The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference

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  Miller was an American Bar Advisor to the drafting committee that revised the
  Uniform Limited Liability Company Act sponsored by the National Conference of
  Commissioners on Uniform State Laws. This Article has been prepared in con-
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Limited Liability Companies (LLCs) are now publicly as well as privately owned. They may provide critical nursing home care, engage in environmental remediation involving toxic chemicals, or provide electrical power in Iraq or elsewhere. At what point should investors be able to remove an errant LLC manager and/or obtain damages where the manager is neglecting patients or not diligently handling chemicals? The National Conference of Commissioners on Uniform State Laws (NCCUSL) has grappled with this question in the revision of its Uniform Limited Liability Company Act, and the American Bar Association has just begun overhauling its model LLC statute.¹ The Revised Uniform Limited Liability Company Act now

¹. See Revised Unif. Ltd. Liab. Co. Act § 409(c) (2006) providing:
Subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company’s activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests
defines the duty of care as being, subject to the business judgment rule, a duty to act with "the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company." This reflects a change from the original Uniform Limited Liability Company Act, which imposed a duty to refrain from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. State LLC statutes are almost evenly divided between those that state that the duty of care is a duty to exercise standard care or prudence and those that require managers to refrain from grossly negligent or intentional misconduct. Also, conflicting positions are being taken with regard to the degree to which the duty of care may be modified by contract. Delaware permits fiduciary duties in limited partnerships and LLCs to be expanded, restricted or eliminated by contract, except for the implied contractual covenant of good faith and fair dealing—the parameters of which are expected to emerge in Delaware case law.

Prior literature has analyzed the merits of contractual freedom in the LLC, but relatively few recent articles specifically address the duty of care and the unique attributes of the contemporary LLC manager. The cases reviewed in this Article involve LLCs that provide
extremely important services ranging from psychiatric care to electrical power. The analysis showcases the inappropriateness of the gross negligence standard of care which has been interpreted as involving a "devil-may-care attitude or indifference to duty amounting to recklessness"—a standard that seems particularly low for LLCs that provide important services affecting the public health and welfare. Also, this Article offers a fresh and contemporary perspective on the duty of care and takes into account a number of developments that had not yet occurred when LLC statutes were first enacted. Treasury Regulations now permit LLCs to restrict the LLC member's withdrawal rights—increasing the prospects of a "lock-in" effect that may leave LLC investors at the mercy of entrenched incompetent management—a possibility all too likely if the investor has executed a simple form LLC agreement without seriously studying and negotiating contractual terms, exit rights, or management termination provisions. Also, numerous accounting scandals and duty of loyalty controversies have


8. See Gelfman v. Weeden Investors, L.P., 859 A.2d 89, 114 (Del. Ch. 2004); see also Callison, supra note 7, at 461–62 (criticizing the gross negligence formulation in light of the decision in Gelfman).

9. See Sandra K. Miller et al., An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors, 43 Am. Bus. L.J. 609, 622 (2006) [hereinafter Miller, Empirical Glimpse] (finding that 85% of respondents indicated that they sometimes or often have formed no-frills or simple LLC agreements in a study of practitioners contractual practices in Colorado, Delaware, Kentucky, Minnesota, Montana, and New York); see also Sandra K. Miller, A New Direction for LLC Research in a Contractorarian Legal Environment, 76 S. Cal. L. Rev. 351, 383 (2003) [hereinafter Miller, New Direction] (graphically demonstrating that approximately two-thirds of practitioners believed that many LLC agreements are based on form agreements that are not extensively negotiated in a
surfaced that arguably create a need to increase rather than decrease the accountability of management.¹⁰

This Article raises two major questions. First, should the duty of care be articulated as a duty to refrain from grossly negligent conduct, or is there a need for a more demanding standard such as one based upon negligence and/or reasonable care with perhaps a separate statutory articulation of the business judgment rule? Second, should extensive contractual freedom be granted permitting the LLC operating agreement to indemnify the LLC managers for all types of violations, or should the LLC statute prohibit the LLC operating agreement from indemnifying managers for certain specific types of misconduct (i.e. prohibiting indemnification for intentional wrongful acts or criminal violations, the sustained failure to perform one’s duties, or the taking of improper distributions)? Following this introduction in Part I, Part II addresses the policy goals served by the duty of care. Part III explores the advantages and drawbacks of partnership and corporate models of the duty of care and critiques the duty to refrain from grossly negligent conduct—the standard contained in the Revised Uniform Partnership Act.¹¹ Part IV examines existing LLC duty of care provisions and case law and explores the disconnect between the standard of care one would expect of one discharging highly important services and the gross negligence standard.

study of contractual practices in California, Delaware, New York, and Pennsylvania).


¹¹. See UNIF. P'SHIP ACT (1997).
Part V of this Article recommends that the duty of care be statutorily defined as a duty to act reasonably, subject to the business judgment rule—the language that the author vigorously supported as a member of the NCCUSL Drafting Committee and the formulation that was ultimately adopted in the Revised Uniform Limited Liability Company Act. This position is endorsed largely because it is particularly appropriate to the LLC manager who may assume operational, officer-like duties as well as policy decision-making responsibilities associated with a corporate board of directors. It is a standard that fulfills the socializing role of the duty of care by conveying the important social cue that responsible managerial conduct is expected of management—a message made all the more important because of the significant role LLCs now play in providing goods and services as well as quasi-governmental functions. Also, it holds the promise of providing appropriate equitable remedies on a timely basis, thus enabling investors to intervene to remove entrenched management before the misconduct has deteriorated to the point of becoming reckless or intentionally harmful.

II. POLICY GOALS

Many views have been expressed as to how to best formulate the duty of care applicable to LLC managers and corporate directors. To be sound, the recommended standard must rest upon an accurate understanding of the role played by LLCs in the economy, a grasp of ex-
isting practices used by the LLC, and a clear conception of the overarching goals to be served by the legal duty of care. Specific policy objectives must then be identified that will help achieve the desired goals. The need for a balanced approach to the duty of care emerges as a central theme when one considers the competing policy objectives at stake.16

It is suggested that LLCs play a vital role in a wide range of economic activities and that the duty of care selected must be capable of being applied in a variety of settings amidst diverse management structures. Duty of care provisions must further the over-arching policy goals of fostering investor confidence and controlling agency costs.17 Also, the duty of care provisions must foster the confidence of other stakeholders as well, whether suppliers, customers, employees, trade creditors, or the public at large.18

To further the broad goal of promoting investor confidence in LLCs, the legal system must provide investors with a legal standard of conduct that encourages responsible managerial conduct and provides legal recourse for serious violations.19 Toward this end, the duty of care should include an appropriate statement describing the care expected, an articulation of LLC standards of managerial conduct that


18. Kevin Keasey et al., Introduction: The Corporate Governance Problem—Competing Diagnosis and Solutions, in CORPORATE GOVERNANCE, 8–9 (Kevin Keasey et al. eds., Oxford Univ. Press 1997) (observing that the stakeholder model of the firm explicitly recognizes that others besides the shareholders have an interest or stake in the long-term success of the entity). See Robin Paul Mallory, Adam Smith and the Modern Discourse of Law and Economics, in ADAM SMITH AND THE PHILOSOPHY OF LAW AND ECONOMICS 113, 114–15 (Robin Paul Malloy and Jerry Evensky eds., Kluwer Academic Publishers 1994) (observing that in contrast to John Locke’s theory of the social contract, Adam Smith offers concepts of authority and utility and believes authority is necessary for decision-making and dispute resolution).

19. See CLAPMAN, supra note 16, at xii (discussing the importance of giving investors confidence that there is a legal system in place that will enforce their interests).
will appropriately socialize the business community, rules that offer an effective means of assessing appropriate damages, and a mechanism for restraining certain harmful transactions or offering equitable relief. The ultimate goal is to foster investor confidence through a legal regime that creates and enforces reasonable expectations of responsible management conduct.

A. The Public Interest and the Economic Role of the LLC

The significance of the economic role played by the LLC and by private businesses generally is often overlooked. A great deal of attention has focused on the public corporation in recent years as director misconduct in the context of the public company has seized the spotlight. However, privately owned LLCs are playing an increasingly important role in the economy as more public companies go private and as more new businesses are formed. Given the growing number of LLCs and the breadth of their activities, society at large has a vested interest in the standard of conduct applicable to the LLC manager and in the ultimate success of the LLC itself.

The emergence of the LLC is astounding. More businesses of all types are forming as LLCs than as other non-corporate entities. LLCs were recently reported as accounting for more new business filings than corporations in twenty-nine states. Based on the 2006 filing reports by the International Association of Commercial Administrators, LLC domestic and foreign filings exceeded filings of business and professional corporations in thirty-nine states. In Delaware, the ra-


23. See infra app. I; International Association of Commercial Administrators, Annual Report of the Jurisdictions (2007), available at http://www.iaca.org/downloads/AnnualReports/2007_IACA_AR.pdf (reporting statistical data on the number of business and professional corporations and limited liability companies filed during the year in each state). Written inquiries can be addressed to Mike Ricchio, President, International Association of Commercial Administrators, P.O. Box 40234, Olympia, WA 98504-0234, mricchio@secstate.wa.gov, President Elect Kathy Berg, P.O. Box 146705, P.O. Box 146705, Salt Lake City, UT 84114-6705,
ratio of LLC filings to new corporate filings was 97,942 to 34,384 or approximately 2.85 to 1. In Colorado, the ratio was 2.51 to 1 and in Louisiana, it was 4.11 to 1.24 The breadth of LLC activities is impressive. They provide a broad array of critical services including the provision of private nursing home care, the furnishing of electrical power, the only provision of global satellite voice and data solutions, and legal services.25 Small private firms continue to play a critical role in the economy, with small business (firms with less than 500 employees) representing as much as 99.7% of all employer firms and accounting for sixty to eighty percent of new jobs annually.26

As early as 1996, LLCs were identified as operating in numerous fields of business.27 A sample of 1,252 LLCs revealed LLCs engaged in engineering and management support services, real estate, construction and general contracting, investments, retail, health services, amusement and recreation, agricultural production, restaurants, and leasing services.28 LLC litigation has involved LLCs engaged in diverse businesses ranging from real estate29 to beer distribution.30

Many LLCs provide services that are critical to the functioning of modern society and some LLCs even perform quasi-governmental services.31 LLCs now provide fundamental functions that go to the heart of society’s infrastructure. Some LLCs are owned by public companies

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24. See infra app. I.
28. Id. at 89.
31. Foster-Thompson, LLC v. Thompson, No. 8:04-CV-2128T30EAJ, 2005 WL 3093510, at *1–2 (M.D. Fla. Nov. 18, 2005) (involving a suit by a Florida LLC against its manager where the LLC had entered into a contract with the United States to construct an electrical power generating facility near As Samawah, Iraq).
and provide important telecommunication services. In other instances, LLCs have provided functions requiring a special degree of trust. For example, some LLCs serve as repositories for investments of individual retirement funds while others operate nursing homes.

Most LLCs are privately owned; however, LLCs may be the subject of private placements. They may elect to become publicly traded. If publicly traded, the LLC is subject to special tax rules and may be taxed as a corporation. Finally, publicly owned companies often find it appropriate to invest in LLCs and/or use LLCs within their corporate structures.

Given the growth of LLCs and the sweeping breadth of LLC activities, the public at large has a vested interest in the effectiveness of the legal framework within which the LLC operates. While the primary focus of business entity governance is on the relationship between investors and management rather than on the regulation of the business at large, the governance framework should work compatibly in the larger scheme of things to promote the broad public interest.

B. Investor Confidence

The two major prongs of business entity governance include the duty of loyalty and the duty of care. The duty of loyalty demands that the actor act honestly and in a manner that furthers the best interests of the business entity. The duty of care requires that the

37. See id. § 7704(c)(1)–(2) (generally treating publicly traded partnerships as corporations for federal income tax purposes but exempting such partnerships from corporate treatment where 90 percent of gross income is passive in nature such as interest, dividends, rents, and similar types of income).
39. See id. at 14–17.
actor act carefully in carrying out his managerial or oversight duties.\textsuperscript{40} These fundamental standards are the foundation of investor confidence that the LLC will be managed with honesty and care.

The need for a balanced approach to the duty of care comes clearly into focus when one considers the many important policy objectives to be served by the duty of care. As discussed below, the role of the duty of care is to provide a descriptive standard of conduct, to fulfill socializing, expressive and deterrent functions, to provide remedies, and to encourage service by affording an appropriate degree of judicial intervention.\textsuperscript{41}

C. The Descriptive Role

The first specific objective served by the duty of care is perhaps the most obvious, yet one that is frequently overlooked. To serve as a guideline that reflects positive social values and inspires investor confidence, the duty of care must be sufficiently descriptive, yet capable of application in diverse settings and diverse management structures. It has been argued that the duty of care is so context-specific that a single statutory standard cannot be developed.\textsuperscript{42} However, sufficient flexibility has long been built into the corporate standard of care and can be similarly integrated into a standard applicable to LLCs.\textsuperscript{43} Clearly, whether the investment involves ice cream parlors or nuclear plants, from the investor's viewpoint management should be attentive and responsible regardless of the activity undertaken. Nevertheless, specific management standards and the consequences of irresponsible management may differ depending upon the nature of the firm. The expectations of management may also differ depending upon the allocation of duties under the LLC operating agreement. The duty of care must be capable of providing a broad general guideline for conduct and be susceptible to specific tailoring to individual facts and circumstances.

It is particularly challenging for the duty of care to be appropriately descriptive in light of the diverse management structures employed in the LLC. Although early LLCs were frequently member-managed, LLCs may now have a Board of Directors or any other management structure and still achieve flow-through taxation. Because of

\textsuperscript{40} See id. at 12-14.

\textsuperscript{41} See generally Thomas C. Lee, Comment, Limiting Corporate Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Director's Duty of Care, 136 U. Pa. L. Rev. 239, 261–69 (1987) (mapping out the social policy objectives served by the duty of care).

\textsuperscript{42} See Callison, supra note 7, at 455.

\textsuperscript{43} See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01, at 151–52 (1994) [hereinafter PRINCIPLES] (discussing the flexibility built into the standard of care that expects the director to act with the care of an ordinarily prudent person in a like position under similar circumstances).
the diversity found in the LLC management structure, a duty of care specific to "directors" and "officers" may be inappropriate. Instead, the duty of care of LLC managers should be an integrated standard encompassing operational officer-like duties and director-like duties involving business entity policymaking and oversight.

D. The Socializing, Expressive, and Deterrent Roles

The duty of care serves important expressive functions and should effectively function to socialize the business community, to express community values, to inspire its members to conform to the standard that has been established, to deter misconduct, and to generally enforce reasonable expectations that management will conduct itself responsibly. The duty of care may be viewed as a standard that promotes an internal point of view that promotes appropriately responsible managerial conduct. Alternatively, the duty of care may be regarded as a third party expression that coordinates and encourages careful and thoughtful managerial behavior, thus serving a powerful expressive role of socially appropriate conduct. At the same time, to avoid being counter-productive the duty of care should not be formulated in a manner that dampens risk-taking behavior where the cir-

44. See John C. Coffee, Jr., Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis, 52 GEO. WASH. L. REV. 789, 796–97 (1984) (discussing the educational role played by the duty of care); see also Lee, supra note 41 (discussing the rationales underlying the duty of care).

45. See Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. PA. L. REV. 1735, 1736 (2001) [hereinafter Blair, Trust] (discussing the important link between fiduciary duties and the fostering of trustworthy behavior); see also DeMott, supra note 15, at 926 (discussing the role fiduciary duties play in preserving expectations of behavior that is loyal to the interests of others); Scott J. Shapiro, What is the Internal Point of View? 75 FORDHAM L. REV. 1157, 1157–59 (2006) (indicating that in contrast to the sanctions-based approach, the approach taken by H.L.A. Hart in The Concept of Law emphasizes the internal point of view and theorizes that the actor accepts the rules and makes efforts to comply with them); Owen D. Jones & Timothy H. Goldsmith, Law and Behavioral Biology, 105 COLUM. L. REV. 405, 500 (2005) (discussing the prominent role that behavioral models play in the law and suggesting that the impact of biological forces be integrated into the analysis of the law and behavior); Sarah Helene Duggin & Stephen M. Goldman, Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith, 56 AM. U. L. REV. 211, 274 (2006) (emphasizing the importance of having trust in directors and discussing the requirement that director conduct reflect good faith as a potential tool for restoring trust in corporate governance).

46. See Richard H. McAdams, A Focal Point Theory of Expressive Law, 86 VA. L. REV. 1649, 1671–72 (2000) (observing that the law provides a third-party communication that creates a focal point that coordinates individual activity and that the expression of the law itself plays a powerful role in influencing behavior, although sanctions may still be needed).
cumstances require it. Thus, the need for a balanced legal standard emerges as one considers the competing needs to encourage careful conduct without unduly chilling appropriate risk-taking behaviors.

E. The Remedial Role

The third objective of the duty of care is to provide appropriate remedies. The appropriate remedy could mean reasonable damages to compensate the injured party. It could include injunctive power to restrain certain proposed transactions. Clearly, investor confidence will be fostered if the investor can be assured that there will be a remedy for managerial misconduct. At the same time, however, respect for the legal system may be compromised if the law invites and rewards excessive litigation and legal costs.

F. Encouraging Service and Appropriate Judicial Intervention

Another fundamental goal of the duty of care is to provide a standard of conduct that will promote responsible behavior while being cost effective to the business community and practical when put to the test. The duty of care selected should not be so demanding that it would deter managers from serving or result in undue administrative burdens on the business. A standard of care that is set unrealisti-

47. See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 445 (1993) (observing that it is often in the shareholders' interests for directors or officers to choose the riskier of two alternative decisions).


49. See Lee, supra note 41, at 261–69 (discussing the rationales underlying the duty of care).

50. See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390–97 (1937) (arguing that marketing costs are saved by forming a firm); see also R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 18 (1960) (observing that direct government regulation will not necessarily offer better results than leaving the problem to be solved by the market or the firm). These results have led to the observation that putting aside transaction costs, the parties will tend to bargain in a way that will generate the optimum result and that the market may be more efficient at solving problems than the government. See Richard A. Posner, *Nobel Laureate: Ronald Coase and Methodology*, 7 J. OF ECON. PERSPS. 195, 198 (1993) (discussing the works of Ronald Coase and agreeing with Coase's observation concerning the effectiveness of the market as compared with the government).

51. See Ginger Carroll, *Comment, Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act*, 58 ALA. L. REV. 443, 452–53 (2006) (emphasizing the costs of increased scrutiny of corporate governance); see also Aaron D. Jones, *Corporate Officer Wrong-
cally high could be as destructive as a standard set too low. If the standard and/or penalties are too severe, judges may be reluctant to impose liability in all but the most egregious situations and may inappropriately dismiss worthy cases.

The standard of care should be carefully calibrated to avoid excessive judicial intervention. It is hardly desirable or practical to seek judicial intervention whenever a manager's performance dips below the expected norm.\(^5\) Ample room should be left for the use of non-judicial means of addressing managerial misconduct such as through terminations or firings, or through other non-judicial punitive measures.\(^5\)

Finally, the standard of care should select an appropriate allocation of legal costs as between the entity on one hand and the individual on the other hand. In some cases it may make sense to permit the entity to indemnify the individual for certain violations, while in other cases it may be inappropriate to do so. One interesting approach suggested by the American Law Institute is to limit the personal liability of directors to an amount equal to his or her salary where the violation does not involve a knowing and culpable violation of law, a conscious disregard for duties, or a sustained and unexcused pattern of inattention.\(^5\)

### III. PARTNERSHIP AND CORPORATE MODELS

As discussed above, the duty of care should successfully satisfy the descriptive, socializing, and remedial functions of the law, without imposing large costs or dampening the incentive of management to serve. The contemporary partnership and corporate models for the standard of care offer a starting point for the development of an effective standard of care for the LLC manager. However, each model has shortcomings when one evaluates the extent to which it serves the fundamental policy objectives of the duty of care.

The modern partnership model for the standard of care contained in the *Revised Uniform Partnership Act* states that the partner's duty

\(^5\) See *doing and the Fiduciary Duties of Corporate Officers under Delaware Law*, 44 Am. Bus. L.J. 475, 478 (2007) (discussing "both what state law says and what it should say about the duties and responsibilities of corporate officers").


\(^5\) See *Jones*, supra note 51, at 512.

is limited to refraining from grossly negligent conduct. However, gross negligence has been defined as conduct close to recklessness involving a "devil-may-care" attitude, and as such, sets an extremely low threshold for acceptable business conduct. In fact, the challenge of overcoming the business judgment rule and establishing gross negligence has been characterized as "a near-Herculean" task. To the extent that gross negligence may be equated with recklessness, one may argue that gross negligence as a standard of conduct fails to satisfy the descriptive, socializing, and remedial functions of the duty of care.

The gross negligence formulation improperly conflates or collapses the duty of care with the level of judicial review and consequently loses touch with the fundamental standard of due care that has long governed the conduct of paid agents. Judicial deference to business decision-making may well be appropriate when business decision-making is involved. In such cases, the result may be the imposition of damages when conduct has been grossly negligent. However, it does not necessarily follow that only grossly negligent conduct should entitle a plaintiff to remedies, whether legal or equitable, when opera-
tional conduct and/or oversight responsibilities are at issue. Also, the collapse of the standard of care with the level of judicial review fails to permit the type of fine-tuning that may lead to more judicial scrutiny when there are passive investors and less judicial scrutiny when all partners participate.\(^{61}\)

The corporate model for the standard of care based on the *Revised Model Business Corporation Act* better serves the socializing and cost-containing objectives of the duty of care than the model adopted under the *Revised Uniform Partnership Act*. The corporate model retains an aspirational standard of conduct based on the exercise of reasonable care. However, litigation costs are limited by imposing liability only in the event of gross negligence. The scheme thus preserves the socializing function of the duty of care and also leaves open the opportunity to seek equitable remedies for misconduct that is less extreme than gross negligence. However, the corporate model has been criticized as not providing sufficiently stringent behavioral controls because of the extreme deference shown for the exercise of business judgment.\(^{62}\) In addition, it has been criticized for establishing too low of a standard with regard to oversight responsibilities.\(^{63}\) Also, the *Revised Model Business Corporation Act* contains separate provisions for officers and directors, a distinction that may be ill suited to the multiplicity of management structures housed in the LLC.\(^{64}\)

The "Mandatory Core/Reasonable Care Approach" recommended for the LLC seeks to improve the shortcomings of the partnership and corporate models by introducing a reasonable care standard of conduct, thus differentiating the substantive standard from the standard of judicial review by codifying a business judgment rule to help clarify that the business judgment rule applies when business decision-making is involved, but that generally, the exercise of due care is expected.\(^{65}\) Thus, the application of the business judgment rule would be appropriately confined and the standard for oversight responsibility would be based on due care. The proposal outlined in Part IV addresses the LLC's need for cost containment and flexibility by permitting some contractual modification of the duty of care and by permitting the limitation of damages to the actor's annual salary in

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61. More judicial scrutiny may also be appropriate in other contexts (i.e. where the active LLC member is a minority investor/manager who actively manages the LLC and alleges a squeeze-out by a controlling member) however the present discussion is confined to the duty of care.

62. See Johnson, supra note 52, at 11–14 (observing that little is expected of directors).

63. Id.

64. Compare *Revised Model Bus. Corp. Act* § 8.30 applicable to directors with § 8.42 applicable to officers.

65. See infra Part V.
cases of violations not involving dishonesty and not involving extreme forms of negligence.  

A. The Shortcomings of the Revised Uniform Partnership Act

The original *Uniform Partnership Act* did not contain an express standard of care. Some commentators have argued that the partner's standard of care has always been based on the less stringent duty to refrain from grossly negligent conduct, while others have stressed that partnership law has its roots in agency law and the partner's standard of care is that of the agent, based on the use of due care. At least one commentator maintains that the duty of care in the partnership was bifurcated. Under this view, the partner's conduct as an agent was subject to the "ordinary care" standard but the partner's conduct as a manager was premised upon the lower standard of "gross negligence" by virtue of the application of the business judgment rule.

A few cases support this bifurcation analysis. Recovery was denied on the grounds that the applicable standard of care expected in the partnership was based on due care in a few cases in which a negligent partner sought indemnification or contribution from the partnership. Where a negligent partner sued the partnership for indemni-

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66. *See Principles, supra* note 43, § 7.19 (providing for the limitation on damages to the annual compensation of the actor for violations of the duty of care that do not involve knowing and culpable violations, violations not showing a conscious disregard for duties, and violations not amounting to a sustained and unexcused pattern of inattention).


69. *See id.; see also* Miller, *supra* note 7, at 48 (stating that in light of the fact that partnership and agency law are interwoven, there is support for the view that partners must act with standard care and skill); Beveridge, Jr., *supra* note 59, at 754 (arguing that the partners duty to use the care of an ordinarily prudent person is well-recognized in English and American law and that the due care standard as well as the business judgment rule should be included in the Revised Uniform Partnership Act).

70. *See Jean H. Toal & W. Bratton Riley, Fiduciary Duties of Partners and Limited Liability Company Members Under South Carolina Law: A Perspective from the Bench, 56 S.C. L. REV. 275, 280–81 (2004) (indicating that partners assume the role of agent in conducting the ordinary course of business of the partnership and assume the role of manager making organizational decisions, thus recommending that the duty should be bifurcated in terms of the role as agent and the role as manager).*

71. *See id.*

72. *See Martin, supra* note 68, at 1311–12.
fication, recovery was denied in one medical malpractice case.\textsuperscript{73} Similarly, where a partner had driven negligently, the partner's request for contribution was denied.\textsuperscript{74} On the other hand, where partners sued each other for negligent management they were unsuccessful in recovering on the grounds of ordinary negligence.\textsuperscript{75}

Overall, however, not all the cases fit neatly into the bifurcation paradigm. In one omission case, a partner who failed to get insurance was not liable for the resulting loss ostensibly because the court believed that a member of a joint venture was not liable to another for "mere negligence."\textsuperscript{76} Yet this was a case involving conduct as an agent.\textsuperscript{77} Thus, at best, the partnership law prior to the enactment of the Revised Uniform Partnership Act delivered a mixed message con-

\textsuperscript{73}See \textit{id}. at 1312 n.31; Flynn v. Reaves, 218 S.E.2d 661, 663 (1975).
\textsuperscript{74}See United Brokers' Co. v. Dose, 22 P.2d 204, 205 (Or. 1933).
\textsuperscript{75}See Ferguson v. Williams, 670 S.W.2d 327, 331 (Tex. App. 1984) (indicating that negligence in the management of the affairs of a general partnership or joint venture does not create any right of action); see also Cohen v. Fonseca, 677 So. 2d 1388, 1389 (Fla. Dist. Ct. App. 1996) (involving a defendant who made an error in setting the slab for a guesthouse and observing that in the absence of an agreement there is no liability for ordinary negligence, except that in the present case there was an agreement); Duffy v. Piazza Constr., 815 P.2d 267, 268-69 (Wash. Ct. App. 1991) (involving a defendant who submitted proposals for construction of office space that violated the footage requirements and observing that the co-venturer would not be liable for mistakes of business judgment but would be liable where there is injury to the person or property of the co-venturer or where the venture calls for the exercise of a particular degree of skill).
\textsuperscript{76}Kartage v. Interocean, 167 So. 2d 76, 76 (Fla. Dist. Ct. App. 1964).
\textsuperscript{77}Some cases appear to emphasize the duty of loyalty, but stress that partnership losses resulting from poor judgment or mistakes of judgment are borne by the partnership. See Johnson v. Weber, 803 P.2d 939, 941 (Ariz. Ct. App. 1990) (involving a limited partnership in which the managing partner failed to successfully develop the property but where there was no claim of dishonesty or disloyalty); Borys v. Rudd, 566 N.E.2d 310, 315-17 (Ill. App. Ct. 1991) (involving defendant's failure to file tax returns and his settlement of the partnership's third-party claim, but where there was no claim of fraud or that the defendant lacked good faith); see also Bane v. Ferguson, 890 F.2d 11, 13-14 (7th Cir. 1989) (involving a disastrous merger of a law firm and observing that there is no "tort liability on careless managers for the financial consequences of the collapse of the firm"). For a discussion of the business judgment rule, see Marwil v. Grubbs, No. 1:03-CV-01165-DHF-BS, 2004 WL 2278751, at *2-3, *9 (S.D. Ind. 2004) (involving a suit against directors and officers of a church organization that had entered into risky bargain sales transactions and emphasizing that the business judgment rule requires there to be an informed decision and the exercise of good faith); Rosenthal v. Rosenthal, 543 A.2d 348, 354 (Me. 1988) (observing that the jury should have been instructed on the role of the business judgment rule, and the necessity of defendants' conduct involving fraud or bad faith). See Snell v. De Land, 27 N.E. 183, 184 (Ill. 1891) (observing that a partner is not an insurer of the assets and can only be held for a loss of property when such loss occurs from a willful disregard of duty); Knipe v. Livingston, 57 A. 1130, 1130 (Pa. 1904) (refusing to charge a partner where his unscientific method of bookkeeping resulted in a misleading presentation of the financial health of the firm); see also Thomas v. Milfelt, 222 S.W.2d 359, 359, 365 (Miss. Ct. App. 1949) (involving an automobile
cerning the duty of care, and failed to serve the descriptive function of the duty of care.

Amidst considerable controversy and disagreement, the drafters of the Revised Uniform Partnership Act enacted section 404, which provides that a partner's duty of care is limited to the duty to refrain from engaging in grossly negligent conduct. The policy justifications for this position were apparently that most investors would want to pool their risks together and that over time, losses for negligence fall equally on all partners.

However, the formulation of the duty of care simply as a duty to refrain from grossly negligent conduct fails to satisfy the descriptive and expressive functions of a duty of care since it fails to offer a positive standard of behavior. It loses entirely the standard of reasonable care that has long been associated with the standard of conduct for agents engaged in operations that do not involve business judgments.

In the context of corporate duties, Professor Melvin Eisenberg has articulated a distinction between a standard of conduct and the standard of judicial review. However, his observation applies with equal force to the Revised Uniform Partnership Act's formulation of gross sales and repair business, where the evidence did not indicate that fraud, culpable negligence, or bad faith existed on part of defendant).


80. See RESTATEMENT (SECOND) OF AGENCY § 379(1) (1958) (providing that unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform, and, in addition, to exercise any special skill that he has); RESTATEMENT (THIRD) OF AGENCY § 8.08 (2006) (providing that a principal and agent may establish benchmarks or other measures for the effort and skill to be expected and that an agent's duty of diligence requires the agent to bring the agent's competence to bear on matters undertaken on behalf of the principal); see also Paul Powell, Comment, Dissociating the Fiduciary: Duty Revisions and the Resulting Confusion in Idaho's New Partnership Law, 36 IDAHO L. REV. 145, 156–57 (1999) (observing that Revised Uniform Partnership Act's duty of care departs from the ordinary care standard rooted in agency law).

81. See Eisenberg, supra note 47, at 62 (discussing the standard of conduct as the duty of care that an ordinarily prudent person would reasonably be expected to exercise in a like position, and the standard for judicial review which dictates the degree of scrutiny that a court is likely to exercise in the review of the conduct in question).
negligence. The adoption of a gross negligence standard of care conflates and improperly combines the stated duty of care (reasonable care/due care) with the appropriate standard for judicial review (judicial deference to certain business judgments). It is arguably appropriate for courts to show deference to the decision-making process when reviewing a business decision that requires discretion and a business judgment. However, when the conduct in question does not involve business judgments, the business judgment rule should arguably recede and the applicable standard of conduct should emerge as one based on due care/reasonable care. In other words, a partner who is driving and falls asleep at the wheel has not exercised a business judgment, whereas a director who decides whether to accept a proposal for a merger has indeed exercised business discretion.

By merging the standard of care with the standard of judicial review, the Revised Uniform Partnership Act model loses the socializing and aspirational dimension of the due care standard. It also loses some of its remedial value by eliminating the opportunity of obtaining equitable relief as an alternative to the award of money damages in the case of conduct that may fall slightly short of grossly negligent behavior but which may still be negligent or very negligent.

The separation of the substantive standard of conduct and the standard of judicial review provides the clarity and precision to enable courts to fine-tune the level of judicial scrutiny depending upon the facts and circumstances of the case and the relationship of the parties. It may well be appropriate to provide a reduced level of scrutiny of the duty of care when all parties participate in management and an increased level of scrutiny in the case of centralized management where passive investors have imparted a special degree of trust in managers. Thus, a number of courts have assumed an active posture in reviewing fiduciary duties to protect passive investors and recognize the special level of trust and responsibility that centralized management entails.

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82. See Lee, supra note 41, at 264 (discussing the role of the duty of care and its deterrent and remedial functions).
83. Callison, supra note 7, at 473 (arguing against a statutory standard for the LLC and suggesting that a higher standard of care should be expected where there are passive investors and trust is placed in centralized management).
84. See Curley v. Brignoli Curley & Roberts Assocs., 746 F. Supp. 1208, 1220 (S.D.N.Y. 1989), aff'd, 915 F.2d 81 (2d Cir. 1990) (contractual provision exempting general partner from liability for conduct in good faith did not preclude liability for negligence); Roper v. Thomas, 298 S.E.2d 424, 429 (N.C. Ct. App. 1982) (holding general partners negligent and failing to shelter the general partner with the business judgment rule); M.D. Bldg. Material Co. v. 910 Constr. Venture, 579 N.E.2d 1059, 1062–63 (Ill. App. Ct. 1991) (observing that the passive nature of a limited partner's role has frequently resulted in mismanagement and self-dealing by general partners); Bassan v. Inv. Exch. Corp., 524 P.2d 233, 238 (Wash. 1974) (observing that limited partners “need to rely on the highest stan-
The fairness of the gross negligence standard may be open to question. The gross negligence standard may not necessarily result in a fair allocation of loss in the context of some business entities. As Dean Weidner, Chair of the drafting committee that revised the Uniform Partnership Act observed:

If a ten percent partner negligently shatters $X of partnership property, why should ninety percent of the loss be borne by the other partners? What if the partner's negligence causes a loss to a third party that not only wipes out all partnership assets but also causes the ninety percent partners to lose their separate assets? Is the goal of distributive justice among partners served if the scrupulously careful ninety percent are wiped out and denied the right to be indemnified by the negligent actor?85

Finally, even assuming that the gross negligence standard were the correct approach for general partnerships, it is not necessarily the appropriate standard for business entities that lack personal liability and provide opportunities for passive membership. Since joint and several liability is imposed upon general partners of a general partnership and all partners actively participate, there are already powerful forces that monitor partner conduct. In entities such as the LLC, there may be more of a need to articulate a strong standard of care because LLC members have limited liability and may be active or passive.

In conclusion, the gross negligence standard under the Revised Uniform Partnership Act may fail to achieve the descriptive, socializing, expressive, and remedial objectives of the duty of care. In some instances, it may fail to achieve an equitable distribution of loss among partners. Also, it may be an inappropriate standard to govern LLC managers' conduct given that the LLC provides limited liability and the potential for passive ownership.

B. The Advantages and Shortcomings of the Corporate Model

The corporate model of care contained in the Revised Model Business Corporation Act contains separate standards of conduct for directors86 and officers.87 The corporate scheme sets forth an aspirational standard of conduct for directors based on the exercise of reasonable standards of conduct from general partner" because limited partners do not have a voice in decision-making);
85. Weidner, Midstream, supra note 79, at 852.
86. See REVISED MODEL BUS. CORP. ACT § 8.30 (2005) providing:
Standards of Conduct for Directors
(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.
(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge
care. However, liability for damages is imposed only in one of five types of circumstances where the director: 1) was not acting in good faith; 2) did not believe the conduct was in the best interests of the company; 3) was not reasonably informed; 4) engaged in a self-interested transaction, received an improper benefit, or otherwise dealt unfairly with the company or shareholders; or 5) engaged in conduct that involved a sustained attention to the oversight of the business or affairs.\textsuperscript{88} Under the business judgment rule, the standard of judicial review presumes that absent self-dealing, if there has been a minimal level of care, the court will not second-guess the decision in question.\textsuperscript{89}

Thus, it may be argued that this corporate approach better serves the descriptive function of the duty of care than the \textit{Revised Uniform Partnership Act} formulation because the standard of care is preserved as a positive standard to which directors may aspire. Professor Coffee has long regarded the duty of care as a normative standard with an important "educational and socializing effect."\textsuperscript{90} It may be argued that the dual formulation that separates out the standard of care from the standard of liability furthers the overall objective of business entity governance to control costs by imposing liability only in grave circumstances. The dual formulation also arguably serves the remedial objective of the duty of care by leaving open the possibility of seeking

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their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

87. See \textit{id.} § 8.42 (2005) providing in part:

\begin{quote}
Standards of Conduct for Officers
(a) An officer, when performing in such capacity, has the duty to act:
(1) in good faith;
(2) with the care that a person in a like position would reasonably exercise under similar circumstances; and
(3) in a manner the officer reasonably believes to be in the best interests of the corporation.
\end{quote}

88. See Miller & Rutledge, \textit{supra} note 7, at 345 (tracing the evolution of the business judgment rule from the corporate to non-corporate contexts).

89. See \textit{id.; Revised Model Bus. Corp. Act} § 2.02(b)(4)-(5) (2002) providing:

(b) The articles of incorporation may set forth:
(4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law; and
(5) a provision permitting or making obligatory indemnification of a director for liability (as defined in section 8.50(5)) to any person for any action taken, or any failure to take any action, as a director, except liability for (A) receipt of a financial benefit to which he is not entitled, (B) an intentional infliction of harm on the corporation or its shareholders, (C) a violation of section 8.33 or (D) an intentional violation of criminal law.

90. Coffee, \textit{supra} note 44, at 796.
equitable relief as distinguished from money damages for lesser offenses than those that would justify a damage award.

Finally, it may be argued that the corporate model retains its roots in agency law. The Revised Model Business Corporation Act adopts a separate standard of conduct for officers based on the conduct expected of a paid agent and requires the exercise of reasonable care.\textsuperscript{91} There is a controversy, however, over whether officers are and should be subject to a business judgment rule and whether they should be subject to damages for failing to exercise reasonable care.\textsuperscript{92} It must be remembered that LLC managers may exercise both officer-like functions as well as discretionary board-like responsibilities. The LLC standard of conduct for LLC managers should be equipped to address conduct in the routine operation of business as well as conduct that entails broad policy-making decisions regarding extraordinary transactions.\textsuperscript{93}

\textsuperscript{91} See Revised Model Bus. Corp. Act § 8.42 (2005) requiring an officer to act in good faith, with the care that a person in a like position would reasonably exercise under similar circumstances, and in a manner the officer reasonably believes to be in the best interest of the corporation. The comments to section 8.42 indicate that the standards of conduct are generally based on the principles of agency.

\textsuperscript{92} See Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 Bus. Law. 439, 440 (2005) [hereinafter Johnson, Corporate Officers] (arguing that the business judgment rule should not be extended to officers in the same broad manner as to Board members because unlike directors, the risk/reward ratio is not as high as for directors, officers' duties may consist of executing rather than making business decisions and for such execution, an ordinary care standard is appropriate and judicial deference is not needed, and that a due care standard gives directors leverage over officers to ensure that they discharge duties with care). See also A. Gilchrist Sparks, III & Lawrence A. Hamermesh, Common Law Duties of Non-Director Corporate Officers, 48 Bus. Law. 215, 236 (1992) (observing that officers' liability under the duty of care is usually greater for officers than directors, largely because of officers' increased familiarity with the corporation and recommending that officers be able to utilize the business judgment rule). Cf. Lawrence A. Hamermesh & A. Gilchrist Sparks III, Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson, 60 Bus. Law. 865, 870–75 (2005) (arguing that officers and directors are sometimes the same and it is difficult to sort out when conduct occurs in the capacity as an officer as distinguished from a director, and that a due care standard will make officers more cautious such that they will seek second and third opinions and incur unnecessary costs).

\textsuperscript{93} An early draft of the Revised Uniform Limited Liability Company Act attempted to formulate a separate standard of conduct for non-discretionary operational conduct and for discretionary conduct but ultimately this approach was found to be difficult and was abandoned. The proposal provided:

A member's duty of care to a member-managed limited liability company in the conduct of and winding up of the limited liability company's business is limited:

(1) when exercising discretionary authority in making decisions to take or not to take action, to acting:

(i) independently;
The business judgment rule shelters corporate directors from judicial scrutiny for business decisions in certain cases in which the director did not engage in self-dealing and makes an informed decision. The corporate model arguably establishes personal liability only in extreme cases as the result of the business judgment rule and corporate indemnification provisions. Critics may argue that the business judgment rule provides too great of a shield from director liability. In Delaware, for example, the business judgment rule is applied as a presumption, thus affecting the burden of proof. According to the Delaware Supreme Court, in Aronson v. Lewis, the business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

The ability to rebut the presumption of the business judgment rule remains an uphill battle—the plaintiff must prove gross negligence and to ultimately prevail, establish causation and damages and overcome the director's possible defense that the challenged transaction was fair. The scope of protection under the approach taken by the American Legal Institute is even wider, extending director or officer protection where the decision-maker makes a business judgment in good faith and: 1) is not interested in the subject; 2) is informed to the extent he or she believes is appropriate in the circumstances; and 3) rationally believes the judgment is in the best interests of the corporation. Some jurisdictions have lowered the standard of care even fur-

(ii) in a manner the member reasonably believes to be in the best interest of the limited liability company; and

(iii) after considering information the member reasonably believes appropriate in the circumstances, including information provided by another person that the member reasonably believes is a competent and reliable source for the information; and

(2) in all other circumstances, to acting with the care that a person in a like position would reasonably exercise under similar circumstances.


94. Miller & Rutledge, supra note 7, at 351-52 (analyzing the business judgment rule in corporate and unincorporated entities).

95. Id. at 348.


97. See id. at 812.

98. See id. at 813; see also Miller & Rutledge, supra note 7, at 353 (discussing the showing required by the plaintiff to overcome the business judgment rule).

99. See PRINCIPLES, supra note 43, § 4.03(c).
ther by providing that liability will be imposed only in the event of willful misconduct or recklessness.100

Even if liability is imposed, indemnification statutes provide a second tier of insulation from personal liability. Following Smith v. Van Gorkom,101 the Delaware Supreme Court decision in which directors were held liable where they were deemed not sufficiently informed about the true value of a company before approving a merger, legislatures across the country followed Delaware's lead by adopting legislation that eliminates or limits the personal liability of a director to the corporation or its stockholders for monetary damages for negligence.102 The Principals of Corporate Governance, published by the American Law Institute, report that since 1985 over thirty states have adopted legislation reducing or eliminating exposure to personal liability for monetary damages for duty of care violations.103 The indemnification provisions vary in the degree of protection afforded.104 The approach taken by the American Law Institute is to permit indemnification except for knowing violations of law, or for certain fines, penalties, judgments or settlements where the policy would preclude indemnification.105 The Revised Model Business Corporation Act permits indemnification where the director's conduct was in good faith, and where the director believed the conduct to be in the best interests

100. See, e.g., IND. CODE ANN. § 23-1-35-1(e) (LexisNexis 1999) and associated commentary (indicating subsection (e)'s standard is different from the "gross negligence" standard and "willful misconduct" or "recklessness" require, at minimum, a conscious disregard of or indifference to the consequences of a risky act such as in Orkin Exterminating Co. v. Trainer, 486 N.E.2d 1019, 1023 (Ind. Ct. App. 1982) and that gross negligence involves more than ordinary inadvertence, but less than such conscious disregard or indifference according to William L. Prosser & W. Page Keeton, The Law of Torts 212 (5th ed. 1984)).


102. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). Delaware permits such indemnification agreements, except that such provisions may not "eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit." Id.; Charles M. Elson & Robert B. Thompson, Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives, 96 NW. U. L. REV. 579, 582–83 (2002) (discussing Van Gorkom and the role of markets, private ordering, the law, and norms on constraining board conduct); see also Donald C. Langevoort, The Human Nature of Corporate Boards: Laws, Norms and Unintended Consequences of Independence and Accountability, 89 GEO. L.J. 797, 800 (2000) (discussing the prominent influence of extralegal social forces in shaping board behavior). See generally Symposium, Norms & Corporate Law, 149 U. PA. L. REV. 1607 (2001) (discussing the role of norms and that of corporate law).


105. See PRINCIPLES, supra note 43, § 7.20(b)–(c).
of the corporation, or at least not opposed to its best interests, and
where in a criminal context the director had no reasonable cause to
believe the conduct was unlawful.106

In Delaware, only inexcusable inattentiveness and/or a complete
abduction of one's duties to oversee the business have triggered judg-
ments for plaintiffs.107 Thus, in In re Caremark International Inc.,108
where officers were indicted for receiving kickbacks for referrals of
medical supplies and equipment, the Delaware Court refused to im-
pose liability upon the directors where the court believed that they
had in good faith regarded the corporation's information and reporting
system as adequate.109 A sustained or systematic failure of the board
to exercise oversight such as an utter failure to attempt to assure a
reasonable information and reporting system exists would constitute a
lack of good faith necessary to justify the imposition of liability.110
Only egregious conduct will nullify Delaware's indemnification provi-
sions permitting the corporation to indemnify persons who acted in
good faith and in a manner reasonably believed to be in the best inter-
ests of the company.111 According to In re Walt Disney,112 indemni-

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107. See Francis v. United Jersey Bank, 432 A.2d 805, 814 (Del. 1981) (involving direc-
tors who were held liable for negligence in failing to prevent other directors from
embezzling funds where the widow of the former CFO had inherited half of the
 corporet stock and failed to attend board meetings, read financial statements, or
learn about the business thus enabling her son to steal money from the com-
pany); PRINCIPLES, supra note 43, § 4.01 (discussing the prerequisite of a con-
scious exercise of judgment to gain protection of the business judgment rule); see
also Graham v. Allis-Chalmers Mfg., 188 A.2d 125-30 (Del. 1963) (failing to hold
defendants liable but observing that liability could result if directors had reck-
lessly trusted untrustworthy employees, neglected cavalierly to perform job du-
ties or willfully or through inattention ignored obvious danger signs).
109. Id. at 970-71.
110. Id. at 971; see Halpert Enter. v. Harrison, No. 06 Civ. 2331(HB), 2007 WL
486561 (S.D.N.Y. Feb. 14, 2007) (dismissing a shareholders' derivative action
against Harrison and other directors, officers, and Board members of J.P. Morgan
 Chase & Co. alleging breach of fiduciary duty, gross mismanagement, corporate
 waste and securities violations for failing to prevent transactions such as Enron
 and WorldCom that cost J.P. Morgan over $4 billion in fines, civil litigation costs,
 and settlements); see also Stone v. Ritter, 911 A.2d 362 (Del. 2006) (affirming
dismissal of shareholders suit based in part of failure of the oversight function).
111. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (permitting indemnification agree-
ments, except that such provisions may not "eliminate or limit the liability of a
director: (i) for any breach of the director's duty of loyalty to the corporation or its
stockholders; (ii) for acts or omissions not in good faith or which involve inten-
tional misconduct or a knowing violation of law; (iii) under §174 of this title; or
(iv) for any transaction from which the director derived an improper personal
benefit").
112. 906 A.2d 27 (Del. 2006) (affirming the Chancery Court's ruling in favor of the
defendants where the Disney Board had authorized the payment of $130 million
in severance pay to Orvitz, its CEO, after he had served only fourteen months of a
cation in Delaware is denied for a lack of good faith only where the behavior is qualitatively more culpable than gross negligence, where, for instance, the conduct encompasses an intentional dereliction of duty or conscious disregard for one's responsibilities.\footnote{113} For example, in \textit{ATR-Kim Eng Financial Corp. v. Araneta},\footnote{114} two directors were jointly liable with the ninety percent owner/director of a corporation, where the two directors had failed to implement a reporting or monitoring system to prevent the transfer of the company's assets to the majority owner's children. Liability was imposed upon these two directors because of their intentional abandonment of duties, which was construed by the court as a breach of their duty of loyalty.\footnote{115} It may be argued that Delaware's corporate standard for oversight responsibilities might be too low since only an utter failure to implement any reporting or information system or controls, or a conscious failure to monitor or oversee operations appears to amount to a failure to discharge the duty of loyalty in good faith.\footnote{116}

Clearly, the corporate model provides mixed messages—on one hand it sets an aspirational standard of reasonable care for directors and officers, yet by virtue of the business judgment rule and liberal indemnification provisions, imposes personal liability on directors for business decisions only in rare cases of extreme wrongdoing. Standards of conduct should inspire and reflect responsible behavior without unduly chilling risk-taking behavior.\footnote{117}

\footnote{113}{See \textit{Disney}, 906 A.2d at 27.}
\footnote{115}{Id. at *21.}
\footnote{116}{See \textit{Stone v. Ritter}, 911 A.2d 362, 370–71 (Del. 2006) (involving a suit growing out of a money laundering scheme and a bank's failure to file Suspicious Activity Reports in violation of the Bank Secrecy Act where the Delaware Supreme Court affirmed the dismissal of a derivative complaint alleging the directors failed to properly exercise its oversight role).}
\footnote{117}{See \textit{In re Caremark Int'l Inc.}, 698 A.2d 959, 968–69 n.16 (Del. Ch. 1996).}

The vocabulary of negligence while often employed is not well-suited to judicial review of board inattentiveness, especially if one attempts to look to the substance of the decision as any evidence of possible "negligence." Where review of board functioning is involved, the courts leave behind as a relevant point of reference the decisions of the hypothetical "reasonable person" who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of ordinary judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based on what an ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons
firm mechanisms should be the first line of defense against poor management, at some point legal intervention may become necessary before conduct degenerates to the point that the director has completely abandoned duties, particularly if management is entrenched in a private entity. Ultimately, too much judicial deference can erode investor confidence in the legal scheme of business entity governance.\textsuperscript{118}

Three major points of clarification may be helpful to ensure that the corporate model does not result in too little or too much judicial intervention in the LLC context. First, it may be helpful for courts in LLC cases to clarify that the business judgment rule only applies when business decision-making is involved but does not excuse non-performance of duties. Second, courts should recognize that if the statutory formulation already states that the duty of care is to refrain from grossly negligent conduct, the standard of care articulated as gross negligence already factors in judicial deference to business decision-making.\textsuperscript{119} Further judicial deference might result in too relaxed a standard.\textsuperscript{120} Third, it may be helpful for courts to clarify that misbehavior more serious than ordinary inadvertence is necessary to trigger judicial intervention; however, the level of misbehavior necessary to permit legal or equitable remedies need not be so egregious as to amount to intentional and/or a complete and utter abandonment of duties.

Ultimately, a balanced approach to the duty of care is recommended that would prevent excessive judicial intervention but ensure rigorous judicial remedies for conduct that is below ordinary inadvertence. The business judgment rule should not excuse the duty to monitor and actively assume responsibilities.\textsuperscript{121} The driver asleep at the wheel, the officer who totally neglects the books, or the director who fails to oversee the business are not exercising business judgment. The level of negligence that should justify judicial intervention should probably be something that need not amount to intentional misconduct that is so grave as to become tantamount to bad faith or a breach in the duty of loyalty. Nevertheless, the misconduct should be more

\textsuperscript{118} See Edward Rock & Michael Wachter, Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants, 96 NW. U. L. REV. 651, 664–65 (2002) (explaining judicial deference in corporate law as the expression of discomfort with applying the trustee/agency law duty of care to directors because the relationship between the corporation and director is an internal relationship governed largely by the firm, whereas the relationship between the settlor or beneficiary and the trustee is an external relationship governed by the so-called market).

\textsuperscript{119} See Miller & Rutledge, supra note 7, at 362–63.

\textsuperscript{120} Id.

\textsuperscript{121} See Principles, supra note 43, § 4.01.
serious than instances of carelessness and/or moderate degrees of poor performance.

As discussed in Part IV.D, some courts in the LLC context have already implicitly recognized that the business judgment rule plays no role in excusing non-performance. While not always thoroughly articulating their rationale, some decisions appear to be striking a balanced approach to judicial monitoring. Ultimately, after discussing the LLC statutory and judicial environment in Part IV below, Part V recommends a slight tailoring of the corporate model of care for use in the LLC. It suggests a separate articulation of the duty of care rooted in agency concepts—a duty to act with the care that a person in a like position would reasonably exercise under similar circumstances. It then suggests a careful application of the business judgment rule so that the business judgment rule does not overwhelm and negate the overall standard to act reasonably when the actor is discharging operational or oversight responsibilities. The Revised Uniform Limited Liability Company Act is consistent with these recommendations but does not offer statutory guidelines on the business judgment rule. 122

IV. STATUTES, INDEMNIFICATION, & LLC CASE LAW

Most state LLC statutes include statutory provisions concerning the duty of care. 123 Only a few states follow the Delaware approach and permit fiduciary duties to be eliminated. 124 While LLCs are still in their infancy, judicial interpretations are beginning to emerge. The case law provides a window into the increasingly important economic role played by LLCs in industries involving oil and gas, energy and real estate, and the provision of quasi-governmental services. While


123. See infra apps. B & C.

124. Only a few states permit the elimination of duties (i.e. Arkansas, District of Columbia, Georgia, and Kentucky). See Ark. Code Ann. § 4-32-404 (2007) (permitting the elimination of fiduciary duties); Colo. Rev. Stat. Ann. § 7-80-108(1.5) (2006) (providing the duties of such member, manager, or other person may be restricted or eliminated by provisions in the operating agreement, as long as any such provision is not manifestly unreasonable); Del. Code Ann. tit. 6, § 18-1101(c) (2005) (permitting duties to be expanded, restricted, or eliminated); D.C. Code Ann. § 29-1020 (LexisNexis 2007) (indicating that liability “may be limited or eliminated in the articles of organization” except for willful misconduct); Ga. Code Ann. § 14-11-305(4)(A) (2003) (providing that the “member’s or manager’s duties and liabilities may be expanded, restricted, or eliminated by provisions in the articles of organization or a written operating agreement” but not for “intentional misconduct or a knowing violation of law” or “for any transactions for which the person received a personal benefit in violation or breach of any provision of a written operating agreement”); Idaho Code Ann. § 53-624 (2000) (providing for the elimination of duties without apparent restriction); Ky. Rev. Stat. Ann. § 275.180 (West 2006) (providing that the operating agreement may eliminate or limit personal liability for monetary damages for a breach of any duty).
the vast majority of fiduciary duty litigation pertains to violations of the duty of loyalty, duty of care cases are beginning to emerge and courts are recognizing the LLC manager's duty to act and to actively assume managerial duties. Whether supervising bookkeeping and banking functions,\textsuperscript{125} performing due diligence procedures,\textsuperscript{126} or obtaining licenses for the LLC's operations,\textsuperscript{127} the LLC manager is expected to actively discharge responsibilities. Case law further suggests that a corporate director may not circumvent fiduciary duties by forming an LLC and purporting to discharge business operations through the LLC.\textsuperscript{128}

A. A Range of Standards

The statutory LLC duty of care provisions include: 1) ordinary care, good faith business judgment of the best interests of the company, or prudent person language;\textsuperscript{129} 2) the requirement to refrain from gross negligence or willful misconduct;\textsuperscript{130} 3) the requirement to refrain from recklessness;\textsuperscript{131} and 4) statutory silence on the duty of care with case law precedents based on due care or on the duty to refrain from grossly negligent conduct.\textsuperscript{132}

B. Contractual Definition

Most LLC statutes may be described as enabling statutes that presuppose that the major issues concerning LLC operations and governance matters will be determined by the LLC operating agreement. Many statutes contain express standards with regard to fiduciary du-


\textsuperscript{129} See infra app. B; 2 CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW § 10.02 (2006) (providing an overview of duty of care provisions); see also Miller & Rutledge, supra note 7, at 365–66 (discussing the statutory environment of the duty of care in the context of the LLC).

\textsuperscript{130} See infra app. C.

\textsuperscript{131} See IND. CODE ANN. § 23-1-35-1(e) (LexisNexis 1999) (providing that a director is not liable unless he has breached or failed to perform his duties and the failure constitutes willful or reckless conduct); 2 BISHOP & KLEINBERGER, supra note 129, § 10.02[1][d].

\textsuperscript{132} For example, Delaware's LLC statute lacks a statutory standard of care and the Maryland LLC statute lacks a statutory statement of care except with regard to the provision of professional services. See MD. CODE ANN., CORPS. & ASS'NS § 4A-301.1 (LexisNexis 1999).
ties and then provide limitations on the extent to which these duties may be modified or eliminated by the LLC agreement.

Delaware has taken the lead in providing contractual freedom with regard to the definition of fiduciary duties. The Delaware LLC statute is silent with respect to required fiduciary duties. The duty of loyalty has been judicially imposed in the LLC context largely through the requirement that self-interested transactions be shown to be fundamentally fair. The duty of care is regarded as less exacting than that based on simple negligence. Initially, the Delaware LLC statute provided that the member's or manager's duties and liabilities may be expanded or restricted by provisions in the LLC agreement. However, the LLC statute was modified following the Delaware Supreme Court decision in *Gotham Partners v. Hallwood Realty Partners* in which the Court admonished the legal community that scrupulous adherence to fiduciary duties is normally expected and that the statute did not permit the contractual elimination of fiduciary duties. The Delaware LLC statute now provides that duties may be expanded, restricted, or eliminated by the LLC agreement, provided that the agreement may not eliminate the contractual covenant of good faith and fair dealing. Similarly, the Kentucky LLC statute permits the agreement to eliminate or limit personal liability for monetary damages. However, the Kentucky provision does not contain Delaware's caveat prohibiting the elimination of the contractual covenant of good faith and fair dealing. It remains to be seen whether Delaware's prohibition on the elimination of the duty of good faith will operate in practice as a significant constraint on managerial conduct in the LLC.

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134. *Aronson v. Lewis*, 473 A.2d 805, 813 n.6 (Del. 1984) (challenging loans and an employment agreement that benefited a 47% shareholder and indicating that the defendants were protected by the business judgment rule where plaintiffs failed to show that defendants were self-interested, lacked independence, or acted contrary to the best interests of the corporation).


137. Id. at 168 (dictum).


140. Id.

enant narrowly, the covenant of good faith could be used to combat a variety of furtive conduct in instances where fiduciary duties have been waived.

The more common approach is to permit personal liability to be eliminated or limited in the LLC operating agreement but to place significant restrictions on fiduciary duty waivers or contractual indemnification provisions. Minnesota is a case in point. The Minnesota LLC statute permits the articles or agreement to eliminate or limit the liability of the LLC governor. However, liability may not be eliminated or limited for breaches of the duty of loyalty, acts or omissions not in good faith, or for conduct involving intentional misconduct or knowing violations of law, violations of laws governing the sale of securities, illegal distributions, or for transactions from which the governor receives an improper personal benefit. Thus, while the LLC agreement may not limit liability for breach of the duty of loyalty violations, it may protect the manager from liability for acts or omissions that do not rise to the level of intentional misconduct or to the knowing violation of law.

Even liberal jurisdictions such as Florida and Georgia place restrictions on contractual waivers. In Florida, the LLC operating agreement may not eliminate the duty of loyalty although it may identify types or categories of activities that do not violate the duty of loyalty if not manifestly unreasonable. Also, the agreement may not unreasonably reduce the duty of care.

In Georgia, the member's or manager's duties may be contractually expanded, restricted, or eliminated by the articles of organization or the operating agreement. However, there can be no elimination or limitation upon liability arising from intentional misconduct, knowing


144. See infra app. A.


146. Liability may not be eliminated or limited for acts or omissions occurring before the date when the articles or agreement containing the limiting provisions were in effect. See id. at §§ 322B.663(4)(1)–(5).

147. See FLA. STAT. ANN. § 608.423(2)(b) (West 2007).

148. Id. § 608.423(2)(c).
violations of law, or for transactions for which a personal benefit was received in violation of the written operating agreement.\textsuperscript{149}

The first \textit{Uniform Limited Liability Company Act} prohibited the contractual elimination of the duty of loyalty, the unreasonable restriction of information rights, and the unreasonable reduction of the duty of care.\textsuperscript{150} It permitted the parties to identify specific categories of activities that did not violate the duty of loyalty if not manifestly unreasonable.\textsuperscript{151} The \textit{Revised Uniform Limited Liability Company Act} goes further and permits the operating agreement to eliminate the duty to account and the duty to refrain from competition if not manifestly unreasonable.\textsuperscript{152} The revised statute permits the agreement to alter any other fiduciary duty including eliminating particular aspects of that duty.\textsuperscript{153} Also, it permits the agreement to alter the duty of care except for intentional or knowing violations of law.\textsuperscript{154} As more fully discussed in Part V, to further the socializing and remedial objectives of the duty of care, limitations are strongly recommended to prevent the complete elimination of fiduciary duties.

C. Indemnification Restrictions

Most LLC statutes permit the LLC agreement to provide indemnification to a manager or member for liability arising out of LLC litigation, but place restrictions on the circumstances in which the indemnification may be made.\textsuperscript{155}

A number of states prohibit indemnification unless there was a good faith reasonable belief that the conduct in question was in the

\begin{itemize}
\item \textsuperscript{149} \textit{GA. CODE ANN.} § 14-11-305(4)(A) (West 2003).
\item \textsuperscript{150} \textit{UNIF. LTD. LIAB. CO. ACT} § 103(b) (1996).
\item \textsuperscript{151} \textit{Id.} § 103(b)(2).
\item \textsuperscript{152} \textit{REVISED UNIF. LTD. LIAB. CO. ACT} § 110(d)(1) (2006) providing:
\begin{enumerate}
\item If not manifestly unreasonable, the operating agreement may:
\begin{enumerate}
\item restrict or eliminate the duty:
\begin{enumerate}
\item as required in Section 409(b)(1) and (g), to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;
\item as required in Section 409(b)(2) and (g), to refrain from competing with the company in the conduct or winding up of the company's business before as or on behalf of a party having an interest adverse to the company; and
\item as required by Section 409(b)(3) and (g), to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.
\end{enumerate}
\end{enumerate}
\end{enumerate}
\end{enumerate}
\item \textsuperscript{153} \textit{Id.} § 110(d)(4).
\item \textsuperscript{154} \textit{Id.} § 110(d)(3).
\item \textsuperscript{155} \textit{See infra} apps. D & E including selected states that restrict the circumstances in which indemnification may be provided.
\end{itemize}
best interests of the LLC or was not opposed to its best interests.\textsuperscript{156} Others additionally stipulate that the individual must not have received an improper personal benefit.\textsuperscript{157} Another typical condition is that in the case of a criminal proceeding, the person had no reasonable cause to believe that the conduct was unlawful.\textsuperscript{158} Some states require that the person not have engaged in willful misconduct or a knowing violation of law.\textsuperscript{159}

Many states prohibit the LLC agreement from indemnifying an individual where defined types of misconduct have occurred.\textsuperscript{160} For example, Colorado permits indemnification if there has not been a violation of duties owed to the LLC.\textsuperscript{161} Alabama prohibits indemnification if there has been negligence or misconduct in the performance of duties.\textsuperscript{162} A more common provision is for the statute to prohibit indemnification if there has been willful misconduct or recklessness.\textsuperscript{163} Other prohibitions include the receipt of improper distributions,\textsuperscript{164} improper financial benefits, services, or involve the failure to perform duties.\textsuperscript{165}

Delaware and a handful of other states fail to place statutory restrictions on indemnification provisions.\textsuperscript{166} Although Delaware's corporate indemnification provision prohibits corporations from indemnifying a director for conduct not in "good faith,"\textsuperscript{167} the Delaware LLC statute permits indemnification with respect to \textit{all claims and demands} whatsoever.\textsuperscript{168}

\begin{itemize}

\item \textsuperscript{156} See infra app. D including selected states requiring a good faith and reasonable belief that the conduct was in the LLC's best interests or not opposed to its best interests.

\item \textsuperscript{157} See infra app. E.

\item \textsuperscript{158} See infra app. E.


\item \textsuperscript{160} See infra app. E citing states in which various restrictions are placed on indemnification.


\item \textsuperscript{162} Ala. Code § 10-12-4(n) (LexisNexis 1999).

\item \textsuperscript{163} See infra app. E including citations to provisions in Washington D.C., Montana, Maryland, and Pennsylvania.


\item \textsuperscript{165} See Wash. Rev. Code Ann. § 25.15.040 (West 2006).

\item \textsuperscript{166} See infra app. F including Arizona, Arkansas, Connecticut, Idaho, Kansas, Kentucky, New Jersey, and New Mexico.

\item \textsuperscript{167} See Del. Code Ann. tit. 8, § 145(a) (2001) (granting power to indemnify "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation, and, with regard to any criminal action or proceeding had no reasonable cause to believe the conduct was unlawful").

\item \textsuperscript{168} Compare Del. Code Ann. tit. 8, § 102(b)(7) (2001) (providing that a corporation may eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages but shall not eliminate or limit liability for any breach of the duty of loyalty, acts or omissions not in good faith or which
As more fully discussed below, statutory restrictions on indemnification provisions are recommended. It is argued that LLC managers should not be able to evade the consequences of serious violations of the duty of care. As explained long ago by Joseph Bishop, Jr.:

"Where civil liability is the sole or principal deterrent to self-enrichment at the corporation's expense, the director should not be permitted to insure himself against such liability . . . . For like reasons, directors should not be able to insure themselves against liability based on negligence of a gross description, amounting to a total abdication of the responsibility imposed upon them by law."

As discussed below, Bishop's rationale applies with equal force in the LLC context.

D. LLC Duty of Care Case Law and Standards of Conduct

While the overwhelming majority of cases involve allegations of a breach of the duty of loyalty, LLC cases involving allegations of breach of the duty of care have begun to surface. Three major themes are emerging from the case law. First, the case law that involves the furnishing of critical infrastructure services or other special services highlights the important nature of the economic activities undertaken by some LLCs. It is particularly in these infrastructure cases that a standard articulated as simply a duty to refrain from grossly negligent conduct or reckless conduct seems out of place. Second, the cases reviewed involving monitoring and/or oversight responsibilities suggest that courts seem to be taking a balanced approach, although the decisions could have been improved by a more thorough explanation of their rationales. Nevertheless, the courts in the LLC cases considered below are not intervening when merely moderately careless or moderately negligent conduct is involved, yet are not requiring a total and complete abandonment of duties virtually amounting to bad faith or intentional misconduct in order to trigger judicial action. The third important point that may be gleaned from the cases is that it may be


170. Cf. ATR-Kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N, 2006 WL 3783520 (Del. Ch. Dec. 21, 2006) (imposing liability for a breach in the duty of loyalty where two of the directors intentionally abandoned their oversight duties which was thought to be an utter failure to monitor that amounted to a failure to discharge the duty of loyalty in good faith).
helpful to have coherence in standards of conduct across business entities. One of the cases reviewed below involves the use of an LLC to circumvent corporate fiduciary duties. This case underscores the importance of preventing the LLC from being used to commit breaches in the duty of loyalty or care stemming from relationships grounded in corporations or other non-LLC entity structures.

In terms of the volume of fiduciary duty litigation, the duty of loyalty cases seem to predominate and even some of the duty of care cases are hybrid cases involving allegations of breaches of the duty of loyalty as well as care. This is consistent with the pattern that was observed long ago in the corporate arena when the pure duty of care cases untouched by concomitant breaches in the duty of loyalty were described as "the proverbial shaving of pigs—much squeal and little wool."  

1. The Infrastructure Cases

The public interest in responsible LLC management becomes evident when one considers the explosive growth of the LLC. As discussed in Part II.A., LLCs now rank among publicly traded business entities and can be seen in a wide range of industries including oil and gas, energy and distribution, and real estate. LLC case law additionally underscores the range and relative importance of the economic role played by the LLC. Foster-Thompson, LLC v. Thompson, Cement-Lock v. Gas Technology Institute, and Willoughby Rehabilitation & Health Care Center, LLC v. Webster remind us that critical quasi-governmental services may be housed in the LLC and that LLC business activities can potentially affect the environment, public health, and/or public safety.

Foster-Thompson, LLC was a Florida LLC created for the purpose of constructing electrical power generating facilities in Iraq. The LLC was awarded a $24 million contract by the United States through the Coalition Provisional Authority. The defendant was the manager and engineering supervisor. The suit was instituted by the LLC against the defendant manager who allegedly sold and brokered the sale of power generating equipment and components to others on his own personal behalf, used LLC funds for non-business related activities, made and received kickbacks, and failed to properly supervise the

171. Bishop, supra note 169, at 1095.
176. Foster-Thompson, 2005 WL 3093510 at *1.
project. The Court failed to grant the defendant’s motions for summary judgment and observed that Florida’s LLC statute creates a duty of care as well as a duty of loyalty.177

In Cement-Lock, a suit was brought against a group of entities including Endesco Clean Harbors, LLC.178 The case arose out of the mishandling of grant money earmarked for the marketing of technology that remediates contaminated materials and converts them into a cement additive. The court held that the plaintiffs had adequately pleaded a breach of fiduciary duties including the duty of care, loyalty, and good faith. The allegations ranged from the receipt of kickbacks to the misappropriation of research grant funds.179

Both Foster-Thompson and Cement-Lock reflect the breadth of activities undertaken by LLCs. Whether the LLC provides electrical power, remediates contaminated materials, constructs public tunnels, roadways or buildings, or provides nursing care, an improperly managed LLC may adversely affect the public. From the investor’s perspective, whether the LLC provides utilities that are a critical part of the society’s infrastructure or offers manicure and pedicure services, expectations of responsible management deserve to be equally respected. However, where the LLC provides critical services, duty of care violations may not only disappoint reasonable investor expectations, but also may result in serious consequences to third parties. While the primary goal of business entity governance law is to promote investor confidence and not to regulate business for the protection of third parties, it is important for business entity governance standards to generally promote, rather than frustrate, overall policy goals of achieving responsible management. Cases such as Foster-Thompson and Cement-Lock involving vital services remind us of the importance of creating a legal environment that promotes responsible managerial conduct through both internal governance standards and legal constraints for the protection of third parties.

A duty of care articulated as a duty to refrain from grossly negligent or reckless conduct seems out of place particularly where the LLC’s services involve key features of society’s infrastructure or other services having a significant impact upon the public. While it is important to ensure that standards of conduct do not lead to excessive legal intervention, it is also important, particularly where key services are involved, to retain the socializing aspects of the law. Also, it may become important to ensure that equitable remedies will become available to investors before the LLC manager’s conduct degenerates to a complete abandonment of duties or to reckless or intentional misconduct. Foster-Thompson and Cement-Lock provide examples of the

177. Id. at *4.
179. See id.
In contexts in which the duty to act reasonably seems most appropriate as an internal governance standard.

2. The Duty to Actively Assume Management Duties

As stated previously in the discussion of the corporate model, corporate law recognizes an affirmative duty to actively assume one's management duties. The business judgment rule insulates directors from liability for making poor business decisions, but its application presupposes attention to one's duties. As explained by the Principles of Corporate Governance:

There is, however, no reason to provide special protection where no business decision-making is to be found. If, for example, directors have failed to oversee the conduct of the corporation's business by not even considering the need for an effective audit process, and this permits an executive to abscond with corporate funds, business judgment rule protection would be manifestly undesirable. The same would be true where a director received but did not read basic financial information, over time, and thus allowed his corporation to be looted.

The duty to actively discharge one's responsibilities in LLC management has been recognized in the LLC context in connection with oversight responsibilities for the financial records. In Shell v. King, the courts applied the corporate-like language of Tennessee's LLC statute, which requires that a manager discharge duties in good faith in a manner the manager reasonably believes to be in the best interests of the LLC and with the care of an ordinarily prudent person under similar circumstances. The plaintiffs, a husband and wife, owned a fifty percent interest in an LLC that was engaged in landscaping while the defendant owned the remaining fifty percent. The defendant also owned another landscaping company for which plaintiffs installed landscaping designs. Plaintiffs alleged that the LLC was forced out of business in part because defendant neglected the company and customers, failed to pay debts in a timely fashion, falsely claimed a capital account far greater than its actual value, and charged inflated amounts for salary expenses payable to the business garden center which defendant owned. Most importantly, the trial court found that the defendant had failed to properly review and check the work of the bookkeeper to ensure that amounts were properly deposited in the bank. Eventually a large sum was stolen by the bookkeeper who was ultimately charged with embezzlement.

180. See Francis v. United Jersey Bank, 432 A.2d 814, 826 (N.J. 1981) (holding that the directors had a duty to prevent other directors from misappropriating trust funds and breached their duty by not taking an active role in the corporation).
181. See PRINCIPLES, supra note 43, § 4.01(c) cmt. c.
183. See id. at *6.
184. See id. at *1–3.
The Court of Appeals reviewed the facts in light of Tennessee's LLC statute requiring that a manager discharge duties in good faith, in a manner the manager reasonably believes to be in the best interests of the LLC, and with the care an ordinarily prudent person in a like position would exercise. The Court of Appeals affirmed the holding of the trial court that the defendant was negligent in failing to take any steps to verify that cash and financial records were handled properly. Such wholesale delegation of duties without proper review was viewed as a breach of fiduciary obligations.

The court in the Shell case appeared to reach the right result, applying a balanced approach to the duty of care. The misconduct involved more than an ordinary level of carelessness—yet was not so extensive that it amounted to a complete and utter abandonment of duties. The LLC manager in the case failed to discharge his duties and the misconduct was substantially below what one would expect of an LLC manager who acted reasonably. While the decision appeared to reach the right result, it could have been improved by a more complete explanation of the court's reasoning. In particular it could have been improved by a discussion of the fact that one normally applies the business judgment rule, but that given the facts of the case, the alleged conduct involved a failure to act and as such was not entitled to the deference of the business judgment rule.

The Shell decision is consistent with corporate precedents that speak to the failure to actively discharge one's duties. Although the Shell case arose under an LLC statute requiring the exercise of reasonable care, a similar result was reached under a Delaware LLC operating agreement. In Healthcare Management & Investment Holdings, LLC v. Feldman, the LLC sued the Chief Financial Officer (CFO) of its psychiatric facility, who in turn, sued the LLC when their relationship broke down. The litigation raised the question of whether the CFO's liability for breach of a fiduciary duty and for several other claims would be limited under the LLC operating agreement. The agreement limited the Director's liability except for a breach of the duty of loyalty or for acts or omissions not in good faith or which involved gross negligence, intentional misconduct, or a knowing violation of law.

In connection with a motion for summary judgment with regard to the allegations of breaches of the fiduciary duties, the court considered whether a rational trier of fact could conclude that Feldman's conduct

185. See id. at *6.
186. See id. at *7.
188. See id. at *1–3. The other claims included allegations of misappropriation of trade secrets, tortious interference of business relationships, and unfair competition. See id. at *3.
was grossly negligent. The court also considered whether the business judgment rule protected Feldman from liability. The court ultimately reviewed the facts and concluded that a rational trier of fact could conclude that Feldman was grossly negligent and that his conduct was not protected by the business judgment rule. The court observed that the evidence indicated that Feldman failed to set up an organized structure for the LLC and failed to obtain required licenses before entering into major projects that had to be cancelled in one case, thus costing significant outlays and professional embarrassment, and in one situation resulted in the LLC's probation. The court further observed that Feldman had failed to prepare a budget, failed to prepare financial statements, and failed to open a single facility.

At least in the Shell and Healthcare Management cases, the courts do not appear to be intervening excessively, but rather appear poised to provide remedies where conduct is substantially below what would normally be expected of an LLC manager who acted reasonably. However, the opinions would have been enhanced had the courts offered more detailed explanations of their reasoning and of why the business judgment rule should not insulate the director from liability in failure to act and/or failure to monitor cases.

3. Guidance on Gradations of Care

The failure to act cases discussed above involving LLC managers who had failed to assume duties in a rather wholesale fashion present the easy questions regarding business entity governance. The manager who fails to assume his or her responsibilities violates most formulations of the duty of care whether expressed as a duty to exercise reasonable care, a duty to refrain from grossly negligent conduct, or even a duty to refrain from reckless conduct. If the failure to act is sweeping enough, it might arguably constitute both a breach in the duty of care and conduct amounting to bad faith. As indicated in Part III.B, in ATR-Kim Eng Financial Corp. v. Araneta, two directors were jointly liable where they had failed to implement a reporting or monitoring system that amounted to an intentional abandonment of duties tantamount to a breach of the duty of loyalty. These failure-to-act situations present the easy cases because the directors' omissions were so extensive and complete. The more difficult challenges are to distinguish ordinary negligence from gross negligence and to refine the circumstances in which the business judgment rule should apply.

189. See id. at *11–12.
190. See id. at *11.
191. See supra Part IV.D.2.
For example, *Johnson v. Songwriter Collective, LLC* presents departures from care that are less extreme than those in the failure-to-act cases described above.\(^{193}\) In *Johnson*, the District Court for the Middle District of Tennessee was asked to dismiss an allegation of negligence against the management of an LLC that was created to manage music of songwriters and to convert royalties from songwriting into cash flow.\(^{194}\) The plaintiffs asserted that defendants had violated section 10(b) of the Securities Exchange Act of 1934 and also alleged that the defendants had violated Tennessee’s duty of care provision when they induced plaintiffs to transfer a catalog of his music compositions.\(^{195}\) The plaintiff alleged that the defendants failed to disclose a variety of risks and erroneously stated that the plaintiff would realize a substantial writer’s draw from the investment.\(^{196}\)

The decision required the court to determine whether the facts stated were sufficient to support an allegation of negligence. The Tennessee LLC statute follows the typical corporate approach and requires LLC managers to exercise the care an ordinary person in a like position would exercise under similar circumstances.\(^{197}\) Although the court stopped short of defining negligence, it indicated that the allegations made in the complaint had supported plaintiff’s theory of negligence.\(^{198}\) The allegations appearing to support the negligence theory included the failure to perform due diligence with respect to LLC members’ catalogs of music and amounts payable,\(^{199}\) the loss of sensitive financial information,\(^{200}\) and the failure to ensure adequate capital to service a bridge loan.\(^{201}\)

One reading of the case is that the “negligent” manager apparently includes one who attempts to discharge his or her duties but does so in a deficient manner. However, the defendants’ duty of care violations are somewhat interwoven with the allegations of fraud. The court apparently found it difficult to isolate the duty of care infractions and was disturbed by allegations of bad faith, i.e., involving failures to disclose key facts and the making of misrepresentations.\(^{202}\) Ultimately, the Court refused to dismiss the allegations of negligence and breach of the duty of loyalty. However, the discussion of negligence was limited and the alleged loss of financial data might not have justified judicial action alone if viewed independently of the duty of loyalty issues.

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\(^{194}\) See id. at *14–15.

\(^{195}\) See id. at *7, *14.

\(^{196}\) See id. at *3.

\(^{197}\) See id. at *15.

\(^{198}\) See id.

\(^{199}\) See id. at *5.

\(^{200}\) See id.

\(^{201}\) See id.

\(^{202}\) See id. at *3–4, *16.
On the other hand, the alleged failure to perform due diligence is the sort of infraction that most courts would regard as a breach of fiduciary duty.

The Johnson case illustrates the need for increased guidance, whether from the judiciary or the legislature, regarding the distinctions among ordinary negligence, gross negligence, recklessness, and intentional misconduct in the context of LLC legislation. As more fully discussed in Part V, it is recommended that LLC legislation include a statement that the LLC manager is expected to act reasonably, subject to the business judgment rule. The failure to perform one's duties and/or the performance of duties in a manner that involves a substantial deviation from reasonable care should be sufficient grounds for equitable remedies. Investors should not have to wait until conduct has deteriorated to the point of involving wanton conduct or intentional harm to obtain equitable remedies. It is suggested that liability for damages be premised upon gross negligence, with gross negligence constituting a substantial departure from the standard of ordinary care but not necessarily amounting to recklessness or intentional harm. This is consistent with the concept of recklessness as a level of misconduct more severe than gross negligence under draft versions of the Restatement (Third) of Torts.

203. See id. at *8 (indicating in its discussion of recklessness and a 10b5 allegation, that recklessness involves highly unreasonable conduct which is an extreme departure from the standards of ordinary care: “[w]hile the danger need not be known, it must at least be so obvious that any reasonable man would have known it. . . . It is ‘a mental state apart from negligence and akin to a conscious disregard’”).


Taken at face value, [gross negligence] simply means negligence that is especially bad. Given this literal interpretation, gross negligence carries a meaning that is less than recklessness. The term “willful or wanton misconduct” is also frequently employed. “Willful misconduct” sometimes refers to conduct involving an intent to cause harm; but “wanton misconduct” is commonly understood to mean recklessness. Frequently, courts refer to conduct that displays a “reckless disregard for risk” or a “reckless indifference to risk.” When a person’s conduct creates a known risk that can be reduced by relatively moderate precautions, to state that the person displays a reckless disregard for risk is equivalent to stating that the person’s conduct is reckless.

But see LA. REV. STAT. ANN. § 12:1314(B), (C) (Supp. 2008), providing that gross negligence for purposes of the LLC statute means recklessness:

B. Notwithstanding the provisions of Subsection A of this Section, a member or manager shall not be personally liable to the limited liability company or the members thereof for monetary damages unless the member of manager acted in a grossly negligent manner as defined in Subsection C of this Section, or engaged in conduct which demonstrates a greater disregard of the duty of care than gross negligence, including but
4. Circumventing Corporate Duties Through the LLC

LLC case law has not only raised questions concerning the application of the standard of care with regard to the LLC manager, but also has raised questions concerning the application of the fiduciary duties when there is an overlap between corporate officers and/or directors and an LLC. In *Barbieri v. Swing-N-Slide Corp.*,205 a director and several officers of Swing-N-Slide, a Delaware corporation, formed a limited liability company, Greengrass Management, LLC, and a general partnership, Greengrass Holdings, for the purpose of making a tender offer for the stock of Swing-N-Slide. The general partnership that was to make the tender offer was owned by one partner who was unaffiliated with Swing-N-Slide, but the other partner was Greengrass Management, LLC, a newly-formed LLC that was owned by the senior management of Swing-N-Slide. Plaintiffs alleged that Greengrass, LLC owed a fiduciary duty to the corporation’s shareholders. Plaintiffs argued that the directors and officers of Swing-N-Slide could not circumvent their fiduciary duties through the use of the general partnership and the LLC. The court agreed with the shareholders, holding that management owed a fiduciary duty to the shareholders, and the fiduciary duties of management had to be imputed to the LLC they formed. The court ultimately refused to grant the defendants’ motion to dismiss the plaintiff’s claim against the LLC. The court observed that where allegations support the conclusion that an entity was formed and controlled by fiduciaries for the purposes solely related to the entity to which those persons owed fiduciary duties, the entity assumes the same fiduciary obligations.206

The facts of *Swing-N-Slide* expose the potential for the abusive use of the LLC and/or other entities to circumvent fiduciary duties or to side-step other legal obligations. The decision highlights the advantage of developing coherence among fiduciary duties in different business entities. It also underscores the importance of looking behind the form to the substance of a transaction to ensure that it has a bona fide business purpose and is not a subterfuge for evading legal responsibilities.207

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*not limited to intentional tortious conduct or intentional breach of his duty of loyalty.*

C. As used in this Section “gross negligence” shall be defined as reckless disregard of or a carelessness amounting to indifference to the best interests of the limited liability company or the members thereof.

206. See id. at *1–3.
207. *See In re USACafes*, 600 A.2d 43, 48–50 (Del. Ch. 1991) (involving a suit by limited partners against the corporate general partner as well as the individual directors of the corporate general partner alleging that the Board members had received certain side payments that should have gone to the partnership for the sale of assets and observing that directors of a corporate general partner owe
In conclusion, with regard to the statutory LLC landscape, almost equal numbers of states formulate the duty of care using some type of ordinary care language or using a standard tied to the duty to refrain from gross negligence or recklessness. Most states place restrictions on indemnification provisions and permit the LLC to indemnify only if there has been a good faith reasonable belief that the conduct was in the best interests of the LLC or not opposed to its best interests. Also, most states place some restrictions on the extent to which the LLC operating agreement may contractually alter the duty of care. Delaware's statutory law appears to be the most liberal. It both permits unlimited contractual waivers, except for the implied covenant of good faith and fair dealing, and permits the LLC to indemnify the LLC manager for all types of claims without apparent statutory restriction. This provides an unwarranted discrepancy between indemnification standards applicable to corporations and to LLCs. It remains to be seen whether courts will impose public policy limitations to the extent to which a private agreement can insulate a manager from liability for acts of bad faith towards the entity.208

The infrastructure cases highlight the need to articulate a standard based on the duty to act reasonably. Although all investors should be entitled to protection from breaches in the duty of loyalty and the duty of care, a standard based simply on a duty to refrain from grossly negligent conduct seems inappropriate particularly where critical services are involved, whether in nursing home care, environment remediation, or other important fields. By and large, as demonstrated by the Shell and Healthcare Management cases, at least some courts appear to be applying the corporate model in a balanced fashion, intervening where conduct involves substantial departures from reasonable conduct. It is clear that the LLC manager cannot delegate duties in a wholesale fashion. While the right results appear to have been reached in the failure-to-act cases, it would be helpful for courts to more fully articulate their reasoning, more fully define their terms, and more thoughtfully provide guidance with respect to the scope of the business judgment rule. Finally, as illustrated by Bar-

208. See Lazarus v. Am. Real Estate Partners, L.P., No. CIV.A.16788, 2001 WL 1045643, at *8, *11 (Del. Ch. Sept. 6, 2001) (indicating that courts have not yet been faced with an agreement that sought to insulate a general partner in a limited partnership for acts of bad faith and, thus, have not yet needed to decide whether such an agreement would violate Delaware public policy).
bieri v. Swing-N-Slide Corp., there is a need for coherence in the application of fiduciary duties across business entities and to prevent the use of one business entity to circumvent fiduciary duties arising in another entity. One should not be able to sanitize one's conduct or side-step fiduciary duties by structuring transactions through an LLC.

V. RECOMMENDATIONS FOR DUTIES IN THE LLC

As indicated at the start, NCCUSL's discussions concerning the duty of care sparked significant controversy and ignited a heated dialogue among participants. On the eve of the presentation of the Revised Uniform Limited Liability Company Act on the floor of the National Conference in July 2006, some committee members continued to debate the duty of care provisions. The first Uniform Limited Liability Company Act had followed the Revised Uniform Partnership Act language providing that the duty of care is "limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."209 Some passionately supported the continued use of the Revised Uniform Partnership Act language, arguing that the standard of care for partners and corporate directors is gross negligence. Others thought that the standard of care would be better stated as a duty to exercise due care subject to the business judgment rule—a result which, like the gross negligence formulation, leads to damages where there has been gross negligence in business decision-making, but which also offers broader remedies in a wider range of contexts and conveys the hope or aspiration that behavior will be reasonable. Supporters of the gross negligence formulation feared the reasonable care approach would trigger an avalanche of litigation that would impose liability for mere negligence and would place courts in the business of managing LLCs.

This Article argues in favor of the language ultimately adopted by the NCCUSL Committee requiring that "[s]ubject to the business judgment rule, the duty of care . . . is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company."210 In this manner, it is hoped that courts will continue to demonstrate appropriate deference for business decision-making, but will intervene to impose damages where there is a substantial departure from the standard to act reasonably.211 The Delaware statutory approach permitting the complete contractual

211. Harry Haynsworth, former Dean of William Mitchell Law School, vigorously argued that the Revised Uniform Limited Liability Company Act should contain guidance as to the business judgment rule. However, these discussions arose late in the drafting process and the suggestion was not followed.
elimination of fiduciary duties is rejected. Instead, it is recommended that parties be permitted to contractually modify or elaborate on fiduciary duties, but not eliminate them. A similarly moderate position is taken with respect to indemnification provisions. Delaware's approach of permitting indemnification for all claims whatsoever is rejected. Instead, it is suggested that the LLC be permitted to indemnify the LLC manager for selected violations, but not for acts or omissions that were not in good faith, where an improper personal benefit was taken, where there was willful misconduct, or where there was a conscious disregard for the best interests of the company.

The above recommendations, hereinafter described as the "Mandatory Core/Reasonable Care Approach" to the duty of care, best accomplish the overall social policy goal of business entity govern-

212. See Lucian Arye Bebchuk, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments, 102 Harv. L. Rev. 1820, 1850–51 (1989) (observing that complete opting out of corporate law rules is likely to be undesirable where a value-decreasing amendment is strongly redistributive in favor of the managers and where rules protect the value to shareholders by preventing minority freeze-outs).

213. The recommended approach agrees with the approach taken in REVISED UNIF. LTD. LIAB. CO. ACT § 110(d)(3) (2006), which permits the alteration of the duty of care except to authorize intentional or knowing violation of the law. However, the Revised Act permits the elimination of the duty to account—an essential part of the duty of loyalty and the elimination of the duty of loyalty is not recommended. See id. § 110(d)(1). Although the discussion above does not address the duty of loyalty, the reasoning that supports the prohibition on the elimination of the duty of care also supports the prohibition on the elimination of the duty of loyalty, see § 110(d), providing:

(d) If not manifestly unreasonable, the operating agreement may:
(1) restrict or eliminate the duty:
   (A) as required in Section 409(b)(1) and (g), to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;
   (B) as required in Section 409(b)(2) and (g), to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
   (C) as required by Section 409(b)(3) and (g), to refrain from competing with the company in the conduct of the company's business before the dissolution of the company;
(2) identify specific types or categories of activities that do not violate the duty of loyalty;
(3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;
(4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and
(5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under Section 409(d).
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ance—to foster investor confidence while keeping transaction costs at a minimum. Investors need assurance that there is a legal system that will enforce reasonable expectations that management will behave with loyalty and with reasonable care. Specifically the Mandatory Core/Reasonable Care approach: 1) is consistent with the duty of care rooted in agency law, is suitable to the range of operational and policy-oriented duties undertaken by LLC managers, and is appropriate particularly in light of the important nature of the services provided by some LLCs; 2) provides a broad general standard that can be applied across all business entities and is consistent with the development of a unified business entity statute; 3) best fulfills the socializing role of the duty of care; 4) allows the opportunity for providing appropriate equitable or legal remedies, enabling investors to remove entrenched management before misconduct deteriorates to the point of becoming reckless or intentionally harmful; and 5) is consistent with the policy of tort and regulatory business law to promote responsible business conduct. Finally, it is suggested that courts continue to seek a balanced case-by-case approach to the duty of care. Judicial remedies should be made available only when the misbehavior is more serious than ordinary inadvertence, but need not be made available only when the misconduct has become so egregious as to amount to an intentional, reckless, or utter abandonment of duties.

A. The Duty to Act Reasonably is Rooted in Agency Law

As indicated in Part II.C, LLC managers may perform operational as distinguished from business policy decision-making. The standard to act reasonably is well grounded in agency law and is therefore well suited to the LLC structure. In the drafting of the Revised Uniform Limited Liability Company Act, an early attempt was made to formulate a separate duty of care for operational as distinguished from dis-

cretionary conduct. The duty to act reasonably was thought most appropriate to operational duties. However, it is difficult to definitively separate out operational from discretionary duties. Some operational functions might involve policy decision-making. For example, the development of safety protocols may involve an interplay between operational and policy functions. It would be difficult for a statute to exhaustively define and distinguish operational from policy-oriented decision-making. A more practical approach is to retain an overall statutory standard to act reasonably to be tempered with the business judgment rule on a case-by-case basis.

B. Fine-Tuning to the Facts and Circumstances and Suitable to a Unified Business Entity Statute

As indicated in Part II.D, the duty of care should serve as a guideline that reflects the standard of care that is expected. Now that a multiplicity of business forms dot the business entity landscape, the need for comprehensive and integrated rules has become apparent. NCCUSL has formed a new drafting committee to draft a uniform business entity structure that would bring all types of partnerships, LLCs, and corporations under one statutory umbrella. The standard of care selected for a Uniform Limited Liability Company Act should be capable of being tailored to a wide variety of facts and circumstances and a range of relationships among investors and management.215

A formulation to act with the care that a person in a like position would reasonably exercise under similar circumstances offers a broad standard that can be applied across all business entities, yet can be fine-tuned depending upon the particular setting and management structure.

J. William Callison has argued that where all investors participate in the venture, such as in a general partnership, each participant has an incentive and the power to monitor the business.216 Callison maintains that in such a setting, the risk of a co-participant's ordinary neg-

215. See William T. Allen, Jack B. Jacobs & Leo Strine, Jr., Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. Law. 1287, 1297 (2001) (recommending that a standard of review should be functional by providing judges with a practical and logical framework, avoiding needless complexity, and offering an alignment with the public policies that animate the corporate law by providing incentives for directors to act in furtherance of corporate and stockholder interests and by deferring to outcomes reached through intra-corporate dispute resolution). See generally William H. Clark, Jr., What the Business World is Looking For in an Organizational Form: The Pennsylvania Experience, 32 WAKE FOREST L. REV. 149 (1997) (discussing the variety of and need for multiple business forms).

216. See Callison, supra note 7, at 473, 483 (arguing against a statutory standard for the LLC).
ligence is arguably considered a cost of doing business and a slightly lower standard of care may be appropriate. However, as the structure moves to one involving centralized management, a higher degree of trust is imparted to management and a higher level of care is expected of management.

A formulation of care based on a duty to act reasonably subject to the business judgment rule provides the flexibility to tailor the appropriate standard to the facts and circumstances and the relationship between the investors and management. Also, it provides a high enough standard of conduct to achieve the law's socializing goals and to reflect most investors' reasonable expectations of how management should conduct itself. Not all investors may initially invest in the LLC and participate in the drafting of an LLC operating agreement. Some parties may become investors in the LLC as transferees where, for example, they inherit the LLC interest or become creditors by virtue of an LLC member's bankruptcy. The recommended approach would permit considerable private contracting surrounding the duty of care. However, it would still require a minimum mandatory standard of conduct that most investors would be likely to expect of responsible management. By maintaining a behavioral floor of reasonable conduct, the recommended standard is likely to be consistent with most investors' general expectations of management, including those investors who have not had the opportunity to expressly negotiate LLC operating agreement terms.

While the standard to act with the care that a person in a like position would reasonably exercise under the circumstances protects those who may not have participated in LLC operating agreement negotiations, it remains a moderate standard that would leave room for business risk-taking. It avoids the term negligence and minimizes confusion with a standard based on simple negligence that might otherwise chill the taking of reasonable risks. For similar reasons, the Revised Model Business Corporation Act avoids terms like prudence, which might deter reasonable risk-taking. It is suggested that LLC statutes similarly avoid terms such as prudence in their duty of care sections.

As discussed in Part II, LLCs may vary considerably. They may be public or private and may be engaged in a broad spectrum of activities. While setting forth a broad general standard of conduct, the recommended approach also leaves room for an analysis of reasonableness under the particular facts and circumstances of each

217. See Revised Model Bus. Corp. Act. § 8.30 cmts. (2005) (indicating that the traditional formulation for a director's care has been geared to the ordinarily prudent person but that the use of the term suggests that negligence is the proper determinant for measuring deficient and thus actionable performance and this has caused confusion and misunderstanding).
situation. Both the management configuration and the public or private nature of the firm affect the investor's reasonable expectations of management. Also, the level of judicial scrutiny may be subtly influenced by the relative power of the investors vis-à-vis management or the nature of the investor as a voluntary investor or as a creditor. Courts may be especially inclined to assume a more active monitoring posture in an LLC involving the private passive investor. Like the investor in a privately owned limited partnership, the passive LLC member may be more vulnerable to managerial misconduct than in other settings. The manager of a privately owned, manager-managed LLC lacks the incentive to care that may be present in a general partnership in which personal liability is imposed. The manager of the privately owned, manager-managed LLC also lacks the direct oversight brought by the participation of other investors. On the other hand, the manager of the privately owned LLC may be free of corporate constraints typically springing from board of director oversight of officer performance. Internal controls stemming from audit committee oversight of a board of directors may be lacking. At the same time, the LLC manager may have significant control over the preparation of the limited liability company agreement. The formulation to act with the care that a person in a like position would reasonably exercise, subject to the business judgment rule allows judicial leeway to adjust the level of judicial deference depending upon the facts and circumstances. Finally, it is a standard that has its roots in corporate law and is capable of being applied across all types of business enterprises. Thus, it is a formulation that would work well in jurisdictions that adopt a unified business entity statute.

C. A Socializing Influence for the Private Market

In the large scheme of things, the central role of business entity governance is to foster investor confidence while not unduly raising transaction costs. Factors that work either singly or in combination to create opportunities for abuse in the absence of a public market include: 1) domination by a controlling owner in the management of the firm or in developing its operating agreement; 2) the separation of ownership and managerial control; 3) vulnerability resulting from the illiquid nature of the investment; and/or 4) decreased transparency and accountability resulting from reduced requirements concerning financial reporting and internal controls.

The above potential difficulties are exacerbated in the context of the LLC because of its highly contractual nature. If the LLC operat-

218. The National Conference of Commissioners on Uniform State Laws has commissioned a committee to develop a unified business entity statute.

219. See sources cited supra note 214.
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ing agreement has been drafted by management, it may well include a sole discretion clause and/or other provisions intended to immunize even the most outrageously irresponsible or self-serving conduct. Although the empirical findings challenge the assumption that that passive LLC investors and minority investors are not represented, there may be unequal levels of legal representation as between active and passive participants and controlling and minority investors. The empirical studies on the contractual playing field are not conclusive but certainly raise questions regarding the fairness of the contractual playing field.

The need to preserve minimum mandatory fiduciary duties is even more compelling in the LLC than in other private entities precisely because of its inherent flexibility, its highly contractual character, and the possibility that there may be an unequal contractual playing field. The privilege of contractual flexibility should not be without outer statutory limits as to basic acceptable management conduct. LLC statutes and the courts that enforce them play a prominent role in defining the social context of the LLC. The social context of the firm conveys important social cues on expectations of trustworthy behavior. To effectively promote responsible management and to deter opportunistic conduct, it is important for the LLC statutory skeleton to promote and reflect reasonable expectations of trustworthiness within the context of defined business relationships.

Although the avoidance of unnecessary costs is an important policy goal, investors must have confidence that responsible and trustworthy management conduct is expected. While the quality of management is to a large extent part of the investor's risk, the investor must have confidence that the law will provide a remedy in cases of sustained

220. See Paul M. Altman & Srinivas M. Raju, Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law, 60 Bus. Law. 1469, 1484–85 (2005) (suggesting the use of a discretionary clause that allows the general partner to disregard the consideration of the interests or factors affecting the partnership or the limited partners, thus providing language that would be expressly inconsistent with the requirement that discretion be exercised reasonably).

221. See generally Miller, Empirical Glimpse, supra note 9, at 618, 623, app. at 643 (finding that in firms with active participants, a greater percentage of respondents reported representing the controlling member than the minority (84% v. 67%), that while 44% indicated that they "often" represented controlling members, only 10% said they did so with regard to the minority, and also finding disparities between legal representation of controlling members as compared to the minority in firms with passive investors (64% v. 55%).)

inattention or substantial departures from standards of reasonableness.223

A statutory standard that insulates a manager from liability for grossly negligent conduct conveys the wrong signal as to acceptable business conduct. Some decisions have interpreted gross negligence to be conduct that "involves a devil-may-care attitude or indifference to duty amounting to recklessness."224 A statutory formulation that limits the duty of care to a duty to refrain from grossly negligent conduct has been described as sending a "socially impoverished message."225

The attractiveness of the LLC largely rests on its flexibility. However, to prevent the LLC from becoming an instrument of exploitation and a vehicle through which fundamental fiduciary duties of corporations can be circumvented, the LLC statutory framework should retain and articulate positive standards of acceptable management conduct.

The purpose of the standard of care is not to protect third parties vis-à-vis the business entity—the regulation of the LLC's underlying business is the province of administrative and tort law. Rather, the focus of business entity governance generally is to allocate the risk of loss for misconduct among investors, management, and the business entity. Nevertheless, the standard established as the duty of care—both its letter and spirit—should not violate broad public policy goals or work at cross-purposes with fundamental regulatory goals. There is arguably a major disconnect between a business entity governance standard resting on the duty to refrain from grossly negligent conduct, as that term has been interpreted, and widely accepted standards of

223. The emphasis on the efficiency of legal rules is rooted in the works of scholars at the University of Chicago including, but not limited to Ronald Coase and Richard Posner. The New Haven School associated with Guido Calabresi emphasizes the role of justice and fairness as well as efficiency and envisions an increased role for statutory and governmental intervention. See Nicholas Mercuro & Steven G. Meedema, Economics & the Law: From Posner to Post-Modernism 81–83 (1997) (comparing the Chicago School of Economics with the New Haven school that endorses a broader role for government intervention and embraces the role of justice and fairness as well as market efficiencies); see also Bebchuk, supra note 212, at 1849 (arguing against complete opting out where the benefits exceed the costs such as where there may be self-dealing); Blair, Trust, supra note 45, at 1736 (observing that the phenomenon of trust provides insight into the nature and purpose of fiduciary duty); John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Colum. L. Rev. 1618, 1676–83 (1989) (discussing that whether to allow opting out of corporate law depends on the public ramifications of allowing private innovation and the efficiency of the judicial system in addressing conflicts, among other considerations); Mitchell J. Wiet, 14 Annals Health L. 399, 407 (2005) (observing that social norms play an important role in promoting individuals to act in compliance with the law and discussing health care governance).


225. Vestal, supra note 78, at 573–74.
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conduct under tort and administrative law. A standard tied merely to
duty to refrain from devil-may-care conduct arguably works at cross-
purposes with third party standards and violates broad public policy
goals of administrative and tort law to encourage responsible conduct
in business management.

A standard based on the duty to act with the care that a person in a
like position would exercise under similar circumstances does not run
contrary to broad public policy under tort and/or administrative law
and does provide a workable framework under a variety of scholarly
approaches to fiduciary duties. Whether one lines up on the side of
the traditionalist or the contractarian, the duty to act with the care
that a person in a like position provides a moderate standard that is
neither overly permissive nor excessively stringent. The traditionalist
expects managers to act in the interest of others and presupposes
mandatory constraints.226 An active judicial posture to enforce con-
straints is expected. Although the traditionalist might lean toward a
slightly more demanding standard, the traditionalist would ulti-
mately welcome active judicial monitoring of standards. Even under
the contractarian approach, the importance of active judicial enforce-
ment of mandatory minimum standards is necessary. The con-
tractarian seeks a cost-minimizing legal environment227 and
mandatory fiduciary duties are generally criticized for increasing
costs.228 However, active judicial monitoring of minimum basic stan-
dards is not fundamentally inconsistent with contractarian theory.229
A legal environment that is too permissive arguably fosters aggressive
business practices. Too little statutory or judicial guidance and/or too
great a measure of leniency may create the need for costly individual-
ized contractual innovation to draft self-styled legal protections. In
the long run, too much ambiguity and/or leniency may lead to exces-

226. See Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (establishing a bench-
mark for the duties of co-venturers above the morals of the marketplace); Claire
Moore Dickerson, Equilibrium Destabilized: Fiduciary Duties Under the Uniform
ing the contractarian worldview and criticizing the contractarian's cost-sensitive
approach to fiduciary duties); see also Lawrence E. Mitchell, The Death of Fiduci-
that in Meinhard, Justice Cardozo "clearly viewed active compliance with fiduci-
ary norms as a moral imperative"); Vestal, supra note 78, at 573–74 (arguing that the
Revised Uniform Partnership Act sends a "socially impoverished message" be-
because it narrows the range of fiduciary obligations).

227. See Larry E. Ribstein, The Deregulation of Limited Liability and the Death of

228. See Dickerson, supra note 226, at 454–55 (explaining the contractarian world-
view and criticizing the contractarian's cost-sensitive approach to fiduciary
duties). See generally F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE
CORPORATIONS (3d ed. 1998 & Supp. 2002) (providing an exhaustive treatise on
the legal issues commonly encountered by the privately owned corporation).

229. See Coffee, supra note 223, at 1620–21.
sive costs for structuring and drafting business deals and could lead to increased rates of litigation. Additionally, active judicial monitoring to enforce a basic standard of reasonable conduct is consistent with the team production approach to the business entity. Team production theorists such as Blair and Stout regard the business entity as a team, see management as a mechanism that resolves team conflicts, and believe that this role is best achieved in an environment that fosters trustworthy behavior. A standard of conduct based on the duty to act with the care that a person in a like position would reasonably exercise under similar circumstances conveys the important social cue that trustworthy and responsible behavior is appropriate.

In short, the social message conveyed by the standard of care is more compelling in the LLC than in other entities because of the LLC's inherent flexibility, its highly contractual nature, and the realities of the potentially unequal contractual playing field. The expectation that management must act with the care of a person in a like position would reasonably exercise under similar circumstances, tempered by the business judgment rule, establishes a reasonable mandatory minimum standard of conduct. It has the potential to foster investor confidence and keep transaction costs to a minimum by providing some certainty in the otherwise fluid LLC environment. It is a standard that may deter careless conduct and sends the positive social message that the LLC will not be a safe haven for careless management. Finally, it is a benchmark that does not run contrary to the overall public policy goals of tort and administrative law to encourage responsible management conduct.

D. Fulfilling the Remedial Role

One of the major roles of the duty of care is to foster investor confidence that there are legal and/or equitable remedies that will become available should the duty of care be violated. Remedies may include legal remedies such as an award of damages and/or the use of

230. See Miller, New Direction, supra note 9, at 420 (reporting that of 199 lawyers who indicated that they had handled majority/minority disputes, 50% of Delaware respondents indicated that the dispute resulted in litigation, whereas only 21%, 8.6%, and 25% of respondents in California, New York, and Pennsylvania indicated lawsuits were filed). The higher rate of litigation in Delaware could indicate that increased legal ambiguity created by the contractarian approach to corporate governance actually increases litigation and related legal costs. Of course many other explanations may be operative including differences in the relative competency of courts in the different states. Further research is recommended.

231. See generally Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 Va. L. Rev. 247 (1999); Blair, Trust, supra note 45.

232. See Lee, supra note 41, at 262–63 (discussing the rationales underlying the duty of care).
injunctive power to restrain certain conduct or transactions, or to develop other equitable remedies that the situation requires.

As previously indicated, the expectation that management must act with the care of a person in a like position would reasonably exercise under similar circumstances, tempered by the business judgment rule provides a benchmark that makes sense given the diverse managerial activities in which LLC managers engage, whether operational, involving oversight, or entailing decision-making. It ties into the basic standard of care that is expected of paid agents and thus is a suitable standard governing operational conduct. Yet, because the standard to act with the care of a person in a like position would reasonably exercise under the circumstances incorporates the business judgment rule, it is a viable benchmark for business decision-making and will prevent excessive judicial intermeddling in business policy decision-making.

Most importantly, the standard to act with the care of a person in a like position would reasonably exercise would allow investors to obtain equitable remedies before the misconduct has deteriorated to the point of becoming reckless or intentionally harmful. Equitable remedies should be made available for serious misconduct that substantially departs from the care a person in a like position would reasonably exercise, but which may not yet be termed reckless. Such remedies may become critical to enable investors to root out entrenched and extremely irresponsible management before the conduct causes bankruptcy and/or very serious harm to third parties.

The role of business entity governance is primarily to govern the relationship among investors and between investors and management—not to directly regulate business. However, if the LLC is privately owned and centrally managed under an operating agreement drafted to protect management, there is a potential for the entrenchment of management. A legal framework that permits timely equitable remedies to address entrenched and seriously irresponsible management in urgent circumstances is in the public interest. Such equitable remedies may be even more important than they were previously now that Treasury Regulations permit LLCs to be structured in a way that eliminates the investor's right to freely withdraw his or her investment. This change in tax treatment has increased the chances that LLC investors may become "locked-into" their LLC investment and may leave some LLC investors at the mercy of en-

233. See I.R.C. § 7701 (2000); Treas. Reg. § 301.7701-1 (2006); see also Sandra K. Miller, What Buy-out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of a Minority Owner of a Limited Liability Company?, 38 HARV. J. ON LEGIS. 413, 413-14, 416 (2001) (discussing the relaxation of tax requirements and the increased potential for investors to be locked into their investment and recommending a statutory prohibition on unreasonable reductions in fiduciary duties and the remedy for dissolution or buy out in the event of management deadlock or oppressive conduct by majority owners).
trenched incompetent management—a possibility all too likely if the investor has executed a simple form LLC agreement without seriously studying and negotiating contractual terms, exit rights, or management termination provisions.234

Limitations on the complete contractual elimination of the duty of loyalty and the duty of care could prove essential in removing or restraining management. While the usual recourse for misconduct should be non-judicial in nature, involving termination, removal, and the like, these remedies may not be available or viable in all circumstances.235 Limitations on the complete contractual elimination of duties and a standard tied to reasonableness, subject to the business judgment rule, provide a reasonable balance between contractual freedom and mandatory constraints in an effort to foster responsible business conduct.

E. Consistency with Overall Goals of Tort and Other Business Laws

A standard of care articulated as a duty to act reasonably is consistent with the overall public policy goals of tort and other regulatory laws to encourage responsible business management. While in practice, the imposition of liability would only occur where there are substantial departures from ordinary care by virtue of the business judgment rule, the positive articulation of a duty to act reasonably is consistent with overall public policy. Particularly where key services are offered, whether in the form of electrical power or nursing home care, a standard of conduct to merely refrain from grossly negligent conduct appears out-of-place, especially given some courts' definition of gross negligence as being the equivalent of reckless or intentional misconduct.

F. A Balanced Approach is Recommended

A balanced approach to the duty of care and the business judgment rule is recommended. Generally, excessive judicial intervention in business is undesirable. The forces operating to regulate managerial performance should stem from sources other than the courtroom. The LLC operating agreement, monetary awards, internal disciplinary

234. See Miller, Empirical Glimpse, supra note 9, at 618 (finding that 85% of respondents indicated that they sometimes or often have formed no-frills or simple LLC agreements in a study of practitioners contractual practices in Colorado, Delaware, Kentucky, Minnesota, Montana, and New York); see also Miller, New Direction, supra note 9, at 383 (finding that approximately two-thirds of practitioners believed that many LLC agreements formed are based on form agreements that are not extensively negotiated in a study of contractual practices in California, Delaware, New York, and Pennsylvania).

processes, and terminations should serve to control most instances of misconduct. However, courts should be positioned to intervene before behavior degenerates to the point of amounting to a complete and utter abandonment of duties or intentionally poor performance.

A balanced approach should be taken to the duty of care and to the business judgment rule. While judicial deference may be typically appropriate with respect to the publicly traded corporation, it should be recognized that the same level of judicial deference might be ill-suited to some LLCs. Generally the business judgment rule provides that if a board demonstrates a minimum level of care, the courts will not review and second-guess the decision that is being challenged. The policy justifications for the business judgment rule include the need to encourage directors to serve and take risks, to prevent courts from encroaching upon business decisions, and to preserve the autonomy and central authority of the corporate board of directors. These same policy justifications may not be present in all LLCs. LLCs can be member-managed, can have one or more LLC managers who may or may not be owners, or may have a corporate structure consisting of officers and a board of directors. LLC managers may or may not be highly compensated, may or may not be highly sophisticated, and may or may not need particular incentives to serve. Similarly, LLC managers may or may not need encouragement to assume risks, depending largely on the terms of their compensation arrangements. Some LLC managers in highly negotiated and sophisticated investments may have compensation packages that tie compensation to performance. Others may not. Those that do will presumably have every incentive to take risks that will translate into successful performance. There will only be a need to shore up the central authority of an LLC if in fact there is centralized management and a board of directors that needs shoring up vis-à-vis a team of officers. Thus, the policy interests in fostering service and risk-taking and in promoting the central authority of LLC management do not definitively support a broad formulation of the business judgment rule.

In some LLCs there may be compelling reasons to support an active judicial posture in monitoring fiduciary duties of LLC managers. Investors arguably select the highly contractual LLC largely to obtain

236. See Miller & Rutledge, supra note 7, at 345.
237. See Johnson, Corporate Officers, supra note 92, at 455.
238. See Hal R. Arkes & Cindy A. Schipani, Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias, 73 Ore. L. Rev. 587, 623–24 (1994) (comparing the differences in legal treatment of corporate directors and physicians and discussing the lower tolerance for risk in the case of the physicians); see also Johnson, Corporate Officers, supra note 92, at 453–65 (discussing the policy rationales for the business judgment rule in the case of directors including encouraging directors to serve, to take risks, to avoid judicial encroachment into the business sphere, and to preserve the Board’s authority).
shelter from excessive judicial intrusion into private business matters. They seek flexibility and freedom in business structure. Nevertheless, it is precisely in the context of this highly contractual business entity that investors need the most assurance that courts will enforce certain basic minimum fiduciary duties.

Unlike corporations, LLCs may be structured without multiple levels of management that would otherwise provide checks and balances on each other’s powers. In a public corporation, there will be an audit committee, a board of directors, and corporate officers. Officers are accountable to the board. In many instances, corporate governance will be structured to comply with mandatory rules under the relevant stock exchange. In contrast, privately owned LLCs need not create extensive internal accounting controls. LLC operating agreements and managerial employment agreements may be drafted by management in the best interests of the managers leaving little opportunity for investors to influence contract terms. Private LLCs are not subject to restrictions of a stock exchange that might require board independence and a code of ethics that requires fair dealing, and prohibits theft of opportunities, breaches of confidentiality, and the misuse of company assets. Particularly in such private contexts, it is important for courts to be positioned to enforce certain basic minimal fiduciary duties. Particularly in the context of the LLC with centralized management, managers should be reminded of the outer limits of acceptable conduct that constrain the private contract. This reminder is particularly needed in the privately owned LLC with centralized management where the normal checks and balances created by active member/management, multiple layers of management, and rigorous accounting and auditing standards may be absent. An overly expansive interpretation of the business judgment rule can overwhelm the basic standard that managers must act reasonably and responsibly. On the other hand, too narrow an interpretation could lead to excessive judicial intrusion into business activities. Thus, a balanced approach to judicial monitoring is recommended.

239. See New York Stock Exchange, Corporate Governance Rules (2003), http://www.nyse.com/pdfs/finalcorpgrvrules.pdf (last visited Sept. 14, 2007) (providing that certain listed companies have a majority of independent directors, a nominating/corporate governance committee composed entirely of independent directors, a compensation committee composed of entirely independent directors, an audit committee, disclosed corporate governance guidelines including director orientation and continuing education, annual performance evaluations, a code of business conduct that encompasses rules procedures for waiving the code, rules against taking corporate opportunities and breaches of confidentiality, fair dealing, and the protection of company assets).
VI. CONCLUSION

A standard of care based on the duty to act with the care that a person in a like position would reasonably exercise under similar circumstances subject to the business judgment rule is recommended. Such a standard is rooted in agency law, and when coupled with the business judgment rule, can provide a general benchmark that makes sense given the operational, oversight, or business policy-making functions that LLC managers may assume. The reasonable care/business judgment rule formulation provides the judicial leeway necessary to calibrate the standard of judicial review based on the relationship between the investors and management and the public or private nature of the firm. Particularly where the LLC is privately owned and centrally managed, a higher degree of trust may be imparted to management, and a higher level of care may be appropriate. The flexibility to tighten up the standard of scrutiny in the private, centrally managed LLC is particularly important given the absence of managerial constraints that flow from restrictive internal controls or from the direct oversight of active members. Checks and balances provided by multiple layers of management, the oversight of an audit committee, or the questioning eye of an independent board of directors may be present in public corporations but lacking in a privately owned LLC. In such an environment, it is important to provide a legal standard that sends a strong, positive message as to the expected standard of conduct. A standard based on the duty to act with the care that a person in a like position would reasonably exercise under similar circumstances subject to the business judgment rule provides a positive social cue that responsible managerial behavior is expected. Also, it provides a benchmark that does not run contrary to the overall public policy goals of tort and administrative law to encourage responsible management conduct.
LLC Statutes Nationwide

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<td>Colorado</td>
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<td>Illinois</td>
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<td>KAN. STAT. ANN. §§ 17-7662 to -76,142 (Supp. 2006)</td>
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<td>Massachusetts</td>
<td>MASS. GEN. LAWS ANN. ch. 156C, §§ 1–69 (West 2005 &amp; Supp. 2007)</td>
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<td>Montana</td>
<td><strong>MONT. CODE ANN. §§ 35-8-101 to -1307 (2005)</strong></td>
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<td><strong>NEV. REV. STAT. §§ 86.011-590 (2007)</strong></td>
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<td>New Jersey</td>
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<td><strong>OHIO REV. CODE ANN. §§ 1705.01-.58 (LexisNexis 2001)</strong></td>
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**APPENDIX B. GOOD FAITH/PRUDENT PERSON**

LLC Statutes Using Good Faith Prudent Person Standard of Care Language*

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<td>Alaska</td>
<td>ALASKA STAT. § 10.50.135(a) (2004)</td>
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<td>R.I. GEN. LAWS § 7-16-17(a) (1999)</td>
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<td>Vermont</td>
<td>VT. STAT. ANN. tit. 11, § 3059(c) (1997)</td>
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* The actual language employed varies from statute to statute. For comprehensive tables, discussion, and analysis of duty of care and duty of loyalty provisions, see BISHOP & KLEINBERGER, supra note, at 129, ¶ 10-16; LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. 9-1 (2002).
APPENDIX C. GROSS NEGLIGENCE/WILLFUL MISCONDUCT

LLC Statutes Using Gross Negligence or Willful Misconduct in Standard of Care Language

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<td>Arkansas</td>
<td>ARK. CODE ANN. § 4-32-402 (2001)</td>
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<td>D.C. CODE ANN. §29-1003 (LexisNexis 2001)</td>
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<td>Hawaii</td>
<td>HAW. REV. STAT. § 428-409(c) (2004)</td>
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<td>Montana</td>
<td>MONT. CODE ANN. § 35-8-310(3) (2005)</td>
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<td>New Mexico</td>
<td>N.M. STAT. ANN. § 53-19-16(B) (LexisNexis 2001)</td>
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<td>Oregon</td>
<td>OR. REV. STAT. § 63.155(3) (2003)</td>
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<td>Tennessee</td>
<td>TENN. CODE ANN. § 48-249-403(c) (2008)</td>
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<td>Washington</td>
<td>WASH. REV. CODE ANN. § 25.15.155(1) (West 2005)</td>
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<td>West Virginia</td>
<td>W. VA. CODE ANN. § 31B-4-409(c) (LexisNexis 2003)</td>
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<td>Wisconsin</td>
<td>WIS. STAT. ANN. § 183.0402(1) (West 2002 &amp; Supp. 2007)</td>
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APPENDIX D. INDEMNIFICATION: BEST INTERESTS

Indemnification Provisions Requiring Good Faith and Reasonable Belief, Conduct in Best Interests or Not Opposed to Best Interests of the LLC, or Containing Restrictions Tied to Honesty*

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<td>MISS. CODE ANN. § 79-29-110 (West 1999 &amp; Supp. 2007)</td>
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<td>Nevada</td>
<td>NEV. REV. STAT. § 86.411 and 86.421 (2007)</td>
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<tr>
<td>Utah</td>
<td>UTAH CODE ANN. § 48-2c-1802 (2002)</td>
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* There is some variation in this language. For example, Maine prohibits indemnification if it is finally adjudicated that the person did not act honestly or in the reasonable belief that the action was in or not opposed to the best interests of the LLC or where there is a criminal action or proceeding and there was reasonable cause to believe that the conduct was unlawful. Minnesota provides that the LLC shall provide indemnification if the person has not been indemnified by another organization or employee benefit plan and the person acted in good faith, received no improper personal benefit or otherwise satisfied provisions concerning conflicts of interest, and reasonably believed the conduct was in the best interests of the LLC or not opposed to its best interests. Mississippi and Nevada provide that the LLC may provide indemnification if the person conducted himself in good faith and he reasonably believed that the conduct was in the best interests of the LLC or not opposed to its best interests, had no reasonable cause to believe the conduct was unlawful in the case of a criminal proceeding, and may not indemnify if the person was adjudged liable to the LLC or in receipt of an improper personal benefit. New Hampshire permits indemnification if the person conducted himself in good faith, and reasonably believed the conduct to be in the best interests of the LLC or not opposed to its best interests, and prohibits indemnification where the person is adjudged liable to the LLC or liable for a personal benefit improperly received by him. New York prohibits indemnification if it is adjudicated that the person exercised bad faith, deliberate dishonesty, or personally gained. North Dakota permits indemnification if the person was not otherwise reimbursed, acted in good faith, received no improper personal benefit, had no reasonable cause to believe the conduct was unlawful in a criminal proceeding, and reasonably believed the conduct was in the best interests of the LLC or not opposed to its best interests. Tennessee and Utah permit indemnification if the individual acted in good faith and reasonably believed the conduct was in the LLC's best interests or not opposed to its best interests, and had no reasonable cause to believe the conduct was unlawful in the event of a criminal proceeding.
APPENDIX E. INDEMNIFICATION: OTHER RESTRICTIONS

Selected Indemnification Provisions Containing Other Restrictions*

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<td>Alabama</td>
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<td>California</td>
<td>CAL. CORP. CODE §§ 17155, 17153 (Deering 2006)</td>
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<td>Colorado</td>
<td>COLO. REV. STAT. § 7-80-407 (2007)</td>
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<td>District of Columbia</td>
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<td>FLA. STAT. ANN. § 608.4229 (West 2007)</td>
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<td>Maryland</td>
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<td>Michigan</td>
<td>MICH. COMP. LAWS ANN. §§ 450.4407-.4408 (West 2002 &amp; Supp. 2007)</td>
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<td>Ohio</td>
<td>OHIO REV. CODE ANN. § 1705.32 (LexisNexis 2004)</td>
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<td>TEX. BUS. ORGS. CODE ANN. § 8.102 (Vernon 2007)</td>
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<td>Washington</td>
<td>WASH. REV. CODE ANN. § 25.15.040 (West 2005)</td>
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<td>Wisconsin</td>
<td>WIS. STAT. ANN. § 183.0403 (West 2002 &amp; Supp. 2007)</td>
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* Various language prohibiting indemnification is employed. Alabama prohibits indemnification for negligence or misconduct in the performance of duties. California prohibits indemnification for violations of fiduciary duties. Colorado permits indemnification if liability incurred without violation of duties to the LLC. The District of Columbia permits indemnification, but not for willful misconduct. Florida prohibits indemnification for violations of criminal law, transactions for which improper personal benefit was received, prohibited distributions were made, or for conduct that amounts to willful misconduct or a conscious disregard for the best interests of the LLC. Iowa prohibits indemnification for amounts to which the manager is not entitled, intentional infliction of harm on the company or its members, for improper distributions, or intentional violations of law. Maryland prohibits indemnification for willful misconduct or recklessness. Michigan prohibits indemnification for receipt of financial benefits to which a manager is not entitled, for improper distributions, or knowing violations of...
law. It is not entirely clear whether Missouri imposes limitations on contractual indemnification provisions since section 347.088(2.2) provides that duties and liabilities may be expanded or restricted by the operating agreement, thus possibly implying that liabilities may not be eliminated by contract, yet section 347.081 broadly states that it is the policy to give maximum effect to the principle of freedom of contract. Montana prohibits indemnification in the case of willful misconduct or recklessness. Ohio requires that the person acted in good faith and reasonably believed the conduct to be in the LLC's best interests or not opposed to its best interests, had no reason to believe the conduct was unlawful if arising in a criminal proceeding, and if the person was adjudged negligent or engaged in misconduct, the court believes that in the circumstances the person is fairly and reasonably entitled to indemnification. Oklahoma and Oregon prohibit indemnification for violations of the duty of loyalty, acts or omissions not in good faith, or where an improper personal benefit was obtained. Oregon also prohibits indemnification where an unlawful distribution was made. Pennsylvania prohibits indemnification where a court has found willful misconduct or recklessness. Texas prohibits indemnification for penalties, fines, taxes, employee benefit plan excise taxes, willful or intentional misconduct, breach of the duty of loyalty, or for an act or omission not in good faith that constitutes a breach of duty where liability is established in a court and appeals have been exhausted or foreclosed. Virginia prohibits indemnification for willful misconduct or a knowing violation of the criminal law. Washington prohibits indemnification for intentional misconduct or a knowing violation of law, or where there was receipt of money, property or services to which the person was not legally entitled. Wisconsin prohibits indemnification where there has been a failure to perform duties.

APPENDIX F. INDEMNIFICATION WITHOUT RESTRICTIONS

Indemnification Provisions Without Express Statutory Restrictions

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<th>State</th>
<th>Statutory Provision</th>
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APPENDIX G. SAMPLE STATUTORY LANGUAGE

Sample Statutory Language Offering Contractual Freedom But Prohibiting the Elimination of Duties

I. Simple Provision Permitting Expansion of Duties or Restriction But Not Elimination

The member's, manager's or other person's duties and liabilities may be expanded or restricted by provision in the operating agreement. Mo. Ann. Stat. § 347.088(2) (West Supp. 2008).

II. Permitting Identification of Activities That Do Not Violate Fiduciary Duties

(b) The operating agreement may not:

(1) unreasonably restrict a right to information or access to records under [ ];
(2) eliminate the duty of loyalty under [ ], but the agreement may:
   (i) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and
   (ii) specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
(3) unreasonably reduce the duty of care under [ ];
(4) eliminate the obligation of good faith and fair dealing under [ ], but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;
(5) vary the right to expel a member in an event specified in [ ];
(6) vary the requirement to wind up the limited liability company's business in a case specified in [ ]; or
(7) restrict rights of a person, other than a manager, member, and transferee of a member's distributional interest, under this chapter.

III. Prohibiting Elimination of Liability for Breaches of Duty of Loyalty, Good Faith, Intentional Misconduct, Unlawful Distributions, or Receipts of Improper Personal Benefits

(a) Subject to subsection (b), the articles of organization or operating agreement may eliminate or limit the personal liability of a manager
to the limited liability company or to its members for monetary damages for breach of any duty provided for in [ ].

(b) No provision permitted under subsection (a) may limit or eliminate the liability of a manager for:

(1) Breach of the manager's duty of loyalty to the limited liability company or its members;

(2) Acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

(3) The liability imposed pursuant to the provisions of [ ] dealing with unlawful distributions or

(4) Any transaction from which the manager derived an improper personal benefit, unless the transaction was with the informed consent of the members or a majority of the disinterested managers. No provision eliminating or limiting the personal liability of a manager will be effective with respect to causes of action arising prior to the inclusion of the provision in the articles of organization or operating agreement.


IV. Extremely Liberal Guidelines on the Delineation of Duties That Will Not Violate Duties*  

(1) The articles of organization or an operating agreement of a limited liability company may not:

(a) Eliminate completely the duty of loyalty under subsection ( ) of this section, but the articles of organization or an operating agreement may:

(A) Identify specific types or categories of activities that do not violate the duty of loyalty, if not unconscionable; and

(B) Specify the number or percentage of members, whether interested or disinterested, or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

(b) Unreasonably reduce the duty of care under subsection ( ) of this section.

(c) Eliminate completely the obligation of good faith and fair dealing under . . . this section, but the articles of organization or an operating agreement may determine the standards by which performance of the obligation of good faith and fair dealing is to be measured, if the standards are not unconscionable.
(2) For the purposes of subsection ( ) of this section, specific types or categories of activities that may be identified as not violating the duty of loyalty include, but are not limited to:

(a) Competing with the limited liability company in the conduct of the business of the limited liability company before the dissolution of the limited liability company; and

(b) Entering into or engaging in, for a member's own account, an investment, business, transaction or activity that is similar to the investments, businesses, transactions or activities of the limited liability company without:

(A) First offering the limited liability company or the other members an opportunity to participate in the investment, business, transaction or activity; or

(B) Having any obligation to account to the limited liability company or the other members for the investment, business, transaction or activity or the profits from the investment, business, transaction or activity.

OR.


* This alternative is not recommended.

APPENDIX H. SAMPLE STATUTORY LANGUAGE

Sample Statutory Language Regarding Prohibitions on Indemnification

No Indemnification for Penalties, Fines, Taxes, Employee Benefit Excise Taxes, Willful or Intentional Misconduct, Breach of the Duty of Loyalty, Act or Omission Not in Good Faith

General Scope of Permissive Indemnification

(a) Subject to Subsection (b), an enterprise may indemnify a governing person, former governing person, or delegate against:

(1) a judgment; and

(2) expenses, other than a judgment, that are reasonable and actually incurred by the person in connection with a proceeding.

(b) Indemnification under this subchapter of a person who is found liable to the enterprise or is found liable because the person improperly received a personal benefit:

(1) is limited to reasonable expenses actually incurred by the person in connection with the proceeding;
(2) does not include a judgment, a penalty, a fine, and an excise or similar tax, including an excise tax assessed against the person with respect to an employee benefit plan; and

(3) may not be made in relation to a proceeding in which the person has been found liable for:

(A) willful or intentional misconduct in the performance of the person's duty to the enterprise;

(B) breach of the person's duty of loyalty owed to the enterprise; or

(C) an act or omission not committed in good faith that constitutes a breach of a duty owed by the person to the enterprise.

(c) A governing person, former governing person, or delegate is considered to have been found liable in relation to a claim, issue, or matter only if the liability is established by an order, including a judgment or decree of a court, and all appeals of the order are exhausted or foreclosed by law.

TEX. BUS. ORGS. CODE ANN. § 8.102 (Vernon 2007).

No Indemnification for Knowing Violations of Laws, Civil Penalties

An LLC operating agreement should not have the power or be obligated to indemnify a director, officer, or LLC manager for liabilities and reasonable expenses if:

A) The conduct for which indemnification is sought directly involved a knowing and culpable violation of law or a significant pecuniary benefit was obtained to which the actor was not legally entitled;

B) To the extent that the indemnification would involve any amount paid in satisfaction of a fine, civil penalty, or similar judgment as a result of violation of statutory law, the policy of which clearly precludes indemnification;

C) If the indemnification would involve any amount paid in settlement of the proceeding and the conduct directly involved a violation of statutory law, the policy of which clearly precludes indemnification;

D) To the extent that the indemnification would involve amounts paid (i) in satisfaction of a judgment or in settlement of an action that was brought by or in the right of the LLC, or (ii) for expenses incurred in any such proceeding in which the actor was adjudged liable to the LLC, except for certain court-ordered indemnification.

See PRINCIPLES, supra note 43, at § 7.20(b).
APPENDIX I. RATIO OF LLC FILINGS TO CORPORATE FILINGS, 2006


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