

# THE NEW ALABAMA LLC ACT: IMPACT ON MEMBERS' RIGHTS AND INTERNAL DISPUTES

"What you're supposed to do when you don't like a thing is change it," or so said Maya Angelou. Taking its cue from the late poet, a committee of the Alabama Law Institute ("ALI") began working in 2007 to overhaul Alabama's limited liability company law. After many years of work, 2014 saw the passage of the new law, to be known as the "Alabama Limited Liability Company Law of 2014" (the "2014 Act").<sup>1</sup> The ALI Committee has this to say about its passage:

*This Act marks a significant improvement in the state of the law in Alabama relating to limited liability companies. The last substantive revision to Alabama's Limited Liability Company Act came in 1997. This revision will bring Alabama to the forefront in laws governing limited liability companies.*

*The committee considered the Revised Uniform Limited Liability Company Act and the Revised Prototype Limited Liability Company Act, but this proposal is unique to Alabama. The committee considered all sources choosing the best provisions from each national proposal and also looked to the law of other states.*

...

*The Act focuses on the contractual nature of the limited liability company. There are few mandatory provisions in the Act; most features of a limited liability company can be modified by the parties to suit their needs.*

...

*Despite the emphasis on allowing the parties to make their own contract, the Act provides that certain obligations, such as the implied contractual covenant of good faith and fair dealing, cannot be modified.<sup>2</sup>*

It may be true that the 2014 Act is a significant improvement in Alabama

law. At the same time, however, the 2014 Act will have some significant impacts on the rights of LLC members and also on internal disputes amongst the membership. This article is intended to provide an overview of some of the larger issues.

## COMPANY AGREEMENT MAY BE "ORAL" OR "IMPLIED"

Under the 2014 Act, what has historically been known as an LLC "operating agreement" will now be known as the "limited liability company agreement."<sup>3</sup> The "company agreement" means "any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied, of the member or members as to the activities and affairs of a limited liability company."<sup>4</sup> Under the previous law, the "operating agreement" was defined as "a written agreement of the member or members governing the affairs of a limited liability company and the conduct of its business."<sup>5</sup>

Whereas previously the LLC would be bound only by the statute and written operating agreement, under the 2014 Act the LLC may also be governed by "oral" and "implied" agreements. Now a member will be able to assert the protection of an oral or implied agreement, while other members may very well deny the existence or substance of such agreement. It is easy to imagine that this change will open the door to many new disputes amongst the members.

## NEW DEFINITION OF "KNOWLEDGE" AND "NOTICE"

The prior law did not include a definition of knowledge or notice. The 2014

Act now defines these terms.<sup>6</sup> This may have the effect of eliminating some doubt and dispute as to when a member and/or the LLC have knowledge or notice.

## "FREEDOM OF CONTRACT," SUPPLEMENTED BY "LAW AND EQUITY"

The 2014 Act states that "It is the policy of this Chapter and this state to give maximum effect to the principles of freedom of contract and to the enforceability of limited liability company agreements."<sup>7</sup> Thus, it is intended that the LLC should be free to operate however the members agree, whether good, bad, or otherwise. That being said, the "principles of law and equity supplement this Chapter" unless specifically displaced.<sup>8</sup> So, in the event of a dispute, one may possibly still look beyond the company agreement to "law and equity."

## ELIMINATION OF "FIDUCIARY DUTIES"

One very significant change in the 2014 Act is that a member or manager's fiduciary duties may now be eliminated. The 2014 Act, as a default, does place several duties on "persons with direction and oversight" of the company, including the duty of loyalty and the duty of care.<sup>9</sup> However, the 2014 Act then provides that "To the extent... a member or other person has duties (including fiduciary duties)... the 'member's or other person's duties may be expanded or restricted or eliminated by a written limited liability company agreement...."<sup>10</sup> Under the prior law, fiduciary duties could not be eliminated, although the operating agreement could specify cer-

tain activities that would not be deemed a breach of the duty of loyalty.<sup>11</sup> Considering the amount of LLC litigation that has been based on the alleged breach of fiduciary duties, permitting the elimination of those duties may also eliminate a large area of litigation.

## NEW STANDARD OF "GOOD FAITH AND FAIR DEALING"

While fiduciary duties may be eliminated, the "implied contractual covenant of good faith and fair dealing may not be eliminated."<sup>12</sup> The company agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."<sup>13</sup>

Historically, Alabama law has not recognized a claim for "bad faith" outside of the insured/insurer context. In other contexts, the Alabama Supreme Court has rejected claims of "bad faith" based on a statutory duty of good faith.<sup>14</sup> It should be clear that the 2014 Act intends to provide an LLC member with a cause of action for breach of the duty of good faith and fair dealing. The extent to which this will be recognized and given effect by the Alabama courts remains to be seen, however.

It should be noted that this section of the 2014 Act is derived from Delaware law. In contrast to Alabama, Delaware's common law has long recognized a cause of action for breach of the implied duty of good faith.<sup>15</sup> The general rule in Delaware is that "The implied covenant of good faith and fair dealing inheres in every contract governed by Delaware law and requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain."<sup>16</sup> As one would expect, there is

a great deal of Delaware case law further defining the law, but that is the general rule. Some additional rules:<sup>17</sup>

*The implied covenant of good faith and fair dealing applies even where the contract allows a party to exercise discretion.*

*A party may breach the implied covenant of good faith and fair dealing without violating an express term of the contract.*

*The implied covenant of good faith and fair dealing is designed to protect the spirit of an agreement when, without violating an express term of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain.*

Thus, if the Alabama courts will look to Delaware for guidance (as is the ALI Committee's intent), then the 2014 Act will provide these general protections for the LLC member.

## ELIMINATION OF "BREACH OF CONTRACT" LIABILITY

Under the 2014 Act, the company agreement may eliminate "any and all liabilities for breach of contract" of a member to the company or to another member.<sup>18</sup> If the LLC is intended to be a creature of contract, and if the company agreement is to be the contract, then this change may mean that the company agreement can essentially be rendered meaningless. A member may breach the company agreement—and any other internal contract—without liability. Presumably, this would include not only the company agreement but also other contracts between members (e.g., loan agreements, buy-sell agreements), and even employment contracts between the LLC and a member or manager. There are many situations where the LLC may need to contract with a member or members with each other, and this change

could have the effect of nullifying them. The only liability that cannot be eliminated is "a bad faith violation of the implied contractual covenant of good faith and fair dealing."

## PENALTIES AGAINST NON-PERFORMING MEMBERS

There are times that the company agreement may require a member to perform. For example, a member may be expected to make an additional capital contribution in response to a capital call. Under the 2014 Act, the company agreement may provide certain penalties for a member who fails to perform in accordance with, or fails to comply with, the terms and conditions of the company agreement.<sup>19</sup> The penalties may include—without limitation—reducing, eliminating, subordinating, selling, and/or forfeiting the defaulting member's ownership interest.<sup>20</sup> Historically, a "squeeze out" from a business entity has been cause for complaint.<sup>21</sup> Now it may be permitted by the company agreement.

## LIABILITY FOR MEMBER'S WRONGFUL DISSOCIATION

Borrowing terminology from partnership law, an LLC member now has the power to "dissociate," or cease to be a member.<sup>22</sup> The member's dissociation may be "wrongful" if is in breach of the company agreement and under certain other circumstances.<sup>23</sup> If the dissociation is wrongful, then the dissociated member may be liable for damages to the LLC and possibly also to the other members.<sup>24</sup>

## MEMBER'S POWER TO BIND THE COMPANY

A member may bind the LLC in three circumstances: (1) when authorized by the company agreement; (2) by consent

of the members; or (3) to the extent provided by other law.<sup>25</sup> The Committee Comment makes clear that the “other law” is intended to be the “law of agency.” Thus, under the 2014 Act, a member may bind the company under principles of agency law, including apparent agency.

## CLAWBACK OF DISTRIBUTIONS

The 2014 Act forbids an LLC from making a distribution to a member “to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities...exceed the fair value of the assets.”<sup>26</sup> If a member knowingly receives an improper distribution, then the member shall be liable to the LLC for the amount of the distribution.<sup>27</sup> Knowledge is key, for the unwitting member who receives an improper distribution is not liable and gets to keep the distribution.<sup>28</sup> The statute of limitations for bringing a “clawback” action is two years from the date of the distribution.<sup>29</sup>

## RESTRICTED ACCESS TO BOOKS AND RECORDS

As with the prior law, the 2014 Act provides a member certain access to “books and records.”<sup>30</sup> The 2014 Act, however, permits some restrictions on access to the books and records. The company agreement may state restrictions or conditions on access, and the company may in the ordinary course of its activities impose additional restrictions (if “reasonable”) and may even keep some information confidential from the members.<sup>31</sup>

The penalty for improperly refusing access is also different in the 2014 Act. Under the prior law, if the requesting member was wrongfully denied access to the books and records, then the requesting member was entitled to a penalty “not to exceed 10 percent of the fair market value of the membership interest of the member.”<sup>32</sup> This has subtly

changed in the 2014 Act, which provides a penalty “not to exceed 10 percent of the fair market value of the transferable interest of the member.”<sup>33</sup> “Transferable interest” is a defined term under the 2014 Act and is only the member’s financial rights—something less than the member’s broader rights.<sup>34</sup> This likely means the value of the penalty will be reduced under the 2014 Act.

## PROCEDURAL RULES FOR MEMBER LAWSUITS (BOTH “DIRECT” AND “DERIVATIVE”)

The prior law provided for “derivative actions” by members.<sup>35</sup> The 2014 Act provides for both “direct” and “derivative” actions by members, subject to certain requirements and procedures.<sup>36</sup> These sections of the 2014 Act appear to be a codification of the law that has already developed under Rule 23.1 of the Alabama Rules of Civil Procedure and case law interpreting that rule. If there is a significant difference between the old procedures and the new, it is not immediately apparent.

## CONCLUSION

In many respects, the 2014 Act will likely be lauded by corporate practitioners who will view it as an improvement to Alabama law, bringing the law more in line with Delaware and other leading jurisdictions. As far as that goes, the 2014 Act may serve a valuable purpose. For individual LLC members, however—and particularly minority members—the 2014 Act will have some significant impacts on their rights. The landscape of litigating internal membership disputes will undoubtedly be different than under the prior law. Like a stone cast into the waters, the 2014 Act will cause many ripples. Many of those ripples may not be felt by the Bar until the disputes begin. ☛

## ENDNOTES

- 1 The 2014 Act will become effective on January 1, 2015, for companies that form after that date or that “opt in.” For existing companies that do not opt in, the 2014 Act will become effective on January 1, 2017. Ala. Code § 10A-5A-12.01.
- 2 The entire text of the 2014 Act, along with the commentary of the ALI Committee, is available on the ALI website at: <http://ali.state.al.us/documents/RevisedLLC.pdf>
- 3 Ala. Code § 10A-5A-1.02(k).
- 4 *Id.*
- 5 Ala. Code § 10A-5-1.02(8).
- 6 Ala. Code § 10A-5A-1.03.
- 7 Ala. Code § 10A-5A-1.06(a).
- 8 Ala. Code § 10A-5A-1.06(b).
- 9 Ala. Code § 10A-5A-4.08.
- 10 Ala. Code § 10A-5A-1.08(b)(1).
- 11 Ala. Code § 10A-5-3.03(l).
- 12 Ala. Code § 10A-5A-1.08(b)(1).
- 13 Ala. Code § 10A-5A-1.08(b)(2).
- 14 See, e.g., Ala. Code § 7-1-203; *Tanner v. Church’s Fried Chicken, Inc.*, 582 So.2d 449, 451 (Ala. 1991); *Government Street Lumber Co., Inc. v. AmSouth Bank, N.A.*, 553 So.2d 68, 72 (Ala. 1989); *Peninsular Life Ins. Co. v. Blackmon*, 476 So.2d 87, 89 (Ala. 1985).
- 15 See *Srinivas M. Raju*, “Fiduciary Duties in the Alternative Entity Context,” ABA, August 16, 2012 (“The implied contractual covenant of good faith and fair dealing is a common-law concept that antedated its usage in DRULPA and the LLC Act. By not defining the term in DRULPA or the LLC Act, the Delaware legislature is assumed to have adopted the common-law concept.”).
- 16 See, e.g., *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 145-46 (Del. Ch. 2009).
- 17 See, e.g., *PAMI-LEMB I, Inc. v. EMB-NHC, LLC*, 857 A.2d 998, 1016 (Del. Ch. 2004).
- 18 Ala. Code § 10A-5A-1.08(b)(2).
- 19 Ala. Code § 10A-5A-1.08(b)(4).
- 20 Ala. Code § 10A-5A-1.08(b)(5).
- 21 See, e.g., *Ex parte Brown*, 562 So. 2d 485 (Ala. 1990).
- 22 Ala. Code § 10A-5A-6.01(a).
- 23 Ala. Code § 10A-5A-6.01(b).
- 24 Ala. Code § 10A-5A-6.01(c).
- 25 Ala. Code § 10A-5A-3.02.
- 26 Ala. Code § 10A-5A-4.06(a)(1).
- 27 Ala. Code § 10A-5A-4.06(a)(2).
- 28 *Id.*
- 29 Ala. Code § 10A-5A-4.06(e).
- 30 Compare Ala. Code § 10A-5-2.06 and Ala. Code § 10A-5A-4.09.
- 31 Ala. Code § 10A-5A-4.09(g).
- 32 Ala. Code § 10A-5-2.06(b).
- 33 Ala. Code § 10A-5A-4.09(b).
- 34 Ala. Code §§ 10A-5A-1.02(i), 10A-5A-5.01.
- 35 Ala. Code § 10A-5.4.04.
- 36 Ala. Code §§ 10A-5A-9.01-9.09.