OPPORTUNITIES AND PITFALLS UNDER OHIO'S NEW LLC ACT

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On January 1, 2022, the new Ohio Revised Limited Liability Act in O.R.C. Chapter 1706 (the "New Act") will go into effect and govern all LLCs formed or registered to do business in Ohio. The new Act is a complete replacement of existing Ohio LLC law under O.R.C. Chapter 1705 and constitutes the default rules for governing Ohio LLCs; however, the new Act emphasizes the principles of "freedom of contract" in providing business owners and investors the ability to override the majority of the default rules under the new Act through the company's operating agreement.

Consequently, the new Act provides a litany of opportunities to business owners and investors to specifically tailor their relationships and management structures. In order to help their clients take advantage of these opportunities, practitioners must become keenly aware of the default rules under the new Act and avoid any unintentional consequences or "pitfalls" with respect to the application of the law to their clients' businesses. Practitioners should begin to review their existing clients' operating agreements to ensure that their terms align with the business owners' expectations while navigating the requirements under the new Act.

MANAGEMENT STRUCTURES AND AUTHORITY

Opportunity – The new Act eliminates the distinction between the member-managed and manager-managed structures under the existing LLC Act and the inherent apparent authority of the members and/or managers to bind the LLC derived from these management structures. Instead, the new Act provides an LLC the flexibility to institute any governing structure and bestow actual authority to certain persons or entities to bind the LLC as defined in the operating agreement, as provided by the consent of the members, or as set forth in a statement of authority filed with the Ohio Secretary of State (a concept borrowed from partnership law but new to Ohio LLCs).

Pitfall – If the management structure is not properly addressed in the operating agreement, then the default rules with respect to management and authority under the new Act will apply. Under the default rules, the activities and affairs of the LLC or series are subject to the oversight of its members. Outside of a few exceptions that require unanimous consent under the default rules (e.g. the ability to amend the operating agreement or undertake any activity that is outside the ordinary course of the company's activities), matters in the ordinary course of the company's activities are to be decided by the majority of the members (or, with respect to a series, the members of that particular series) on a per capita basis. This is in stark contrast to the existing LLC Act, where the management authority of the members (when the operating agreement is silent) is based on the proportion of each member's contribution of capital to the company, as adjusted to reflect additional contributions or withdrawals by such member. Additionally, the default rules under the new Act require that all members share equally in any distributions made by the company (except that when winding up the LLC, each member is first entitled to receive a return of its unreturned contributions before receiving an equal share of distributions from any surplus remaining in the Company). Understandably, many business owners and investors who make substantial contributions to a company will want to avoid scenarios where the management authority of the company is decided by the headcount of the members and operational distributions are shared equally by the members, thereby making the size of a member's contribution inconsequential with respect to control over the company and the distribution of funds.

FIDUCIARY DUTIES

Opportunity – The new Act permits the elimination of all fiduciary duties of the members, managers, or other parties, including the duty of loyalty and the duty of care. The ability to eliminate fiduciary duties may be beneficial to those companies that typically engage passive investors, such as real estate holding companies or investment funds. Owners in these types of entities, who often participate in more than one holding or investment company, usually desire to avoid any duty to present business opportunities to the Company or a duty to refrain from competing with the Company.

Both the existing and new Acts preclude the elimination of the implied covenant of good faith and fair dealing, which is not a fiduciary duty per se, but shares similar traits. Practitioners should consider drafting operating agreement provisions in a manner intended to clarify what will or will not be considered breaches of this covenant.

Pitfall – Under the new Act, the default rules for fiduciary duties of the members and managers are subject to whether the company has managers. If a company has managers, the members do not owe any fiduciary duties to the company or to the other members, but they must exercise their rights consistent with the implied covenant of good faith and fair dealing. Managers owe a duty of loyalty and care. If the company does not have managers, members owe the duties of care and loyalty to the company and the other members. Application of the fiduciary default rules may be viewed as an "opportunity" or a "pitfall" depending on the member's position of control in the LLC. Controlling members typically want to limit their fiduciary obligations to the company and other members in order reduce their exposure for business decisions made on behalf of the LLC, while minority investors generally want to expand the fiduciary obligations to ensure the controlling members act on behalf of the minority investors' interest.

SERIES

Opportunity – The new Act allows for Ohio limited liability companies to be formed or reorganized into series LLCs. A series LLC is a limited liability company that contains one or more separate series. Each series may establish, in its own separate name, its own members, purpose, management, assets, duties, powers, and rights distinct from other series in the company and from the LLC itself. Additionally, each series in a series LLC has the power to sue or be sued, enter into contracts, and, with respect to the assets of the series, convey assets or otherwise encumber such assets by granting liens or security interests on those assets. The biggest benefit of establishing a series is that it affords a high level of protection for assets held by an individual series from the liabilities of other series and the master LLC. Generally, the assets of an individual series are shielded from claims arising from the other series or the LLC itself. Conversely, the other series and the LLC are protected from claims against an individual series. In order for a series to be afforded these protections, the articles of organization and operating agreement of the series LLC must contain specific language regarding the establishment and separateness of each series, and the series LLC must keep and maintain consistently clear and separate records for each series.

Pitfall – Given that the series LLC is still a relatively new but growing concept (currently allowed in approximately one-third of the states), there remains a level of uncertainty regarding whether the benefits of a series will be upheld in jurisdictions outside of Ohio or in certain legal proceedings. For example, there is an inherent risk that the liability shield for the assets of a series may not be recognized in states that do not recognize series limited liability structures or by bankruptcy courts. Furthermore, there is no clear indication that states will follow federal guidelines, which currently provide that each series is to be treated as a separate entity for income tax purposes. This uncertainty adds further complexity as to how series LLCs are required to deal with payroll and state income taxes.

BARRING CREDITOR CLAIMS

Opportunity – The new Act provides a dissolving company the opportunity to bar certain creditor claims following the windup of its operations. The opportunity to bar certain creditor claims depends on whether the dissolving company provides proper notice to its creditors in accordance with the new Act. Proper notice must include the name of the dissolving company, a description of information needed to file a claim, a mailing address to send a claim, and a deadline to submit a claim. For known creditors, the Company must deliver a notice to the known creditors with a statement that any claims against the Company must be filed within 90 days of the notice date. For unknown creditors, the company must publish a notice on the company's website (if it has one) and provide the notice to the Ohio Secretary of State to be posted on its website. In addition, the notice for unknown creditors must include a statement that any claims must be filed within two years of the notice publication date. Creditors who fail to deliver their claims within the specified deadline will be barred from filing claims against the dissolved company.

Pitfall – The ability to bar certain creditor claims is optional and subject to the dissolving company's following of the notice requirements in the new Act. In order to avoid unintentionally missing the opportunity to bar creditor claims, practitioners may want to advise their clients to include a statement under the dissolution section of their operating agreements that references the creditor notice requirements under the new Act.

CONCLUSION

The discussion above highlights only some of the opportunities and pitfalls under the new Act. The new Act makes changes to Ohio LLC law in many other areas, including those relating to derivative claims, charging orders, and failure to maintain an agent. Practitioners should review the new Act in its entirety to avoid surprises down the road.

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