

## **REVISED UNIFORM LIMITED LIABILITY COMPANY ACT - BACKGROUND MEMORANDUM**

House Concurrent Resolution No. 3011 (attached as an [appendix](#)) directs the Legislative Management to study the feasibility and desirability of adopting the Revised Uniform Limited Liability Company Act. In 2006 the National Conference of Commissioners on Uniform State Laws approved and recommended for enactment in all states the Revised Uniform Limited Liability Company Act. This Act revises the original Uniform Limited Liability Company Act, promulgated in 1995 and amended in 1996. The new revision is intended to provide states with modern, updated legislation governing the formation and operation of limited liability companies. A limited liability company is a single business entity that provides limited liability protection for the partners as well as providing all the owners of the business with federal partnership taxation. The Revised Act, which has been endorsed by the American Bar Association and the Real Property, Probate and Trust Law Section of the American Bar Association, has been adopted in the District of Columbia, Iowa, Idaho, Nebraska, Utah, and Wyoming. In 2011 the Revised Act was introduced in California, Kansas, Minnesota, and New Jersey.

### **NORTH DAKOTA LAW RELATING TO LIMITED LIABILITY COMPANIES**

The majority of North Dakota law that relates to limited liability companies has been codified in North Dakota Century Code Chapter 10-32. Numerous other sections of the North Dakota Century Code are directly or indirectly affected by or related to this chapter.

The North Dakota Limited Liability Company Act, which was enacted in 1993, was patterned after the Minnesota Limited Liability Company Act and was prepared by a drafting committee that consisted of representatives from the State Bar Association of North Dakota, the Certified Public Accountant Society, the North Dakota Tax Department, and the North Dakota Secretary of State's office. Various amendments and additions have been made to the Act during every legislative session since enactment in 1993. The Secretary of State, in his testimony in support of 2011 House Concurrent Resolution No. 3011, indicated that as of January 2011 there were 14,503 limited liability companies registered with the Secretary of State, including 9,205 general limited liability companies; 134 professional limited liability companies; 175 farm limited liability companies; 4,949 foreign limited liability companies; 32 foreign professional limited liability companies; and 8 nonprofit limited liability companies.

Section 10-32-02 defines a limited liability company as a "limited liability company, other than a

foreign limited liability company, organized under or governed by this chapter excluding a nonprofit limited liability company organized under or governed by chapter 10-36." This chapter also provides for the governance of a limited liability company.

### **Articles of Organization**

Chapter 10-32 provides that the primary instruments that govern a limited liability company are the articles of organization, the bylaws or operating agreement, and the member-control agreement.

The articles of organization must be filed with the Secretary of State to obtain the benefit of limited liability. Section 10-32-08 provides that if the Secretary of State finds that the articles conform to state law and the fees have been paid, the Secretary of State is required to issue a certificate of organization. Section 10-32-09 provides that the issuance of this certificate begins the limited liability company's official existence. Section 10-32-07 specifies that certain provisions must be contained within the articles of organization. These provisions include the name of the company, the address of the registered office, the address of the registered office and the name of its registered agent, the name and address of all organizers, the effective date of the organization, and a statement stating in years the period of existence of the limited liability company, if other than perpetual. Section 10-32-67 provides that if the first board of governors is not named in the articles of organization, the organizers may elect the first board of governors. Section 10-32-72 provides that the governors' terms, unless otherwise provided in the articles or operating agreement, last until the next regular meeting of the members, but must not exceed five years. Section 10-32-07(2) provides that certain provisions govern a limited liability company unless modified by the articles of organization. Thus, in addition to the above-required provision, the articles may also contain sections that modify default rules of the Act. This subsection also provides that these default provisions govern unless they are modified in the articles of organization.

### **Bylaws or Operating Agreement**

Section 10-32-07(3) sets forth rules that can be in the articles of organization, a member-control agreement, or the bylaws, which may also be known as the operating agreement. Section 10-32-07(4) allows certain optional provisions that, with certain exceptions, may be included in the operating agreement. Section 10-32-68 provides that a limited liability company may have an operating agreement. The operating agreement may contain any provision relating to the management of the business or the

regulation of the affairs of the limited liability company not inconsistent with law or the articles of organization.

### **Member-Control Agreement**

Section 10-32-50 provides for member-control agreements. A member-control agreement is similar to a shareholder agreement in a business corporation. A member-control agreement is meant to control the rights of the members in order to maintain the entity's viability when the members' concerns take different paths. This section states that a member-control agreement relating to any phase or aspect of the business and affairs of a limited liability company is valid and enforceable and may relate to the management of a limited liability company's business; the declaration and payment of distributions; the sharing of profits and losses; the election of governors or managers; the employment of members by the limited liability company; the relations among members and persons who have signed contribution agreements; dissolution, termination, and liquidations of the limited liability company; and arbitration of disputes.

## **REVISED UNIFORM LIMITED LIABILITY COMPANY ACT (2006) SUMMARY**

By the time the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Limited Liability Company Act in 1996, the majority of the states had enacted legislation that provided for limited liability companies. Consequently, by 2006 the 1996 Uniform Act had been enacted in only nine states.

Under the 1996 Uniform Act, a limited liability company has members who primarily contribute capital to the company and who share in the profits or losses. The limited liability company may have managers who do the business of the company. A member may be a manager but nonmember managers are also allowed. If there are no designated managers, members would run the company as general partners in a general partnership. A limited liability company statute has certain key features: a means of creating the company, usually by filing a certificate; a liability shield provision; rules governing the relations between members and between members and any managers; rules governing distributions of profits or losses to members and a member's creditor's rights; rules governing a member's exit rights from the company; rules on dissolution of the company; and rules governing mergers and conversions. A limited liability company usually is governed by an operating agreement that almost always supersedes and overcomes the statutory rules.

The limited liability company originated because of the desire to have a full liability shield while retaining the so-called "passthrough" qualities of a partnership. This means that the company itself pays no federal

income tax, leaving any tax liability to members receiving taxable distributions from the company. Before limited liability companies, full limitation of liability was available only for corporation shareholders. Corporations, however, are taxed as individuals on their income, but shareholders are also taxed on corporate distributions made to them. The ability to obtain passthrough status, then, provided very substantial incentive for states to enact limited liability company statutes. The great wave of statutes preceded the promulgation of the 1996 Uniform Act.

Limited liability companies have other qualities than passthrough status that make them desirable as a business organization. A limited liability company may be tailored specifically to the business or objective of the members because its structure mainly depends upon the agreement between members and managers. This means a kind of flexibility coupled with the liability shield that makes the limited liability company a more efficient kind of organization than the corporation or any of the other unincorporated business organizations for many purposes. The limited liability company kind of structure lends itself to nonprofit organizations, and many states do not require a for-profit reason for organization. The limited liability company form has been adapted to allow a single-member company to be formed. A single person may not form a partnership or limited partnership. Forming a corporation raises the tax issue and the complexities of maintaining a corporation for a single shareholder. A single-member limited liability company resolves these problems and makes it an efficient way for a single individual to have a vicarious liability shield.

Because of the new ideas and developments in the area of limited liability company law since 1996, the Uniform Law Commission reconsidered the 1996 Uniform Act. The result was the 2006 Revised Uniform Limited Liability Company Act.

The issues addressed in the 2006 Uniform Act are issues of formation; relationships between members and managers, if applicable; distributions; disassociation, dissolution, and winding up; foreign limited liability companies; merger and conversion; and actions against a company by members. It is not possible in a short summary to do more than highlight some significant changes. Following are some of the changes made in 2006 over 1996:

1. In the 2006 Act, the operating agreement determines whether a company is manager-managed or member-managed. In the 1996 Act, the kind of management is determined in the certificate of organization. If the agreement is silent, the company is a member-managed company by default. A third-party creditor may seek affirmation of a manager's or a member's authority before doing business with the company and practice indicates does so without checking the official record for the certificate. In addition, certificates of authority may be filed to provide

- notice that only certain members or managers in a company are entitled to do business on behalf of the company.
2. There is no requirement that a company's operating agreement be in writing in either the 1996 or 2006 Act. However, the definitions "record" and "signature" establish that any statute of frauds requirement within the 2006 Act may be satisfied with electronic records and signatures. The 1996 Act does not recognize electronic records or signatures.
  3. A member may not transfer membership in a company unless the operating agreement makes it possible. The only interest that may be transferred is called the "distributional interest" in the 1996 Act and the "transferable interest" in the 2006 Act. In the 2006 Act, a "transferable interest" is generally any right to distributions that a member has under the operating agreement. The operating agreement may impose restrictions on a right to transfer. However, the certificate of organization may provide that a "transferable interest" is freely transferable under the 2006 Act. If it does, the transferable interest may be certificated in the same manner any investment security is and is likely to be a security under Article 8 of the Uniform Commercial Code.
  4. In both the 1996 and the 2006 Acts, members owe a duty of care to each other. The duty in the 1996 Act is to refrain from conduct that is grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. In the 2006 Act, the standard is ordinary care subject to the business judgment rule.
  5. Under both the 1996 and 2006 Acts, the operating agreement governs the relationships between members and members and managers, if any. The 1996 Act, however, provides that the duty of loyalty and the duty of care may not be eliminated in the operating agreement. In the 2006 Act, the operating agreement may eliminate the duty of loyalty or duty of care, provided that elimination is not "manifestly unreasonable." The agreement may not authorize intentional misconduct or knowing violations of law as well.
  6. The 1996 Act does not expressly address the issue of indemnification of members or managers, but the 2006 Act does. The 2006 Act provides for indemnification as a statutory matter, however, the operating agreement may alter the right to indemnification and may limit damages to the company and members for any breach except for breach of the duty of loyalty or for a financial benefit received to which the member or manager is not entitled.
  7. The 1996 Act makes no provision for companies that initially are organized without members. There must be at least one member upon filing the certificate of organization. In the 2006 Act, a member does not necessarily need to be named at least 90 days from the day the certificate is filed. There is a limited ability, therefore, to create what are called "shelf" companies.
  8. The 1996 Act restricts creditors' interests to a member's distributional interest and provides a judgment creditor with a "charging order" as the only method of executing against that interest. The resultant lien may be foreclosed and sold in a judicial foreclosure sale. The 2006 Act further requires a finding--that payment may not be made within a reasonable time--before a court orders foreclosure of the lien. This finding is not required in the 1996 Act. In addition, the 2006 Act makes it clear that a purchase in a foreclosure sale does not make the purchaser a member.
  9. In the 1996 Act, resignation from membership, or dissociation, of a member by express will triggers an obligation to buy the interest of that member in an at-will or term company. Failure to buy may subject the company to a judicial dissolution and winding up of the business. The 2006 Act provides no obligation to buy out a dissociating member nor a ground based upon failure of a buyout for judicial dissolution.
  10. The 1996 Act provides members with the right to file a derivative action on behalf of a company alleging certain kinds of misfeasance on the part of the company by its management. Under the 2006 Act, the company may form a "litigation committee" to investigate claims asserted in a derivative action. This stays the litigation while the committee does its investigation.
  11. The 1996 Act allows no right of direct action against the company on behalf of a member as a plaintiff. The 2006 Act provides for direct action.

### **RECOMMENDATION OF NORTH DAKOTA COMMISSION ON UNIFORM STATE LAWS**

The North Dakota Commission on Uniform State Laws consists of nine members. The primary function of the commission is to represent North Dakota in the National Conference of Commissioners on Uniform State Laws. The national conference consists of approximately 320 uniform law commissioners representing all the states and its purpose is to promote uniformity in state law on all subjects on which uniformity is desirable and practicable and to serve state government by improving state laws for better interstate relationships. Under Sections

54-35-02 and 54-55-04, the state commission may submit its recommendations for enactment of uniform laws or proposed amendments to existing uniform laws to the Legislative Management for its review and recommendation during the interim between legislative sessions.

The Revised Uniform Limited Liability Company Act was among the 2008 recommendations of the North Dakota Commission on Uniform State Laws for introduction in the 2009 legislative session. Before the 2009 legislative session, concerns were expressed by members of the commission and the Secretary of State that the Revised Act should be given a more careful review by the Secretary of State, the State Bar Association of North Dakota, and other interested parties before the Revised Act is introduced for adoption in North Dakota. It was noted that because of the complexity of the Revised Act, it was important to study the Act to ensure that the Revised Act is modified to be consistent with other state practices and procedures. Because of these concerns, it was recommended that a study of the Revised Uniform Limited Liability Company Act be conducted. The study was conducted by the 2009-10 interim Judiciary Committee.

### **PREVIOUS STUDIES**

During the 2009-10 interim, the Legislative Management's interim Judiciary Committee studied the feasibility and desirability of adopting the Revised Uniform Limited Liability Act. The committee received testimony and information from the Secretary of State and the State Bar Association of North Dakota regarding the adoption of the Revised Uniform Limited Liability Company Act. The committee also received information and recommendations from a task force formed by the State Bar Association of North Dakota to conduct an in-depth review of the Revised Uniform Limited Liability Company Act.

Following a review of the Revised Uniform Limited Liability Company Act by the State Bar Association task force, the committee received a report that it was the recommendation of the task force and the Secretary of State to postpone consideration of this Revised Act until the 2013 legislation session. The report cited three reasons for the task force recommendation. First, only four states--Iowa, Idaho, Nebraska, and Wyoming--had enacted the Revised Uniform Limited Liability Company Act. Second, North Dakota's current Limited Liability Company Act, which is a fairly recent enactment, has been regularly updated and is serving the state's citizens well. Finally, Minnesota is currently working on an effort to retain their current Limited Liability Company Act and

is trying to find a way to incorporate aspects of the Revised Uniform Limited Liability Company Act as an alternative available to those entities that may want to utilize it in Minnesota. According to the report, Minnesota's work product and experience with that state's project may be valuable resources for North Dakota to use if consideration is delayed until 2013.

According to the report, the enactment of this legislation is too important to be enacted without careful consideration. The report indicated that one of the controversial elements of the Revised Act is the allowance for a date of creation, which is not the date when the documents were filed with the Secretary of State or on a later specified date. The report indicated there are concerns that this date could actually be a date prior to the filing with the Secretary of State, which could cause a concern for those individuals who rely on the public record and for the filing offices that certify the information. Another concern was that the Revised Act enables the creation of a limited liability company for any purpose whether it is for profit or nonprofit reasons. It was noted that this proposal conflicts with the state's current statutory structure. The report indicated that because of the concerns that the Revised Act has raised in various states, the National Conference of Commissioners on Uniform State Laws considered revisions to the Act during their summer 2010 conference, with final approval of those revisions scheduled during the summer 2011 conference. The interim committee recommended the continuation of the study of the Revised Uniform Limited Liability Company Act during the 2011-12 interim.

### **SUGGESTED STUDY APPROACH**

The committee, in its study of the feasibility and desirability of adopting the Revised Uniform Limited Liability Company Act, may wish to approach this study as follows:

- Receive information from the National Conference of Commissioners on Uniform State Laws regarding the adoption of the Revised Uniform Limited Liability Company Act;
- Seek information and recommendations of the Secretary of State, the State Bar Association of North Dakota, and other interested parties regarding the adoption of the Revised Uniform Limited Liability Company Act; and
- Develop recommendations and prepare legislation necessary to implement the recommendations.

ATTACH:1