

# Fiduciary Duties and Indemnification

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This article explains the provisions of the New Act (A.R.S. §§ 29-3101 to 29-4202) relating to fiduciary duties and rights of indemnification of limited liability companies. The New Act clarifies the duties owed by the managers and members of LLCs, expressly allows limited modifications by agreement, and expressly allows members to elect to apply the rules governing corporate director liability based on fiduciary duty (including the business judgment rule) to LLC managers in lieu of the New Act's default rules on fiduciary duties.[1]

The New Act also provides default rules governing the right of a manager or member to be indemnified by the company against third-party claims.[2] The LLC statute previously in effect (A.R.S. §§ 29-601 to 29-858) (the "Old Act") was silent on both of these topics.

## Fiduciary and Other Duties

For transactional lawyers who draft LLC operating agreements and litigators who help enforce them, fiduciary duties are among the most important issues. A claim of "breach of fiduciary duty" is often raised when disputes arise between LLC managers and members. By including clear default rules, the New Act is designed to increase certainty about those duties and avoid needless litigation caused by inconsistent case law and failure of the Old Act to address this subject.[3]

The New Act confirms that the duties of a member in a member-managed limited liability company are like those of a manager in a manager-managed limited liability company. In addition, the New Act precludes any implied presumption that a member in a manager-managed LLC owes no fiduciary duties, because an operating agreement may confer extensive management rights upon one or more members in such an entity.[4]

The New Act states that members in member-managed LLCs[5] and managers in manager-managed LLCs[6] owe to the company and its members the duty of loyalty and the duty of care, and must discharge the members' duties and obligations and exercise any right consistently with the contractual obligation of good faith and fair dealing.

1. **Duty of Loyalty.** The duty of loyalty includes, but is not limited to, four components:
   (a) to *account* to the company (and hold as trustee) any benefit to which the manager or member is not entitled;
   (b) to *refrain from dealing* with the company "as or on behalf of a *person having an interest adverse* to" the LLC;
   (c) to *refrain from competing* with the company before the company's dissolution (which does not prevent competition after dissolution while the company's affairs are being wound up); and
   (d) to *disclose* to the other members and managers any material conflict of interest with respect to any decision under consideration or any transaction regarding the company or another member's interest in the company. If a material conflict of interest exists, the manager or member must disclose all material facts relating to the decision or transaction under consideration, other than facts already known or reasonably available to the other members and managers. A.R.S. § 29-3409(R) provides guidance on whether a conflict of interest is "material."[7]

   **Example 1:** A manager owns a 20 percent membership interest in a limited liability company and knows a buyer has offered to purchase all the real estate owned by the company. The manager then receives a call from another member of the company seeking to be bought out and offering a price, but that member does not know about the potential buyer. This situation triggers the duty of the manager to disclose the existence of the third-party purchase offer and related facts.

2. **Duty of Care.** The duty of care consists of the requirement to refrain from reckless or grossly negligent conduct or willful or intentional misconduct.[8] This "sets the bar" where the duty of care traditionally has been set in partnership agreements, but the company's operating agreement can raise or lower the

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## KEY ASPECTS OF ARIZONA'S NEW LIMITED LIABILITY COMPANY ACT:

- Based on the Revised Uniform Limited Liability Company Act
- Applies to limited liability companies formed, converted or domesticated on or after Sept. 1, 2019, and all other LLCs on Sept. 1, 2020
- Retains current procedures for formation and filing, mergers, conversions and other entity transactions, rights of creditors, distributions and many other matters
- On certain itemized issues, an operating agreement cannot override the New Act's rules. See A.R.S. § 29-3105.
- Codifies duties of managers and members and indemnification and reimbursement rights
- Clarifies rules regarding member voting and expulsion, information rights, derivative actions, dissolution and registering of foreign "series" companies
- Clients should take this opportunity to review existing operating agreements, particularly provisions on fiduciary duties, in light of the new law, and make appropriate changes.

bar (except that that the bar cannot be lowered below willful or intentional misconduct). Unlike the Revised Uniform Limited Liability Act ("RULLCA"), upon which the New Act was largely based, the duty of care under the New Act does not require refraining from a "knowing violation of law" because that standard does not distinguish between trivial and serious violations and because of inconsistencies among federal and state laws regarding cannabis and other subjects.

3. **Good Faith and Fair Dealing.** The contractual obligation of good faith and fair dealing is implied by contract law in every contract.[9] Under A.R.S. §§ 29-3409(D) and (L), each manager and member must perform his or her duties, and exercise his or her rights, under the New Act and under the operating agreement consistently with the contractual obligation of good faith and fair dealing. This obligation may not be varied or eliminated by the operating agreement. Note, too, that this obligation applies not only to all provisions of written operating agreements, but also to provisions supplied by the "default" rules of the New Act.

4. **Other Provisions of A.R.S. § 29-3409.** All members must join in any authorization (before the fact) or ratification (after the fact) of any act or omission by a manager or member that would otherwise violate the duty of loyalty, and only after the manager or member has disclosed all material facts.[10] This unanimity rule is a default rule. A.R.S. §§ 29-3409(G) and (O) establish a "no harm no foul" rule as a defense for a manager or member who has violated the duty to refrain from acting adverse to the company or has failed to disclose a conflict of interest, to prevent inconsequential violations from being used as a sword against a manager or member. A.R.S. §§ 29-3409(H) and (P) state that a member has the same enforcement rights against the limited liability company as a third party with respect to a transaction or contract that involves a conflict of interest so long as the operating agreement or the other members authorized or ratified the transaction or contract.[11] Lastly, note that other duties may exist under the common law and are not displaced by the New Act.

   **Example 2:** A member makes a secured loan to a limited liability company that has been authorized by the operating agreement or by the other members. That member has the right to enforce his or her remedies against the collateral without having to seek another member authorization.

5. **Limits on Disclaimers and Waivers of Fiduciary Duties.** The New Act prohibits any modification or elimination of the contractual obligation of good faith and fair dealing in whole (*i.e.,* generally) or in part (*i.e.,* as applicable to specified situations), and any lessening of the duty of care below the standard of willful or intentional misconduct. The New Act allows an operating agreement to *specify a method* by which a specific act that would otherwise violate a duty can be authorized or ratified, or a method by which liability for violating such a duty can be eliminated, limited or indemnified against.[12]

   **Example 3:** A limited liability company's operating agreement states that all decisions must be made by a two-thirds vote of the managers. Is this sufficient to "specify a method" by which an act that otherwise violates a duty can be ratified? No. A general provision establishing a minimum threshold of voting power for approval of management or operational decisions is not sufficient to limit or eliminate a member's or manager's liability under A.R.S. § 29-3105(D).

6. **An Alternative: The Corporate Model.** The New Act expressly allows an operating agreement to incorporate the fiduciary duties of a corporate director, officer or shareholder in Arizona and, unless the operating agreement provides otherwise, adopts the rules of evidence and evidentiary presumptions (*i.e.,* the business judgment rule) that apply to the fiduciary duties of a director or shareholder of a corporation under Arizona law.[13]

## *Indemnification and Reimbursement Rights*

The New Act deals comprehensively with the rights of managers and members to be indemnified and reimbursed by a limited liability company and to be advanced defense costs, topics about which the Old Act was silent.

**1. Reimbursement.** A.R.S. § 29-3408(A) requires a company to reimburse a present or former member of a member-managed limited liability company or manager of a manager-managed limited liability company for any payment previously made by the member or manager if:

(a) the payment was made in the course of the member's or manager's activities on behalf of the company;
(b) the payment did not violate the distribution rules under A.R.S. § 29-3405 (as modified by the operating agreement);
(c) the payment did not violate the management authority rules under A.R.S. § 29-3407 (as modified by the operating agreement), such as reimbursement of a payment that was made outside the ordinary course of the company's business or where the members or managers disagreed whether the payment should be made; and
(d) the payment did not violate the member's or the manager's fiduciary duties under A.R.S. § 29-3409 (as modified by the operating agreement), such as payment that involved a conflict of interest on the part of the paying member or manager.

Note that the statute does not entitle a member to reimbursement by a manager-managed limited liability company.

**2. Indemnification.** Under A.R.S. § 29-3408(B), a limited liability company is required to indemnify a member or manager against a claim or demand if:

(a) the claim or liability exists by reason of the person's present or former capacity as a member or manager; and
(b) the claim or liability did not arise out of the person's breach of the operating agreement or of A.R.S. § 29-3405 (distribution rules), A.R.S. § 29-3407 (management rules), or A.R.S. § 29-3409 (fiduciary duties), in each case as modified by the operating agreement.

The drafting committee was concerned about a manager (or a member in a member-managed LLC) who, being accused of wrongdoing, causes the company to indemnify that accused manager (or member or an affiliate), where the members do not agree that the requirements for reimbursement or indemnification have been satisfied. Ultimately, the drafting committee decided that this issue did not require specific statutory

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safeguards in the indemnification section of A.R.S. § 29-3408, because the duty of loyalty to avoid conflicts of interest under A.R.S. § 29-3409 would breached if a manager caused the company to indemnify that manager against his or her own wrongdoing.

**Example 4**: A managing member benefits himself or his affiliate by exploiting an opportunity that should have been afforded the company, and the other members sue him. He causes the company to defend himself against the allegations and, if needed, to indemnify himself against all of his losses in the suit. Absent approval by members or a provision in the operating agreement to the contrary, this is a breach of the duty of loyalty. What if the operating agreement permits the manager or managing member to exculpate himself or herself? A.R.S. § 29-3105 allows the members to agree to this in an operating agreement or to do so after the fact if the members unanimously agree. What if the operating agreement simply disclaims all fiduciary duties, including the duty of loyalty? A.R.S. § 29-3105 does not permit a disclaimer of the duty to avoid "willful or intentional misconduct." In contrast, the operating agreement could permit the manager to cause the company to defend the manager against, for example, a claim of gross negligence.

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3. **Advances.** The New Act permits (but does not require) a limited liability company to advance reasonable defense costs incurred by a person relating to a claim made against the person by reason of the person's present or former capacity as a member or manager.[14] (Note: Unlike RULLCA, the decision to advance expenses should be treated as outside the ordinary course of business and subject to majority in interest vote of the members[15] or majority vote of the managers.[16])

Those in control will commonly cause the LLC to advance their legal fees and other defense costs, even where the claim is that of mismanagement. A person receiving advances must repay the company if it is ultimately determined that the requirements for indemnification were not satisfied.

4. **Reimbursement or Indemnification by Unanimous Member Consent.** A.R.S. § 29-3408(D) clarifies that, if approved by all of the members after disclosure of all material facts, an LLC may reimburse or indemnify a manager

or member with respect to a claim or liability, even if the statutory requirements under A.R.S. § 29-3408(A) and (B) are not met. Note that transferees of an interest in the company have no veto right in this situation unless and until they are admitted as members. Note too that the New Act is silent about indemnification to officers, but the operating agreement can extend indemnification obligations to officers, employees and other persons providing services to or acting for the company.

## Tips for Practitioners

Prior to the effective date of the New Act, practitioners who have undertaken a continuing responsibility for the operating agreements of their clients should ask, "Do the operating agreements address the question of fiduciary duties and indemnification as my client wishes?" If they do not, the next question is, "Will my client be surprised and disagree with the imposition of the default fiduciary duties and default rules of indemnification?" If so, the operating agreements should be amended, in a manner that does not run afoul of A.R.S. § 29-3105, to put in place alternatives to the default provisions.

Remember that a person's practical exposure for breaching any duty involves not only the standard for that duty but also any operating agreement provision that exonerates the person from liability for breach of that duty or that entitles the person to indemnification despite the breach, so those provisions also must be considered.

For limited liability companies that already exist now or prior to Sept. 1, 2019, the deadline for amendments to the operating agreement is Sept. 1, 2020, because on that date the "default" duties and indemnification provisions become effective if not overridden by a preexisting operation agreement. For LLCs that will be formed on or after Sept. 1, 2019, practitioners should be asking these questions of their clients and should be building these questions into their forms or checklists now. Some practitioners have expressed concern on behalf of an LLC having no written operating agreement that its managers or members would be surprised to learn that they have fiduciary duties under the New Act. The drafters of the New Act considered this issue, and it was the consensus that the default fiduciary duties of the New Act (a) represent duties that already exist under case law or would be found to exist by a court that is competently applying relevant principles, and (b) represent commercially reasonable expectations.

**Example 5:** Attorney A advises real estate developer clients who typically permit their managers and members to participate in other real estate developments that could compete for tenants, addressing potential competition by prohibiting it within 10 miles in employment agreements. If included in the operating agreement, this would override the default fiduciary duty of loyalty that would otherwise prevent managers from involvement in all competing real estate developments.

**Example 6:** Attorney B has drafted several operating agreements for a client who operates several businesses, and its owners have never felt obligated to indemnify its managers against claims, but have required its managers to purchase insurance for that purpose. Before the New Act becomes effective for existing limited liability companies in 2020, the operating agreement should be amended to address the default obligations of the company to indemnify its managers.

## endnotes

1. A.R.S. § 29-3409.
2. *Id.* § 29-3408.
3. *Butler Law Firm PLC v. Higgins*, 234 Ariz. 456, 410 P.3d 1223 (Ariz. 2018), illustrates the danger of confusing precedent without statutory guidance. This decision cited misleading *dicta* regarding the duties of members from *TM2008 Invs. Inc. v. Procon Capital Corp.*, 234 Ariz. 421, 323 P.3d 704 (App. 2014), an earlier case acknowledging that the Old Act was silent on fiduciary duties of a member to other members and stressing the importance of looking at the operating agreement rather than wrongly imputing duties in instructions to the jury. The *Butler Law Firm* decision cited an overly broad statement in *Procon* about members' duties ("LLC members do not owe each other fiduciary duties unless they are expressly included in the operating agreement"), a cite that was unnecessary (as members' duties was not at issue in *Butler Law Firm*) and misplaced (given that *Procon* may have involved a manager-managed limited liability company—the case is unclear—and therefore may have been inapplicable to the member-managed limited liability company in *Butler Law Firm)*. The quoted dicta does not survive A.R.S § 29-3409(A)-(H).
4. A.R.S. § 29-3409(Q).
5. *Id.* § 29-3409(A)-(H).
6. *Id.* § 29-3409(I)-(P).
7. This express duty of disclosure does not appear in Section 409 of RULLCA, but was added by the New Act's drafting committee to redress situations where a member actively involved in management could utilize superior knowledge to the disadvantage of passive members.
8. A.R.S. §§ 29-3409(C) and (K).
9. *See* Restatement (Second) Contracts § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement"):
   > "Fair dealing" is … a commitment to deal 'fairly' in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.

   *Gerber v. Enterprise Prods. Holdings LLC*, 67 A.3d 400, 418-19 (Del. 2013) (quoting *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440–42 (Del. Ch. 2012), *aff'd in part, rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013)) (footnotes and citations omitted) (internal quotations omitted without ellipsis by *Gerber*).
10. A.R.S. §§ 29-3409(F) and (N).
11. This subsection is similar to Section 29-608 of the Old Act.
12. A.R.S. §§ 29-3105(D)(3)-(4).
13. *Id.* § 29-3409(E).
14. *Id.* § 29-3408(C).
15. *Id.* § 29-3407(B)(3).
16. *Id.* § 29-3407(C)(3).