NCBA Summary of Senate Bill 439

Summary of Proposed Overhaul of the North Carolina Limited Liability Company Act

1. Affirmation of Contractual Underpinnings of the North Carolina Limited Liability Company Act. The public policy underlying the North Carolina Limited Liability Company Act (the "Act") is stated in G.S. § 57C-10-03(e): "[I]t is the policy of [the Act] to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements." The revisions to the Act are proposed to more clearly, concisely, and effectively achieve and implement that stated public policy objective.

(a) No writing requirement. The revised Act would eliminate all requirements that any part of a North Carolina limited liability company's operating agreement be in writing. The revisions, however, do not go as far as the Delaware Limited Liability Company Act, which makes the "statute of frauds" inapplicable to Delaware limited liability company agreements. Under the revised Act, the operating agreement may be established in the same ways as any contract; i.e., by written, oral, or implied assent among the parties to the contract. As under the current Act, however, the parties may require that all of the components of the operating agreement be in a signed, written document or in any other prescribed form.

(b) Supplemental Nature of the Act. In furtherance of the foregoing, the revised Act would establish that its provisions concerning the internal affairs of North Carolina limited liability companies are intended to apply only if, and to the extent, other provision is not made in the operating agreement. Accordingly, parties are free to modify, waive, and nullify the rules of the Act that would otherwise govern their respective rights and duties. The limited extent to which that freedom of contract is restricted is set forth in Part 3 of Article 2 of the revised Act.

(c) Objective of the Revised Act. The objective of the proposed revisions is to provide certainty and a more detailed framework and structure to allow members of a North Carolina limited liability company to be confident that their management and ownership arrangements will be accommodated by and enforced under the Act. This flexibility is partially achieved through the introduction of certain new defined terms: (a) those relating to the management of the limited liability company: "company officials," (which may but need not be "managers"); (b) those relating to the two different types of owners of limited liability companies: "economic interest owners" (referred to under the current Act as "assignees") and "members," and in reference to either economic interest owners or members or both, "interest owners," and the interest held by either being referred to as an "ownership interest" instead of a "membership interest"; and (c) those relating to the economic interest of an owner: "contribution amount," "capital interest," and "economic interest."

(d) Clarification of Matters that May be Agreed Upon by the Members. In addition to the members being able to require the operating agreement to be in writing or other prescribed form, the revised Act would make it clear that the members' freedom of contract extends to decisions concerning the following matters:

(i) *Management Duties*. The duties of those responsible for the management of the company, including the scope or elimination of fiduciary and

other duties, except nonwaivable contractual duties, including the implied contractual covenant of good faith and fair dealing and the requirement that the terms of the contract not be unconscionable at the time they are made;

(ii) *Exculpation and Indemnification*. The liabilities and other consequences to those managing the company for any breach or failure in the performance of their duties;

(iii) *Penalties*. The imposition of penalties and other remedies for breach of the operating agreement or the occurrence of proscribed events;

(iv) *ADR*. The right of the parties to select the manner in which they are to resolve their disputes, including having such dispute resolution procedures supplant the right to bring derivative actions or actions to cause the company to be judicially dissolved; and

(v) *Information Rights*. The right to establish certain rules and procedures concerning access that owners may have to certain information, while specifying the type of information that can not be denied members who comply with prescribed rules and procedures.

2. Foreign Limited Liability Companies.

The revised Act would harmonize, where appropriate, the rules under the LLC Act with their counterparts under the BCA. One such set of rules where this would be accomplished are those relative to foreign limited liability companies.

3. Clarifying, Modernizing, and Coordinating Provisions of the Act.

The remaining revisions are more in the nature of clarifying (i.e., removing ambiguities), simplifying, and modernizing the Act and coordinating its provisions to accommodate the new concepts and features described above. These revisions include those described in the following non-exhaustive list:

(i) coordinating the terms relating to bankruptcy with the current United States Bankruptcy Code;

(ii) clarifying that the flexibility of the Act accommodates entities and arrangements such as low profit limited liability companies without the need to adopt separate sets of provisions such as those found in G.S. § 57C-2-03;

(iii) providing that organizers may act by majority consent;

(iv) removing the requirement that the articles of organization state whether the LLC is "member-managed" or "manager-managed";

(v) clarifying that an LLC need not have any managers, instead management may be vested in persons having different titles and different powers and duties as may be provided in the operating agreement;

(vi) allowing managers to delegate responsibilities to other persons without the approval by the members unless the operating agreement provides otherwise;

(vii) providing that the term of a limited liability company is presumed to be perpetual unless other provision is made in the operating agreement (instead of in the articles of organization);

(viii) adopting rules of construction to eliminate repetition of phrases and qualifiers to make the Act easier to read and more user friendly;

(ix) clarifying and modernizing the default rules relating to capital contributions and excuses from performances and basing distributions on the proportional contributions (of services as well as capital) of the owners (including promises to make contributions in the future);

(x) conforming the default rules and procedures relative to derivative actions with those in the BCA; and

(xi) the elimination of redundant and otherwise superfluous provisions, including (A) G.S. § 57C-10-03(b) and (c) (concerning the law of estoppel and agency when § 57C-10-05 broadly provides that rules of equity and law supplement those under the Act) and (B) § 57C-2-02(l)-(16) (illustrating the type of powers a limited liability company may exercise when the breath of the statement in that section that there are no limitations or restrictions to such power other than not engaging in illegal activities makes doing so unnecessary).

4. Other Changes of Note.

(a) Override of UCC §§ 9-406 and 9-408. Because the application of UCC §§ 9-406 and 9-408, as currently in effect, may allow a member to encumber his or her economic interest in breach of the operating agreement [which may result in the foreclosure of that interest under circumstances that may result in adverse tax consequences to the other members, the transfer of ownership of the economic interest to a corporation or other ineligible shareholder of an S corporation, for those LLCs that elect to be taxed as S corporations, or a technical termination under I.R.C. § 708(b)(1)(B)], the revised Act adopts the approach taken in states such as Delaware and Virginia (among other states, including those states that have recently restated their LLC Acts: Texas, Mississippi, and New Hampshire) to not have UCC §§ 9-406 and 9-408 apply to LLC ownership interests.

(b) Certificate of Existence. An example of the type of clean up undertaken by the revised LLC Act concerns the certificates of existence issued by the Secretary of State. While the current LLC Act provides that one may conclusively rely on a certificate of existence as to the existence of an LLC, one does so at his or her peril. This is because, as contrasted from a corporation under the BCA, the filing of articles of dissolution is not the event that causes an LLC to dissolve. Thus, the Secretary of State is not in a position to certify as to whether the LLC has dissolved. All she can do is certify as to the status of the LLC's filings made in her office, which certification will be conclusive evidence as to the accuracy of its contents.

(c) Deletion of Low Profit Limited Liability Company (L3C) Provisions. As under current law, the flexibility of the restated Limited Liability Company Act accommodates the organization of limited liability companies that qualify for "program related investments" under I.R.C. § 4944(c) by private foundations without the need for any additional or special provisions under Chapter 57C.

5. Concepts the Committee Elected to Not Recommend.

(a) Series or Cell Limited Liability Companies. The committee carefully reviewed and considered the merits of adopting an elaborate set of provisions that have been adopted in 10 other states, allowing limited liability companies to create internally segmented liability "cells" or "series." Under those provisions, not only are the members of the limited liability company shielded from personal liability for the debts and obligations of the limited liability company itself, but separately identified groups of assets of the company may be shielded from liabilities attributable to other groups of the company's assets. No uniform set of provisions have been adopted by the states allowing for "series" or "cell" limited liability companies. The committee concluded that the confusion and potential abuse associated with such entities, together with the public policy of North Carolina against excessive fragmentation of an incorporated enterprise, outweigh the potential benefits that may be derived from Chapter 57C adopting a set of provisions to allow for such structures. The committee will continue to monitor developments in this area.

(b) Contractual Appraisal Rights. The committee reviewed the contractual appraisal rights provisions of the Delaware Limited Liability Company Act and concluded that the flexibility of Chapter 57C accommodates the inclusion of such rights in an LLC's operating agreement without the need for any additional or special provisions under Chapter 57C.

(c) Statute of Frauds. Chapter 22 of the North Carolina General Statutes does not require agreements that cannot be performed within one year to be in writing, which was the subject of the Delaware Chancery Court decision in *Olson v. Halvorsen*, C.A. No. 1884-VCL (De. Ch. Ct. 2008). Thus, the committee determined that a counterpart to section 18-101(7), excluding operating agreements from the application of the "statute of frauds," was not necessary or appropriate. Other than to expressly acknowledge the intention of the General Assembly to promote the freedom of the parties to an operating agreement to arrange their business affairs (including their respective rights and duties) as they may agree and the other rules of construction and statements of public policy in G.S. 57C-10-01 (including sanctioning the assessment of penalites under LLC's operating agreement, G.S, 57C-2-32(a)), the Act does not provide additional or special rules for resolving situations in which overlapping or conflicting laws may apply. Instead, such situations are to be resolved under the rules applicable to statutory construction and conflict of laws.