



## NEW RULES FOR OHIO LLCs CODIFY FIDUCIARY DUTIES OWED BY LLC MEMBERS

Your company's operating agreement has changed, and you may not even know it. Effective in May of this year, amendments to Ohio's limited liability company ("LLC") statutes took effect to add a number of rules applicable to every Ohio LLC. As with most of the rules in Ohio's LLC statutes, many of these provisions may be altered by the LLC's operating agreement. However, certain of the new provisions may not be altered by the operating agreement. If you do not want the new rules that may be altered to apply to your Ohio LLC, you should consult an attorney to consider amending your company's operating agreement.

### SPECIFIC FIDUCIARY DUTIES

Ohio courts have imposed fiduciary duties on LLC members, but until the recent amendment, the LLC statutes did not define these duties. Now, the statute adds minimum levels of member fiduciary duty obligations which are subject to "reasonable" limitation in a company's operating agreement as described below.

**Member's Duty of Loyalty.** A member owes a duty of loyalty to the LLC and any fellow member. The duty of loyalty is limited to (1) the member accounting to the company and to fellow members for the company's profits and property, (2) refraining from dealing with the company as an adverse party, and (3) refraining from competing with the company.

Of these three elements, the non-competition standard is the most problematic. Members who are simply passive investors in an Ohio LLC

may find this new statutory non-competition duty onerous and should seek to have their operating agreement amended to clarify that their investments in other similar businesses will not be a violation of their duty of loyalty.

**Member's Duty of Care.** A member's default duty of care to the LLC is a limited version of the fiduciary duty of care otherwise required of partners in a partnership or board members of a corporation. This duty is limited to the member "refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."

**Member's Obligation of Good Faith and Fair Dealing.** A member owes the obligation of good faith and fair dealing to the company and any other member, which is an obligation to deal with others honestly, fairly, and in good faith.

**Manager/Non-Member Duties.** If an LLC's manager is not a member, then the manager owes to the company the same duties as prior to the amendments – the duties of good faith, loyalty, and ordinary care (a more burdensome standard than the gross negligence standard imposed on members by the amendments).

**Manager/Member Duties.** If the manager is a member, then the only fiduciary duties the member/manager owes to the company and the other members are the required member duties now stated in the LLC statutes, as may be limited in the company's operating agreement. If the manager is a member who has agreed in writing to serve as a manager, then the member/manager owes to the company and to

the other members the same fiduciary duties of loyalty and care that a non-member manager owes to the company. The purpose of these rules is to be able to identify the fiduciary duties owed by a member who is also serving as an LLC's manager. The critical point is that by agreeing in writing to serve as a manager, a member/manager increases the level of fiduciary duties owed to the LLC.

#### **NEW RULES THAT MAY NOT BE ALTERED BY THE OPERATING AGREEMENT**

Ohio's LLC law now provides that a company's operating agreement governs relations among members and between members, any managers, and the company. In addition, the company is bound by the operating agreement, whether or not the company executes it.

**Limitations.** Under new Ohio Revised Code Section 1705.081, an operating agreement may not:

- vary the rights and duties stated in the company's articles of organization;
- unreasonably restrict a member's right to access the company's books and records;
- eliminate a member's duty of loyalty (although a company's operating agreement may list reasonable types or categories of activities that members may pursue without violating their duty of loyalty);
- unreasonably reduce the duty of care;
- eliminate the member's obligation of good faith and fair dealing with the company and any other member (members may set reasonable standards in a company's operating agreement by which the obligation of good faith and fair dealing is to be measured);
- eliminate a manager's fiduciary duties (although a company's operating agreement may list reasonable types or categories of activities that managers may pursue without violating their duties and may set reasonable standards in a company's operating agreement by which the manager's duties are to be measured);

- vary the process of winding up the company following dissolution as described in the statute; or
- restrict the rights of third parties.

The most critical limitations on this list are the provisions prohibiting elimination of member fiduciary duties. The practical issue here arises if investors form an LLC to pursue a particular investment opportunity and they have no desire to take on the duties of "fiduciaries" to one another. Can these investors achieve their desire to invest without also owing fiduciary duties given the statute's prohibition on complete elimination of fiduciary duties?

While the statute allows duties to be limited to a degree, even these opportunities to limit duties will require careful drafting. If a court determines that an operating agreement's duty limitation is unreasonable, the court may hold members to the full default fiduciary duties. It is worth noting that some practitioners recognize the uncertainty created by this new statute and the unpredictability of whether a court would find a limitation reasonable. Whether the practitioners are able to persuade the General Assembly to clarify this statute (including by possibly allowing members to completely eliminate certain duties) remains to be seen.

If your company's current operating agreement includes provisions that eliminate duties or otherwise appear to contradict these new prohibitions, you will want to consider amending it to align with the amended LLC statutes or converting the Ohio LLC to another state where these default duties do not exist.

**New Members.** One change that strikes us as odd is in the reach of the terms of a company's operating agreement. If a third party takes an LLC membership interest as an assignee or becomes a substitute member, that third party is immediately bound by the terms of the company's operating agreement, even if the third party has neither signed nor seen it.

This creates an interesting dynamic. It adds an opportunity for members to craft creative provisions that will apply only to assignees following assignment. Imagine a capital call provision that requires any assignee to contribute a substantial sum of money to the

LLC upon receiving the assigned units. A third party would be well served to closely investigate an LLC prior to taking an assignment of the LLC membership interest, including by reviewing the LLC's operating agreement to determine what potential liabilities or hidden financial burdens come with the membership interest.

### WITHDRAWAL

When a member withdraws from an LLC, the non-competition element of his or her duty of loyalty ends. The withdrawing member's other duty of loyalty elements and the member's duty of care continues after withdrawal only as to

those matters occurring prior to the member's withdrawal.

### CONCLUSION

Ohio LLC members should take a close look at their current operating agreements. If the default rules added to Ohio's LLC statutes do not reflect the arrangement the members desire to have with one another and with the company, the members should amend their operating agreement to clarify the duties they have to the company and one another. Failure to properly limit member fiduciary duties may create unexpected obligations or liabilities.

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### ADDITIONAL INFORMATION

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