPA at least permits the filing of a notice of dissolution which clarifies the termination of pre-dissolution partner authority.[362] It is odd that ULLCA did not follow RUPA in this as it did in so many other respects.

Section 805: Articles of Termination

This section permits an LLC to file "articles of termination"[363] and provides that upon filing "[t]he existence of a limited liability company is terminated."[364] However, the section does not provide for the effect of the filing or for consequences of failing to file. As to the consequences of filing, the comment to this section goes beyond the black letter in saying that "[t]he termination of legal existence also terminates the company's liability shield" as well as the obligation to file annual reports.[365] Even if the comment controls, it is not clear what "terminates the company's liability shield" means. Presumably the members retain limited liability for pre-termination debts.

Section 902: Conversion

358. ULLCA § 804(a)(2).
359. *Id*. § 102(b).
360. *See supra* note 132.
361. *See* RUPA § 804.
362. *Id*. § 805.
363. ULLCA § 805(a).
364. *Id*. § 805(b).
365. *Id*. § 805 cmt.

Article 9 provides for conversions and mergers of LLCs.[366] To the extent that this article permits mergers with and conversions into entities other than LLCs, it creates potential conflicts with the statutes that provide for those entities. For example, conversion must be approved by all of the partners, which term includes limited partners,[367] or by the vote required in the partnership agreement.[368] Suppose in a limited partnership/LLC conversion that the limited partnership statute and agreement are silent on conversion, and that neither the statute nor the agreement require a vote by the limited partners.[369] Is a conversion approved only by general partners valid? If the limited partnership agreement controls limited partner voting rights, why should not the default agreement provided by the limited partnership statute, which gives no voting rights, also control?

Section 903: Effect of Conversion

Section 903 provides that a converted LLC is the "same entity" as prior to the conversion.[370] It then specifies effects of the conversion, including vesting of property, debts and rights in the LLC.[371] It is not clear what "same entity" means other than the effects specified in subsection (b). For example, does it mean that a landlord who contracted with a general partnership must now accept a limited liability business association as a tenant? If so, the statute questionably effects a retroactive change in existing contracts.[372]

Section 904: Merger

366. *Id*. §§ 901–907.

367. *Id*. § 901(5).

368. *Id*. § 902(b).

369. RULPA section 302 provides that the partnership agreement may grant voting rights to limited partners.

370. ULLCA § 903(a).

371. *Id*. § 903(b).

372. Although the original general partners will continue to be personally liable, this provision may mean that new members, who might have been personally liable as partners for post-admission lease payments under UPA §§ 15 and 17, will have limited liability as LLC members.

Section 904 provides for mergers of LLCs with LLCs and other business entities.

1. Purpose and Effect of "Plan" Requirement

The merger must be "[p]ursuant to a plan"[373] with specified requirements.[374] This is needless and confusing. It is not clear what the effect is of a plan-less merger in an informal firm — precisely the sort of firm for which the Act in general and these provisions in particular are most necessary. Moreover, since the plan may be oral, it may be unclear whether there is a plan or what it says. Consequently, the requirement of a plan does little to reduce litigation over merger terms. Rather, it only adds something to litigate about — that is, the existence of a statutory "plan." Finally, the members may agree to dispense with the plan.[375] Does actually dispensing with a plan constitute an oral operating agreement not to require a plan?

2. Application of Other Statutes

As with the conversion provisions,[376] the merger provisions create possible conflicts with other statutes. For example, ULLCA requires the same vote by a limited partnership as is required for a conversion,[377] and therefore creates the same potential conflict discussed above[378] with the limited partnership voting requirements.

Section 905: Articles of Merger

ULLCA provides for articles of merger,[379] upon the filing of which the merger is effective.[380] The section does not specify the effect of failing to file the articles. There is no apparent reason why the merger should not be effective at least among the members according to the terms of a final merger plan. Moreover, the non-exclu-

373. *Id*. § 904(a).
374. *Id*. § 904(b).
375. *See id*. § 103(b) (not listing this provision as one of those which cannot be waived in the operating agreement).
376. *See supra* text accompanying notes 366–69.
377. ULLCA § 904(c)(3).
378. *See supra* text accompanying notes 366–69.
379. ULLCA § 905.
380. *Id*. § 904(e).

sivity provision suggests that the agreement may be effective even as to third parties without filing.[381]

Section 906: Effect of Merger

Section 906 provides that a merger terminates the "separate existence" of LLCs and other non-surviving parties to the merger.[382] It then lists specific effects of the merger, including those on property, rights and liabilities. It is not clear what the overall termination of "separate existence" means apart from the specific listed effects or whether termination of "separate existence" in this section means something different from saying that a firm which converts "is for all purposes the same entity" as before the conversion.[383]

Section 907: Nonexclusive

Section 907 provides that "[t]his [article] does not preclude an entity from being converted or merged under other law."[384] Under this provision, the Act provides a "safe harbor" for mergers and conversions.[385] Unfortunately, it is not clear whether "other law" means (1) the law of other states; (2) the law relating to other business entities; (3) the law of the parties' contracts; (4) common as opposed to statutory law; (5) all of the above; or (6) none of the above.

Assuming this section has the broadest meaning, it raises a question concerning the effect of the merger and conversion provisions. Why comply with the Act if the merger is effective even without compliance? Conversely, a court may conclude that Article 9 does have some function, and may therefore invalidate noncomplying mergers or conversions despite section 907, even if the transactions might have been effective without Article 9.

Sections 1001–1009: Foreign Limited Liability Companies

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381. *Id*. § 907, discussed *infra* at notes 384–85 (questioning effect of merger relative to all other law).

382. ULLCA § 906(a)(1).

383. *Id*. § 903(a), discussed *supra* at notes 370–72.

384. *Id*. § 907.

385. The comment to section 904 so characterizes the merger provision.

Article 10 provides for certificates of authority[386] and application of formation-state law of foreign limited liability companies.[387] There are similar provisions in many other LLC statutes.[388] Thus, while this Article does not present any policy problems, it also does not provide any benefits in facilitating uniformity or providing a model law.

Sections 1101–1104: Derivative Actions

Article 11 provides for derivative actions by LLC members in the right of the firm.[389] These provisions, although similar to those in RULPA,[390] raise several questions in LLC statutes.

1. Relation with Member's Individual Action

Members' individual rights to sue are broadly defined under ULLCA.[391] The separate derivative remedy may give rise to litigation over whether members are suing individually or derivatively.[392]

2. Critique of Derivative Remedy

Apart from the potential confusion with the member's individual remedy, an important basic issue is whether LLC members should have a derivative remedy. The derivative remedy involves very substantial litigation costs which often exceed the benefit of the action to anyone other than lawyers.[393] In light of these costs, litigation within the firm should be considered an extraordinary action which should be evaluated by managers and members generally

386. ULLCA § 1002.

387. *Id*. § 1001. "Foreign limited liability company" is defined as "an unincorporated entity organized under laws other than the laws of this State, which afford limited liability to its owners comparable to the liability under section 303 and is not required to obtain a certificate of authority to transact business under any law of this State other than this [Act]." *Id*. at § 101(8).

388. More than one-third of the states have similar provisions. *See* RIBSTEIN & KEATINGE, *supra* note 11, at 13-28 to -29 (table of state provisions).

389. ULLCA §§ 1101–1104.

390. *See* RULPA §§ 1001–1004.

391. ULLCA § 410.

392. *See supra* text accompanying notes 240–44 (discussing ULLCA § 410).

393. *See generally* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271–74 (1986).

rather than left to the discretion of a lone disgruntled member. A derivative remedy might make some sense in a public corporation since even seemingly disinterested managers may sympathize with defendants[394] and requiring a shareholder to obtain authority from the other shareholders would be burdensome. Also, in a limited partnership it may make sense not to require members to seek authority from limited partners who are completely isolated from management power and information.

But, unlike these other types of firms, in the sort of small, informal LLC for which the act should be designed, a default derivative remedy is clearly a mistake.[395] In an LLC, there is no concern about leaving members to the mercy of hostile board members since they can seek authority directly from the members. As long as the suit cannot be blocked by *interested* members or managers, fiduciary duty suits on behalf of the firm should be authorized by the members, who are in the best position to make the critical cost-benefit analysis. In short, individual members should not be able to litigate on behalf of the firm if authorized members or managers have refused to sue or if "an effort to cause [authorized] members or managers to commence the action is not likely to succeed."[396]

Even if requiring authority for suits on behalf of the firm might leave some fiduciary breaches unremedied or undeterred, it is important to evaluate the need for the derivative remedy in the light of members' other means of self-protection. As discussed in subsection 1, LLC members are likely to be able to characterize their claims as direct rather than derivative.[397] Moreover, unless otherwise agreed, disgruntled members have the power to dissociate at will and be paid a judicially-determined value of their interest in the firm,[398] rather than merely the minority-discounted share price that an exiting corporate shareholder can obtain. LLC members also have veto and removal powers that corporate shareholders generally do not have.[399]

Finally, even if individual members should be able to sue for

394. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981) (noting possible "there but for the grace of God go I" attitude of members and directors).

395. *See* RIBSTEIN & KEATINGE, *supra* note 11, § 10.03.

396. ULLCA § 1101.

397. ULLCA section 410 creates an individual cause of action against the LLC.

398. *See id.* §§ 603, 701.

399. *See* ULLCA § 404.

injuries to the firm without seeking authority from other members or managers, it is not clear that they should have a *derivative* remedy. A derivative remedy puts the recovery back in the firm, and therefore back in control of managers who, by hypothesis, cannot be trusted with it. Members in closely held firms cannot "cash in" the award simply by selling their stock as can corporate shareholders.[400] Additionally, courts can easily award direct recovery to the very LLC members who were injured by the breach because LLC membership does not rapidly change in highly liquid markets. Consistent with these principles, the American Law Institute's *Principles of Corporate Governance*[401] provide that in closely held corporations courts may treat derivative claims as direct actions in certain circumstances.[402] It is ironic that the LLC Act should move toward a corporate-type derivative remedy just as close corporation law moves in the opposite direction.

For all of these reasons, the limited-partnership-type derivative remedy is unsuited for LLCs. A much better alternative is the Prototype Act provision for suit on behalf of the firm by one or more members of any LLC, or by managers of a manager-managed LLC, if authorized by a majority of disinterested members or managers.[403]

3. Waiver

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400. *See* Crosby v. Beam, 548 N.E.2d 217, 220 (Ohio 1989) (citing the latter problem in allowing a claim for unreasonable salaries in a close corporation to be brought directly). Members have a default power to exit the firm. ULLCA § 602. However, if this power is not enough to make a litigation remedy unnecessary, then it follows that it should not be enough to protect the members from managers' misuse of a derivative judgment.

401. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994).

402. The A.L.I. states that

> [i]n the case of a closely held corporation . . . the court in its discretion may treat an action raising derivative claims as a direct action, . . . if it finds that to do so will not (i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recover among all interested persons.

2 *id*. § 7.01(d); *see* Richards v. Bryan, 879 P.2d 638, 648 (Kan. Ct. App. 1994) (applying this rule to permit a direct suit on an otherwise derivative-type claim).

403. PROTOTYPE ACT, *supra* note 49, § 1102.

ULLCA does not list the provisions relating to the derivative remedy as non-waivable.[404] This strongly implies that the members ought to be able to contract around the derivative remedy.[405] This is the right result, since even if the statute should provide by default for a derivative remedy, members surely should be able to contract out of the remedy, particularly given the serious questions concerning its suitability for LLCs. However, making the derivative remedy a default rule is no answer for the closely held firms for which ULLCA should be designed. The derivative remedy, which assumes that members are isolated and powerless, is particularly poorly suited for such closely held firms. At the same time, such firms are unlikely to contract in detail regarding remedies.

V. CONCLUSION

Variety among LLC statutes is not a problem. Rather, evolution of LLC law is the answer to the question of what this new business form should be. Thus, there was no problem for ULLCA to solve. The perfect statute is beyond the capability of any drafters. It is time to abandon the mirage of central planning in creating law for business associations.

Moreover, ULLCA is not even a suitable model for future LLC legislation.[406] ULLCA makes many poor policy choices, including terms that are unsuited for informal firms, unnecessary mandatory rules, and rules that are inappropriately borrowed from other business forms. The drafting is often convoluted, complex and otherwise inept. ULLCA is best suited for lawyers, since it creates a strong need for sophisticated customized agreements that avoid the statutory defaults, and for skillful litigators when the inevitable disputes arise. Among ULLCA's more serious problems are the following: (1) Unclear definition of operating agreement; (2) excessive and unclear restrictions on the extent to which the operating agreement can waive the provisions of the act; (3) unclear provisions on the

404. ULLCA § 103(b).

405. ULLCA raises a question whether waiver will be enforced by providing that the operating agreement may not "eliminate" the duty of loyalty or "unreasonably reduce" the duty of care. *Id.* § 103(b)(2), (3). It is not clear whether agreements eliminating remedies for fiduciary breach would come within these prohibitions.

406. NCCUSL may have botched the job precisely because it was trying to write a uniform law. *See Model Laws, supra* note 32.

effect of the articles of organization; (4) unduly broad agency power to transfer real property; (5) questionable provision for contracting for personal liability; (6) unnecessary and perverse creditor-protection restrictions on distributions and compromise of contribution obligations; (7) questionable default veto power of members even in manager-managed firms; (8) unwieldy default duties to provide information to members; (9) confusing and overbroad fiduciary duties; (10) overbroad grounds for judicial dissolution; (11) confusion concerning effect of providing for a term; (12) wholly unworkable provisions on dissolution; and (13) unnecessary and perverse derivative remedy.

One point should be clear: no state should rush to scrap its current law to adopt this one. This conclusion is shared by an American Bar Association committee that studied the Act. Based on an Advisors' Report that had many criticisms of ULLCA, including several that are also discussed in this Article,[407] the committee was able to make only the following lukewarm recommendation:

> BE IT RESOLVED, That the American Bar Association approves the Uniform Limited Liability Company Act (1994) promulgated in 1994 by the National Conference of Commissioners on Uniform State Laws as an appropriate Act for those states desiring to adopt the substantive Law suggested therein.
> This recommendation is made with the qualification that (i) such approval is not an endorsement of all of the provisions of the ULLCA and (ii) the ULLCA should not be adopted by a state without careful review. It is further understood and agreed that the Advisors' Report on the Uniform Limited Liability Company Act submitted on March 13, 1995 shall be attached to and become part of this resolution.[408]

407. *See* Robert R. Keatinge & James W. Reynolds, Committee on Partnerships and Unincorporated Business Organizations of the Business Law Section of the American Bar Association, Advisors' Report on the Uniform Limited Liability Company Act (March 13, 1995) [hereinafter Advisors' Report]. Like this Article, the Report criticized, among other things, ULLCA's mandatory fiduciary duties and unwieldy dissociation and dissolution provisions, including the term/at-will distinction. The Report did say that "ULLCA represents an improvement over most existing LLC statutes . . . ." *Id*. at 1. This statement is neither supported by the text of the Report nor endorsed by this Article.

408. Resolution Adopted by the Partnership and Unincorporated Business Organization Committee (March 24, 1995).

In undertaking the "careful review" suggested in the above resolution, state legislatures should take into account the fact that there is nothing in ULLCA that is worth copying that is not already in many other state statutes or the Prototype. Moreover, as detailed in the Advisors' Report, ULLCA has gone through many rapid-fire changes that have precluded thorough scrutiny of the Act by the general legal community.[409] Thus, even a legislature that endorsed the general idea of uniformity and that "desir[ed] to adopt the substantive law suggested" in ULLCA should be very reluctant to adopt all of the current version of ULLCA. Since NCCUSL discourages partial adoption of its proposals, the states face an all-or-nothing choice. Clearly, in a choice between their way or the highway, it is best to hit the road.

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409. *See* Advisors' Report, *supra* note 407, at 2.