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PROTECTING SMALL BUSINESS OWNERS: WHY NEW MEXICO SHOULD ADOPT THE UNIFORM LIMITED LIABILITY COMPANY ACT

Jaya M. Rhodes*

I. INTRODUCTION

The heart of the New Mexico economy is driven by small businesses. Small business owners account for 96 percent of the state's employers, and over 120,000 New Mexico businesses do not keep employees on their payroll.¹ As the New Mexico economy continues to grow through the efforts of small companies and self-employed entrepreneurs, the use of the limited liability company (LLC) as the preferred corporate vehicle has exploded since its recognition by the New Mexico Legislature.² The New Mexico LLC statute was enacted in 1993,³ and within ten years the limited liability company was the predominant business entity in New Mexico and accounted for nearly 60 percent of new corporate filings.⁴

The LLC combines the personal liability shield of the corporation with the pass-through tax benefits of the partnership.⁵ First recognized by statutes in Wyoming and Florida,⁶ the LLC has become the preferred method for organizing small businesses over the past few decades.⁷ The National Conference of Commissioners on Uniform State Laws (NC-

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1. *New Mexico Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09nm.pdf> (last visited Sept. 2, 2011).

2. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

3. *Id.*

4. Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 37 (2004).

5. 54 C.J.S. *Limited Liability Companies* § 3 (2010).

6. Wyoming passed the first LLC statute in 1977. WYO. STAT. ANN. §§ 17-15-101 to 17-15-136 (Michie 1989 & Supp. 1995); Florida followed in 1982. FLA. STAT. ANN. §§ 608.401-608.471 (West 1993 & Supp. 1995).

7. Friedman, *supra* note 4, at 75. The LLC “has become the dominant form for newly-created small businesses in a clear majority of the states and is rivaling corporations for that distinction in several more.” *Id.* at 35.

CUSL) has issued a Revised Uniform Act,⁸ but currently New Mexico has its own statute governing limited liability companies.⁹

Enacted in June 1993, the New Mexico Limited Liability Act (New Mexico Act) promulgated rules governing the formation and management of limited liability companies.¹⁰ Two years later, after most states had adopted their own LLC statutes, the NCCUSL formulated the first Uniform Limited Liability Company Act, which was adopted by a total of eight states including Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia.¹¹ In 2006, the NCCUSL drafted the Revised Uniform Limited Liability Company Act (Revised Uniform Act), possibly as a response to the limited number of states who chose to adopt the original Uniform Act. Since then, four states including Idaho, Iowa, Nebraska, and Wyoming have adopted the Revised Uniform Act, and the District of Columbia and Indiana have introduced legislation contemplating its adoption.¹² In addition, Alabama, Arkansas, Minnesota, Montana, New Jersey, South Carolina, and the Virgin Islands are expected to introduce legislation proposing the adoption of the Revised Uniform Act in 2011.¹³

This comment compares the fiduciary duties, member obligations, and default provisions featured in the Revised Uniform Act and the New Mexico Act. It includes an examination of the business characteristics and economy of New Mexico as well as other states that have adopted similar statutes. Finally, the comment sets forth a number of reasons why the New Mexico Legislature should adopt the Revised Uniform Act as a mechanism to provide clear guidelines for small business owners.

II. BACKGROUND LAW

Part II provides background on the various LLC statutes as well as the current approach of courts to member disputes. More specifically,

8. Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 36 (2008).

9. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

10. *Id.*

11. National Conference of Commissioners on Uniform State Laws, Uniform Limited Liability Company Act Fact Sheet-Original ULLCA, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca.asp (last visited May 15, 2012).

12. National Conference of Commissioners on Uniform State Laws, Revised Uniform Limited Liability Company Act Legislative Fact Sheet, *available at* [http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20\(Revised\)](http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised)).

13. RULLCA Legislative Proposal from the State Bar of Calif., at 2, <http://www.calbar.ca.gov/LinkClick.aspx?fileticket=ZU68OHm6zHI%3D&tabid=2796>.

Section A outlines the differences between the New Mexico Act and the Revised Uniform Act. Section B discusses the tendency of New Mexico Courts to embrace fiduciary duties in the context of small businesses despite the drafters' attempt to limit them in the New Mexico Act. Section C discusses the duties and obligations imposed by the Courts on the managing members of small business entities in jurisdictions that have adopted the Revised Uniform Act.

A. Key Differences Between the New Mexico Act and the Revised Uniform Act

1. Voting and Management

In determining how to delegate the authority and responsibilities of managers and members, limited liability companies can be organized in one of two ways. In a manager-managed LLC, one or more persons are designated to make management decisions and direct the affairs of the company.¹⁴ In a member-managed LLC, all members are vested with management responsibilities.¹⁵ The default rules under the New Mexico Act provide for a member-managed LLC.¹⁶ In addition, voting rights are tied to relative economic interest under the New Mexico Act.¹⁷ Under the Revised Uniform Act, an LLC is manager-managed by default, although at times it may also be member-managed.¹⁸ In addition, the Revised Uniform Act provides for equal voting rights in the form of the one member, one vote structure used by partnerships.¹⁹

2. Agency

Another potential difference between the Revised Uniform Act and the New Mexico Act is whether non-managing members automatically have agency authority to act on behalf of the company. If members do have agency authority, the company will generally be liable for their actions. The Revised Uniform Act expressly rejects the statutory apparent agency approach, stating that “[a] member is not an agent of a limited liability company solely by reason of being a member.”²⁰ Under the Revised Uniform Act, therefore, generally only managers are agents of the company.²¹ The New Mexico Act, on the other hand, is silent on the issue

14. See 54 C.J.S. *Limited Liability Companies* § 11 (2011).

15. *Id.*

16. NMSA 1978, § 53-19-15 (2004).

17. *Id.* at § 53-19-17.

18. Revised Unif. Ltd. Liab. Co. Act § 407 (2006) [hereinafter RULLCA].

19. *Id.*

20. *Id.* at § 301(a).

21. See *id.* at § 301.

of agency and does not address member liability.²² Since New Mexico Courts have also not ruled on this issue, trial courts are left without guidance as to how to determine member liability and agency issues in the context of many situations such as common breach of contract claims.

3. Operating Agreement

One of the most significant differences between the Revised Uniform Act and the New Mexico Act is the way in which the members can form the company's operating agreement. The operating agreement is the agreement that governs the operation of the business, the financial structure, the voting structure, and the managerial rights and responsibilities of each member of the LLC.²³ The Revised Uniform Act imposes rather lenient requirements on the formation of an operating agreement. The operating agreement can be oral,²⁴ written, or may be comprised of a number of separate documents and records as long as it is formed with the consent of all the members.²⁵ Under the New Mexico Act, the operating agreement must be in writing.²⁶

4. The LLC as a Party to an Arbitration Agreement

Whether the LLC as an individual entity is a party to, and therefore bound by, any arbitration agreement contained in the operating agreement has significant consequences in the event of a member dispute. After the departure of a member of an LLC, there are many claims that commonly arise such as breach of fiduciary duty, interference with prospective contractual relations, fraud, and misappropriation of trade secrets. Whether the LLC is a party to the arbitration agreement deter-

22. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004). As the New Mexico Court of Appeals noted in *Bogle v. Summit Investment. Co.*, 2005-NMCA-024, ¶ 18, 107 P.3d 520, 528, the New Mexico LLC Act dictates that "an agent of a corporation may be held liable for the consequences of his own acts or omissions, including tortious acts." Beyond that, however, the statute does not provide any further guidance as to when members and managers have the authority to bind the company as agents. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

23. 54 C.J.S. *Limited Liability Companies* § 18 (2011) (The operating agreement "regulate[s] or establish[es] the affairs of the company, the conduct of its business, and the rights, duties, and relationships of the parties to the agreement.").

24. RULLCA § 102(13) (2006) (The Uniform Act defines the operating agreement as "the agreement, whether or not referred to as an operating agreement and whether oral, in a record, implied, or in any combination thereof, of all the members of a limited liability company.").

25. *Id.* at § 102, comment, ¶ 13. The comment also notes that an agreement between less than all the members, while enforceable as a valid contract among those members, would not become part of the operating agreement. *Id.*

26. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

mines whether the dispute may be litigated rather than arbitrated. The Revised Uniform Act explicitly states that the LLC is a party to the operating agreement regardless of whether the company itself has consented to, or agreed to be bound by, the agreement.²⁷

Under the New Mexico Act, it is unclear whether the LLC is a party to the operating agreement or any arbitration clause therein.²⁸ Although a member has the option of signing on behalf of the LLC to ensure that it is a party to the agreement, New Mexico courts are unlikely to conclude that the LLC is automatically a party to the agreement without obtaining the “company’s” signature.²⁹ New Mexico takes the position that non-signatory third parties are generally not bound by the agreement and are not subject to, and cannot compel, arbitration. In *Horanburg v. Felter*, the New Mexico Court of Appeals reversed the district court’s decision to allow a co-worker who was a non-signatory to an employment agreement to compel arbitration against a signatory employee stemming from an incident involving assault.³⁰ The court noted that the co-worker’s claims were not derived from the arbitration clause and that nothing in the agreement compelled a non-signatory employee to arbitrate tort claims against a signatory to the agreement.³¹ Similarly, in *Monette v. Tinsley*, the court held that the trial court properly concluded that because a guarantor of a promissory note was not a signatory to the underlying loan contract, he was not subject to arbitration.³²

27. RULLCA § 111(a) (2006). The way in which a company would normally manifest assent to the operating agreement is to designate someone to sign on behalf of the LLC, but the Uniform Act provides that members are bound by the operating agreement regardless of whether a member signs on behalf of the company. *Id.*

28. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

29. *See, e.g.,* *Thompson v. THI of N.M. at Casa Arena*, No. CIV 05-1331 JB/LCS, 2008 WL 5999653, at *14 (D.N.M. Dec. 24, 2008) (“A non-signatory [corporation] to an arbitration agreement generally cannot be forced to arbitrate claims.”).

30. *Horanburg v. Felter*, 2004-NMCA-121, ¶ 16, 99 P.3d 685, 689. In *Horanburg*, an employee of Lovelace Health Systems was suing the hospital and a doctor employed by the hospital for retaliation, negligent hire and retention, constructive discharge, intentional infliction of emotional distress, assault, battery, and violation of the Human Rights Act. *Id.* at 2, 99 P.3d at 686. The employee had previously signed an agreement to arbitrate claims with Lovelace. *Id.* The doctor was not a signatory to that agreement. *Id.* at 15-16, 99 P.3d at 689.

31. *Id.* at 16, 99 P.3d at 689.

32. *Monette v. Tinsley*, 1999-NMCA-040, ¶ 9, 975 P.2d 361, 363. While the plaintiff there witnessed the underlying contract and guaranteed the loan which accompanied the contract, he did not actually sign the contract. *Id.* The contract contained an arbitration clause. *Id.* at 4, 975 P.2d at 363.

5. Distributions of Profits and Allocation of Losses

Another key difference between the Revised Uniform Act and the New Mexico Act is the default rule relating to the sharing of profits and losses. The Revised Uniform Act does not provide for a default rule governing the distributions of profits and the sharing of losses.³³ Although much of the Revised Uniform Act is based on the Revised Uniform Partnership Act, which provides a default rule for sharing profits and losses equally based on the number of partners,³⁴ the drafters of the Revised Uniform Act intentionally did not include such a provision.³⁵ Conversely, the New Mexico Act includes a default provision governing the sharing of profits and losses.³⁶ Under the New Mexico Act, profits and losses are shared in proportion to each member's relative capital account, or their economic interest at any specific time.³⁷

B. Fiduciary Duties & Small Businesses: the New Mexico Legislature's Attempt to Limit Them Versus the Tendency of New Mexico Courts to Expand Them

Though many differences between the New Mexico Act and the Revised Uniform Act make the Revised Uniform Act more suitable for New Mexico businesses, perhaps the most significant difference between them is the way each deals with fiduciary duties owed by managers and managing members. While the Revised Uniform Act enumerates the specific fiduciary duties owed by managing members and provides for a mechanism to limit them, the New Mexico Act provides a vague and limited description of the duties owed by managing members.³⁸ This is significant

33. RULLCA §§ 101 to 1106 (2006).

34. Revised Unif. P'ship Act § 401(b) (1997) [hereinafter RUPA].

35. RULLCA § 404, comment (2006). In a comment following the section governing the sharing of distributions before dissolution, the drafters noted that "[n]early all limited partnerships will choose to allocate profits and losses in order to comply with applicable tax, accounting and other regulatory requirements. Those requirements, rather than this Act, are the proper source of guidance for that profit and loss allocation." *Id.*

36. NMSA 1978, § 53-19-22 (2004). The New Mexico Act provides that:

The profits and losses of a limited liability company shall be allocated among the members in the manner provided in the articles of organization or an operating agreement. If neither the articles of organization nor an operating agreement provide for allocation, such profits and losses shall be allocated among the members in proportion to the value of their respective contributions to capital, adjusted to reflect all withdrawals from capital.

Id.

37. *Id.*

38. Compare NMSA 1978, § 53-19-16(D) (2004) with RULLCA § 409(a)-(d) (2006).

because, although the language of the New Mexico Act limits the fiduciary duties owed by managing members,³⁹ New Mexico courts have been more than willing to impose duties similar to those enumerated in the Revised Uniform Act on managers of LLCs and other small business entities.⁴⁰

Under the New Mexico Act, non-managing members of an LLC are not liable for duty of care breaches, and it is unclear whether any fiduciary duties are owed based on the statute.⁴¹ In addition, managing members are not liable for duty of care breaches in the absence of gross negligence or willful misconduct.⁴² Although the New Mexico Act does not specifically mention the duty of loyalty, it does impose liability for transactions and conduct that would traditionally fall into that category. Managing members are required to account for profits or benefits derived from transactions connected with the LLC, use of company property, or use of confidential information.⁴³ Beyond that, however, the New Mexico Act does not contain a prohibition on self-dealing or conflict of interest transactions or a requirement that members execute their duties according to the duty of good faith and fair dealing. If a managing member fails to comply with his or her duties but the offending transaction is approved by a majority of disinterested managers or members or is fair to LLC, the statutory safe-harbor provision will nonetheless protect them from liability.⁴⁴ The New Mexico Act does not specifically provide for a mechanism to limit or eliminate the fiduciary duties owed by managing members, and it is unlikely the courts would honor such an agreement.⁴⁵

Unlike the New Mexico Act, the Revised Uniform Act provides an enumerated list defining the standards of conduct for members and managers of an LLC.⁴⁶ In order to fulfill their duty of loyalty, managing mem-

39. NMSA 1978, § 53-19-16(D) (2004). The New Mexico Act only references the managing members' responsibility to account for any profit or benefit he derives from "any transaction connected with the conduct or winding up of the" LLC or any use of company property. *Id.* The statute contains no language referencing the duty of loyalty, care, or good faith and fair dealing. *Id.*

40. *See, e.g.,* *Mayeux v. Winder*, 2006-NMCA-028, 131 P.3d 85.

41. NMSA 1978, § 53-19-16(A) (2004).

42. *Id.* at § 53-19-16(B).

43. *Id.* at § 53-19-16(D).

44. *Id.*

45. *See McMinn v. MBF Operating Acquisition Corp.*, 2007-NMSC-040, ¶ 17, 164 P.3d 41, 46. (The court noted that "common law fiduciary duties that exist outside of New Mexico's corporations statutes . . . are essential to maintaining the integrity of business relationships in New Mexico," and as such, any construction of a New Mexico statute that would eliminate claims relating to these duties "must be approached with caution.").

46. RULLCA § 409 (2006).

bers are required to account for profits, to refrain from dealing with the LLC on behalf of a person with an adverse interest, and to refrain from competing with the LLC.⁴⁷ In addition, they are required to exercise their duty of care by acting with the care that a similarly circumstanced person would reasonably believe to be in the best interests of the company.⁴⁸ Finally, managing members are also required to exercise good faith and fair dealing in discharging their duties.⁴⁹ Like the New Mexico Act, the Revised Uniform Act contains a safe-harbor provision that shelters otherwise violative transactions if the transaction is fair to the LLC.⁵⁰ In addition to providing the safe-harbor provisions, the Revised Uniform Act allows the operating agreement to eliminate specific duties including: to account, to refrain from dealing with the company as an adverse party, to refrain from competing (provided that it is not “manifestly unreasonable” to do so⁵¹), and to authorize specific acts or transactions that would otherwise violate the duty of loyalty.⁵²

Despite the attempt by the drafters of the New Mexico Act to limit the fiduciary duties imposed on managing members of an LLC, New Mexico courts have nonetheless embraced those duties enumerated in the Revised Uniform Act in the context of LLCs. In *Mayeux v. Winder*, the New Mexico Court of Appeals set forth the standard necessary to succeed in a breach of fiduciary duty claim between members of an LLC.⁵³ The plaintiffs there were shareholders in a land development LLC who alleged that the managing member used company funds to pay for his other development projects and personal expenses.⁵⁴ The Court affirmed the trial court’s determination that the defendant did not breach his fiduciary duties to the LLC because he did not engage in self-dealing or fraud and because he executed his duties with good faith and in a manner that was not adverse to the best interests of the company.⁵⁵ In articulating the applicable legal standard, the court made it clear that self-dealing and conflict of interest transactions could amount to a breach of fiduciary duty⁵⁶ despite the fact that the New Mexico Act, which includes a section

47. *Id.* at § 409(b).

48. *Id.* at § 409(c).

49. *Id.* at § 409(d).

50. *Id.* at § 409(e).

51. *Id.* at § 110(d).

52. *Id.* at § 409(f).

53. 2006-NMCA-028, 131 P.3d 85.

54. *Id.* at 4-5, 131 P.3d at 88.

55. *Id.* at 8, 131 P.3d at 89.

56. *Id.* at 20-21, 131 P.3d at 91.

governing the liability of managing members, does not impose liability for these types of activities.⁵⁷

New Mexico courts have also embraced the types of fiduciary duties featured in the Revised Uniform Act in the context of other small business entities. For example, courts have placed a particularly high standard on the conduct of fiduciaries within a closely held corporation. In *McMinn v. MBF Operating Acquisition Corp. (McMinn II)*, the New Mexico Supreme Court found that the majority shareholders had breached their fiduciary duties when they initiated a merger aimed at eliminating the interest of a minority shareholder.⁵⁸ The majority shareholders set up a corporation and merged it with the original company in order to exclude the minority from participation and ownership.⁵⁹ The Court determined that the merger constituted a conflict of interest transaction and that such transactions “are traditionally held up to careful scrutiny under fiduciary duty principles implicating the duty of loyalty.”⁶⁰

New Mexico courts have imposed stringent fiduciary duties on members of a partnership as well. In *C.B. & T. Co. v. Hefner*, the New Mexico Court of Appeals spelled out the fiduciary obligations of partners. There, the defendant breached his fiduciary duty by failing to disclose his knowledge of valuable partnership assets while negotiating a contract for the sale of land.⁶¹ The court determined that because of their confidential relationship, partners are required to deal with each other openly, fairly, and honestly.⁶² Partners also have a duty of full disclosure. This means that prior to entering into a transaction, partners are required to have “exercised the highest good faith and fairness.”⁶³ In addition, the transaction must be “entered into with a full knowledge of all material facts by” all of the members of the partnership.⁶⁴ Finally, partners have a

57. See NMSA 1978, § 53-19-16(D) (2004). In fact, the *Mayeux* court did not rely on the New Mexico LLC Act in articulating the legal standard for imposing liability on managing members and failed to cite it in the case. *Mayeux*, 2006-NMCA-028, 131 P.3d 85.

58. *McMinn v. MBF Operating Acquisition Corp. (McMinn II)*, 2007-NMSC-040, ¶¶ 8-10, 164 P.3d 41, 44.

59. *Id.* at 1, 164 P.3d at 42.

60. *Id.* at 21, 164 P.3d at 46-47. See also *Peters Corp. v. N.M. Banquest Investors Corp.*, 2008-NMSC-039, 188 P.3d 1185, for a full explanation of the breach of fiduciary duty standard set forth in *Mayeux*. *Peters Corp.* notes that a breach of fiduciary duty occurs when a shareholder participates in some form of self-dealing, meaning that the “fiduciary conducted a transaction with himself” for his own benefit. *Id.* at 27, 188 P.3d at 1193.

61. *C.B. & T. Co. v. Hefner*, 98 N.M. 594, 651 P.2d 1029 (Ct. App. 1982).

62. *Id.* at 601, 651 P.2d at 1036.

63. *Id.* at 600, 651 P.2d at 1035.

64. *Id.*

duty to refrain from giving false or incomplete answers when other members of the partnership request information from them.⁶⁵

Courts have also demonstrated a willingness to impose common law fiduciary duties in addition to statutory duties set forth in laws governing corporate entities. For example, in *Walta v. Gallegos Law Firm, P.C.*, the New Mexico Court of Appeals allowed a minority shareholder in a law firm to assert an individual claim based on a breach of common law fiduciary duty separate from the remedies available under statutory corporate law.⁶⁶ In allowing a breach of fiduciary claim to proceed under common law rather than statutory principles, *GCM, Inc. v. Kentucky Century Life Insurance Co.*, also noted that “the controlling statute does not appear to preclude . . . an obligation if it arises under common law principles.”⁶⁷ Essentially, rather than looking to corporate statutes to determine whether a fiduciary duty exists between parties in a particular context, New Mexico courts will look at whether the relationship between the parties is one of “trust and confidence.”⁶⁸

C. The Obligations and Duties of Small Business Members in Jurisdictions That Have Adopted the Revised Uniform Act

Four states, including Idaho, Iowa, Nebraska, and Wyoming, have adopted a version of the Revised Uniform Act to date.⁶⁹ In each of these states, courts have imposed fiduciary duties on members of limited liabil-

65. *Id.* at 601, 651 P.2d at 1036.

66. *Walta v. Gallegos Law Firm, P.C.*, 2002-NMCA-015, ¶ 38, 40 P.3d 449, 457. In allowing the common law claim to proceed, the court there noted that “[w]e recognize that the legislature has now imposed a statutory fiduciary standard on partnerships,” but “we do not believe the statutory standard affects the common law principles which we cite.” *Id.* at 38, 40 P.3d at 457. *Walta* also noted that the classic common law fiduciary duties articulated in *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928), applied to partnerships in New Mexico. *Meinhard* held that the standard of duty partners owe to one another is the utmost good faith and loyalty, and that “[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” *Id.* at 551.

67. *GCM, Inc. v. Kentucky Cent. Life Ins. Co.*, 1997-NMSC-052, ¶ 20, 947 P.2d 143, 149.

68. *Moody v. Stribling*, 1999-NMCA-094, ¶ 18, 985 P.2d 1210, 1216 (internal quotation marks and citation omitted) (noting that “a fiduciary relationship exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of one reposing the confidence”).

69. National Conference of Commissioners on Uniform State Laws, Revised Uniform Limited Liability Company Act Legislative Fact Sheet, available at [http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20\(Revised\)](http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised)).

ity companies and other small business entities both prior to and after the adoption of the Revised Uniform Act that are similar to those duties embraced by New Mexico Courts.

In Idaho, members of an LLC currently owe one another fiduciary duties of loyalty and care.⁷⁰ Although Idaho codified those duties in 2008 when it adopted its version of the Revised Uniform Act,⁷¹ like New Mexico, Idaho courts imposed stringent fiduciary duties on members of small business entities even prior to its adoption.⁷² Idaho courts have also been willing to impose a fiduciary duty any time a relationship of trust and confidence existed due to some sort of special circumstances such as the formation of a contract.⁷³ Fiduciary obligations, therefore, could arise when the parties are “members of the same family, partners, attorney and client, executor and beneficiary of an estate, principal and agent, insurer and insured, or close friends.”⁷⁴

Nebraska is another state that recently adopted a version of the Revised Uniform Act. Like New Mexico, Nebraska courts consistently have embraced fiduciary duties in the context of small business entities despite the fact that Nebraska’s former LLC Act did not impose any fiduciary duties on managers or members of a limited liability company.⁷⁵ Members of Nebraska limited partnerships, for example, had fiduciary duties in-

70. *Bushi v. Sage Health Care, PLLC*, 203 P.3d 694, 699 (Idaho 2009).

71. IDAHO CODE ANN. § 30-6-101 (2008).

72. Although *Bushi* adjudicated a matter that arose prior to the adoption of the Uniform Act, the case nonetheless held that members of an LLC owed one another common law fiduciary duties prior to its adoption. *Bushi*, 203 P.3d at 699. *Bushi* also cited *McConnell v. Hunt Sports Ent.*, 725 N.E.2d 1193 (Ohio App. 1999), which noted that a limited liability company, like a partnership, involves fiduciary duties and *Purcell v. Southern Hills Investments, LLC*, 847 N.E.2d 991 (Ind. App. 2006), which held that common law fiduciary duties similar to those imposed on partnerships and closely held corporations are applicable to LLCs, to support its assertion that members of an LLC owe one another common law fiduciary duties including trust and loyalty.

73. *Wade Baker & Sons Farms v. Corp. of the Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints*, 42 P.3d 715, 721 (Idaho Ct. App. 2002) (citing *Mitchell v. Barendregt*, 820 P.2d 707, 714 (Idaho App. 1991), *overruled on other grounds*).

74. *Id.*

75. In *Poppert v. Dicke*, 747 N.W.2d 629, 632 (Neb. 2008), the court dismissed an appeal from a trial court finding that under Nebraska’s Limited Liability Company Act, NEB. REV. STAT. § 21-2601 to 21-2654 (1997), there were no fiduciary duties imposed upon managers and members of an LLC. Although the court dismissed the appeal on jurisdictional grounds, the text of the former Nebraska LLC Act does not support the trial court’s finding that the statute does not impose fiduciary duties on managing members of an LLC. *See* NEB. REV. STAT. § 21-2601 to 21-2654 (1997).

cluding the duty of loyalty and the duty of care.⁷⁶ Specifically, limited partners were required to refrain from dealing with the partnership as an adversary, to refrain from competing, to account for profits, and to refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or from committing a violation of the law.⁷⁷ Nebraska has also recognized that fiduciary duties exist in the context of closely held corporations including the duty to exercise reasonable care and to refrain from usurping opportunities from the company for personal gain.⁷⁸

Courts in Iowa and Wyoming also subjected fiduciaries in small business entities to stringent standards of conduct prior to adopting the Revised Uniform Act. Iowa courts imposed duties derived from the duty of loyalty and the duty of care on fiduciaries in small business entities such as limited partnerships and LLCs.⁷⁹ Similarly, Wyoming courts have imposed a duty of good faith and fair dealing,⁸⁰ as well a duty to refrain from competing with the business on managing members of an LLC.⁸¹

III. ANALYSIS

The New Mexico Act lacks clear guidelines as to what is expected of each member of an LLC. As a result, members attempting to run their business or litigate claims are left to sort out the seemingly contradictory expectations between the LLC statute and the New Mexico caselaw. The analysis portion of this comment sets forth a number of reasons why the adoption of the Revised Uniform Act will benefit small business owners in the state and provide a solution to the problems created by the New Mexico Act.

76. *McGinley-Schilz Co. v. Wunschel*, No. A-07-1324, 2008 WL 5195982, at *6 (Neb. Ct. App. 2008).

77. *Id.*

78. *Trieweiler v. Sears*, 689 N.W.2d 807, 821, 994 (Neb. 2004).

79. *See, e.g., Whalen v. Connelly*, 593 N.W.2d 147, 151 (Iowa 1999) (noting that the duty of loyalty claim asserted by a former member of a limited partnership included the duty to refrain from diverting company assets for personal use and from usurping a corporate opportunity); *Bottoms v. Stapleton*, 706 N.W.2d 411, 415 (Iowa 2005) (allowing an LLC member to sue a former member for breach of fiduciary duty alleging that he converted company assets for his own use); *Lange v. Lange*, 520 N.W.2d 113, 120 (Iowa 1994) (holding that members of a closely held corporation owe a duty of loyalty to one another that includes refraining from usurping a corporate opportunity for one's own benefit).

80. *See Lieberman v. Mossbrook*, 208 P.3d 1296, 1311-12 (Wyo. 2009).

81. *See Belden v. Thorkildsen*, 156 P.3d 320, 323 (Wyo. 2007).

A. The Default Provisions of the Revised Uniform Act Favor Small Businesses

The default provisions provided in the Revised Uniform Act protect small businesses by imposing fiduciary obligations on members and setting forth clear guidelines for management while allowing more sophisticated business owners to define the contours of the company's governing documents. Under both the New Mexico Act and the Revised Uniform Act, the default provisions provided in the statute can be modified by the operating agreement.⁸² In weighing the importance of a statute's default provisions when determining whether to adopt it, the legislature should consider the demographics of the state including the nature and size of each business. The author's opinion is that factors such as the average number of members and employees in each company, the sophistication of local businesses owners, the percentage of family owned businesses in the state, the percentage of businesses organized with the help of attorneys, and the frequency with which founding members customize their operating agreements should all be used to inform legislatures of the relative importance of the default provisions contained in a statute governing corporation formation.

Based on the types of businesses that are commonly organized in New Mexico and the fact that the overwhelming majority of the businesses in the state are small businesses,⁸³ New Mexico needs a comprehensive corporate statute like the Revised Uniform Act. This is especially true in light of the fact that it is unclear whether a single-member LLC can deviate from the provisions of a state's LLC act by drafting a contrary operating agreement.⁸⁴ Since the New Mexico Act is silent regarding issues like who is bound by the operating agreement and fiduciary duties

82. RULLCA § 110, comment (2006); Larry E. Ribstein & Robert R. Keatinge, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:16 (2d ed. 2011) (“[T]he ‘operating agreement’ or equivalent document has the effect of varying the statutory default provisions.”).

83. U.S. Dept. of Commerce: Bureau of the Census, New Mexico Quickfacts (updated Nov. 4, 2010), http://www.sba.gov/sites/default/files/files/State%20Economic%20Profiles%202009_New%20Mexico.pdf (last visited Sept. 2, 2011); *New Mexico Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09nm.pdf> (last visited Sept. 2, 2011). Of the 155,623 firms in New Mexico, 117,752 of them are managed by 1 or more owners with no employees. New Mexico Small Business Profile. Among New Mexico businesses that do have employees, 36,430 of them are classified as small businesses while only 1,441 are classified as large businesses, meaning they employ over 500 people. *Id.*

84. Larry E. Ribstein & Robert R. Keatinge, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:16 (2d ed. 2011).

including the duty of care and the duty of loyalty,⁸⁵ business owners who incorporate without the help of an attorney are at a disadvantage. The current lack of statutory guidelines requires companies in New Mexico to either draft detailed operating agreements in anticipation of the scenarios that are not contemplated by the New Mexico Act or seek resolution from the courts after a problem arises. This places a strain on small business owners with limited resources.

B. The “Freedom of Contract” Approach Adopted from the Delaware LLC Act Conflicts with the Nature of New Mexico Businesses

Further evidence that the current statute is inconsistent with character and size of New Mexico businesses can be found in a comparison of the New Mexico Act and the Delaware LLC Act. New Mexico and Delaware differ greatly in terms of the types of businesses that incorporate in each state as well as the sophistication of the business owners.⁸⁶ Despite this fact, however, the New Mexico Act has adopted the “freedom of contract” approach featured in the Delaware Act; the doctrine emphasizes the importance of customizing the LLC operating agreement rather than relying on statutory default provisions.⁸⁷

Under the Delaware Act, “LLC members’ rights begin with and typically end with the [o]perating [a]greement;” the type of fiduciary duty claims that can be asserted, the affairs of the company, and the members’ rights and obligations to one another must all be contracted for upon

85. NMSA 1978, § 53-19-16(A) (2004).

86. See STATE OF DELAWARE, DEPARTMENT OF STATE: DIVISION OF CORPORATIONS, *About Agency* (updated Jan. 19, 2011), <http://corp.delaware.gov/aboutagency.shtml> (last visited Sept. 9, 2011). “Delaware is a leading domicile for U.S. and international corporations,” and “[m]ore than 50% of all publicly-traded companies in the United States, including 63% of the Fortune 500, have chosen Delaware as their legal home.” *Id.* In New Mexico, on the other hand, the overwhelming majority of businesses are small partnerships employing very few, if any, employees. *New Mexico Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09nm.pdf> (last visited Sept. 2, 2011). In 2010, there were no Fortune 500 companies incorporated in the state of New Mexico. CNN Money, *Fortune 500: Our Annual Ranking of America’s Largest Corporations*, <http://money.cnn.com/magazines/fortune/fortune500/2010/states/NM.html> (last visited Sept. 9, 2011).

87. 6 DEL. CODE ANN. §18-1101(b) (2010). The policy of the Delaware Legislature as indicated in the statute is “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” *Id.* The New Mexico Act contains similar language indicating a policy favoring freedom of contract. NMSA 1978, § 53-19-65 (2004).

incorporation.⁸⁸ In recognizing the LLC as an option for corporation formation, Delaware envisioned that the LLC would be more similar to a corporation (C-Corp) rather than an informal business entity like a partnership.⁸⁹ In addition, the Delaware statute opted to treat the LLC as “a creature of contract,” meaning that the contours of the operating agreement were meant to be tailored according to the members’ preferences to govern the voting structure, management rights, and economic arrangements of the company.⁹⁰

The freedom of contract approach featured in the New Mexico Act and the Delaware LLC Act does not adequately serve the needs of small businesses in New Mexico. The so-called contractarian policy⁹¹ presumes that companies will be incorporated with the help of attorneys and that detailed LLC agreements will be drafted to set forth the obligations and procedures not defined by the statute.⁹² The policy’s utility, therefore depends on the care and attention the drafter puts into the LLC operating agreement.⁹³ Although the freedom of contract approach endorsed by the Delaware and New Mexico statutes envisions the adoption of detailed operating agreements drafted with the guidance of an attorney,⁹⁴ courts are often charged with the task of interpreting agreements that are drafted by members with no legal experience.⁹⁵ The approach disadvantages small business owners who incorporate without the help of an attorney.

88. Walker v. Resource Dev. Co. Ltd., 791 A.2d 799, 813 (Del. Ch. 2000); Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, at * 1, § 14.02 The Delaware Limited Liability Company Act (2009).

89. Poore v. Fox Hollow Enters., No. 93A-09-005, 1994 WL 150872, at *2 (Del. Super. Ct. 1994).

90. *Id.*

91. Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, at * 1, § 14.02 The Delaware Limited Liability Company Act (2009).

92. See Willie Gary LLC v. James & Jackson LLC, No. Civ.A. 1781, 2006 WL 75309, at *2, (Del.Ch. 2006). The court in *Willie Gary* warns that “[w]ith the contractual freedom granted by the LLC Act comes the duty to [draft the agreement] with precision.” *Id.*

93. Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, at * 1, § 14.02 The Delaware Limited Liability Company Act (2009).

94. See *Willie Gary*, No. Civ.A. 1781, 2006 WL 75309, at *2.

95. See, e.g., *Pharmalytica Services, LLC v. Agno Pharmaceuticals, LLC*, No. 3343-VCN, 2008 WL 2721742, at *1 (Del.Ch. 2008). The court in *Pharmalytica* struggled to discern the proper text of the LLC operating agreement which was “drafted without the guidance of a lawyer.” *Id.*

ney because, as one observer points out, any “informality will serve mainly to enrich the litigating attorneys”⁹⁶ after a problem arises.

The Revised Uniform Act expressly rejects the freedom of contract approach⁹⁷ embraced by the Delaware and New Mexico statutes. The drafters did so in order “to balance the virtues of ‘freedom of contract’ against the dangers that inescapably exist when some have power over the interests of others.”⁹⁸ The Revised Uniform Act clearly spells out the duties and obligations of members of an LLC, and this approach is more appropriate for New Mexico because it provides small business owners who incorporate without the help of an attorney with statutory gap-fillers that protect them from “judicial second-guessing” when a problem arises.⁹⁹ Moreover, because the Revised Uniform Act allows members to use the operating agreement as a device to alter the statutory default provisions,¹⁰⁰ its adoption would satisfy proponents of the freedom of contract approach while simultaneously protecting small businesses owners, many of whom are likely to incorporate without the help of an attorney.¹⁰¹

C. *The Duty of Care*

Despite the importance of imposing fiduciary obligations on members of small businesses, the New Mexico Act limits the fiduciary duties imposed on members and managers of limited liability companies.¹⁰² More specifically, the New Mexico Act does not impose the duty of care on managing members of the company.¹⁰³ The Revised Uniform Act, on the other hand, explicitly imposes a duty of care on managing members.¹⁰⁴

The duty of care is an important part of any statute addressing corporate governance. It typically requires managing members “to act with

96. Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law*, at * 11, § 5.06 Operating Agreements (2009).

97. RULLCA § 110(d) (2006).

98. *Id.* at § 110(d), comment.

99. *Id.* at prefatory note. See also William P. Lynch, *Problems With Court-Annexed Mandatory Arbitration: Illustrations from the New Mexico Experience*, 32 N.M. L. REV. 181, 194 (2002). The author points out that “the right of access to the courts in New Mexico is limited.” *Id.*

100. RULLCA, at prefatory note.

101. See, e.g., Juliet L. Kaz, *Legal Document Services: Dangerous Alternatives to Attorneys?*, 2 J. LEGAL ADVOC. & PRAC. 122, 131 (2000). The author recommends that small business owners incorporate using a document preparation service rather than consulting an attorney. *Id.*

102. NMSA 1978, § 53-19-16 (2004).

103. *Id.*

104. RULLCA at § 409(c).

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.”¹⁰⁵ The duty of care exists to protect shareholders, members, or other business investors from reckless, egregious, or grossly incompetent behavior by the managing members of the company.¹⁰⁶ Because the duty exists to protect business members from outlandish conduct, it is extremely difficult to prove that a managing member breached the duty of care.¹⁰⁷ In determining whether an officer or managing member breached his or her duty of care, courts will typically apply a standard of gross negligence.¹⁰⁸ Under the gross negligence standard, directors of the company will incur liability if they have “acted with ‘reckless indifference to or a deliberate disregard of the whole body of stockholders or [taken] actions which are without the bounds of reason.’”¹⁰⁹

The business judgment rule can also be used to protect managing members and corporate directors from incurring liability for a breach of the duty of care.¹¹⁰ The business judgment rule provides:

If in the course of management, directors arrive at a decision, within the corporation’s powers (*inter vires*) and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment

105. *Id.*

106. *See, e.g.*, CAL. CORP. CODE § 204(a)(10)(A)(iv) - (v) (West 1987). The California statute explains that the duty of care cannot be disposed of in the operating agreement because it is intended to protect shareholders from “acts or omissions that show a reckless disregard for the director’s duty to the corporation or its shareholders in circumstances in which the director was aware, or should have been aware . . . of a risk of serious injury to the corporation or its shareholders.” *Id.* The duty of care also protects business members from “an unexcused pattern of inattention that amounts to an abdication of the director’s duty to the corporation or its shareholders.” *Id.*

107. Bernard Black et al., *Legal Liability of Directors and Company Officials Part I: Substantive Grounds for Liability (Report to the Russian Securities Agency)*, 2007 COLUM. BUS. L. REV. 614, 761 (2007).

108. *See, e.g.*, *In re Bank of America Corp. Securities*, 757 F.Supp.2d 260, 338 (S.D.N.Y. 2010); *In re TEU Holdings, Inc.*, 287 B.R. 26, 32 (D.Del. 2002); *Wahlcome-troflex, Inc. v. Baldwin*, 991 A.2d 44, 48 (Me. 2010).

109. *In re Bank of America Corp. Securities*, 757 F.Supp.2d at 338 (quoting *Tomczak v. Morton Thiokol, Inc.*, No. 7861, 1990 WL 42607, at *12 (Del.Ch. 1990)).

110. *See, e.g.*, *McMinn v. MBF Operating Acquisition Corp. (McMinn II)*, 2007-NMSC-040, ¶¶ 8-10, 164 P.3d 41, 44.

for that of the directors to enjoin or set aside the transaction or to surcharge the directors for any resulting loss.¹¹¹

Because courts will not second-guess a decision made by managing members who have exercised at least a minimum level of care,¹¹² the imposition of the duty of care offers significant protection to both members and managers of a company while providing a recourse for the most egregious types of behavior.

The current New Mexico LLC statute is inadequate because it does not impose the duty of care on managing members of the company.¹¹³ Since the LLC is quickly becoming the primary entity used to incorporate small businesses,¹¹⁴ it is incumbent upon the New Mexico Legislature to modify or replace the current statute and impose the duty of care on managing members of the LLC. As further proof of this, a number of states have recognized the need for increased fiduciary obligations in the context of small, closely held business entities.¹¹⁵ Minnesota and North Dakota, for example, have enacted statutes imposing special fiduciary duties on closely held LLCs.¹¹⁶ Minnesota, which has similar demographics to New Mexico in terms of the percentage of small businesses in each state,¹¹⁷ imposes a broad interpretation of the duty of care on *all* members of the company.¹¹⁸ Members of closely held limited liability companies are required to “act in an honest, fair, and reasonable manner in the operation of the . . . company.”¹¹⁹ North Dakota has adopted a statute with similar language.¹²⁰ The drafters of the Revised Uniform Act have also

111. *White on Behalf of Banes Co. Derivative Action v. Banes Co.*, 116 N.M. 611, 614, 866 P.2d 339, 343 (1993) (quoting *DiIaconi v. New Cal Corp.*, 97 N.M. 782, 788, 643 P.2d 1234, 1240 (Ct. App. 1982).

112. Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: the Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 344 (2005).

113. *See* NMSA 1978, § 53-19-16 (2004).

114. Friedman, *supra* note 4, at 67.

115. *See, eg.*, MINN. STAT. § 322B.833 (1999); N.D. Cent. Code §10-32-119(4) (2003).

116. *Id.*

117. Small firms account for 96 percent of New Mexico’s employers. *New Mexico Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09nm.pdf> (last visited Sept. 2, 2011). Similarly, in Minnesota, small firms account for 98 percent of the state’s employers. *Minnesota Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09mn.pdf> (last visited Sept. 10, 2011).

118. MINN. STAT. § 322B.833.

119. *Id.*

120. N.D. Cent. Code §10-32-119(4).

recognized the closely held nature of limited liability companies¹²¹ because New Mexico is home to primarily small, closely held business entities,¹²² New Mexico should adopt the act.

Further evidence that the absence of the duty of care from the New Mexico Act is an anomaly can be found by examining the New Mexico statute governing corporations. Unlike the New Mexico Act, the New Mexico Business Corporation Act imposes the duty of care on managing directors of a corporation.¹²³ The statute requires a director of a corporation to “serve, in good faith, in a manner the director believes to be in or not opposed to the best interests of the corporation, and with such care as an ordinarily prudent person would use under similar circumstances in a like position.”¹²⁴ Not only does the New Mexico Business Corporation Act embrace the duty of care, but it also prevents directors from contractually eliminating liability if the conduct constitutes “negligence, willful misconduct or recklessness.”¹²⁵ The inclusion of the duty of care in the statute governing C-Corps and its exclusion from the statute governing LLCs means that sophisticated corporate actors are currently provided greater protections in the form of fiduciary obligations than small business owners.¹²⁶ By adopting the Revised Uniform Act, the New Mexico Legislature would afford LLC managers the same protection from gross negligence and duty of care violations that corporate directors currently enjoy.¹²⁷

D. *The Duty of Loyalty*

The duty of loyalty is perhaps the most important fiduciary obligation in the context of closely held business entities. The duty of loyalty requires managing members of a company to account for any profits de-

121. RULLCA § 903, comment (2006). In determining how derivative actions should proceed, the drafters of the Uniform Act explained that they arrived at their decision after considering the fact that most LLCs are closely held business entities. *Id.*

122. *See New Mexico Small Business Profile*, U.S. SMALL BUSINESS ADMINISTRATION (Oct. 2009), <http://archive.sba.gov/advo/research/profiles/09nm.pdf> (last visited Sept. 2, 2011).

123. NMSA 1978, § 53-11-35(B) (1987).

124. *Id.*

125. *Id.* at § 53-12-2(E)(2)(a).

126. Christopher Kerns, *Current Developments in Directors' and Officers' Liability Insurance: Duty to Defend, Allocation of Loss, and Advancement of Expenses*, 454 *PLI/Comm* 597, 605 (1988). “Most corporations and directors and officers are sophisticated business people with the ability and interest in maintaining a strong and successful defense from claims brought against them.” *Id.*

127. RULLCA § 409(c) (2006).

rived from the company, to refrain from dealing with the company as an adverse party, and to refrain from competing with the company.¹²⁸ While the New Mexico Act imposes a limited version of the duty of loyalty,¹²⁹ it does not impose the traditional obligations imposed on members of a corporation or closely held business entity. The Revised Uniform Act, on the other hand, imposes the traditional fiduciary obligations associated with the duty of loyalty on managing members.¹³⁰

One aspect of the duty of loyalty is the avoidance of conflict of interest transactions.¹³¹ Conflict of interest transactions occur where the private interests of the officer or director of a company are in direct conflict with the best interests of the company.¹³² A classic example of a conflict of interest transaction arises where a managing member of a company purchases materials from or extends credit to a company in which they have a financial interest.¹³³ Another aspect of the duty of loyalty is the duty to refrain from appropriating an opportunity belonging to the corporation for one's own personal benefit.¹³⁴ An example of this includes taking advantage of profitable investment opportunities that the company could have enjoyed.¹³⁵

The imposition of the duty of loyalty on members of an LLC is vital to the survival and function of small business entities in New Mexico. The types of activities prohibited by the duty of loyalty featured in the Revised Uniform Act¹³⁶ have the potential to put small companies out of business. For example, the duty of loyalty prevents members of a company from stealing trade secrets and confidential information to use in a competing business.¹³⁷ The duty of loyalty also prevents current employees of a company from contacting the company's customers and enacting

128. *Id.* at § 409(b).

129. NMSA 1978, § 53-19-16(D) (2004). Managing members are required to account for profits or benefits derived from transactions connected with the LLC, use of company property, or use of confidential information. *Id.*

130. RULLCA § 409(b) (providing protection for members in the form of the duty of care, loyalty, and good faith).

131. *Matter of Seidman*, 37 F.3d 911, 933 (3d Cir. 1994).

132. *See, e.g., Krim v. ProNet, Inc.*, 744 A.2d 523, 525 (Del. Ch. 1999); *C & Y Corp. v. General Biometrics, Inc.*, 896 P.2d 47, 54 (Utah Ct. App. 1995); *Stathis v. Geldermann, Inc.*, 630 N.E.2d 926, 933 (Ill. App. 1994).

133. *See, e.g., Zakibe v. Ahrens & McCarron, Inc.*, 28 S.W.3d 373 (Mo. App. 2000).

134. 4 C.O.A. 569 *Misappropriation of Corporate Opportunity* § 355 (1984).

135. *In re eBay, Inc. Shareholders Litigation*, No. C.A. 19988-NC, 2004 WL 253521, at *1 (Del. Ch. 2004).

136. RULLCA § 409(b) (2006).

137. *See, e.g., Badrinauth v. MetLife Corp.*, No. 04-cv-2552, 2008 WL 906459, at *5 (D.N.J. 2008).

a plan to establish a competing business while employed.¹³⁸ Business owners can also use the duty of loyalty as an alternative cause of action to claims for breach of contract or misappropriation of trade secrets¹³⁹ when their company suffered an injury at the hands of a former member or employee.

The New Mexico statute should impose the duty of loyalty on the managing members of a limited liability company. By declining to incorporate the fiduciary duty trifecta, the current New Mexico statute puts small businesses at risk. The Revised Uniform Act achieves a balance between protecting small business entities and affording owners the opportunity to define the contours of fiduciary duties using the operating agreement.¹⁴⁰ If not manifestly unreasonable, members may limit the duty of loyalty by identifying specific activities that do not violate it.¹⁴¹ Members may also alter the duty of care, however, the operating agreement may not “authorize intentional misconduct or [a] knowing violation of law.”¹⁴² This compromise featured in the Revised Uniform Act allows sophisticated members to contract for their rights and obligations upfront while protecting less sophisticated business owners by providing statutory defaults.

E. The Duty of Good Faith and Fair Dealing

The duty of good faith and fair dealing is another important duty that is typically imposed on members of a business entity as well as parties to a contract. The duty of good faith and fair dealing is defined broadly, and its meaning can vary depending on the context of its use. In the context of corporations, partnerships, and limited liability companies, this duty requires a managing member to execute his or her duties with honesty and fidelity.¹⁴³ Although there is no agreed upon standard for good faith, it typically requires things like honesty, sincerity, adherence to generally accepted standards of decency in that particular business, adherence to corporate norms, obedience to all applicable laws, and fidelity

138. See, e.g., *Platinum Management, Inc. v. Dahms*, 666 A.2d 1028, 1042-1043 (N.J. Super. Ct. Law Div. 1995).

139. See, e.g., *University Sports Pub. Co. v. Playmakers Media Co.*, 725 F.Supp.2d 378, 385 (S.D.N.Y. 2010). The court in *University Sports* noted that the act of violating a confidentiality agreement might “sustain a breach of contract, breach of fiduciary duty, or theft of trade secrets claim.” *Id.*

140. RULLCA § 110, comment (d) (2006).

141. *Id.* at § 110(d).

142. *Id.* at § 110(d)(3).

143. Restatement (Second) of Contracts § 205 (1981).

to office.¹⁴⁴ While the New Mexico Act is silent with regard to the duty of good faith and fair dealing,¹⁴⁵ the Revised Uniform Act requires managing members to discharge their duties and exercise their rights in a way that is consistent with the obligations of good faith and fair dealing.¹⁴⁶

The inclusion of the duty of good faith and fair dealing in any corporate governance statute is important for a number of reasons. First, the duty provides a theory of liability when a breach based on the duty of care is unavailable. Although managing members of an LLC may sometimes be liable for a breach of the duty of care by mismanaging the company or engaging in reckless behavior,¹⁴⁷ the rule often provides a presumption of proper management that is impossible to overcome.¹⁴⁸ In addition, the duty of good faith and fair dealing allows courts flexibility in fashioning an appropriate remedy when a member asserts claims for breach of contract, corporate mismanagement, or fraud.¹⁴⁹ Though the contours of the duty of good faith and fair dealing haven't been defined, its inclusion in the New Mexico Act would give members broader protection in the event of corporate misconduct. In addition, adopting the Revised Uniform Act, which imposes this duty, would be consistent with the approach already taken by the New Mexico judiciary.¹⁵⁰

F. A Case Study in the Need for Statutory Guidance: The LLC as a Party to the Arbitration Clause

One of the most glaring examples of the need for statutory gap-filler provisions in the New Mexico Act is the absence of a provision governing who is bound by the operating agreement and any arbitration clause contained therein. While the Revised Uniform Act explicitly states that the LLC is bound by the operating agreement,¹⁵¹ the New Mexico Act is silent with respect to this issue.¹⁵² Arbitration provisions have become in-

144. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1, 5 (2006).

145. NMSA 1978, § 53-19-16 (2004).

146. RULLCA § 409(d).

147. *See, e.g.*, NMSA 1978, § 53-19-16(B) (2004).

148. *See White on Behalf of Banes Co. Derivative Action v. Banes Co.*, 116 N.M. 611, 614, 866 P.2d 339, 343 (N.M. 1993).

149. *See, e.g.*, *Mayeux v. Winder*, 2006-NMCA-028, 131 P.3d 85.

150. *Id.* (recognizing the duty of good faith and fair dealing in the context of a limited liability company).

151. RULLCA § 111(a).

152. NMSA 1978, §§ 53-19-1 to 53-19-74 (2004).

creasingly common in all types of employment and business contracts.¹⁵³ As a result, the New Mexico Act leaves courts with the task of examining the language of each LLC arbitration provision to determine whether the parties meant for the company or only the individual members to be bound by it.¹⁵⁴

There is a split in authority with respect to whether the company itself is bound by an arbitration clause signed by the individual members of an LLC.¹⁵⁵ The majority view, articulated in *Elf Atochem North America, Inc. v. Jaffari*, is that an LLC is bound by any arbitration provisions contained in the operating agreement regardless of whether the company itself is a signatory.¹⁵⁶ In *Elf*, a member of a Delaware LLC brought a derivative suit against the company for breach of fiduciary duty.¹⁵⁷ The member, who wished to litigate the claims rather than arbitrate them, asserted that although he signed a dispute resolution clause, he wasn't required to litigate claims against the non-signatory company.¹⁵⁸ In holding against the member and sending the claims to arbitration, the court noted that "it is the members who are the real parties in interest," and that "[t]he LLC is simply their joint business vehicle."¹⁵⁹

The minority view, articulated in *Trover v. 419 OCR, Inc.*, is that the LLC is not bound to arbitrate unless it is a signatory to the arbitration provision or operating agreement.¹⁶⁰ An LLC may become a signatory by having a member sign the operating agreement on behalf of the company. In *Trover*, a member of an Illinois LLC brought a derivative suit against the LLC for breach of contract, breach of fiduciary duty, and corporate waste.¹⁶¹ The LLC filed a motion to compel arbitration and relied on *Elf* to assert that the claims between the members and the non-signatory LLC were subject to arbitration.¹⁶² After considering the case as an issue of first impression, the Appellate Court of Illinois declined to adopt

153. Jeremy Senderowicz, *Consumer Arbitration and Freedom of Contract: A Proposal to Facilitate Consumers' Informed Consent to Arbitration Clauses in Form Contracts*, 32 COLUM. J.L. & SOC. PROBS. 275, 276 (1998-1999).

154. See, e.g., *Thompson v. THI of N.M. at Casa Arena*, No. CIV 05-1331 JB/LCS, 2008 WL 5999653, at *14 (D.N.M. Dec. 24, 2008).

155. Compare *Elf Atochem North Am., Inc. v. Jaffari*, 727 A.2d 286, 293 (Del. Supr. Ct. 1999); *Trover v. 419 OCR, Inc.*, 921 N.E.2d 1249, 1254 (Ill. App. 2010).

156. *Elf Atochem North Am., Inc.*, 727 A.2d at 293.

157. *Id.* at 295.

158. *Id.* at 293.

159. *Id.* at 293.

160. *Trover*, 921 N.E.2d at 1254.

161. *Id.* at 1252.

162. *Id.* at 1254.

Elf.¹⁶³ In rejecting *Elf*'s contention that the entity is merely the vehicle for the members, the court in *Trover* noted that the provision in question required arbitration for controversies "between the parties" and that the LLC could not be a party because it is a separate legal entity under state law.¹⁶⁴

The New Mexico courts have not yet ruled on whether any arbitration provisions contained in the operating agreement bind the LLC. When the situation does arise, however, it will not be as simple as deciding whether to adopt *Elf* versus *Trover*. While the courts in those cases relied on their respective state statutes to arrive at their decisions,¹⁶⁵ New Mexico courts will have to make the decision without any statutory guidance whatsoever. In the meantime, business owners and members will be forced to engage in costly pretrial litigation every time a dispute arises to determine the scope of each individual arbitration clause. If New Mexico adopted the Revised Uniform Act, the arbitrability of member-company disputes would be defined at the outset¹⁶⁶ and both small business owners and courts could be spared precious time and resources.

IV. CONCLUSION

The current New Mexico Act raises serious problems for small business owners. It disadvantages members who incorporate without the help of an attorney, and the absence of statutory gap-fillers leads to time consuming and costly litigation when the relationship between members breaks down. By declining to impose fiduciary duties on the members of an LLC, the statute also exposes small business owners to numerous risks involving former members and employees misappropriating customer lists, trade secrets, and business opportunities.

The adoption of the Revised Uniform Act would solve many of the problems created by the New Mexico Act. The Revised Uniform Act would allow sophisticated business owners to customize their governing contracts while providing safeguards for small business owners who incor-

163. *Id.* at 1254.

164. *Id.* at 1254.

165. The court in *Trover* relied on the Illinois Limited Liability Company Act, 805 ILCS 180/5-1(c) (2006), to conclude that the LLC was not bound. *Id.* at 1254. Similarly, the Delaware statute relied upon by the court in *Elf Atochem North Am., Inc. v. Jaffari*, 727 A.2d 286, 293 (Del. Supr. Ct. 1999) explicitly states that the LLC is bound by the operating agreement. The act provides that an LLC is bound by its operating agreement whether or not the LLC is a signatory to the agreement. DEL. CODE ANN., § 18-101(7) (1999).

166. RULLCA § 111(a) (2006).

porate without the assistance of an attorney. Although it is unlikely that the drafters of the New Mexico Act could have anticipated the rapid growth of the LLC, it is time for the legislature to revisit the issue and enact a comprehensive law that provides guidance to both the judiciary and small businesses operating in the state.

