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Inside
Honoring Those Who Served and Sacrificed to Protect Our Freedom

The New Arkansas Uniform Limited Liability Company Act: A Statutory Overhaul

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This article provides an overview of Arkansas' recently-enacted version of the Uniform Limited Liability Company Act and its impact on both existing and new limited liability companies organized in Arkansas.

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Introduction

We live in a time of dramatic change. In fact, for limited liability companies organized under Arkansas law, that change has already begun to occur. Act 1041 of the 2021 Acts of the Arkansas General Assembly (“Act 1041”),¹ signed into law on April 30, 2021, with an effective date of September 1, 2021, repealed in its entirety the state’s former limited liability company statutory scheme, commonly known as the Arkansas Small Business Entity Tax Pass Through Act (the “Old Act”),² and replaced it with the Arkansas Uniform Limited Liability Company Act (the “New Act”),³ making Arkansas the 20th state at the time to adopt the Uniform Limited Liability Company Act (2006) (last revised 2013) (the “RULLCA”).⁴ Because limited liability companies (“LLCs”) are now the most popular form of business entity in the United States,⁵ the New Act will have a broad impact on the Arkansas business law landscape. The New Act, modeled after the RULLCA, represents a substantial overhaul of the law governing Arkansas LLCs, and now applies to *all* LLCs organized under this state’s laws. There is no savings clause for the Old Act or any ongoing transition period for LLCs organized under the Old Act, and since September 1, 2021, the New Act has applied to all Arkansas LLCs without regard for their date of organization.⁶

Advocates of the RULLCA believe it provides “reduced compliance costs, streamlined administration and consistency across jurisdictions.”⁷ That may be an important virtue of the New Act, but certain provisions of the New Act make substantive and material changes to the statutory law that governed Arkansas LLCs prior to September 1, 2021, and that expand the potential personal liability of those managing the LLC, including all members in a member-managed LLC. This article summarizes key changes the New Act brings to the governance and operation of Arkansas LLCs, and also highlights important provisions that may prompt owner-members of Arkansas LLCs to amend their existing operating agreements and possibly change their historical governance practices.



History of LLCs in Arkansas

Prior to 1993, Arkansans seeking both limited legal liability and pass-through tax treatment for their business activities, *i.e.*, the payment of taxes solely through the business owners' tax returns, and not by the business itself, had only a certain type of close corporation ("S corporation") available to obtain the desired tax pass-through treatment. Regulations of the Internal Revenue Service pertaining to S corporations at the time, among other things, imposed strict limitations on the number of shareholders and required all shareholders to be natural persons.⁸ In April 1993, the Arkansas business landscape changed with the enactment of the Old Act and the introduction of the LLC as a new form of tax-efficient legal entity under which an owner or owners could conduct business, large or small. The LLC form was designed to provide the same limited liability to members as that commonly associated with stockholders' immunity from liability in most cases for debts and obligations of a corporation, while retaining sufficient characteristics to be taxed as a partnership (allowing pass-through treatment to the members of all taxable gains and losses for federal income tax purposes⁹). Since the Old Act's adoption, the use of LLCs in Arkansas business has proliferated across all sectors of economic activity in the state, whether farming or high tech, manufacturing or

retail, or professional services of all types. When advising on the formation of a new business, the question for many Arkansas practitioners has evolved from "*Should we form an LLC?*" to "*Why not?*"

One of the chief advantages of electing to own and operate a business governed by the Old Act was the freedom of the members of an LLC to choose provisions they specifically agreed to include in the operating agreement, the basic LLC governance document. By making contractual agreements among themselves regarding such provisions, Members could avoid application of substantially all the "default" provisions in the Old Act that would otherwise be mandated if the operating agreement failed to address the particular subject matter. A principal example of this contractual flexibility included the ability of the members to choose to manage the LLC themselves or appoint a manager or managers to run the affairs of the business with varying degrees of responsibility to the members. In either case, the persons responsible for the actions of the LLC could be exculpated in the operating agreement from most liabilities resulting from the failure to properly exercise their operating responsibilities.

Establishment of Nonwaivable Fiduciary Duties under the New Act

While the New Act generally preserves the concept of allowing LLC members the

freedom of contract in most cases,¹⁰ the New Act imposes certain new, more extensive and nonwaivable statutory fiduciary duties, upon the manager or managers in the case of a manager-managed LLC, and upon the members in a member-managed LLC. The imposition of nonwaivable fiduciary duties upon LLC members or managers, as applicable, which can be altered only in certain ways under the New Act,¹¹ is one of the most significant changes introduced by the New Act. These fiduciary duties, among others, include new and expanded duties of loyalty¹² and care.¹³ These particular duties embrace concepts that should be familiar to most practitioners in corporate law, but they were not recognized as being applicable under the Old Act.¹⁴ In addition, in certain cases the class of persons owing fiduciary duties to others in an LLC environment has been expanded¹⁵ or made non-alterable by contract except in limited cases.¹⁶ Where the fiduciary duties may be altered or limited, there is an overriding qualifier: so long as such alterations or limitations are not "manifestly unreasonable."¹⁷ This new term is to be determined by the court as a matter of law where a dispute exists concerning the affected fiduciary duty.¹⁸ The importation into Arkansas LLCs of these new fiduciary duties and the undefined standard by which the performance of these duties, if altered, is to be judged will likely present novel issues and require interpretation by Arkansas courts.

It should be noted that these fiduciary duties will apply in the governance of an LLC whether it was formed under the Old Act or under the New Act; thus, it is important for practitioners, if they haven't already done so, to promptly address the issues in drafting operating agreements for any newly-created LLCs, and to also bring these matters to the attention of their clients with LLCs created under the Old Act in order to determine whether it would be advisable to take any steps by amending pre-existing operating agreements to modify or limit, to the extent permissible under the New Act, such nonwaivable fiduciary duty provisions now applying to all Arkansas LLC operating agreements.

The Old Act's handling of duties of the members or managers could be characterized as "ultra-contractarian"—the view that the obligations members and managers owed to one another could be altered or rejected through the "freedom of contract." This approach traditionally has been attractive to parties working with legal counsel experienced in defining the business relationships among the members and, where applicable, between the managers and the members. For example, subject to a contrary provision in the operating agreement, the Old Act provided that members and managers were not liable to one another "in damages or otherwise" for any act or omission unless it "constitute[d] gross negligence or willful misconduct."¹⁹ The Old Act also did not articulate a fulsome duty of loyalty or an obligation of good faith and fair dealing. Critics of the Old Act, however, have noted that this failure to address in full the fiduciary duty of loyalty and duty of care applicable to members and managers could facilitate an abuse of power by persons with management authority.²⁰

The New Act spells out the following duties that will now arise by default upon members in a member-managed LLC under the New Act:

1. Duty of Loyalty: "A member of a member-managed limited liability company owes to the company and . . . the other members the duties of loyalty and care." Under the New Act, the fiduciary duty of loyalty of a member in a member-managed limited liability company includes the duties: (1) to account to the company and to hold

as trustee for it any property, profit or benefit derived by the member: (i) in the conduct or winding up of the company's activities and affairs; (ii) from a use by the member of the company's property; or (iii) from the appropriation of a company opportunity; (2) to refrain from dealing with the company in the conduct or winding up of the company's activities and affairs as or on behalf of a person having an interest adverse to the company;²¹ and (3) to refrain from competing with the company in the conduct of the company's activities and affairs before the dissolution of the company.²²

2. Duty of Care: "The duty of care of a member of a member-managed limited liability company in the conduct or winding up of the company's activities and affairs is to refrain from engaging in gross negligence, recklessness, willful misconduct or knowing violation of law."²³

3. Obligation of Good Faith and Fair Dealing: "A member shall discharge the duties and obligations under this title or under the operating agreement and exercise any rights consistent with the contractual obligation of good faith and fair dealing."²⁴

Counterpart provisions likewise apply to manager-managed LLCs.²⁵ Furthermore, the New Act limits the ability of members to modify these default duties, which is a significant departure from the freedom of contract approach afforded under the Old Act. The New Act does permit parties to an operating agreement to alter the statutory default rules concerning these duties, but in most cases, only to the extent such changes are not "manifestly unreasonable."²⁶ For example, the duty of loyalty (including the duty to refrain from competition) may be altered only to the extent not manifestly unreasonable. Additionally, the obligations between members of good faith and fair dealing may not be eliminated, but the operating agreement may provide standards by which the obligation is judged.

Although there appear to be no cases from other jurisdictions squarely deciding what the term "manifestly unreasonable" means in the context of the RULLCA, at least one court, in a case arising in a bankruptcy proceeding, addressed the meaning of that term arising in the context of the Revised Uniform Partnership Act, stating essentially that in the absence of other guidance the

court would simply have to use its common sense in defining the term.²⁷ Unless other courts further define the meaning of this term in the context of the RULLCA in the interim, Arkansas courts may be faced in the future with interpreting what is and what is not "manifestly unreasonable" within the context of LLC members and managers and their relationships to each other, with no guidelines other than the court's "common sense."

Mandatory Information Disclosures

While the New Act will replace many parallel provisions in the Old Act, in some cases, it will establish entirely new obligations for members and managers. For example, the New Act requires that an LLC "furnish to each member . . . without demand, any information concerning the company's activities, affairs, financial condition, and other circumstances which the company knows and [that] is material to the proper exercise of the member's rights and duties under the operating agreement or [the New Act], except to the extent the company can establish that it reasonably believes the member already knows the information . . ."²⁸ The Old Act included no such explicit obligation.²⁹ Instead, the Old Act provided any member the right, upon reasonable request, to "inspect and copy . . . any limited liability company record, wherever the record is located."³⁰ It remains to be seen whether this open-ended responsibility to provide all information, without request of a member, that the Company knows, and that is material to a proper exercise of a member's rights and duties under the operating agreement or the New Act, will invite litigation against managers and managing-members of Arkansas LLCs for the failure to fully furnish each member all "material" information relevant to such member's rights and duties.³¹

Expulsion of a Member

The New Act will also bring a new ability to expel a member where an LLC's operating agreement is silent. Under the Old Act, absent written agreement, a person would cease to be a member under a narrow set of circumstances,³² and courts were limited to dissolving an LLC entirely where it was "not reasonably practicable to carry on the

business of the [LLC] in conformity with the operating agreement.”³³ The New Act permits the expulsion of a member “by an affirmative vote or consent of all the other members” in the event conducting business with an existing member would be illegal. Additionally, under the New Act, any member may petition a court to expel another member where the member has engaged in wrongful conduct, has committed a material breach of the operating agreement, or has engaged in conduct that makes it impracticable to carry on the activities and affairs of the company with the person as a member.³⁴

Operating Agreement May be Unwritten

According to one commentator, one quirk of the Old Act is the requirement that an LLC maintain a written operating agreement without (i) any requirements as to its contents or (ii) clear guidance regarding the consequences for the failure of an LLC to have one.³⁵ By contrast, the New Act defines an “operating agreement” as the “agreement, whether or not referred to as an operating agreement and whether oral, implied, in a record, or in a combination thereof, of all the members of a limited liability company, including a sole member” regarding the governance of the LLC.³⁶ Thus, it would be possible under the New Act for Arkansas LLC members and managers operating under a simple form of written operating agreement under the Old Act, but who currently operate day to day under the convenience of “handshake” understandings among the members, to possibly have those informal understandings automatically engrafted upon the written agreement without any required affirmative action on the part of the members or managers.³⁷ The practical counseling point here, obviously, is that oral agreements may have wide variances between the parties regarding their interpretation, and that the interests of all parties will be best protected when a written agreement is put in place that requires all amendments or other understandings, including amendments, to be in writing and signed by the members, and that clearly spells out the conduct required and the relationships among the members, *inter se*, and between the managers and the members.

Conclusion

For all LLCs organized under Arkansas law, it is a fact that operating agreements and the duties and relationships between the members in a member-managed LLC and the members and the managers in a manager-managed LLC have already changed, effective September 1, 2021, whether or not the members and managers intended or agreed to make the changes. With a practitioner’s eye on the New Act’s many default rules, Arkansas attorneys should revisit existing LLC operating agreements and address these new rules with clients and ensure that, if appropriate, clients’ operating agreements are promptly amended (i) to clearly provide for alternatives to the default provisions of the New Act³⁸ that are not viewed as appropriate for the clients’ business expectations, other than the nonwaivable fiduciary duties required by the New Act, and (ii) to expressly alter the default standards regarding the fiduciary duties and obligations prescribed in the New Act in a permissible way, all the while being cautious regarding what may constitute “manifestly unreasonable” alterations or changes.

Endnotes:

1. *See SB601: To Repeal The Small Business Entity Tax Pass Through Act; And To Establish The Uniform Limited Liability Company Act*, ARK. STATE LEGIS., available at <https://www.arkleg.state.ar.us/Bills/Detail?id=SB601&dBienniumSession=2021%2F2021R> (last accessed May 13, 2021); *see also Limited Liability Company Act, Revised*, UNIFORM LAW COMMISSION, available at <https://www.uniformlaws.org/committees/community-home?CommunityKey=bbea059c-6853-4f45-b69b-7ca2e49cf740> (last accessed May 13, 2021).
2. ARK. CODE ANN. § 4-32-101 *et seq.*
3. Codified as ARK. CODE ANN. § 4-38-101 *et seq.*
4. *See Limited Liability Company Act, Revised*, UNIFORM LAW COMMISSION, available at <https://www.uniformlaws.org/committees/community-home?communitykey=bbea059c-6853-4f45-b69b-7ca2e49cf740&tab=groupdetails> (last accessed May 21, 2021).
5. *See Trends in New Business Entities: 30 Years of Data*, BERMAN SOLUTIONS (Feb. 24, 2021), available at <https://www.berkmansolutions.com/articles/entities/30->

years-of-new-business-entities.

6. ARK. CODE ANN. § 4-38-110.
7. *Why Your State Should Adopt the Uniform Limited Liability Company Act ULLCA (2006) (Last Amended 2013)*, UNIFORM LAW COMMISSION, available at <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=36ed703c-12ad-070f-fa01-64010b1dabb6&forceDialog=0> (last accessed May 13, 2021).
8. *See* Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity Is Born*, 46 ARK. L. REV. 791, 792–93 (1994).
9. *Id.* at 796.
10. ARK. CODE ANN. § 4-38-105(a).
11. ARK. CODE ANN. § 4-38-105(e)(5).
12. ARK. CODE ANN. § 4-38-409(b).
13. ARK. CODE ANN. § 4-38-409(c).
14. *See K.C. Properties of N.W. Arkansas, Inc. v. Lowell Inv. Partners, LLC*, 373 Ark. 14, 280 S.W.3d 1 (2008).
15. For example, in a member-managed LLC, each member now has fiduciary duties to all other members. *See* ARK. CODE ANN. § 4-38-409(a).
16. *See, e.g.*, ARK. CODE ANN. § 4-38-105(e)(5); ARK. CODE ANN. § 4-38-105(f).
17. ARK. CODE ANN. § 4-38-105(e)(6).
18. ARK. CODE ANN. § 4-38-105(g).
19. ARK. CODE ANN. § 4-32-402(1).
20. Carol Goforth, *Making the Case for the Uniform Limited Liability Company Act (2013) in Arkansas*, 40 U. ARK. LITTLE ROCK L. REV. 187, 200 (2017).
21. It is a defense to a claim under clause (b)(2), and any comparable claim in equity or at common law, that the transaction was fair to the limited liability company. *See* ARK. CODE ANN. § 4-38-409(g).
22. ARK. CODE ANN. § 4-38-409(b).
23. ARK. CODE ANN. § 4-38-409(c).
24. ARK. CODE ANN. § 4-38-409(d).
25. ARK. CODE ANN. § 4-38-409(i).
26. ARK. CODE ANN. § 4-38-105(e)(6); ARK. CODE ANN. § 4-38-105(f)(3).
27. *See In re Brobeck, Phleger & Harrison L.L.P.*, 408 B.R. 318, 335 (Bankr. N.D. Cal 2009), also cited in the Commentary to Section 105(e) of the RULLCA: “RUPA [UPA (1997)] does not define what is ‘manifestly unreasonable’ and the parties have not cited, nor can the court locate, a decision that defines the term. Absent case law or even a dictionary definition, the court must rely on its common sense to recognize

something as manifestly unreasonable.”

The Commentary to Section 105(e) of the RULLCA, which was not adopted in the New Act, also includes an extended discussion of the term as used in subsection (e) and recommends the process that should be followed in determining the meaning of the term in the specific context of a court proceeding where the term is relevant to the issues in the particular case.

28. ARK. CODE ANN. § 4-38-410(a)(2)(A).

29. Note, however, that Arkansas’ Uniform Partnership Act has established this affirmative disclosure obligation in the case of a partnership. *See* ARK. CODE ANN. § 4-46-403.

30. ARK. CODE ANN. § 4-32-405(b).

31. REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 410(a)(2) CMT. (UNIF. LAW COMM’N 2014) (The comment to the RULLCA regarding this subsection clarifies that “[t]his paragraph imposes a duty on the limited liability company, not the members who manage the LLC. However, a member could be liable in damages if the member were to: (i) breach a duty under Section 409 or the operating agreement; and (ii) in doing so cause or suffer the LLC to breach the duty

stated in this paragraph.”).

32. *See* ARK. CODE ANN. § 4-32-805 (including, among other things, in the event the member files a voluntary petition in bankruptcy, makes an assignment for the benefit of creditors, or a member’s death).

33. *See* ARK. CODE ANN. § 4-32-905.

34. *See* ARK. CODE ANN. § 4-38-602(6).

35. Carol Goforth, *Making the Case for the Uniform Limited Liability Company Act (2013) in Arkansas*, 40 U. ARK. LITTLE L. REV. 187, 198 (2017) (“As to the contents of the agreement, a careful perusal of the statute does not indicate that anything has to be in the required agreement. As for the consequences of not having one, other than the obvious result that the statutory default rules will then control the relationship of the parties and the operation of the business, there also appears to be no specified consequence for not following the explicit statutory mandate.”).

36. ARK. CODE ANN. § 4-38-102(3).

37. *See* Goforth, *supra* note 35, at 199.

38. *See* ARK. CODE ANN. § 4-38-105(a). ■

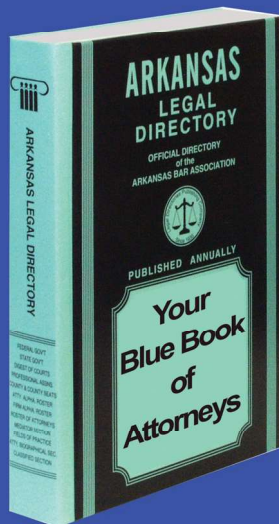


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