

TUESDAY, MARCH 17, 2020

PERSPECTIVE

Does a non-managing member of an LLC owe a fiduciary duty to the other members?

By Bruce Isaacs

A typical situation which often finds its way into mediation: (1) two or more “partners” form a business venture together; (2) rather than form the venture as a general partnership or a corporation, they form the business as a limited liability company under California law; (3) the venture does not succeed; (4) the members can no longer get along and distrust each other; (5) the members point fingers at each other, accusing each of various breaches of fiduciary duty; and (6) the members ultimately attend a mediation so they can effectuate a business divorce and get out of each other’s lives.

Even though the business venture was formed as an LLC, rather than as a pure partnership, the “partners” (i.e., the members) still owe each other the same fiduciary duties they would owe each other in a partnership context, right? Not necessarily. As explained below, whether or not fiduciary duties arise at all depends upon the structure of the LLC and who, in particular, is designated as the manager(s). Is the LLC designated as a “member-managed” or as a “manager-managed” LLC in the articles of organization? This designation makes a critical difference.

The Controlling Statute: California Corporations Code Section 17704.09

Section 17704.09, which became effective Jan. 1, 2014, and which applies to LLCs formed on or after that date, sets forth what fiduciary duties, if any, are owed in a “member-managed” LLC as compared to

(including the appropriation of any “corporate” opportunity; (2) to not take actions or positions as though the member is adverse to the LLC; and (3) to not compete with the business of the LLC.

This distinction between a member-managed LLC and a manager-managed LLC makes perfect sense. It is extremely common for money investors to join an LLC solely for investment purposes and without any desire to manage the LLC or bring other investment opportunities to it.

a “manager-managed” LLC.

The Member-Managed LLC (where the articles of organization expressly provide that the LLC shall be a “member-managed” LLC)

The statute provides that where the articles of organization designate the members as the managers, a member owes a duty of loyalty and a duty of care to the LLC itself *and* to the other members. The duty of loyalty, however, is limited to some degree. Section 17704.09(b) (1)-(3) expressly states that a member’s duty of loyalty owed to the LLC itself and to the other members is limited, insofar as the conduct or the winding up of the LLC is concerned, to the following: (1) to account (properly) to the LLC and to hold, as a trustee for the LLC, and for the benefit of the LLC, any property, profit or benefit

In exercising these statutory fiduciary duties owed to the LLC itself and to the other members, the member-manager must likewise uphold the duty of good faith and fair dealing. The statute also provides that a member does not violate their fiduciary duties, whether established by the statute or by the controlling operating agreement, just because the member’s conduct “furthers the member’s own interest.” In short, in a member-managed LLC, the members owe the above-described fiduciary duties to the LLC itself *and* to the other members.

The Manager-Managed LLC (where the articles of organization expressly provide that the LLC shall be a “manager-managed” LLC) Where the articles of organization designate the LLC as a

manager-managed LLC, the fiduciary duty relationships between members change in a major way. As Section 17704.09(f)(1)-(3) provides, if the LLC is designated as a “manager-managed” LLC, **then the manager, whether a member of the LLC or an outside employee non-member, has all of the fiduciary duties described above, but a mere member who, by definition, is not a part of the management of the LLC, has no fiduciary duties at all.** Although a non-managing member must still act in accordance with the duty of good faith and fair dealing, a member does not have *any* fiduciary duty to the LLC or to any other member solely by reason of being a member. Thus, if the LLC is designated as a manager-managed LLC, then a member has no fiduciary duties at all — and a claim for breach of fiduciary duty by a member against a non-managing member will not lie and will provide essentially no leverage at a mediation.

This distinction between a member-managed LLC and a manager-managed LLC makes perfect sense. It is extremely common for money investors to join an LLC solely for investment purposes and without any desire to manage the LLC or bring other investment opportunities to it. For example, an investor may contribute financing to a particular film project,

formed as a standalone LLC, but the passive investor doesn't want to manage the project or to share other film financing opportunities. The member's failure to do so cannot be, and should not be, a breach of fiduciary duty. This is true so long as the LLC was designated as a manager-managed LLC in the articles of organization. If, however, the LLC was inadvertently designated as a member-managed LLC, then all of the members would indeed owe the above fiduciary duties to the others (and, in such an instance, this would mean that all of the owners would be de facto managers of the LLC as well).

In sum, the statute creates two different frameworks for when the fiduciary duties arise. If member-managed, then the fiduciary duties attach. If manager-managed, then the fiduciary duties do not attach at all as to the members of the LLC (except for the duty of good faith and fair dealing as set forth in Section 17704.09(d)), but the fiduciary duties do attach as to the managers of the LLC.

Some of the Case Law Construing California Corporations Code Section 17704.09

In *Left Coast Wrestling, LLC v. Dearborn International LLC*, the LLC Left Coast had an idea for a wrestling tournament where the finals would take place on the battleship The Midway, anchored in San Diego.

The LLC promoted the wrestling tournament by making use of a slogan/trademark called the "Battle of the Midway," a slogan/mark which the LLC alleged was a protectable common law trademark. The defendant allegedly stole the idea and appropriated the common law trademark. The LLC sued both the rival LLC and an individual, a Mr. Le, who was once an "active" member in the Left Coast LLC, for various claims including breach of fiduciary duty. The defendants defaulted and upon a motion to enter a default judgment, the district court had to determine whether or not Mr. Le owed a fiduciary duty to the Left Coast LLC and to the other members. The court concluded that Mr. Le did owe a fiduciary duty because the LLC was a member-managed LLC and, therefore, pursuant to Section 17704.09, Le owed a fiduciary duty to his former LLC and its members.

In *Eurolog Packing Group, North America, LLC v. EPG Industries, LLC*, two parties formed an LLC. The plaintiff alleged that his fellow member of the LLC, Grem, breached a fiduciary duty by appropriating the customer list and setting up a competing business. The plaintiff sued for breach of fiduciary duty, among other claims, but the district court ruled that Grem did *not* owe a fiduciary duty because Grem was not a *managing* member pursuant to the operating agreement. The plaintiff then amended

the complaint and alleged that Grem did in fact become a managing member of the LLC, by virtue of a modification of the operating agreement based upon the words and conduct of the parties. Once plaintiff sufficiently alleged that Grem was a managing-member, the court ruled that the breach of fiduciary duty claim could go forward, citing Section 17704.09(f)(1). After this court decision, the parties attended a mediation at which they were able to reach a full and final settlement.

As *Left Coast, Eurolog* and the statute itself make clear, if the LLC is structured as a member-managed LLC, then fiduciary duties arise and, if the LLC is structured as a manager-managed LLC, then the fiduciary duties do not arise as to the members of the LLC, but the fiduciary duties do arise as to the managers of the LLC.

What This All Means for the Purposes of the Mediation of a Business Divorce

Often times, in a business divorce context, one member of an LLC (or both) has asserted a breach of fiduciary duty claim against the other. As demonstrated above, such a tactic may not provide additional leverage, depending upon: (1) whether or not the LLC is structured as a member-managed LLC or a manager-managed LLC; and (2) whether or not the breach of fiduciary duty claim is directed against a mere member or a manager. It is critical

that, at the time of formation, the person organizing the LLC makes sure to designate the LLC as a member-managed LLC or as a manager-managed LLC so as to make sure the client's objectives (about whether or not fiduciary duties attach) are properly addressed. If the LLC is structured as a manager-managed LLC, then the non-managing member accused of wrong-doing has not breached a fiduciary duty and the opposing member will not have this particular leverage at the mediation. Thus, the recognition of the actual existence or non-existence of a breach of fiduciary duty claim is crucial because it helps the parties get past non-viable and non-productive legal arguments and enables them to focus on the more practical solutions. In short, a *realistic* evaluation of the breach of fiduciary duty claims is essential and will facilitate a prompt and meaningful resolution of all of the pending business disputes. ■

Bruce Isaacs is a mediator and arbitrator at Signature Resolution.

