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## Handling Fiduciary Issues in Limited Liability Company Formations Under the New Hampshire Limited Liability Company Act—A Practical Introduction

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## Handling Fiduciary Issues in Limited Liability Company Formations Under the New Hampshire Limited Liability Company Act—A Practical Introduction

JOHN M. CUNNINGHAM\*

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## I. INTRODUCTION

### A. *The Purpose of This Article*

By promoting careful and loyal management, the fiduciary provisions in the limited liability company (LLC) agreement of a New Hampshire LLC can make an important contribution to the LLC's success.<sup>1</sup> This article will:

- Identify the principal fiduciary issues that are normally relevant in planning and negotiating these agreements;
- Summarize the relevant statutory and common-law rules governing these issues;

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1. Section 1, VII of the New Hampshire Limited Liability Company Act (New Hampshire LLC Act) defines a limited liability company agreement as "a written agreement of the members or a document adopted by the sole member as to the affairs of the limited liability company and the conduct of its business." N.H. REV. STAT. ANN. § 304-C:1(VII) (2005). This article will focus on LLC agreements for multi-member LLCs. These agreements are, in effect, partnership agreements among the members of these LLCs. The agreement's principal functions is to define the legal and tax structure of the LLC and the rights and duties *inter se* among the LLC, its members and its managers. *See generally* JOHN M. CUNNINGHAM & VERNON R. PROCTOR, DRAFTING DELAWARE LLC AGREEMENTS: FORMS AND PRACTICE MANUAL chs. 8, 9, 10, 11 (Ch. 14A forthcoming May 2010) (2009) [hereinafter DRAFTING DELAWARE LLC AGREEMENTS] (explaining the structure and function of LLC agreements).

- State whether these rules are mandatory, default, or permissive rules; and
- Suggest how to address each issue in representing prospective members and managers in negotiating New Hampshire LLC deals.<sup>2</sup>

The starting point in discussing how to negotiate the above fiduciary issues will be the fiduciary provisions of the template form, designated Form 6.2, in *Drafting Limited Liability Company Operating Agreements*,<sup>3</sup> a general (i.e., not state-specific) book on how to plan, negotiate, and draft LLC operating agreements. The provisions in Form 6.2 seek to strike a balance between the interest of LLC members in preventing manager misconduct and the interest of LLC managers (and of the LLC founders and promoters who appoint them) in protecting managers from undue exposure to removal and to personal liability for the conduct of unavoidably risky business enterprises. These Form 6.2 provisions will thus provide a useful basis for addressing these often conflicting interests.

#### B. *The Origin and Scope of LLC Fiduciary Law*

Absent an agreement among the parties to the contrary, business-entity fiduciary duties arise automatically under state common law and applicable statutory law whenever one person entrusts the management of his or her business to another person and the other person agrees to accept this entrustment.<sup>4</sup> The two principal fiduciary du-

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2. The New Hampshire LLC Act provides for two basic management structures—a “member management” structure, under which each member of the LLC is also a manager and has LLC agency authority; and a “manager management” structure, under which only those persons (whether members or non-members) who are specifically appointed as managers in the LLC agreement are managers. N.H. REV. STAT. ANN. § 304-C:26(I)–(II). In this article, the term “manager” will refer both to members of member-managed, multi-member LLCs and to managers of manager-managed, multi-member LLCs.

3. JOHN CUNNINGHAM, *DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS*, at F6.2-1 (1998) [hereinafter Form 6.2].

4. *Bond Purchase, L.L.C. v. Patriot Tax Credit Props., L.P.*, 746 A.2d 842, 864 (Del. Ch. 1999); *DRAFTING DELAWARE LLC AGREEMENTS*, *supra* note 1 (manuscript at 2) (describing entrustment theory as the basis for LLC fiduciary law).

ties are the duty of care and the duty of loyalty.<sup>5</sup> The duty of care requires that business managers carry out their management responsibilities non-negligently.<sup>6</sup> The duty of loyalty requires that business managers avoid conflicts of interest with the entity that they have agreed to manage.<sup>7</sup>

However, the common law of Delaware implies that managers are subject not only to a general duty of loyalty but also to seven separate subsidiary fiduciary duties implicit in that duty.<sup>8</sup> As discussed below, these subsidiary duties probably apply also under the New Hampshire LLC Act.

Moreover, statutory and common law in New Hampshire, Delaware, and other states provide rules governing issues that are not themselves fiduciary, but are highly relevant to the interpretation and enforcement of the core fiduciary duties of care and loyalty.<sup>9</sup> These

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The term “fiduciary” is derived from the Latin word “*fiducia*,” meaning “trust.” MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 465 (11th ed. 2006).

5. *Barnes v. Andrews*, 298 F. 614, 616 (S.D.N.Y. 1924); *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 2).

6. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 14).

7. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 20). *See generally Meinhard*, 164 N.E. at 546. For many decades, Justice Cardozo’s classic decision in *Meinhard* has been the most influential case on the duty of loyalty and other fiduciary issues, and many New Hampshire cases have referenced *Meinhard* when discussing fiduciary duties. *E.g.*, *Waite ex rel. Bretton Woods Acquisition Co. v. Sylvester*, 560 A.2d 619, 622–23 (N.H. 1989); *In re Estate of Crowley*, 529 A.2d 960, 962 (N.H. 1987); *In re Concerned Corporators of Portsmouth Sav. Bank*, 525 A.2d 671, 685–86 (N.H. 1987); *Mussman’s Case*, 364 A.2d 1263, 1265 (N.H. 1976).

8. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 20–21). No Delaware case specifically states that there are seven subsidiary duties implicit in the general duty of loyalty. Additionally, Delaware cases generally refer to these subsidiary duties as “aspects” or “elements” of the general duty of loyalty rather than as free-standing duties. *See, e.g.*, *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006). A review of Delaware case demonstrates, however, that all seven duties are implicit in the general duty of loyalty under Delaware law. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 19–31). Furthermore, it is useful from a practice viewpoint to describe these duties as *subsidiary duties* implicit in this the general duty rather than as aspects of the general duty. *Id.*

9. *Id.* (manuscript at 2).

include rules governing the prosecution of members' claims that managers have breached their fiduciary duties, remedies for these breaches, and manager defenses against claims of fiduciary breach.<sup>10</sup>

*C. The Importance of Fiduciary Provisions in New Hampshire LLC Agreements*

The negotiation of comprehensive fiduciary rules in connection with an LLC formation can be a key element of the formation, since these rules may provide members with powerful means to encourage sound LLC management, to deter manager misconduct, and to remedy this misconduct if it occurs. To the extent they achieve these goals, fiduciary rules can be of great economic value to an LLC.<sup>11</sup>

In addition, the fiduciary rules in an LLC agreement can contribute significantly to the establishment of a relationship of mutual respect, cooperation, and trust among the LLC's members and managers. This relationship may help create a personally satisfying LLC work and investment environment. Indirectly, this purely human benefit of fiduciary rules can also substantially enhance the LLC's economic situation.

Finally, the process of planning with one's clients how to handle fiduciary issues in an LLC formation and negotiating these issues with other parties to the formation can provide a valuable means to teach clients and other parties about their fiduciary rights and duties. This learning opportunity increases the likelihood of fiduciary compliance in the future.

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10. In this article, the phrases "fiduciary duties," "fiduciary rules," and "fiduciary issues" will not only refer to fiduciary duties, rules, and issues relating directly to fiduciary duties as such, but also to all closely related duties, rules, and issues, including, for example, issues relating to fiduciary causes of action, defenses to fiduciary claims, procedures for resolving fiduciary disputes (such as derivative actions) and manager indemnifications.

11. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 3); see J. William Callison & Allan W. Vestal, *Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform*, 42 SUFFOLK U. L. REV. 493, 497 (2009); Rutheford B. Campbell, *Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes*, 96 KY. L.J. 163, 168 (2007). *But see* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 224 (2009).

D. *The Relevance of Delaware Fiduciary Common Law to New Hampshire LLC Fiduciary Law*

The New Hampshire LLC Act contains numerous fiduciary rules. This article will discuss each rule briefly. There are no New Hampshire cases addressing LLC fiduciary issues. However, the New Hampshire LLC Act is based principally on the Delaware LLC Act<sup>12</sup> and there is an extensive body of Delaware common law on the fiduciary rights and duties of business owners and their managers, including the fiduciary rights and duties of LLC members and managers. Accordingly, in the absence of New Hampshire authority on a particular issue, this article will generally refer to Delaware common-law fiduciary rules.<sup>13</sup>

Furthermore, since Delaware cases routinely apply Delaware corporate and limited partnership fiduciary common-law rules to LLCs,<sup>14</sup> this article will frequently refer to these cases.

E. *The Fiduciary Rules in an LLC Agreement as Forming a Complex System of Interactive Parts*

The fiduciary provisions in the New Hampshire LLC Act and in LLC agreements form complex, multi-part systems in which each provision interacts in important ways with other provisions. When

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12. There is no recorded legislative history of the New Hampshire LLC Act. However, the drafters of the New Hampshire LLC Act followed the recommendation of Robert Keatinge, a leading LLC expert, and modeled the New Hampshire LLC Act after the Delaware Limited Liability Company Act. Compare DEL. CODE ANN. tit. 6, § 18-1101(b) (1999) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”), and DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 2008) (defining a “Limited liability company agreement”), with N.H. REV. STAT. ANN. § 304-C:78 (2005) (“It is the policy of this chapter to give the maximum effect to the principal of freedom of contract and to the enforceability of limited liability company agreements.”), and *id.* § 304-C:1(VI) (defining a “Limited liability company agreement”).

13. Additionally, New Hampshire courts have looked to Delaware case law for support in a variety of business and fiduciary issues. *E.g.*, *Kessler v. Gleich*, 938 A.2d 80, 86 (N.H. 2007) (citing *In re Cencom Cable Income Partners, L.P.*, No. C.A. 14634, 2000 WL 130629, at \*3 (Del. Ch. Jan. 27, 2000)).

14. *E.g.*, *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 290 (Del. 1999).

planning and negotiating fiduciary issues in a New Hampshire LLC deal, lawyers must be aware of the dynamic interrelationship of these issues and must address each issue accordingly. For example, if the governing LLC agreement provides managers with broad exculpation from personal liability for fiduciary breaches, an ordinary prudence standard of care—a relatively high standard of care for managers—may do little to ensure careful management or to deter or remedy manager negligence.

F. *The Categorization of Fiduciary and Other Provisions of the New Hampshire LLC Act*

Obviously, in order to handle fiduciary issues in a New Hampshire LLC formation, lawyers must be familiar with all of the fiduciary provisions and related provisions in the New Hampshire LLC Act. In addition, however, they must properly categorize each of these rules as definitional, mandatory, default, or permissive.<sup>15</sup>

The definitional rules of the New Hampshire LLC Act are simply statutory definitions of terms used in the Act. Lawyers must know these definitions so that they will use the right terms for the right concepts in the relevant LLC agreement and thus avoid potentially dangerous terminological ambiguity.<sup>16</sup>

The mandatory rules of the New Hampshire LLC Act, by their terms or by implication, may not be validly altered in LLC agreements. Lawyers must know each of these rules so that they can instruct the LLC, the LLC's members, or the LLC's managers to act consistent with these mandatory rules. Furthermore, lawyers must know these rules so they do not inadvertently include provisions in

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15. In *Elf Atochem*, the court systematically categorized provisions of the Delaware LLC Act at issue in the decision as mandatory, default, or permissive, and it construed these provisions on the basis of this categorization. *Id.* at 292; see also DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1, ch. 6 (discussing the meaning and practical significance of these categories in Delaware LLC formation practice and a category of provisions identified in the chapter as “definitional” provisions—i.e., provisions that formally that define terms of art employed in the act).

16. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1, at ch. 6.

LLC agreements which conflict with mandatory rules and are thus legally invalid.<sup>17</sup>

The default statutory rules of the New Hampshire LLC Act are rules that govern an LLC unless the governing LLC agreement provides otherwise.<sup>18</sup> Lawyers must know the default rules that are relevant to New Hampshire LLC formations so that they can seek to override the default rules in the governing LLC agreement if these rules are contrary to their client's interests. Furthermore, lawyers must know these rules so that, if a particular default rule favors their client, they may be able, by remaining silent about it, to obtain its inclusion in the LLC deal by default.

The permissive rules of the New Hampshire LLC Act expressly permit, but do not require, the members to adopt specified arrangements in the governing LLC agreement.<sup>19</sup> Lawyers must know all of the permissive rules in the New Hampshire LLC Act that are relevant to LLC formations so that they can implement them in the governing LLC agreement if any of the arrangements covered by these rules are useful to their client. Permissive rules can also be useful as a basis for LLC opinion practice.

Section 18-1101(b) of the Delaware LLC Act provides that “[i]t is the policy of [the Delaware LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”<sup>20</sup> On the basis of this provision, in *Elf Atochem North America, Inc. v. Jaffari* the Delaware Supreme Court stated in dicta that it would generally treat even seemingly mandatory provisions of the Delaware LLC Act as mere default provisions subject to alteration by an LLC's members in their LLC agreement absent an intent in these provisions to protect creditors or other third parties.<sup>21</sup> Obviously, *Elf Atochem* is not dispositive authority in New Hampshire. However, in resolving New Hampshire LLC fiduciary claims, the New Hampshire courts are likely find the case persuasive, since, as noted above, the terms of section 78(II) of the New Hampshire LLC Act are identical to those

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17. *Id.*

18. *Id.*

19. *Id.* at 6-32 to -35.

20. DEL. CODE. ANN. tit. 6, § 18-1101(b) (1999).

21. 727 A.2d 286, 291-92 (Del. 1999).

of Delaware LLC Act § 18-1101(b).<sup>22</sup> Thus, this article will sometimes apply the *Elf Atochem* approach in categorizing arguably mandatory provisions of the New Hampshire LLC Act as default provisions.

## II. THE FIDUCIARY DUTY OF CARE

### A. *The Gross Negligence Standard of Care*

Section 31(IV) of the New Hampshire LLC Act expressly imposes on LLC managers both a duty of care and a mandatory minimum standard of care—namely, avoiding gross negligence.<sup>23</sup> Additionally, section 78(III)(b) of the New Hampshire LLC Act provides that members may expand or restrict the fiduciary and other duties of any manager; however, members are not permitted to restrict the gross negligence standard of care provided for in section 31(IV).<sup>24</sup>

No New Hampshire LLC case law defines the term “gross negligence,”<sup>25</sup> but Delaware case law defines “gross negligence” as conduct that is recklessly indifferent to the LLC and its members or that is “outside the bounds of reason.”<sup>26</sup>

### B. *The Duty of Care Under Form 6.2, Sections 17.1 and 17.2*

The gross negligence standard is markedly lenient toward managers and is unlikely to deter manager negligence. In order to strike an appropriate balance between members and managers with respect to the duty of care, section 17.1 of Form 6.2 imposes a duty of ordinary prudence on managers similar to the standard of care that section 8.30 of the New Hampshire Business Corporation Act imposes

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22. See *supra* note 12 and accompanying text.

23. N.H. REV. STAT. ANN. § 304-C:31(IV)–(VI) (2005).

24. *Id.* § 304-C:78(III)(b).

25. The New Hampshire Supreme Court has defined gross negligence, for the purposes of tort law, as “the absence of slight diligence or the want of even scant care.” *Corrigan v. Clark*, 36 A.2d 631, 632 (N.H. 1944).

26. *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005); see also DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 14).

on corporate directors.<sup>27</sup> However, because LLC managers generally must exercise not only the oversight and decision-making functions of corporate directors but also numerous operational responsibilities, section 17.2 defines ordinary prudence to include not only decision-making but also operational capabilities. The complete text of sections 17.1 and 17.2 is as follows:

*17.1 Manager's Fiduciary Duty of Care; Standard of Care*

*The manager shall owe a duty of care to the LLC and to the other members. The standard of care shall be competence (as defined in Section 17.2).*

*17.2 Competence—Definition*

*The manager shall be deemed to perform the manager's duties under this Agreement competently if the manager performs them with the knowledge, judgment, skill, diligence, initiative and timeliness that an ordinarily competent person in a like position would use under similar circumstances.*<sup>28</sup>

LLC members generally find the provisions of section 17 to be adequate with regard to the duty of care and standard of care of managers. However, managers may want to amend the section to provide for a gross negligence standard of care. Indeed, some managers may want the governing LLC agreement to eliminate their duty of care altogether. However, because of the absence of the word “eliminate” in section 78(III)(b) of the New Hampshire LLC Act, it is likely that any such elimination would be invalid.<sup>29</sup>

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27. See N.H. REV. STAT. ANN. § 293-A:8.30 (1999) (stating that directors have a duty to act in good faith and in a manner that they believe is in the best interest of the corporation).

28. Form 6.2, *supra* note 3, §§ 17.1–2.

29. See *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167–68 (Del. 2002). Managers who want to completely eliminate their fiduciary duties of care and loyalty can only do so under section 18-1101(c) of the Delaware Limited Liability Company Act and under similar provisions of the small number of other non-New Hampshire LLC acts that so permit. See, e.g., DEL. CODE ANN. tit. 6, § 18-1101(c) (1999). Section 18-1101(c) of the Delaware Limited Liability Act provides that:

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company

### C. *The Business Judgment Rule and the Duty of Care*

The business judgment rule is a common-law rule that creates the presumption that managers' business judgments are correct.<sup>30</sup> Plaintiffs can successfully challenge this presumption by adequately pleading that a manager has done any of three things: (1) acted in bad faith; (2) breached his or her duty of loyalty; or (3) acted on the basis of inadequate information.<sup>31</sup>

The business judgment rule is a presumption that the Court will not second-guess decisions made by directors unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process . . . .<sup>32</sup>

The business judgment rule reflects the courts' awareness that many business judgments involve an unavoidable element of risk and their reluctance to second-guess these judgments.<sup>33</sup>

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or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

*Id.*

30. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000).

31. *See id.*; *Kahn v. Portnoy*, No. 3515-CC, 2008 Del. Ch. LEXIS 184, at \*20 (Del. Ch. Dec. 11, 2008) (applying the business judgment rule in a claim against the managers of a Delaware LLC); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* 4-163 (3d ed. 2009).

32. *Kahn*, 2008 Del. Ch. LEXIS 184, at \*20 (internal citations omitted) (quoting *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 652 n.42 (Del. Ch. 2008)).

33. In Delaware, the rule also reflects a general policy of the courts to protect managers from negligence claims. *See Aronson*, 473 A.2d at 813-14. Delaware courts have applied the business judgment rule as a mandatory rule applicable to Delaware LLCs. *See, e.g., Kahn*, 2008 Del. Ch. LEXIS 184, at \*20; *Minn. INVCO of RSA #7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 797 (Del. Ch. 2006).

However, if a plaintiff who alleges manager negligence is able to overcome the presumption arising under the business judgment rule, then the Delaware courts require that the manager bear the burden of proof<sup>34</sup> in showing the “entire fairness” of the decision in question.<sup>35</sup>

No New Hampshire case law exists regarding the applicability of the business judgment rule to LLCs or to other unincorporated business entities. It is hard to predict whether the New Hampshire courts will apply the rule to these entities. However, if faced with the issue, New Hampshire courts should apply the rule to New Hampshire LLCs only if the management of these LLCs involves significant entrepreneurial risk.

D. *The Business Judgment Rule in Form 6.2, Sections 26.4 and 26.11(a)*

The three-part test provided for in the business judgment rule is reflected in Form 6.2, section 26.4.<sup>36</sup> Under section 26.11(a), the burden of proof shifts from members to managers if the members are able to prove that the managers acted on an uninformed basis, that they acted in bad faith, or that they had a conflict of interest with regard to the matter in question.<sup>37</sup> Sections 26.4 and 26.11(a) provide as follows:

*26.4 Presumption of Compliance of Manager Actions with the Managers' Duty of Care*

*(a) Presumption of Compliance. If a claimant makes a claim that any conduct by a manager has breached the manager's fiduciary duty of care, the manager shall be deemed to have complied with this duty with respect to this conduct unless the claimant shows on the basis of a preponderance of the evidence:*

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34. Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 898 (Del. Ch. 1999) (citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

35. Boyer v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

36. FORM 6.2, *supra* note 3, § 26.4(a).

37. *Id.* § 26.11(a).

(1) That before engaging in the conduct, the manager failed to obtain reasonably adequate information or to adequately consider that information; or

(2) That in engaging in the conduct, the manager acted in bad faith; or

(3) That with respect to the conduct, the manager had a conflict of interest.

(b) Approval by Disinterested Members. For purposes of this Section 26.4, a manager shall be deemed not to have had a conflict of interest if the conduct in question was approved in advance by majority vote of disinterested members.

....

#### 26.11 *Shifting of Burden of Proof in Certain Cases Involving Claims of Breach of Fiduciary Duties*

(a) Claims of Breach of the Duty of Care. If, in connection with a claim that the manager has breached the manager's fiduciary duty of care, a claimant adequately pleads that the manager has engaged in any conduct described in Sections 26.4(a)(1) through (3), the burden of proof shall shift from the claimant to the manager and the manager shall bear the burden of proving that the manager complied with the manager's duty of care in the matter in question.<sup>38</sup>

Members who wish to deter manager negligence may want to provide in their LLC agreements that the business judgment rule shall not apply to member claims against the managers. Managers will normally support the inclusion of the rule in LLC agreements and will oppose the burden shifting provided for under section 26.11(a) of Form 6.2.

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38. Form 6.2, *supra* note 3, §§ 26.4, 26.11.

### III. THE FIDUCIARY DUTY OF LOYALTY

#### A. Introduction

The fiduciary duty of loyalty owed by LLC managers is the duty, in all matters relating to the LLC, to subordinate their self-interest to the best interest of the LLC—that is, to avoid conflicts of interest with the LLC.<sup>39</sup>

As noted in Part I of this article, Delaware common law can be read to imply that the duty of loyalty involves seven specific subsidiary duties. These subsidiary duties are:

1. A duty not to compete against the LLC;
2. A duty to follow “arms’ length” procedures in engaging in business with the LLC;
3. A duty not to usurp LLC business opportunities;
4. A duty not to derive improper personal benefits from their status and activities as managers (as, for example, by unauthorized personal use of LLC property);
5. A duty to make disclosures to the members;
6. A duty of confidentiality; and
7. A duty of good faith.<sup>40</sup>

The fiduciary duty of good faith is best understood by reference to fiduciary bad faith. Fiduciary bad-faith conduct means, in essence, intentionally or knowingly inflicting or permitting the infliction of harm on the LLC.<sup>41</sup>

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39. See *In re* Regional Diagnostics, LLC, 372 B.R. 3, 28 (Bankr. N.D. Ohio 2007); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181–82 (Del. 1986); BALOTTI & FINKELSTEIN, *supra* note 31, at 4-117.

40. *E.g.*, *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 154–55 (Del. 1996) (duty not to usurp business opportunities); *HMG/Courtland Props., Inc. v. Gray*, 749 A.2d 94, 113–14 (Del. Ch. 1999) (duty to make disclosures); see also DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 20–32). While outside the jurisdictions of Delaware and New Hampshire, *Jones Co., Inc. v. Frank Burke, Jr.*, 117 N.E.2d 237 (N.Y. 1954) provides an instructive example of the duty not to compete.

41. See *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 64–66 (Del. 2006).

The New Hampshire LLC Act does not expressly impose either a general duty of loyalty or any of the above subsidiary duties on managers. However, section 9(I) of the New Hampshire LLC Act provides that an LLC may indemnify managers for damages they incur in their capacity as managers if, when engaging in the conduct resulting in these damages, they reasonably believed that this conduct was not opposed to the best interest of the LLC.<sup>42</sup> Section 9(I) implicitly imposes a general duty of loyalty on New Hampshire LLC managers.<sup>43</sup> In addition, by barring indemnification for bad faith conduct, section 9(I) of the New Hampshire LLC Act implies that managers have a fiduciary duty to act in good faith.<sup>44</sup>

Further, by barring indemnification for improper personal benefits, section 9(II) implies that managers have a fiduciary duty of loyalty to avoid these benefits.<sup>45</sup> Section 31(V)(b)(2), a default rule requiring managers to hold as trustees improper personal benefits, also impliedly prohibits these benefits.<sup>46</sup>

Moreover, section 31(V)(b)(3), a default rule requiring managers to hold in trust benefits from contracts with the LLC, should be read to imply that LLC managers have a duty of loyalty with respect to business transactions with the LLC.<sup>47</sup>

Finally, while there is no New Hampshire case law on the matter, on the basis of Delaware precedents and other authority, the New Hampshire courts would likely rule that the other subsidiary duties of loyalty identified above also apply to New Hampshire LLC managers.<sup>48</sup>

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42. N.H. REV. STAT. ANN. § 304-C:9(I) (2005).

43. *See id.*

44. *See id.*

45. *See id.* § 304-C:9(II).

46. *Id.* § 304-C:31(V)(b)(2).

47. *See id.* § 304-C:31(V)(b)(3).

48. *See supra* note 40 and accompanying text. An instructive decision of the U.S. District Court for the District of New Hampshire concerning the duty of loyalty of corporate directors is *Drolet v. Healthsource, Inc.*, 968 F. Supp. 757, 761 (D.N.H. 1997).

B. *Can the Duty of Loyalty Be Eliminated Under New Hampshire LLC Act Section 31(VI)?*

Section 31(VI) of the New Hampshire LLC Act provides as follows:

Subject to the liability of a member or manager for acts of gross negligence or willful misconduct provided for in RSA 304-C:31, IV, a limited liability company agreement may eliminate or limit the personal liability of a member or manager for monetary damages for breach of any duty provided for in paragraph V.<sup>49</sup>

Section 31(VI) arguably provides that the members of a New Hampshire LLC may eliminate the fiduciary duty of loyalty and its seven subsidiary duties in an LLC agreement. However, the matter is by no means clear, since section 78(III)(b) provides that the members may expand or restrict manager fiduciary duties, except for the duties to avoid gross negligence and willful misconduct.<sup>50</sup> It may be reasonably argued that the absence of the word “eliminate” in section 78(III)(b) means that the members may *not* eliminate the duty of loyalty or any subsidiary duty.<sup>51</sup> The best reading of section 78(III)(b) is that the general duty of loyalty and all of its seven subsidiary duties may be restricted in LLC agreements except in manifestly unreasonable ways but may not be entirely eliminated.<sup>52</sup>

C. *Form 6.2, Sections 18 Through 20*

The general duty of loyalty and its seven subsidiary duties are imposed on managers under Form 6.2, sections 18 through 20. Sections 18 through 20 are titled as follows:

*18.1 Manager’s Fiduciary Duty of Loyalty—General Rule*

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49. N.H. REV. STAT. ANN. § 304-C:31(VI).

50. *Id.* § 304-C:78(III)(b).

51. *See id.*

52. The concept of “manifest unreasonableness” as a ground for invalidating alterations of statutory fiduciary duties in general partnership agreements is employed in the Revised Uniform Partnership (“RUPA”). REV. UNIF. P’SHIP ACT § 103(b)(3) & cmt. (1997).

*18.2 Manager's Duty Not to Compete against the LLC, Etc.*

*18.3 Manager's Fiduciary Duty with Respect to LLC Business Opportunities*

*18.4 Manager's Fiduciary Duty in Doing Business with the LLC*

*18.5 Manager's Fiduciary Duty to Avoid Improper Personal Benefits*

*18.6 Manager's Fiduciary Duty in Using LLC Property, Etc.*

*18.7 Manager's Fiduciary Duty of Good Faith*

*19.1 Manager's Fiduciary Duty of Confidentiality*

*19.2 Binding Effect of This Section; Termination of Binding Effect*

*20.1 Manager's Fiduciary Duty of Disclosure in Connection with the LLC's Formation*

*20.2 Manager's Fiduciary Duty of Disclosure in Connection with the LLC's Operation and Dissolution, Etc.*

*20.3 Disclosures Concerning Manager Relationships and Interests*

*20.4 Nondisclosure Agreements*

*20.5 No Requirement to Breach Privacy*

*20.6 Manager's Duty to Update Disclosures after Signing This Agreement*

LLC members should sometimes seek to make the provisions of the above sections more stringent by, for example, making the prohibitions contained in the provisions absolute rather than subject to member vote. Managers sometimes seek to make them less stringent by, for example, carving out specific exceptions to one or more of the above seven subsidiary duties of the general duty of loyalty. New Hampshire courts will likely respect these exceptions if they are not manifestly unreasonable.<sup>53</sup> However, as noted above, it is

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53. See *supra* note 52 and accompanying text.

unlikely that New Hampshire courts will permit the complete elimination of the general duty of loyalty or of any of its seven subsidiary duties.<sup>54</sup>

#### IV. THE FIDUCIARY DUTY OF MANAGERS TOWARD MINORITY MEMBERS AND OTHER SPECIFIC CLASSES AND GROUPS OF MEMBERS

The New Hampshire LLC Act does not address the issue whether managers have a fiduciary duty of loyalty to minority members and no New Hampshire LLC case law exists on this issue. By contrast, Delaware case law makes clear that, in general, LLC managers have fiduciary duties *equally* toward *each* LLC member, and not just to majority members.<sup>55</sup> However, the Delaware case law also provides that managers may lawfully discriminate against particular members if this discrimination is necessary in order to protect the LLC enterprise.<sup>56</sup> Under New Hampshire LLC Act section 78(II)(b), the freedom-of-contract provision, an LLC agreement may provide that managers have fiduciary duties toward one or more specified classes of members but not to other specified classes.<sup>57</sup>

The fact that managers owe fiduciary duties equally to all of the members is implicit in the various fiduciary provisions of Form 6.2. However, minority members may want to amend these provisions to make this obligation explicit.<sup>58</sup>

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54. See *supra* note 40 and accompanying text.

55. See *Burton v. Exxon Corp.*, 583 F. Supp. 405, 414 (S.D.N.Y. 1984); BALOTTI & FINKELSTEIN, *supra* note 31, at 4-153.

56. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181-82 (Del. 1986); BALOTTI & FINKELSTEIN, *supra* note 31, at 4-154.

57. See N.H. REV. STAT. ANN. § 304-C:78(II) (2005).

58. New Hampshire law is also silent on the fiduciary duty of the majority members of LLCs to the minority. However, while no such fiduciary duty exists, the majority members have a duty to the minority members under the implied contractual covenant of good faith and fair dealing as in effect under New Hampshire contract law. See, e.g., *Centronics Corp. v. Genicom Corp.*, 562 A.2d 187, 190-91 (N.H. 1989). New Hampshire case law does address the fiduciary duties of majority corporate shareholders toward minority shareholders. See, e.g., *Kennedy v. Titcomb*, 553 A.2d 1322, 1323-24 (N.H. 1989).

## V. THE IMPLIED CONTRACTUAL COVENANT OF GOOD FAITH AND FAIR DEALING

### A. *Introduction*

The common law in New Hampshire and other states, including Delaware, implies, on the part of parties to contracts, a promise (a “covenant”) to act in good faith toward all other contract parties and to deal fairly with them.<sup>59</sup> This implied contractual covenant of good faith and fair dealing (the Implied Covenant) is grounded in state public policy favoring the enforcement of contracts<sup>60</sup>—a policy also set forth in Article I, Section 10, Clause 1 of the United States Constitution.

In general, the Implied Covenant requires that on all issues not expressly addressed in a contract, each contract party must act consistently with the reasonable expectations of the other contract parties.<sup>61</sup> On these issues, contract parties must avoid, among other things:

1. Engaging in misrepresentation, fraud, or deceit with respect to contract matters;
2. Abusing discretion accorded to the party under the contract in question;
3. Failing to perform duties clearly implicit in the contract;
4. Taking actions that interfere with or prevent the other party’s performance under the contract;
5. Taking unfair advantage of the other party in respect of the contract;

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59. See, e.g., *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, C.A. Nos. 4479-VCN, 4886-VCN, 2009 WL 4052681, at \*8 (Del. Ch. Nov. 12, 2009); *Centronics*, 562 A.2d at 190–91; *Griswold v. Heat Inc.*, 229 A.2d 183, 187 (N.H. 1967); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 40–43).

60. See *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*10 (Del. Ch. May 7, 2008) (explaining that “the implied covenant of good faith and fair dealing protects the spirit of what was actually bargained and negotiated for in the contract”); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 41).

61. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 41).

6. Engaging in conduct that conflicts with customary and expected practice in the business, trade, or profession relevant to the contract; and
7. More generally, acting in a manner that is notably irrational.<sup>62</sup>

The New Hampshire LLC Act makes no reference to the Implied Covenant. However, Delaware LLC Act sections 18-1101(b) and (c) provide, in effect, that LLC agreements may not eliminate the Implied Covenant as a duty of managers and that they may not eliminate the personal liability of managers for breaching the duty.<sup>63</sup> It is likely that under the New Hampshire LLC Act, as under the Delaware LLC Act, a court would construe state public policy to preclude both the elimination of the Implied Covenant and the elimination of the liability of managers for breaching it.

However, New Hampshire lawyers and their LLC formation clients should be aware that the protections afforded to LLC members against manager misconduct under the Implied Covenant are likely to be less effective in preventing manager misconduct than fiduciary protections. Among other considerations, the courts of New Hampshire are likely to be reluctant to apply the Implied Covenant, since this will require the court to guess the intent of the relevant contract parties and may raise the risk that they will err in doing so.<sup>64</sup>

#### B. *The Implied Covenant Under Form 6.2, Section 21*

Form 6.2, section 21 requires managers to comply with the Implied Covenant. In addition, for the benefit of members and managers not familiar with the Implied Covenant, section 21 provides that

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62. *Id.* (manuscript at 42). See generally Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 *BUS. LAW.* 1469, 1474–85 (2005).

63. See DEL. CODE ANN. tit. 6, §§ 18-1101(b)–(c) (1999).

64. A number of leading cases explain the New Hampshire common law concerning the implied contractual covenant of good faith and fair dealing and the meaning of the terms good faith and fair dealing for purposes of this doctrine. See, e.g., *Hathorn v. Loftus*, 726 A.2d 1278, 1281 (N.H. 1999); *Centronics*, 562 A.2d at 190–91; *Griswold*, 229 A.2d at 187–88.

managers will be deemed to have breached this covenant if they engage in conduct that defeats the members' reasonable expectations without reasonable justification. Section 21 provides as follows:

*Section 21 Manager's Duty to Comply with the Implied Contractual Covenant of Good Faith and Fair Dealing*

*(a) The manager shall comply with the implied contractual covenant of good faith and fair dealing in accordance with the contract law of the State of [New Hampshire].*

*(b) The manager shall be deemed to have breached the implied contractual covenant of good faith and fair dealing if, without reasonable justification, the manager engages in conduct that defeats the reasonable expectations of the members under this Agreement with respect to issues not addressed in the Agreement.<sup>65</sup>*

Since the Implied Covenant is grounded in state public policy, it presumably cannot be validly altered or eliminated in an LLC agreement under the New Hampshire LLC Act.<sup>66</sup> Thus, there would appear to be little opportunity for either members or managers to negotiate amendments to the terms of Section 21.

*C. The Relationship Between the Fiduciary Duty of Good Faith and the Contractual Duty of Good Faith Under the Implied Covenant*

The fiduciary duty of good faith requires, in general, that LLC managers avoid intentionally or knowingly inflicting or permitting the infliction of harm on their LLC.<sup>67</sup> The duty of good faith under the Implied Covenant requires managers not only to avoid fiduciary bad faith, but also to avoid any other conduct that will defeat the reasonable expectations of the members under the LLC agreement

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65. Form 6.2, *supra* note 3, § 21.

66. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*10 (Del. Ch. May 7, 2008); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 41).

67. *See In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64–66 (Del. 2006).

on issues not directly addressed in the agreement.<sup>68</sup> This includes conduct, whether or not conscious or intentional, that is inconsistent with normal commercial practice in the relevant profession, business, or trade.

## VI. THE RIGHT OF LLC MEMBERS TO OBTAIN RECORDS AND INFORMATION FOR USE IN INVESTIGATING AND CHALLENGING MANAGER FIDUCIARY BREACHES

### A. *Introduction—New Hampshire LLC Act Section 28*

New Hampshire LLC Act section 28 provides that upon written demand and for a proper purpose, but subject to reasonable restrictions to protect confidentiality, LLC members may obtain from their LLC a wide variety of records and information, including information about the “status and financial condition of the [LLC],” information in the LLC’s tax returns, and “other information regarding the affairs of the limited liability company as is just and reasonable.”<sup>69</sup> Members may bring actions in the Superior Court to enforce section 28.<sup>70</sup>

No New Hampshire case addresses on section 28 of the New Hampshire LLC Act, including the issue of what constitutes a “proper purpose” for obtaining LLC records and information. However, the best, and often the only, source of authority for obtaining records and information relevant to possible manager misconduct is the LLC agreement itself. Furthermore, Delaware case law makes clear that under section 18-305 of the Delaware LLC Act, the provision that corresponds to New Hampshire LLC Act section 28, the investigation of possible manager misconduct constitutes a proper purpose for seeking LLC records and information.<sup>71</sup> Delaware case

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68. *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, C.A. Nos. 4479-VCN, 4886-VCN, 2009 WL 4052681, at \*8 (Del. Ch. Nov. 12, 2009); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 41).

69. N.H. REV. STAT. ANN. § 304-C:28(I) (2005).

70. *Id.* § 304-C:28(VII).

71. *Somerville S Trust v. USV Partners, LLC*, No. Civ.A. 19446-NC, 2002 WL 1832830, at \*5 (Del. Ch. Aug. 2, 2002); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 45).

law also makes clear that, under section 18-305 of the Delaware LLC Act, such records and information, once the members have obtained them, may be used in bringing claims against these managers for breaches of fiduciary and other manager duties.<sup>72</sup> It is probable that the New Hampshire courts would rule similarly under section 28 of the New Hampshire LLC Act, since the relevant terms of section 28 are similar to the corresponding terms of Delaware LLC Act section 18-305.

*B. Form 6.2, Section 14; Member and Manager Amendments*

The section of Form 6.2 that addresses the rights of LLC members to access and use LLC records and information is section 14.

*Section 14 Members' Rights to LLC Records and Information*

*14.1 Access to LLC Records, Etc.*

*For any purpose reasonably related to a member's interests as a member (but only for such a purpose), each member shall (subject to the restrictions set forth in Section 14.2) have the following rights with respect to books and records in the possession or control of the LLC ("LLC records") and with respect to information relating to or in the possession or control of the LLC ("LLC information"):*

*(a) Access to LLC Records. At any reasonable time during normal LLC business hours, upon a written request reasonably identifying specific LLC records and stating the purpose for which each such record is sought, each member shall be entitled to inspect and review each such record that is reasonably related to that purpose.*

*(b) Obtaining of LLC Information. At any reasonable time during normal LLC business hours, upon a written request reasonably identifying specific LLC information and stating the purpose for which this information is*

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72. See generally *NAMA Holdings, LLC v. World Mkt. Ctr. Venture, LLC*, 948 A.2d 411 (Del. Ch. 2007); *Somerville S Trust*, 2002 WL 1832830.

*sought, each member shall be entitled to obtain this information from the manager to the extent that the information is reasonably related to that purpose.*

*(c) Copying of LLC Records, Etc. At any reasonable time during normal LLC business hours, each member shall be entitled to copy at the member's expense any LLC record that the LLC is required to disclose to the member under this Section 14.1.*

*(d) Use of LLC Records and LLC Information. Each member may use LLC records and LLC information disclosed to the member under this Section 14 only for the purpose stated to the LLC as required under the above Sections 14.1(a) and (b).*

#### *14.2 Restrictions*

*The rights of the members to access, obtain, copy and use LLC records and information under Section 14.1 shall be subject:*

*(a) To the duty of confidentiality imposed by Section 19 of this Agreement;*

*(b) To any applicable federal or state laws and regulations, including laws and regulations concerning the privacy of employee medical information; and*

*(c) To restrictions reasonably imposed by the manager.<sup>73</sup>*

Most LLC members are likely to be content with the provisions of section 14 as a basis for investigating and challenging manager misconduct. However, managers may often want to amend the section by, for example, expanding the procedural barriers that members must surmount in order to obtain LLC records and information or by increasing their managerial discretion in providing such records and information to members.

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73. Form 6.2, *supra* note 3, §§ 14.1, 14.2.

## VII. FIDUCIARY DISPUTES—LITIGATION VS. ALTERNATIVE DISPUTE RESOLUTION

### A. *Alternative Dispute Resolution vs. Litigation—General Considerations*

The New Hampshire LLC Act is silent as to the method that LLCs must employ in order to resolve non-derivative internal disputes, including non-derivative claims by members that managers have breached their fiduciary or other duties. Thus, the New Hampshire LLC Act implies that these disputes must be resolved by litigation in an appropriate court.<sup>74</sup>

However, New Hampshire Superior Court Rule 170 requires, with certain narrow exceptions, that cases filed in the Superior Court be assigned to alternative dispute resolution (“ADR”) before being litigated.<sup>75</sup> Sections 27 and 28.1 of Form 6.2 reflect the policy underlying Rule 170.<sup>76</sup> Form 6.2, section 27 provides that if there is a dispute among the members or managers of an LLC, the parties must seek to resolve it in mediation if they cannot voluntarily resolve it among themselves.<sup>77</sup> Form 6.2, section 28.1 provides that if mediation fails, the parties must resolve the dispute in binding and exclusive arbitration, and it provides that they may not litigate any aspect of the dispute except in the narrowly defined circumstances set forth in section 28.5.<sup>78</sup>

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74. New Hampshire LLC derivative disputes are normally resolved through actions under sections 76(I) through 76(III) of the New Hampshire LLC Act. N.H. REV. STAT. ANN. § 304-C:76(I)–(III); *see infra* Part VIII. Unless the parties agree between themselves on alternative dispute resolution, the only forum available under New Hampshire law for third-party resolution of direct (i.e., non-derivative) claims by members against managers is the New Hampshire Superior Court. *Durham v. Durham*, 871 A.2d 41, 44 (N.H. 2005). Additionally, it is clear that the New Hampshire Superior Court has jurisdiction to hear and resolve these claims. *Id.*

75. N.H. SUPER. CT. R. 170(a)(1).

76. Form 6.2, *supra* note 3, §§ 27–28.

77. *Id.* § 27.1.

78. *Id.* §§ 28.1, 28.5.

B. *Factors Potentially Favoring Arbitration over Litigation as the Method of Resolving Member Claims Against Managers*

Even apart from Rule 170, there are eleven principal factors that persons forming New Hampshire LLCs should normally consider in determining whether arbitration is a better option than litigation for their LLC in resolving fiduciary claims against managers. Most of these factors generally support reliance on binding, exclusive arbitration rather than litigation:

1. Arbitration privacy. Litigation is public and may involve the disclosure of sensitive information regarding one or more litigants. By contrast, the rules governing arbitration in a New Hampshire LLC agreement may provide for the confidentiality of some or all of the information disclosed in arbitration proceedings.<sup>79</sup>
2. Speed of resolution. The rules set forth in an LLC agreement may provide for arbitration timetables that will result in greater expedition than is likely to be possible in any court.
3. Resolution of issues not addressed in LLC agreements. Except in rare circumstances, New Hampshire courts will refrain from addressing issues arising in member claims against managers if these issues are not specifically addressed in the LLC agreement.<sup>80</sup> By contrast, arbitration provisions in LLC agreements may confer on an arbitrator

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79. Mediation, arbitration and other methods of alternative dispute resolution (“ADR”) are purely contractual; thus, the parties to ADR arrangements have great freedom in defining their terms. AM. ARBITRATION ASS’N, COMMERCIAL ARBITRATION RULES, R-1 (2009), *available at* <http://www.adr.org/sp.asp?id=22440> (“The parties [to an arbitration under these rules], by written agreement, may vary the procedures set forth in these rules.”). *See generally* COMMERCIAL ARBITRATION AT ITS BEST: SUCCESSFUL STRATEGIES FOR BUSINESS USERS (Thomas Stipanowich & Peter H. Kaskell eds., 2001); PETER R. SILVERMAN, THE CLIENT’S GUIDE TO MEDIATION AND ARBITRATION: THE STRATEGY FOR WINNING (2008).

80. *See* Carriage Hill Health Care, Inc. v. Hayden, No. CIV. 96-101-SD, 1997 WL 833131, at \*2–3 (D.N.H. Apr. 30, 1997) (explaining the narrow scope of the implied covenant of good faith and fair dealing in the context of an employment contract); White v. Ransmeier & Spellman, 950 F. Supp. 39, 42 (D.N.H. 1996).

virtually unlimited authority to address these issues and to fashion new LLC agreement provisions to resolve them.

4. Costs. The arbitration of member claims against managers will normally be less expensive than litigation of these claims in court as long as the arbitration panel consists of a single arbitrator. However, if, as LLC agreements occasionally provide, the panel consists of three arbitrators, arbitration may well be substantially more expensive than litigation.<sup>81</sup>

5. Evidentiary and procedural rules. Unless an LLC agreement provides otherwise, arbitrators deciding member claims against managers are likely to be more liberal in admitting evidence than New Hampshire courts.<sup>82</sup> It is true that the evidentiary and procedural rules in the litigation of member claims against managers are likely to be clearer, more formal, and, thus, arguably fairer than arbitration rules. However, an LLC agreement may provide that arbitrations under the agreement shall be governed by the evidentiary, procedural, or other rules of the courts of the State of New Hampshire or of other specified courts.

6. Industry-specific issues. New Hampshire judges are likely to have a significantly greater knowledge of New Hampshire LLC law than many arbitrators. However, under the arbitration provisions of an LLC agreement, members making claims against managers may be able to select an arbitrator who possesses substantially greater knowledge of specific industrial and commercial laws and practices rele-

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81. Arbitrators are generally practicing or retired lawyers or retired judges who charge fees for their arbitration services at the hourly rates for legal services charged by lawyers with professional backgrounds and credentials generally similar to those of these arbitrators in the relevant geographical area. These rates vary widely but, in larger cities, may amount to several hundred dollars an hour. *See, e.g.,* American Arbitration Association, *Dispute Resolution Services*, [http://www.adr.org/arb\\_med](http://www.adr.org/arb_med) (last visited Jan. 18, 2010).

82. *See, e.g.,* AM. ARBITRATION ASS'N, *supra* note 79, at R-31 (giving arbitrators virtually unlimited authority over the admissibility, relevance and materiality of evidence and over numerous key discovery issues).

vant to the resolution of these claims than any judge is likely to possess.

7. Awarding of litigation costs to prevailing parties. It is normally difficult for a prevailing party in the litigation of member claims against managers in New Hampshire courts to obtain an award of litigation costs.<sup>83</sup> Under the terms of the arbitration provisions in an LLC agreement, these awards may be readily available to prevailing parties.

8. “Compromise decisions.” Although it is sometimes asserted that arbitrators tend to render compromise decisions that are unfair to one or more parties, studies conducted by the Searle Civil Justice Institute of the Northwestern University School of Law raise serious doubts about this assertion.<sup>84</sup>

9. Site convenience. Litigation in the New Hampshire courts may involve substantial inconvenience and travel expenses for one or more parties if these parties are located outside New Hampshire. By contrast, arbitration provisions in LLC agreements can usually provide for arbitration sites reasonably convenient to all parties.

10. Injunctive relief. The New Hampshire Superior Court has inherent authority to grant injunctive relief.<sup>85</sup> It is true

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83. *See, e.g.*, *Clipper Affiliates, Inc. v. Checovich*, 638 A.2d 791, 795–96 (N.H. 1994) (discussing general rule that each party to a lawsuit is responsible for payment of his or her own attorney’s fees).

84. *See* SEARLE CIVIL JUSTICE INST., CONSUMER ARBITRATION BEFORE THE AMERICAN ARBITRATION ASSOCIATION 109–13 (2009), available at [http://www.searlearbitration.org/p/full\\_report.pdf](http://www.searlearbitration.org/p/full_report.pdf); WILLIAM K. SLATE, II, STUDY SHOWS THAT AAA CONSUMER ARBITRATION WORKS (2009), [http://web.me.com/naimark/Naimark\\_Commentary/Commentary\\_Home/Entries/2009/3/23\\_Study\\_shows\\_that\\_aaa\\_Consumer\\_arbitration\\_works.html](http://web.me.com/naimark/Naimark_Commentary/Commentary_Home/Entries/2009/3/23_Study_shows_that_aaa_Consumer_arbitration_works.html).

85. Under New Hampshire law:

The superior court shall have the powers of a court of equity in the following cases: charitable uses; trusts other than those trusts described in RSA 564-A:1, over which the probate court has exclusive jurisdiction as provided in RSA 547:3, I(c) and (d); fraud, accident and mistake; the affairs of partners, joint tenants or owners and tenants in common; the redemption and foreclosure of mortgages; contribution; waste and nuisance; the specific performance of contracts; discovery; cases in which there is

that the arbitration provisions of an LLC agreement may provide arbitrators of member claims against managers with the authority to grant injunctive relief. However, a party to an arbitration may refuse to accept this relief, if ordered by an arbitrator, on the ground, whether valid or not, that it is unavailable in the specific circumstances of the claim, and the party seeking the relief will be able to enforce the injunction only by recourse to the courts.

11. Jury trials. In claims by members against managers, parties may believe that their chances for victory will be greater if a jury decides the claim. Juries are normally provided for only in courts of general jurisdiction, not in arbitration. However, the arbitration provisions in an LLC agreement may provide for the resolution of member claims against managers by a body of decision-makers possessing many essential qualities of jury members. These provisions may also provide that the rules governing jury selection and other jury matters shall be those of a specified court.

### C. *Dispute Resolution Under Form 6.2, Sections 28 and 29*

Sections 27 and 28 of Form 6.2 provide that disputes among the parties to the LLC agreement shall be subject to mandatory mediation and that disputes not resolved by mediation shall be resolved in arbitration.<sup>86</sup> The key arbitration rules in section 29 may be summarized as follows:

1. Single arbitrator. Each arbitration shall be resolved by a single arbitrator.<sup>87</sup>

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not a plain, adequate and complete remedy at law; and in all other cases cognizable in a court of equity, except that the court of probate shall have exclusive jurisdiction over equitable matters arising under its subject matter jurisdiction authority in RSA 547, RSA 547-C and RSA 552:7.

N.H. REV. STAT. ANN. § 498:1 (2005 & Supp. 2009). Further, “[t]he court may hear and determine such cases according to the course of equity, and may grant writs of injunction whenever the same are necessary to prevent fraud or injustice.” *Id.* § 498:2.

86. Form 6.2, *supra* note 3, §§ 28–29.

87. *Id.* § 28.3(b).

2. Administration of arbitration by American Arbitration Association (AAA) if parties cannot agree on arbitrator or site of arbitration.<sup>88</sup> If the parties cannot agree on the identity of the arbitrator or the site of the arbitration, the AAA shall administer the arbitration under appropriate AAA rules.<sup>89</sup> Form 6.2 specifies the AAA's Commercial Arbitration Rules.<sup>90</sup> However, AAA also has specialized rules for disputes involving construction, finance, accounting, insurance, intellectual property, real estate, securities, wills and trusts, and wireless industry matters.<sup>91</sup>
3. Issues subject to arbitration. Any type of dispute arising under or relating to the LLC agreement or relating to the LLC's business or internal affairs shall be subject to arbitration.<sup>92</sup>
4. Permissibility of litigation. The parties may litigate the types of disputes listed above only under specified (and sharply restricted) conditions.<sup>93</sup>
5. Remedies. Arbitrators may award any type of legal or equitable remedy.<sup>94</sup>
6. "Loser pays." To the extent that a party prevails in arbitration, the arbitrator shall award arbitration expenses to the prevailing party.<sup>95</sup>

#### D. *Alternatives to Form 6.2, Sections 28 and 29*

Members may want to negotiate the amendments of sections 28 and 29 differently depending upon how they value the eleven factors that persons forming New Hampshire LLCs should normally con-

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88. *Id.*

89. AM. ARBITRATION ASS'N, *supra* note 79.

90. Form 6.2, *supra* note 3, § 28.3(b).

91. American Arbitration Association, Commercial Services, [http://www.adr.org/commercial\\_arbitration](http://www.adr.org/commercial_arbitration) (last visited Feb. 6, 2010).

92. Form 6.2, *supra* note 3, § 28.4.

93. *Id.* § 28.5.

94. *Id.* § 28.13.

95. *Id.* § 28.9(c).

sider in determining whether arbitration is a better option than litigation in resolving fiduciary claims against managers. It is difficult to generalize about the effect of these factors on particular members or managers. However, as shown in the illustrations below, it is normally fairly easy for members and managers to decide on the basis of these factors which amendments, if any, they should seek in the above sections.

Illustration One. Two individuals, Mr. Manager and Mr. Investor, are negotiating the formation of XYZ, LLC, a two-member, manager-managed, New Hampshire LLC. Mr. Manager resides in St. Louis, Missouri. Mr. Investor resides in Manchester, New Hampshire. Both Mr. Manager and Mr. Investor will be members of XYZ, but, as their names imply, Mr. Manager will be a manager-member and Mr. Investor will be a non-manager-member. Mr. Investor is wealthy and can afford litigation costs far more readily than Mr. Manager. Thus, Mr. Investor negotiates to provide in XYZ's LLC agreement that all disputes under or relating to XYZ's LLC agreement or relating to the business or internal affairs of XYZ shall be resolved exclusively in litigation and that this litigation shall be conducted in the New Hampshire Superior Court.

Illustration Two. Same facts as above, except that because of his proven management expertise, Mr. Manager has substantial leverage in negotiating XYZ's LLC agreement. Using this leverage, Mr. Manager negotiates to provide in this agreement that all of the above types of disputes shall be resolved exclusively in arbitration in St. Louis.

Illustration Three. Same facts as above, but Mr. Manager and Mr. Investor have equal negotiation leverage in the XYZ deal, and both of them believe that most of the issues likely to become subjects of dispute between them with respect to XYZ should be resolved by a decision maker intimately familiar with commercial practices in the highly specialized industry in which XYZ will participate. Accordingly, Mr. Manager and Mr. Investor state in their LLC agreement that disputes between them relating to XYZ shall be decided by an arbitrator with specialized knowledge of this industry in a location convenient to both parties.

## VIII. FIDUCIARY CLAIMS AND THE DERIVATIVE ACTION RULES

A. *The Derivative Action Provisions of New Hampshire LLC Act Section 76*

New Hampshire LLC Act sections 76(I) through 76(III) provide detailed rules governing a special type of New Hampshire Superior Court proceeding called a “derivative action.”<sup>96</sup> In such an action, one or more members may make claims, in the LLC’s name and on its behalf, that managers have breached their fiduciary or other duties.<sup>97</sup> If the members prove their case, they may obtain money damages from the managers and reimbursement of their reasonable expenses, including lawyers’ fees.<sup>98</sup>

Under Delaware law, owners of business entities are barred from making direct claims in the courts regarding management misconduct—i.e., claims in the members’ rights as individual members—if the alleged misconduct primarily affects the entity itself rather than any specific owner and thus “belongs” to the entity.<sup>99</sup> Rather, under Delaware law, the members *must* bring such a claim as a derivative action on behalf of the LLC, and the complexity, cost, and long duration that frequently attend derivative actions may powerfully diminish the likelihood that their claim will succeed.<sup>100</sup>

However, under *Elf Atochem*, although the provisions for derivative actions in sections 18-1001 through 18-1004 of the Delaware LLC Act may appear to be mandatory,<sup>101</sup> they are merely default, since they are not intended to protect third parties.<sup>102</sup> A New Hampshire court would be likely to take the same view of sections 76(I)

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96. N.H. REV. STAT. ANN. § 304-C:76 (2005).

97. *Id.* § 304-C:78(II).

98. *Id.* § 304-C:78(III).

99. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 56); *see, e.g.*, Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1036–39 (Del. 2004) (discussing the difference between direct and derivative actions).

100. *See, e.g.*, Kurt M. Heyman & Patricia L. Enerio, *The Disappearing Distinction Between Derivative and Direct Actions*, 4 DEL. L. REV. 155, 156 (2001); Larry E. Ribstein, *Litigating in LLCs*, 64 BUS. LAW. 739, 743 (2009).

101. *See* DEL. CODE ANN. tit. 6, §§ 18-1001 to -1004 (1999).

102. *See* Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 293–94 (Del. 1999).

through (III) of the New Hampshire LLC Act—namely, that they are default provisions that may be altered in an LLC agreement.<sup>103</sup>

B. *The Treatment of Derivative Actions in Form 6.2, Sections 26.1(a) and 26.1(d); Member and Manager Amendments*

The provisions of Form 6.2 that are primarily relevant to derivative actions are sections 26.1(a) and 26.1(d).

*26.1 Who May Make a Claim; Waivers*

*(a) Claims by Members.* By giving the other members a written notice of mediation under Section 27 or of arbitration under Section 28 and by otherwise complying with the dispute resolution provisions of this Agreement, any member (a “claimant”) may make a claim as a direct claim in the claimant’s own right against one or more other members or against the LLC with respect to any matter arising under or relating to this Agreement or relating to the business or internal affairs of the LLC.

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103. The New Hampshire Supreme Court likely will be flexible in applying the derivative provisions of the New Hampshire LLC Act. *See Kessler v. Gleich*, 938 A.2d 80, 86 (N.H. 2007). In *Kessler*, the New Hampshire Supreme Court quoted a Delaware limited partnership case as follows:

As the Court of Chancery of Delaware recognized in an unreported decision: “In the partnership context, the relationships among the parties may be so simple and the circumstances so clear-cut that the distinction between direct and derivative claims becomes irrelevant,” and that in such situations, “superimposing derivative pleading requirements upon claims needlessly delays ultimate substantive resolution and serves no useful or meaningful public policy purpose.”

*Id.* (quoting *In re Cencom Cable Income Partners*, No. 14634, 2000 WL 130629, at \*3 (Del. Ch. Jan. 27, 2000)). Accordingly, “[a]pplication of corporate law rules to disputes related to a limited partnership necessitates a bit of flexibility.” *Anglo Am. Sec. Fund, L.P. v. S.R. Global Int’l Fund, L.P.*, 829 A.2d 143, 150 (Del. Ch. 2003). The New Hampshire Federal District Court appears to have a critical view of the arguably hollow formalism of traditional corporate derivative rules as applied to non-corporate entities. *See, e.g., Beane v. Beane*, No. 06-CV-446, 2008 U.S. Dist. LEXIS 33530, at \*17 n.11 (D.N.H. Apr. 18, 2008).

*(d) Derivative Actions.* Unless an arbitrator decides otherwise, no claimant making a claim under this Agreement shall be required to comply with any rule specifically governing derivative actions.<sup>104</sup>

The provisions of section 26.1 make it relatively simple for members to make claims of manager misconduct. Thus, there are no amendments of the section that members forming New Hampshire LLCs are likely to need in order to facilitate these claims.

In order to reduce the risk that members will make claims of management misconduct, managers may want to amend Form 6.2, section 26.1 to provide that in order to make a claim of manager misconduct as a direct claim, members must first prove (or at least credibly allege) that the claim does not “belong” to the LLC. They may also want to amend the section to provide that if the claim belongs to the LLC, it must be made in accordance with derivative rules. Finally, they may want to amend the section to provide that if members make a claim either as a derivative or as a direct claim but fail to prove that they have correctly characterized the claim, they may not file a new claim even if it is correctly characterized.<sup>105</sup>

#### IX. BURDENS OF PROOF AND STANDARDS OF PROOF IN MEMBER CLAIMS OF MANAGEMENT MISCONDUCT

The New Hampshire LLC Act is silent about two procedural issues that are likely to be critical in any proceeding in which members claim that managers have breached their fiduciary or other duties. These are: (1) which parties shall bear the burden of proving these claims, and (2) what standard of proof the parties must meet.

The implicit rules under the New Hampshire LLC Act concerning these issues are the normal rules in civil actions in the courts of New Hampshire. Thus, under the New Hampshire LLC Act, the members must bear the burden of proving their claims against man-

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104. Form 6.2, *supra* note 3, § 26.1.

105. Indeed, the very risk that a court or arbitrator may disagree with the members' conclusion as to whether an action against managers for fiduciary breaches is direct or derivative may by itself significantly deter members from bringing such an action.

agers and they must make this proof by a preponderance of the evidence.<sup>106</sup>

The implicit default standard of proof under the Delaware LLC Act for member claims of manager misconduct is the same as that under the New Hampshire LLC Act. However, presumably to deter manager disloyalty, Delaware generally places on managers the burden of proving that they have complied with their duty of loyalty if their LLCs or their members adequately plead claims of manager disloyalty.<sup>107</sup> Additionally, Delaware case law provides that the managers must bear the burden of proving that they have not breached their duty of care if members adequately plead that the managers have failed any part of the three-part test under the business judgment rule.<sup>108</sup>

Consistent with the implicit default rule of the New Hampshire LLC Act, Form 6.2, section 26.10(b) provides that the burden of proof in any claim under the LLC agreement of a New Hampshire LLC shall be proof by a preponderance of the evidence.<sup>109</sup> However, consistent with the Delaware case law, Form 6.2, section 26.11(a) provides that in well-pleaded member claims of manager breaches of the duty of care, managers must bear the burden of proof.<sup>110</sup> Additionally, section 26.11(b) provides that in defending against claims of breach of the duty of loyalty, managers must meet the burden of proof unless they are able to adequately plead the defense of member ratification.<sup>111</sup>

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106. *See, e.g.,* Dunlop v. Daigle, 444 A.2d 519, 520 (N.H. 1982) (“In a civil action the burden of proof is generally on the plaintiff to establish its case by a preponderance of the evidence.”); MCCORMICK ON EVIDENCE § 339 (E. Cleary ed., 2d ed. 1972). Some jurisdictions specify that the existence of a nuisance must be proved by a preponderance of the evidence. *See* 58 AM. JUR. 2D *Nuisance* § 233 (2002); *cf.* Arnold v. Williams, 430 A.2d 155, 156 (N.H. 1981) (standard of proof for prescriptive right is “balance of probabilities,” not “clear and convincing”).

107. *See* BALLOTTI & FINKELSTEIN, *supra* note 31, at 4-123 (describing burden-shifting in claims of breach of loyalty under the Delaware common-law doctrine known as the “entire fairness” doctrine).

108. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 17).

109. Form 6.2, *supra* note 3, § 26.10(b).

110. *Id.* 26.11(b).

111. *Id.*

It is unlikely that members will seek any amendment of the above sections of Form 6.2, since these sections provide them with substantial protection from manager misconduct. By contrast, the managers may want to amend section 26.11 to require that, in seeking to prove any claim of manager misconduct, the members shall have the burden of proof.

## X. MANAGER DEFENSES AGAINST MEMBER CLAIMS OF FIDUCIARY BREACH

### A. *Statutory Defenses Under New Hampshire LLC Act Sections 35 and 78(III)(b) and Common-Law Equitable Defenses*

In litigation or arbitration in which the members of a New Hampshire LLC claim that the managers have breached their fiduciary or other duties, the managers obviously may defend themselves simply on the basis of the relevant facts. However, the New Hampshire LLC Act also provides them with specific statutory defenses to these claims under sections 35 and 78(III)(a).<sup>112</sup>

Section 35 of the New Hampshire LLC Act provides that managers shall be “fully protected” in relying in good faith on the records of the LLC and on “information, opinions, reports or statements presented to the limited liability company by” its other managers and other specified types of persons as to matters the managers reasonably believe are within the competence of these persons.<sup>113</sup> While the section does not expressly state from what types of claims it is intended to protect managers, its terms indicate that it should be read to protect them from damages for *any* type of claim by the members, including contractual claims, claims of breach of the Implied Covenant, and claims of breach of the duties of care and of loyalty.

Section 78(III)(a) of the New Hampshire LLC Act provides that managers “shall not be liable” to the LLC or its members for the manager’s “good faith reliance” on the provisions of the governing LLC agreement.<sup>114</sup> Technically, section 78(III)(a) provides the rele-

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112. N.H. REV. STAT. ANN. § 304-C:35, 78(III)(a) (2005).

113. *See id.* § 304-C:35.

114. *Id.* § 304-C:78(III)(a).

vant managers with exculpation from damages rather than with a defense.<sup>115</sup> However, the section functions in practice as a defense to the same extent as section 35, and, like section 35, it presumably protects managers from every type of claim.

Finally, managers can undoubtedly rely on all of the various types of equitable defenses available to them under New Hampshire law.<sup>116</sup> These equitable defenses include, for example, equitable estoppel, waiver, acquiescence, ratification, laches, and “unclean hands.”

*B. Statutory and Common-Law Defenses Available to Managers Under Form 6.2, Sections 26.3 and 28.13(a)*

The manager defenses set forth in New Hampshire LLC Act sections 38 and 78(III)(b) are reflected in section 26.3 of Form 6.2. However, while sections 38 and 78(III)(b) apply if a manager has relied in “good faith” on LLC records, etc., section 26.3 of Form 6.2 permits this reliance only under the more stringent standard of reasonableness.<sup>117</sup> Form 6.2, section 26.3 provides as follows:

*26.3 No Breach of Duty of Care or Loyalty If the Manager Relies on LLC Records, Etc.*

*The manager shall not be deemed to have breached the manager’s duty of care or loyalty under this Agreement if, with respect to the matter in question, the manager has acted in reasonable reliance on:*

*(a) LLC records;*

*(b) Information, opinions, reports or statements presented to the manager or to the LLC by another member or by any other person as to matters that, when presented, the*

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115. *Id.*

116. No single source defines and explains these various defenses as available under New Hampshire law. However, an excellent discussion of them under Delaware law may be found in DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY ch. 11 (2009). The discussion of them in WOLFE & PITTENGER under the law of Delaware applies equally under New Hampshire law.

117. Form 6.2, *supra* note 3, § 26.3.

*manager reasonably believed to be within the other person's professional or expert competence; or*

*(c) Any provision of this Agreement.*<sup>118</sup>

Form 6.2, section 28.13(a) supplements the defenses available to managers under Form 6.2, section 26.3 with common-law legal and equitable defenses. Section 28.13(a) provides as follows:

*28.13 Permissible Defenses and Remedies*

*In any arbitration under this Section 28, the arbitrator shall have discretion to determine:*

*(a) The extent to which a party may rely upon any specific common law legal or equitable defense . . . .*<sup>119</sup>

In practice, members are generally unlikely to seek amendments of sections 26.3 or 28.13 with respect to the manager defenses they provide. Managers may want to amend section 26 to, among other things, provide for “good faith” reliance rather than “reasonable” reliance and, to the extent possible, to limit the types of remedies available to members.

## XI. MANAGER REMOVALS

### A. *Manager Removals Under New Hampshire LLC Act Sections 31(I), 34, and 27(IV)*

Whatever other remedies the members of an LLC may want with respect to fiduciary and other breaches by a manager, the first remedy they will want will normally be the manager's removal. Three provisions of the New Hampshire LLC Act address manager removals—sections 31(I), 34, and 27(IV).

The third sentence of section 31(I) provides that “[a] manager shall cease to be a manager as provided in a limited liability company agreement.”<sup>120</sup> It is unclear whether this sentence should be construed as permissive or as mandatory. If it is construed as per-

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118. *Id.*

119. *Id.* § 28.13(a).

120. N.H. REV. STAT. ANN. § 304-C:31(I) (2005).

missive, then it simply means that in their LLC agreement, the members of an LLC *may provide* for manager removals. If it is construed as mandatory, then it means that if the members do *not* provide rules in their LLC agreement concerning the removal of managers, these managers *may not* be removed and will remain in office as managers until they die or resign. It is unlikely that a New Hampshire court would adopt this latter construction, since it would effectively eliminate an arguably fundamental right of LLC members—namely, the right to remove managers who breach their fiduciary duties. However, the third sentence of section 31(I) is ambiguous.<sup>121</sup> Thus, the prudent response to the section is to provide in LLC agreements express and comprehensive rules governing manager removals.

Section 34 of the New Hampshire LLC Act provides that an LLC agreement may provide “specified penalties or specified consequences” for manager misconduct.<sup>122</sup> Section 34 implicitly but clearly authorizes, among other “penalties” or “consequences” for breaches by managers of their fiduciary or other duties, their removal as managers.<sup>123</sup>

By its terms, section 27(IV) of the New Hampshire LLC Act provides for the removal of *members*, not *managers*.<sup>124</sup> Thus, the section likely must be read to apply only to removals of managers who are *also members* and not to the removal of *non-member* managers.<sup>125</sup> In essence, the section provides for two different procedures under which members other than the manager-member in question may remove a manager-member. First, it provides that other members may remove the manager-member by a vote of two-thirds of the other members “acting reasonably and in good faith.”<sup>126</sup> Second, it provides that any two other members—or in the case of an LLC with only two members, one of the members—may petition a court to remove the manager-member.<sup>127</sup>

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121. *Id.*

122. *Id.* § 304-C:34(I).

123. *Id.* § 304-C:34(II).

124. N.H. REV. STAT. ANN. § 304-C:27(IV) (Supp. 2009).

125. *See id.*

126. *Id.* § 304-C:27(IV)(a).

127. *Id.* § 304-C:27(IV)(b).

However, applying the dicta of the Delaware Supreme Court in *Elf Atochem*, all of the various provisions of section 27(IV) can safely be construed as default.<sup>128</sup> Thus, for example, it seems clear that no provision of the section would prevent the members of a New Hampshire LLC from providing in their LLC agreement that a manager-member may be removed for causes other than “inability or unwillingness to exercise management responsibilities, actions beyond authority or contrary to the limited liability company agreement, or fraudulent or illegal actions in relation to the business and affairs of the company.”<sup>129</sup>

B. *Manager Removals Under Form 6.2, Section 15.5; Member and Manager Amendments*

Form 6.2, section 15.5 provides that a manager-member may be removed by majority vote of the other members “at any time with or without cause” upon the majority vote of the other members.<sup>130</sup> In practice, the members of multi-member LLCs typically do not seek to amend section 15.5, since it provides them with broad discretion in removing managers. However, many managers may want to seek amendments of the section. These amendments may include, for example, provisions for manager removal only if the managers commit serious breaches of the LLC agreement and fail to cure these breaches (if curable) within a reasonable time after receipt of notice.

XII. OTHER REMEDIES AVAILABLE TO MEMBERS FOR MANAGER  
BREACHES OF THEIR FIDUCIARY AND OTHER DUTIES

A. *Remedies Available Under New Hampshire LLC Act Section 34  
to Members Making Claims Against Managers*

Even in planning for the negotiation of New Hampshire LLC deals, prospective members and their lawyers should consider the remedies they may want for breaches by managers of their fiduciary

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128. *See* *Elf Atochem N. Am. Inc. v. Jaffari*, 727 A.2d 286, 295 (Del. 1999).

129. N.H. REV. STAT. ANN. § 304-C:27(IV).

130. Form 6.2, *supra* note 3, § 15.5.

duties. These may normally include: (1) the statutory remedies under New Hampshire LLC Act section 34; and (2) various common-law and equitable remedies.

Section 34 of the New Hampshire LLC Act is a permissive provision that provides members with virtually unlimited flexibility as to the types of remedies they may obtain against managers for breaches of fiduciary and other duties, including “penalties” (which might otherwise be unavailable to them because of the general rule of contract law prohibiting penalties).<sup>131</sup>

*B. Common-Law Legal and Equitable Remedies Potentially Useful to Members Making Claims Against Managers*

In addition to the classic common-law legal remedies of compensatory and punitive damages, there are ten main types of equitable remedies potentially useful to members claiming manager breaches of their fiduciary or other duties. These are:

1. Prohibitory and mandatory injunctions;
2. Specific performance;
3. Rescission and rescissionary damages;
4. Reformation;
5. Accounting;
6. Constructive and resulting trusts and the related remedy of equitable liens;
7. Subrogation;
8. *Quia timet*;
9. Equitable restitution; and
10. Declaratory relief.<sup>132</sup>

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131. N.H. REV. STAT. ANN § 304-C:34 (2005).

132. A useful resource under Delaware law with respect to the above equitable remedies is WOLFE & PITTENGER, *supra* note 116, ch. 11. The discussion in WOLFE & PITTENGER generally applies equally under New Hampshire law.

As with legal and equitable defenses, a detailed discussion of the above legal and equitable remedies is beyond the scope of this article. However, if lawyers are representing members who are considering or who have brought such claims, they should normally advise these members not only about the statutory and common-law legal remedies potentially useful to them, but also about all potentially useful common-law equitable remedies.

*C. Remedies Available to Members Under Form 6.2, Section 28.13(b)*

For the reasons outlined in Part VII of this article, practitioners should generally recommend to clients forming New Hampshire LLCs that their LLC agreements provide for mediation and arbitration rather than litigation as the methods for resolving member claims against managers and other LLC internal disputes. Mediation and arbitration can be particularly appropriate for New Hampshire LLCs with relatively few members and relatively limited capital.

Thus, Form 6.2, sections 27 and 28 provide for the resolution of LLC internal disputes by mandatory mediation followed, if necessary, by mandatory arbitration.<sup>133</sup> As discussed in Part VII of this article, the hallmark of these and other alternative dispute resolution methods is procedural flexibility. This flexibility is reflected in Form 6.2, section 28.13(b). Section 28 is entitled “Dispute Resolution—Mandatory Arbitration.” Section 28.13(b) provides as follows:

*28.13 Permissible Defenses and Remedies*

*In any arbitration under this Section 28, the arbitrator shall have discretion to determine:*

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*(b) Whether to award any specific legal or equitable remedy.*<sup>134</sup>

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133. Form 6.2, *supra* note 3, §§ 27, 28.

134. *Id.* § 28.13(b).

In view of the virtually unlimited range of remedies available to members under section 28.13(b), there are no amendments of that section which members are likely to want. However, managers may want to eliminate from the coverage of section 28.13(b) one or more of the various types of statutory and common-law remedies potentially available to members under that section.

### XIII. EXCULPATION OF MANAGERS FROM PERSONAL LIABILITY FOR FIDUCIARY AND OTHER BREACHES

#### A. *Exculpation of Managers Under the New Hampshire LLC Act*

Section 31(V)(a) of the New Hampshire LLC Act, the default rule, generally provides that unless the LLC agreement provides otherwise, a manager shall not be liable “for any action taken or failure to act on behalf of the [LLC].”<sup>135</sup> However, under section 31(VI), the members of an LLC in their LLC agreement may not exculpate managers from personal liability for a breach of the duty of care for *gross negligence*.<sup>136</sup> Additionally, under section 31(VI), the members of an LLC in their LLC agreement may not exculpate managers from personal liability for *willful misconduct*.<sup>137</sup> Though there appears to be no New Hampshire authority on the matter, on its face willful misconduct appears to refer to conduct that Delaware common law refers to as *bad faith* conduct, i.e., intentionally or consciously disregarding fiduciary responsibilities.<sup>138</sup>

Further, under section 9(I), the members of an LLC may not exculpate managers for bad faith conduct or disloyal conduct.<sup>139</sup> It is

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135. N.H. REV. STAT. ANN. § 304-C:31(V)(a) (2005).

136. *Id.* § 304-C:31(VI); *see also id.* § 304-C:31(IV).

137. *Id.* § 304-C:31(VI).

138. *See Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243 (Del. 2009) (“[B]ad faith will be found if ‘a fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.’” (quoting *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006))); *Robotti & Co. v. Liddell*, C.A. No. 3128-VCN, 2010 WL 157474, at \*11 (Del. Ch. Jan. 14, 2010) (explaining that bad faith, in the context of a breach of the duty of loyalty, arises “when a fiduciary consciously disregards his or her responsibilities”).

139. N.H. REV. STAT. ANN. § 304-C:9(I).

true that Section 9(I) addresses indemnification, not exculpation. However, while the matter is not without doubt, it is likely that the members may not lawfully exculpate managers for amounts for which they cannot lawfully indemnify them. Finally, under sections 31(V)(b)(2) and (3), the members of an LLC may restrict the liability of managers for breaches of their duty of loyalty but may not eliminate this liability.<sup>140</sup>

*B. Exculpation of Managers Under Form 6.2, Section 26.5; Member and Manager Amendments*

Section 26.5 of Form 6.2 addresses manager exculpation.<sup>141</sup> This section provides no general exculpation for LLC managers. Rather, it requires that the manager request exculpation in each case and that the exculpation be approved by majority vote of the disinterested members.<sup>142</sup> Additionally, the section prohibits exculpation of personal liability for breaches of the Implied Covenant.<sup>143</sup>

In practice, the members of New Hampshire LLCs may sometimes want to amend section 26.5 of Form 6.2 to prohibit exculpation altogether or to provide for stricter procedural requirements for exculpation, while managers may often want to amend the section to mandate exculpation of damages for specified types of conduct.

#### XIV. LLC INDEMNIFICATION OF MANAGERS

*A. Indemnification Under Section 9 of the New Hampshire LLC Act*

New Hampshire LLC Act section 9 sets forth provisions concerning LLC indemnification of managers for expenses, including attorneys' fees, judgments, and settlements, which they have incurred in defending themselves from claims arising from their conduct as managers.<sup>144</sup> Under section 9, an LLC agreement may not indemnify a manager for expenses relating to derivative actions in

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140. *Id.* § 304-C:31 (V)(b)(2)–(3).

141. Form 6.2, *supra* note 3, § 26.5.

142. *Id.*

143. *Id.*

144. N.H. REV. STAT. ANN. § 304-C:9(I).

which the manager was judged liable to the LLC.<sup>145</sup> Additionally, the LLC Agreement may not indemnify a manager for expenses incurred by the manager in a direct action in which the manager was judged liable for having derived an improper personal benefit.<sup>146</sup> Finally, subject to the above prohibitions, section 9(I) provides that LLC agreements may indemnify managers for any expenses incurred by them if, in the matter in question the managers: (1) conducted themselves in good faith; and (2) reasonably believed that their conduct was “not opposed to the best interest of the [LLC].”<sup>147</sup>

*B. Manager Indemnification Under Form 6.2, Section 26.7; Member and Manager Amendments*

Like New Hampshire LLC Act section 9, Form 6.2, section 26.7 permits LLCs to indemnify members, managers, and other persons.<sup>148</sup> However, the section limits the scope of section 9 of the New Hampshire LLC Act so that the liabilities that the LLC may indemnify under section 26.7 are limited to those relating to the business and internal affairs of the LLC.<sup>149</sup> In addition, under section 26.7, the managers may receive indemnification from the LLC only if they request it in each case and only if a majority of disinterested members approve it.<sup>150</sup>

The text of Form 6.2, section 26.7 provides as follows:

*26.7 Indemnification of Members, the Manager and Others*

*(a) Indemnification. If a member, manager or other person incurs a liability in respect of a claim relating to the business or internal affairs of the LLC, then, if (i) the person requests indemnification of the liability in writing in each case; and (ii) the disinterested members approve it by majority vote, the LLC may indemnify the person for the liability to the extent*

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145. *Id.* § 304-C:9(II)(a).

146. *Id.* § 304-C:9(II)(b).

147. *Id.* § 304-C:9(I).

148. Form 6.2, *supra* note 3, § 26.7.

149. *Id.*

150. *Id.*

*permitted by the LLC Act and approved by the disinterested members*

*(b) Liability—Definition. For purposes of Section 26.7(a), a liability means an obligation to pay a judgment, settlement, penalty, fine or reasonable expense (including reasonable attorneys' fees) in respect of a claim described in Section 26.1(a).<sup>151</sup>*

In practice, members may want to amend section 26.6 to bar indemnifications or to impose more stringent conditions for indemnification. Managers may want to amend the section to provide for more extensive indemnification. However, it is possible that a New Hampshire court would rule that any such amendment is invalid on public policy grounds to the extent that it effectively condones serious management misconduct.

#### XV. ADVANCEMENT OF DISPUTE RESOLUTION EXPENSES BY LLCs TO MANAGERS

##### A. *Advancement Under the New Hampshire LLC Act—General Considerations*

The New Hampshire LLC Act is silent on whether LLCs may advance to members, managers, or other persons ADR or litigation expenses likely to be incurred by them in defending themselves against fiduciary and other claims. However, the Act contains no prohibition against advancement; for some LLCs, the prospect of advancement may be a significant factor in attracting competent managers, and the policy of freedom and enforceability of contract set forth in New Hampshire LLC Act section 78(II) unquestionably authorizes advancement provisions in LLC agreements.<sup>152</sup>

Furthermore, although there are no New Hampshire cases concerning LLC advancement, Delaware courts routinely enforce ad-

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151. *Id.*

152. *See* N.H. REV. STAT. ANN § 304-C:78(II).

vancement provisions in LLC agreements in accordance with their terms.<sup>153</sup>

However, the Delaware cases also make clear that: in the absence of specific advancement provisions in an LLC agreement, managers and other parties to the agreement have no right to advancement; the inclusion of indemnification provisions in an LLC agreement by no means implies a right to advancement; and the terms of advancement provisions will be strictly construed.<sup>154</sup>

*B. Advancement Under Form 6.2, Section 26.8; Member and Manager Amendments*

Form 6.2, section 26.8 provides for advancement to current and former members and managers of “reasonable mediation, arbitration and litigation expenses, including reasonable attorneys’ fees” to cover the defense of claims against these members and managers relating to their conduct as members or managers.<sup>155</sup> However, the section makes advancement conditional on a number of factors: these members and managers must request the advancement in writing in each case; they must agree to reimburse the LLC for the advancement to the extent that they do not prevail in the claim in question; and a majority of disinterested members must approve each advancement and the terms of the reimbursement agreement.<sup>156</sup>

Because of financial and other concerns, the members of some LLCs may want to amend section 26.8 to prohibit advancement alto-

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153. *See, e.g.*, *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 587 (Del. Ch. 2006) (holding that the plaintiff was not entitled to advancement because “hold harmless” language in an agreement does not grant advancement rights); *DeLucca v. KKAT Mgmt., LLC*, No. 1384-N, 2006 WL 224058, at \*2 (Del. Ch. Jan. 23, 2006) (finding that the plaintiff was entitled to advancement); *Senior Tour Players 207 Mgmt. Co. v. Golftown 207 Holding Co.*, 853 A.2d 124, 125 (Del. Ch. 2004) (holding that the plaintiffs were entitled to advancement in accordance with the express terms of their agreement); *Morgan v. Grace*, No. 20430, 2003 WL 22461916, at \*3 (Del. Ch. Oct. 29, 2003) (holding that the plaintiffs were entitled to advancement under one agreement but not another, because the right to advancement and the right to indemnification are distinct).

154. DRAFTING DELAWARE LLC AGREEMENTS, *supra* note 1 (manuscript at 71–73).

155. Form 6.2, *supra* note 3, § 26.8.

156. *Id.*

gether. Managers are unlikely to succeed in any effort to eliminate the reimbursement promise requirement in the section. However, they may in some cases be able to obtain an amendment providing for guaranteed advancement.

## XVI. MANAGER LIABILITY INSURANCE

### A. *Introduction*

As noted by Balotti and Finkelstein, director and officer liability insurance “has become an important aid to a corporation in attracting and retaining corporate managers and directors.”<sup>157</sup> For New Hampshire LLCs, provisions in their LLC agreements providing for manager liability insurance, like those providing for exculpations, indemnification, and advancement, can be powerful tools in attracting and retaining effective management. Furthermore, although the New Hampshire LLC Act is silent as to whether LLCs may purchase this kind of insurance and although there are no New Hampshire or Delaware LLC cases on the issue, the right of LLCs to make such purchases is unquestionable under section 78(II) of the New Hampshire LLC Act.<sup>158</sup>

Moreover, for many LLCs, the cost of obtaining manager liability insurance can be relatively low. For example, my personal inquiries indicate that relatively small non-public LLCs may be able to obtain, for an annual premium as low as two thousand dollars, manager liability insurance with a policy limit of \$1 million per claim and an annual \$1 million aggregate limit.

### B. *Liability Insurance Under Form 6.2, Section 26.9*

For many New Hampshire LLCs, the risk that any of their managers will ever be subject to a suit by a member or a third party for their actions as managers is arguably quite small, especially for LLCs with relatively few members, few or no passive investors, and

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157. BALOTTI & FINKELSTEIN, *supra* note 31, at 4-87.

158. *See* N.H. REV. STAT. ANN. § 304-C:78(II) (2005) (setting forth the New Hampshire LLC Act statutory policy of freedom of contract and LLC agreement enforceability).

relatively limited assets. Thus, Form 6.2, section 26.9, the provision of that form that addresses manager liability insurance, merely authorizes the LLC to acquire this insurance but does not require it to do so.<sup>159</sup>

*26.9 LLC's Duty to Provide Liability Insurance for Members and Managers in Certain Circumstances*

*Whether the LLC shall maintain an insurance policy to cover liabilities incurred by members as a result of claims against them in their capacity as members or managers shall be decided by the majority vote of the members.*<sup>160</sup>

However, the managers of some LLCs are likely to want their LLCs to obtain manager liability insurance as a condition for their service as managers. Further, for many LLCs this insurance may be reasonably affordable and thus acceptable to the members as an LLC commitment. In these circumstances, the LLC agreement should contain a provision agreeing to provide the insurance.

However, the terms of director, officer, and manager liability insurance policies vary widely and are sometimes highly negotiable. Thus, an agreement by the members to obtain this insurance for its managers is likely to be only the first step in a potentially complex process of identifying and addressing these terms.<sup>161</sup>

Managers who want their LLC to obtain manager liability insurance will want the broadest possible insurance coverage, including coverage of manager expenses relating to member claims against them. However, for financial or other reasons, members may want relatively narrow coverage.

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159. Form 6.2, *supra* note 3, § 26.9.

160. *Id.*

161. *See generally* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573 (1996) (providing a useful introduction to the legal and practical issues relevant in evaluating and obtaining director and officer liability insurance); DAVID M. GISCHE & VICKI FISHMAN, *DIRECTORS AND OFFICERS LIABILITY INSURANCE*, <http://www.cnapro.com/pdf/D&O-InsOvrvu.pdf> (last visited Jan. 22, 2010).

XVII. THE MANAGEMENT STRUCTURE PROVISIONS OF THE NEW HAMPSHIRE LLC ACT SECTION 31(I) AS IMPLICIT FIDUCIARY PROVISIONS

Thus far, this article has focused primarily on provisions of the New Hampshire LLC Act and on New Hampshire and Delaware case law dealing more or less expressly with LLC fiduciary issues as such. On their face, the first and second sentences of New Hampshire LLC Act section 31(I) deal only with general issues of LLC management structure and not with fiduciary issues.<sup>162</sup> However, these two sentences, properly understood, are among the more important fiduciary provisions in the New Hampshire LLC Act.

The first two sentences of section 31(I) are permissive provisions. The first sentence provides as follows: “A limited liability company agreement may provide for the management, in whole or in part, of a limited liability company by a manager or managers, who shall be chosen by the members in the manner provided in the limited liability company agreement.”<sup>163</sup> The second sentence of section 31(I), which is also presumably a permissive provision, provides that the managers of LLCs “shall hold the offices and have the responsibilities accorded to [them] by the members and set forth in a limited liability company agreement.”<sup>164</sup>

The above sentences, when read together, must be construed to provide an implicit general statutory default rule that, to the extent that the members of an LLC do not expressly or impliedly “accord” to the managers the right to decide an LLC matter under section 31(I) in their LLC agreement, *the members must be deemed to have retained the right to decide that matter by member vote.*

Admittedly, this general rule cannot be extended to the decision of matters pertaining to the day-to-day business of the LLC, since by the very act of appointing managers, the members must be deemed to have granted to managers the right to decide these matters. However, the rule clearly *does* apply, albeit by implication, to all LLC matters *other* than day-to-day business matters.

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162. N.H. REV. STAT. ANN § 304-C:31(I).

163. *Id.*

164. *Id.*

Furthermore, these non-day-to-day matters must be deemed by implication to include, among many other types of matters, numerous important *fiduciary* matters involving the control of manager conduct but not expressly addressed in other provisions of the New Hampshire LLC Act or in any relevant case law. This is so because, in the absence of express terms to the contrary in an LLC agreement, the members cannot reasonably be deemed to have granted this control to the managers themselves.

In particular, the above two sentences must be deemed to provide the members with an implicit but clear statutory default right to decide by member vote the following critical types of LLC fiduciary issues (and possibly numerous other fiduciary issues) not expressly addressed under any other New Hampshire LLC Act provision or relevant case:

1. Whether to approve a manager's competing against the LLC;
2. Whether to approve a manager's appropriating an LLC business opportunity;
3. Whether to approve a manager's engaging in a business transaction with the LLC and the terms of that engagement;
4. Whether to approve a manager's accepting a personal benefit obtained by reason of the manager's status or actions as a manager;
5. Whether to authorize the LLC to bring a claim against the manager for breaches of the manager's fiduciary or other duties;
6. Whether to remove a manager for breach of fiduciary or other duties;
7. Whether to seek remedies against managers other than removal for manager breaches of their fiduciary or other duties (such as money damages);
8. Whether to require the LLC to obtain liability insurance for manager breaches of their fiduciary and other duties;

9. Whether to approve the LLC's advancement of litigation expenses to managers charged with fiduciary or other breaches;
10. Whether to approve exculpation of managers who have breached their fiduciary or other duties;
11. Whether to approve LLC indemnification of managers who owe damages for breaches of their fiduciary or other duties;
12. Whether to impose a duty on the managers concerning an issue on which Delaware common law and the agreement are silent.

Finally, it is clear that under the default voting rules of section 24(V), the above matters may be decided by the vote of a mere *majority* of the members and do not require a supermajority vote.<sup>165</sup>

### XVIII. CONCLUSION

Sound fiduciary provisions can contribute significantly to the success of New Hampshire LLCs. However, in order to competently handle fiduciary issues in New Hampshire LLC formations, lawyers must have a thorough knowledge of New Hampshire LLC statutory and common-law fiduciary rules. In addition, with respect to New Hampshire LLC fiduciary issues on which there is no New Hampshire statutory or common law, they must know the relevant Delaware law, since the New Hampshire LLC Act is based to a substantial degree on the Delaware LLC Act.

Finally, they must know how to handle the very different interests that will be relevant if they are negotiating on behalf of prospec-

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165. N.H. REV. STAT. ANN. § 304-C:24(V). Section 24(V) provides that, unless the LLC agreement or the New Hampshire LLC Act provides otherwise, each member shall have one vote on each matter on which the members may vote, and that each such matter shall be decided by vote of members holding a majority of member votes. *Id.* Furthermore, no provision of the New Hampshire LLC Act expressly or impliedly provides that fiduciary matters shall be decided by *other* than a majority vote.

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tive members or prospective managers in a New Hampshire LLC formation.