Minority Members of a Michigan Limited Liability Company

Fiduciaries or Not?

By Keefe A. Brooks and Jason D. Killips

Amanda, Bob, and Charlie open a steakhouse in Birmingham. The restaurant is owned and operated by Steak LLC, a Michigan limited liability company (LLC). Amanda, Bob, and Charlie each own one-third of Steak LLC, and Amanda serves as managing member. The restaurant is very successful, and for a time, the three members are quite happy.

Two years later, Charlie decides to open his own steakhouse in Rochester. This restaurant is owned and operated by Red Meat LLC, also a Michigan limited liability company; Charlie is its only member. It does not use any of Steak's recipes or other intellectual property, but as a steakhouse, Red Meat competes with Steak to some degree.

Amanda and Bob are understandably upset, but can they do anything about it? Put another way, has Charlie violated any duty to Amanda, Bob, or Steak by starting Red Meat in Rochester?

Michigan law does not provide a definitive answer to this question. Because the legislation creating LLCs defines the duties of managers and other controlling persons but not minority members, we believe the preferred approach is to permit the members of the LLC to define for themselves which duties, if any, the non-controlling members should owe.

Fast Facts:

Michigan statutory law is silent as to whether minority members of an LLC owe duties to each other or to the LLC.

Michigan's LLC statute imposes specific duties on certain LLC members, but often provides that those duties may be modified by the operating agreement.

The authors believe that a court considering whether minority members of an LLC owe duties to each other or the LLC should hold that such members owe only those duties imposed by the LLC's operating agreement.

One size does not fit all

Consideration of which duties LLC members owe each other and the LLC itself should begin with the history and purpose of LLCs, which, in turn, begins with consideration of the other traditional forms of business entities: partnerships and corporations.

A partnership is two or more people associating themselves to carry on a business for profit, regardless of whether they intend to create the legal relationship of "partnership."[1] The existence of a partnership relationship centers on mutual agency and joint liability.[2] As the Michigan Court of Appeals has explained:

> The courts universally recognize the fiduciary relationship of partners and impose on them obligations of the utmost good faith and integrity in their dealings with one another in partnership affairs. Partners are held to a standard stricter than the morals of the marketplace and their fiduciary duties should be broadly construed, "connoting not mere honesty but the punctilio of honor most sensitive." The fiduciary duty among partners is generally one of full and frank disclosure of all relevant information. Each partner has the right to know all that the others know, and each is required to make full disclosure of all material facts within his knowledge in any way relating to the partnership affairs.[3]

See also MCL 449.20, stating: "Partners shall render on demand true and full information of all things affecting the partnership to any partner…." Each partner similarly has a fiduciary duty to the partnership itself,[4] and is jointly liable for the debts of the partnership.[5]

Shareholders in a corporation, on the other hand, generally do not owe each other or the corporation any fiduciary duties.[6] There are exceptions. Directors, officers, and majority shareholders are fiduciaries who owe a duty of good faith to the corporation.[7] Shareholders in a closely held corporation who participate in management and control also owe each other "a higher standard of fiduciary responsibility, a standard more akin to partnership law."[8] And shareholders may, by agreement, dictate the relationship among themselves and the corporation.[9] Shareholders are not generally liable for the debts of the corporation beyond the amount of their investment in the company.[10] This separate corporate form may, however, be disregarded when it is used to evade the law.[11]

The Michigan Limited Liability Company Act

The limited liability company is a relatively new business entity form, first authorized in Michigan on June 1, 1993.[12] LLCs share some of the characteristics of both partnerships and corporations, and subject to limitations applied by statute or the articles of organization, have "all powers necessary or convenient to effect any purpose for which the company is formed, including all powers granted to corporations in the business corporation act…."[13] Most LLCs are governed by operating agreements "pertaining to the affairs of the limited liability company and the conduct of its business."[14]

Similar to shareholders and corporations, "[u]nless otherwise provided by law or in an operating agreement, a person that is a member or manager, or both, of a limited liability company is not liable for the acts, debts, or obligations of the limited liability company."[15] LLCs are, by default, taxed as if they were partnerships, although an LLC may elect to be taxed as a corporation.[16]

Most often, an LLC is administered by a manager or managers designated in the LLC's articles of organization.[17] By statute, a manager owes a fiduciary duty to the LLC itself but not to the members of the LLC.[18] This does not mean that non-managing members are left without protection, however. Michigan's statute also provides a remedy in favor of the members in the member-oppression section, MCL 450.4515. As the Michigan Court of Appeals has explained:

> Specifically, that subsection permits members of limited liability companies to "bring an action…to establish that acts of the managers or members in control of the limited liability company are illegal, fraudulent, or constitute willfully unfair and oppressive conduct toward the limited liability company or the member." MCL 450.4515(1). "[W]illfully unfair and oppressive conduct" means, at least in part, "a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the member as a member." MCL 450.4515(2). This does not include conduct permitted by the articles of the organization, the operating agreement, or another agreement to which the member is a party, however. *Id.*[19]

Therefore, the Michigan Limited Liability Company Act explicitly addresses the duties that managers, whether members or not, owe to the LLC itself and to the LLC's other members. But the act is silent about duties owed by each member to the others and to the LLC itself. In other words, the act provides no specific answer for a court charged with determining whether Charlie violated any duties when he opened Red Meat LLC.

Who decides—the courts or the members?

What should a reviewing court do when faced with this question—namely, whether Charlie owed any duty to the other members of Steak LLC or to Steak itself?

The court could impose a bright-line rule, holding either that members owe these duties or they do not. This approach,

however, seems likely to leave many LLC members dissatisfied. For example, if Charlie was heavily involved in the day-to-day operation of Steak—hiring staff, designing the atmosphere and menu, and creating a marketing plan—Amanda and Bob would likely expect that Charlie would be using these skills and talents only for the benefit of Steak, and certainly not to compete with it. If, on the other hand, Charlie was a mere passive investor in Steak, he would likely assume he was free to invest his other assets, including his time and talent, in other ventures.

Another approach would be a case-by-case analysis. A court could consider not only the competing member's role in the original LLC, but also those of the other members. The court might also consider what role each member played in the founding of the original LLC or the circumstances under which they joined, the relative level of each member's investment in the LLC, the relative level of each member's time commitment or day-to-day involvement in the LLC, and even the nature of the members' other investments and business dealings at the time they joined the LLC. Testimony about the respective roles and expectations would undoubtedly be relevant. Balancing all these facts and circumstances, the court would then define on a case-by-case basis the level of duty owed by each member. (At least one panel of the Court of Appeals has attempted this, holding in an unpublished opinion that, when there is no evidence that one 50 percent member has any "superiority, influence, control, or responsibility" over the other 50 percent member, they do not owe a duty to each other.[20])

Best to leave it to the members

Instead of trying to reconstruct, years after the LLC was formed and the members were admitted, the allocation of duties and obligations the parties would have agreed to if they had acted reasonably, we think the better approach is for the members to be charged—and empowered—with making this allocation themselves from the outset. Who better to ascertain what the members expect of each other, and who better to weigh the expected contributions of each, than the members themselves?

The Michigan Limited Liability Company Act is already constructed in a manner consistent with this approach. Throughout, it sets defaults, and then provides that those defaults may be modified by the LLC's articles of organization or an operating agreement. As just a few examples:

- The members manage the LLC *unless the articles of organization provide for management by managers.*[21]
- The rights and duties of the managers *may be enlarged or restricted by the articles of organization or an operating agreement.*[22]
- Managers may be removed with or without cause *unless an operating agreement provides that they may be removed only for cause.*[23]
- Voting by managers is governed by statute *but may be modified by the articles of organization or an operating agreement.*[24]
- With some exceptions, the monetary liability of a manager may be eliminated or limited by *the articles of organization or an operating agreement.*[25]
- The conditions under which a manager may establish that a transaction in which the manager is interested is nevertheless appropriate are set by statute *but may be amended by an operating agreement.*[26]
- The process by which a person is admitted as a member of the LLC is set by statute *but may be otherwise provided for in an operating agreement.*[27]
- Voting rights are allocated among members by statute *but may be established and allocated, limited, or eliminated by operating agreement.*[28]
- Membership interests are assignable consistent with the statute *except as provided in an operating agreement.*[29]
- The conditions under which an assignee of a membership interest may become a member are defined by statute *but may be modified by an operating agreement.*[30]
- A member may not withdraw or be expelled from an LLC *unless provided for in an operating agreement.*[31]

Thus, the statutory scheme that provides for LLCs already contains many examples where the rights and duties of members and managers are set by statute but may be altered by an operating agreement.

The current Michigan Limited Liability Company Act is silent about whether minority members owe each other or the LLC any duties. Therefore, this is the statutory default.

But if so many other default rights and duties of members and managers may be altered by an operating agreement, it makes sense that this default, too, may be altered. After all, if the members of a particular LLC believe they should owe each other certain duties and perhaps owe the LLC itself certain others, why not permit them to create those duties through the operating agreement?

This approach provides four significant advantages. First, and in contrast to a bright-line approach, it allows for flexibility to suit the different needs of different LLCs. Second, it places the decisions whether to impose these duties, and which duties to impose, in the hands of the people best positioned to make those decisions, and to decide whether they are willing to have those duties imposed on them. Third, it provides for a more certain outcome when a dispute arises years later because the parties' counsel and a reviewing court will be interpreting an operating agreement, not attempting to balance a set of amorphous factors. Finally, this approach is most fair to members of existing LLCs, since none will find themselves suddenly owing duties they never agreed to accept, and LLCs wishing to more clearly define the duties of their members may amend their operating agreements accordingly. No one finds himself in a situation he did not bargain for.

Delaware courts have adopted a similar rule: "Delaware law imposes no default fiduciary duties on non-managing, non-controlling members of limited liability companies."[32] Specifically, one who is "neither a manager…nor a controlling member…has no fiduciary duties."[33] At least one Delaware chancellor has reasoned that, if members wish to have fiduciary duties owed to them by non-managing, non-controlling members, they should create those duties through contract.[34] New York also imposes on non-managing members only those duties that are created by contract.[35]

Let them eat steak

In conclusion, we think that Michigan appellate courts facing the question of whether LLC members owe each other or the LLC itself any duty of care should adopt a rule consistent with the existing structure of the Michigan Limited Liability Company Act: a member does not owe any duties to the LLC or its other members except those imposed by statute or the LLC's operating agreement.

This is a good result for Amanda, Bob, and Charlie. When they founded Steak LLC, they were in the best position to make many decisions about the operation of the steakhouse. They were also in the best position to make one more: which duties will each of them owe and accept? That decision—made at the appropriate time by the appropriate people and recorded in an operating agreement—determines whether Charlie violated any duties when he founded a competing steakhouse. ■

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ENDNOTES

1. *Byker v Mannes,* 465 Mich 637, 652; 641 NW2d 210 (2002); see also *Lobato v Paulino,* 304 Mich 668, 675; 8 NW2d 873 (1943).
2. *Lobato v Paulino,* 304 Mich at 675; see also *Byker,* 465 Mich at 652.
3. *Band v Livonia Assoc,* 176 Mich App 95, 113–114; 439 NW2d 285 (1989) (citations omitted).
4. MCL 449.21(1).
5. *Commonwealth Capital Inv Corp v McElmurry,* 102 Mich App 536, 541; 302 NW2d 222 (1980); MCL 449.15.
6. *Priddy v Edelman,* 883 F2d 438, 445 (CA 6, 1989).
7. *Salvadore v Connor,* 87 Mich App 664, 675; 276 NW2d 458 (1978).
8. *Estes v Idea Engineering & Fabricating, Inc,* 250 Mich App 270, 281; 649 NW2d 84 (2002) (citations and quotation marks omitted).
9. MCL 450.1488(1)(i).
10. *Klager v Robert Meyer Co,* 415 Mich 402, 411–412; 329 NW2d 721 (1982).
11. *Id.*
12. 1993 PA 23; MCL 450.4101 *et seq.*
13. MCL 450.4210.
14. MCL 450.4102(2)(r).
15. MCL 450.4501(4).
16. See generally IRS, *Taxation of Limited Liability Companies* (June 2016) <https://www.irs.gov/pub/irs-pdf/p3402.pdf> (accessed December 4, 2016).
17. MCL 450.4102(2)(o).
18. MCL 450.4404; *Frank v Linkner,* 310 Mich App 169, 180; 871 NW2d 363 (2015).
19. *Frank,* 310 Mich App at 181.
20. *Alliance Assoc, LC v Alliance Shippers, Inc,* unpublished opinion per curiam of the Court of Appeals, issued June 1, 2006 (Docket No. 265101), p 7.
21. MCL 450.4401.
22. MCL 450.4402(1).
23. MCL 450.4403(2).
24. MCL 450.4405(1).
25. MCL 450.4407.
26. MCL 450.4409.
27. MCL 450.4501.
28. MCL 450.4502.
29. MCL 450.5505(1).
30. MCL 450.5506(1).
31. MCL 450.5509.
32. *Imbert v LCM Interest Holding LLC,* unpublished opinion of the Delaware Court of Chancery, issued May 7, 2013 (Docket No. 7845-ML), p *7, citing *Kuroda v SPJS Holdings, LLC,* unpublished opinion of the Delaware Court of Chancery, issued March 16, 2010 (Docket No. 4030-CC), p *8.
33. *Kuroda,* unpub op at *7.
34. *Id.* at *8.
35. *Kalikow v Shalik,* 986 NYS2d 762, 768 (2014).