Protecting LLC Owners While Preserving LLC Flexibility

Peter Molk[*]

LLC statutes allow owners to restrict or completely waive standard governance protections required of other business forms. Corporate law mandatory stalwarts like fiduciary duties can be entirely eliminated in an LLC. This flexible approach has the potential to generate maximally efficient governance relationships: tailored negotiation among LLC investors can produce an optimal set of governance terms that corporate law's mandatory protections cannot. Yet when owners lack sophistication or bargaining power, contractual freedom allows for terms that lead to mispriced capital, reduced investment, and inefficiently allocated capital across LLCs.

A series of cases has brought this problem to the fore. Recommendations for reform have focused on doing nothing, imposing mandatory protections, or relying on ad-hoc judicial interventions, but these solutions are each ultimately unsatisfying. Instead, I show how a model inspired by securities law's accredited investor concept has the most promise to ensure LLCs' continued viability as a distinct organizational form, with favorable liability and tax treatment to everyday investors and the freedom to craft unique governance relationships for sophisticated ones.

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INTRODUCTION

Limited liability companies, or LLCs, have quickly become the fastest growing form of business organization. New LLC formations now outstrip their traditional corporation counterparts by a two-to-one margin.[1] Favorable tax and limited liability considerations explain much of LLCs' success.[2] Yet more important for many firms are LLC statutes' commitment to contractual freedom. In many states, traditional owner protections apply merely by default to LLCs; owners and managers can modify or entirely waive owner protections that are required of other business forms. No state goes further towards this goal than Delaware, which fixes this approach in its LLC statute by proclaiming that "[i]t is the policy of this [Act] to give the maximum effect to the principle of freedom of contract."[3] This commitment to contractual freedom has helped Delaware lead the market for new LLC formations.[4]

Contractual freedom allows sophisticated LLC parties to craft governance provisions that are individually tailored to meet those parties' specific needs, which in turn lowers the cost of doing business and promises to maximize economic efficiency. When standard governance protections apply merely by default, owners can alter or discard those safeguards when their costs exceed their benefits. Venture capital organizations, for example, might organize as LLCs to reject completely the corporate opportunity doctrine required of corporations; this allows for a venture capitalist to serve as a director of multiple related companies and allows for an efficient way of managing these businesses.[5]

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[1] Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2009).

[2] Partnerships and corporations must elect how they will be classified for federal tax purposes. *See* IRS Form 8832: Entity Classification Election (OMB No. 1545-1516) (2013), http://www.irs.gov/pub/irs-pdf/f8832.pdf. LLCs incur corporation-like double taxation at the entity and owner level if they are deemed by the IRS to be "publicly traded." 26 U.S.C. § 7704 (2018).

[3] DEL. CODE ANN. tit. 6, § 18-1101(b) (2018).

[4] *E.g.*, Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J.L. & ECON. 741, 741 (2012) (finding that larger LLCs usually choose Delaware or their home state).

[5] *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 222-26, 232 (2010) (discussing alternative methods to constraint management). *See generally* Terence Woolf, Note, *The Venture Capitalist's Corporate Opportunity Problem*, 2001 COLUM. BUS. L. REV. 473 (identifying conflicts between standard fiduciary duties and

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This governance flexibility can be especially attractive, because other organizational forms, particularly corporations, have a framework of mandatory one-size-fits-all investor protections. Mandatory safeguards can burden parties with a set of unwieldy protections even when those parties could achieve more efficient governance arrangements on their own. Fiduciary duties of loyalty, for example, are required of corporations even though reputational constraints or trust built from repeat relationships may provide more efficient deterrents to misbehavior than law.[6] When the assumption holds that LLC investors[7] are sophisticated entities that protect their interests, a mere default approach that facilitates tailored contracting may make sense.[8]

investment models built on management of multiple funds by a single entity).

[6] Family ties may also provide an excellent deterrent, but closely held family corporations are not exempt from other, costly mandatory protections. *See generally* Benjamin Means, *The Contractual Foundation of Family-Business Law*, 75 OHIO ST. L.J. 675 (2014). Of course, this is not to say that family firms do not encounter issues of their own from time to time. *See, e.g.*, *id.* at 714-17 (addressing the issue of marital divorce in family firms).

[7] Although LLC literature often uses the term "member" instead of "investor," I use "investor" throughout the paper to make clear that the issues I discuss and address are applicable not just to LLCs whose investors are also involved in a non-investor capacity (where the term "member" is often used) but also those LLCs where investors participate solely as passive lenders of capital, resembling investors of public corporations. Indeed, several publicly traded firms are organized as LLCs, with investors who have no additional involvement with the firm. *See, e.g.*, TravelCenters of Am. LLC, 2016 Annual Report (Form 10-K) (Dec. 31, 2016), http://www.annualreports.com/HostedData/AnnualReports/PDF/NASDAQ_TA_2016.pdf. *See generally* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555 (2012) [hereinafter *Contractual Freedom*] (examining a set of publicly traded LLCs).

[8] There are several examples of this assumption being made as an essential component of advancing contractual freedom. *See, e.g.*, Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1063 (Del. Ch. 2006) ("In the alternative entity context . . . it is more likely that sophisticated parties have carefully negotiated the governing agreement . . . ."); Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 479 (2009) ("[N]oncorporate investors are more likely to be financially sophisticated and more likely to seek legal advice in connection with their investment." (footnote omitted)); Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 848 (2001) ("LLCs . . . are usually [formed] with the advice of counsel."); Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 197, 206 (Andrew S. Gold & Paul B. Miller eds., 2014) ("[T]he parties [to LLCs] are more likely to be fully informed and sophisticated . . . ."); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnership and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 9 (2007) [hereinafter *Judicial Scrutiny*] ("Absent evidence to the contrary, it must be assumed that passive investors who authorize, in the unincorporated business entities' enabling

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LLCs' flexible governance approach has gained significant traction, but it is not without its critics. These critics focus on the negative effects from combining mere default protections with less sophisticated owners who undervalue owner safeguards. There are no minimum standards for who can become an owner of an LLC, and a series of cases has shown the perverse consequences that can result when an entrepreneur induces other investors to sign away fundamental protections without appropriately valuing those protections — as when they undervalue these provisions' importance, do not understand what the legal terms mean, or simply do not read the documents they sign. These investors join the LLC with certain assumptions about how the company will operate, using these assumptions to form the basis of their investment valuation, only to have those assumptions later dashed by the entrepreneur when contractual reality later arises.

The consequences from this situation can be severe. Not only have investors lost money on their particular investment, but also those unexpected losses may either deter them from investing in future projects or lead them to hire legal representation, either of which systematically raises the cost of capital and reduces economic activity.[9] Moreover, the LLC that attracted investors based on misguided owner-protection assumptions was able to raise capital at reduced rates that did not reflect the true cost of capital, resulting in inefficient investment allocations across firms. Corporation-style mandatory protections that cannot be cut back or eliminated protect against these negative consequences.

The following example makes the point, based upon a recent New York case.[10] Phoebe, a budding real estate developer, forms an LLC with herself as majority owner and several small investors. The minority investors each contribute capital ranging from $5,000 to $25,000, but because of the modest individual contribution amounts, few seek legal advice before investing. After a year of mediocre

documents, the elimination or restriction of one or more fiduciary duties are fully informed of the risks and benefits.").

[9] Indeed, this uncertainty over LLC protections is traditionally seen as a reason for corporations' continued use by entrepreneurs who anticipate venture capital funding. *See, e.g.*, Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681, 689 (2013); Joe Wallin, *12 Reasons for a Startup Not to Be an LLC*, STARTUP L. BLOG (Sept. 30, 2011), http://www.startuplawblog.com/2011/09/30/12-reasons-for-a-startup-not-to-be-an-llc.

[10] The example is inspired from the complaint filed in *Ma Carmine, LLC v. Alrose Carmine, LLC*, No. 158625/2014 (N.Y. Sup. Ct. Sept. 4, 2014), which alleged a similar shift in focus from real estate development to operation of a restaurant.

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returns, Phoebe, inspired by the Food Network, decides to liquidate the company's assets and use the proceeds to acquire and operate a floundering seafood restaurant, with ingredients supplied at inflated prices by Phoebe II LLC, a separate entity controlled by Phoebe. The minority investors who now find themselves unhappy owners of a seafood enterprise, rather than the real estate company in which they might have had comparative expertise, decide to review the governing documents to determine their rights. Unfortunately, they discover only bad news. The documents specify that the company can pursue "any lawful purpose," not just real estate investing. The manager is elected by majority vote, so Phoebe as controlling shareholder unilaterally determines the outcome. Managers' duty of loyalty has been waived, so the related party transaction with Phoebe II cannot be successfully challenged. The governing documents cannot be changed without majority consent, so the minority owners cannot alter the provisions without Phoebe's permission. Adding the final insult, owners have no right to withdraw assets or seek judicial dissolution of the company, so minority owners are locked into the company indefinitely, and their future rests on Phoebe's next whim.

The example shows just some of the negative consequences that can result when parties invest against a backdrop of mere default protections. While corporate law makes these rights mandatory for corporations, states' — particularly Delaware's — commitment to LLC contractual freedom has resulted in courts enforcing waivers of these foundational rights.[11] This stance may be justified when parties are sophisticated or represented by able legal counsel. However, when this assumption breaks down — as it has repeatedly in recent years — problems can arise.[12]

[11] *See, e.g.*, Zimmerman v. Crothall, 62 A.3d 676 (Del. Ch. 2013) (enforcing duty of loyalty waiver that allowed managers to be on both sides of transaction); R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008) (enforcing waiver of right to seek judicial dissolution); *In re* Seneca Invs. LLC, 970 A.2d 259 (Del. Ch. 2008) (enforcing change in LLC's business because operating agreement specified "the purpose of the Company is to engage in any lawful act or activity"); Minnesota Invco of RSA No. 7 v. Midwest Wireless Holdings LLC, 903 A.2d 786 (Del. Ch. 2006) (enforcing operating agreement amendment procedure under which majority member could unilaterally amend agreement). LLC owners have no default right to withdraw investments from the LLC. DEL. CODE ANN. tit. 6, § 18-603 (2018).

[12] *See* Pat Andriola, *Leap of Faith: Determining the Standard of Faith Needed to Violate the Implied Covenant of Good Faith and Fair Dealing for Delaware Limited Liability Companies*, 58 B.C. L. REV. E-SUPPLEMENT 1, 1 (2016) ("[I]f their operating agreement so allows, directors of Delaware LLCs are immune from claims such as self-dealing, clandestine profit engorgement, and nepotism, among others.").

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This problem has provoked three general responses. The first is to take a "tough luck" approach: people who invest in LLCs should figure out what they are getting involved in and bear the consequences if they fail to protect themselves in a system of mere default provisions.[13] Neither courts nor legislatures should be imposing mandatory protections to protect minority owners, because this obstructs sophisticated parties' pursuit of economic efficiency. Although this response preserves LLCs' ideal as a creature of contractual freedom, it has been increasingly called into question by pressure from recent cases and research that show the negative consequences that can result from enforcing waivers of fundamental governance terms against sympathetic investors.

The second response argues that Delaware's broad contractual freedom is untenable for the long term; as a result, mandatory minimum owner rights should be imposed on LLCs.[14] Although the precise mandatory protections vary by proposal, they all have in common the benefit that all owners, whether sophisticated or vulnerable, have at least some minimum level of safeguards, with the potential to deter the problems that have recently arisen. While

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[13] *See, e.g.*, Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 179-80 (2006) ("The decision to form a limited partnership or LLC is a choice to adopt a business structure known for its freedom of contract . . . . In effect, by choosing these business forms, with their demonstrated contractual implications, the parties have opted into a textualist mode of interpretation."); Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899 (2011); Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999); Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131; Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Liability Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009); Steele, *Judicial Scrutiny*, *supra* note 8.

[14] *See, e.g.*, SANDRA K. MILLER, LIMITED LIABILITY COMPANIES: A COMMON CORE MODEL OF FIDUCIARY DUTIES (2015); Daniel S. Kleinberger, *Two Decades of "Alternative Entities: From Tax Rationalization through Alphabet Soup to Contract as Deity,"* 14 FORDHAM J. CORP. & FIN. L. 445, 465-71 (2009) (arguing that the LLC should not become a vehicle for transforming fiduciary duties into a set of mere default rules); Benjamin Means, *Contractual Freedom and Family Business*, *in* HANDBOOK ON ALTERNATIVE ENTITIES 40, 40 (Mark J. Lowenstein & Robert W. Hillman eds., 2015) (arguing for a particular need for default and mandatory rules for family businesses); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1611-12 (2004) [hereinafter *Balancing*] (providing an empirical analysis demonstrating a "need for the imposition of judicial remedies for abusive and opportunistic conduct" by fiduciaries); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More than a Decade of Experimentation?*, 32 J. CORP. L. 565, 570-73 (2007) [hereinafter *Experimentation*] (arguing for "mandatory minimum fiduciary duties grounded in statute" to assure reasonable care).

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proponents recognize that LLCs with solely sophisticated owners may suffer as a result of mandatory terms, they argue that these costs are more than outweighed by the benefits of providing basic protections for all LLCs.

A third approach relies on the judiciary to solve problems after they have already arisen. This approach has arguably already started to be implemented by Delaware courts, which have been faced with increasingly inequitable situations in the face of no statutory change.[15] This approach selectively targets only LLCs in need of judicial deterrents and can be an effective way to prevent harm on an ad-hoc basis.

None of these approaches is particularly attractive. Leaving owners to fend for themselves results in misallocations of capital and lower investment when the LLC form is used to extinguish traditional safeguards in ways that go unpriced by unsophisticated investors. However, imposing mandatory protections on *all* owners, regardless of their ability to protect themselves more efficiently through alternative means, undermines a key comparative advantage of the LLC organizational form. Finally, relying on the judiciary to correct problems on a case-by-case basis not only threatens administrative difficulties, but also threatens the predictability that is so important in carrying out long-term business relationships.

Ultimately, unifying the twin goals of protecting everyday investors while providing flexibility to sophisticated ones cannot be achieved with a single set of rules. Instead, this Article suggests dividing LLC protections based on investors' sophistication. Inspired by federal securities law's accredited investor standard, the Article proposes a set of mandatory protections for "unaccredited," less sophisticated LLC owners, while granting considerable contractual flexibility to sophisticated parties to achieve efficient governance arrangements. This approach promises a superior method of preserving governance flexibility while ensuring governance safeguards for investors who need it.

This Article proceeds in four Parts. Part I discusses the LLC statutory framework that provides owners with broad governance flexibility. I review how that framework promises to enhance economic efficiency, because it allows owners to replace statutory protections with more suitable safeguards of their own choosing and design. In doing so, this Part also shows how the law has been applied

[15] *See, e.g.*, *In re* Carlisle Etcetera LLC, 114 A.3d 592 (Del. Ch. 2015) (holding that an assignee lacked standing to seek statutory dissolution of the LLC but had equitable standing to seek dissolution).

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in a variety of recent cases to produce a disturbing series of holdings furthering the potential to take advantage of owners. This trend has highlighted the fundamental incompatibility between default protections and unsophisticated investors, setting the stage for current reform proposals.

Part II identifies and analyzes the existing suggestions for reform. These responses generally follow one of three approaches: do nothing, impose mandatory protections by statute, or address problems on an ad-hoc basis when they emerge. This Part shows how each of these approaches has significant downsides. Doing nothing not only risks capital allocation and capital cost problems, but also seems increasingly untenable as courts encounter ever more situations in need of a remedy. Imposing mandatory rules saddles some firms that have solely sophisticated owners with costly protections they might not want or need, constraining LLCs' potential to reach new heights in economic efficiency. Overly burdensome mandatory rules undermine the key comparative advantage of the LLC organizational form. Finally, relying on the judiciary makes enforcement of LLC governance agreements inherently unpredictable, which increases uncertainty and capital costs, reducing LLCs' attractiveness.

Part III uses the insights developed in the earlier Parts to propose a new framework — what I call the "qualified LLC system" — for protecting LLC owners, built on principles of the accredited investor standard from federal securities law. As the prior Parts make clear, LLCs currently face pressure because the same law attempts to accomplish two opposed goals. When the rules tilt towards everyday investors by imposing new protections, then sophisticated ones are harmed; when the rules tilt towards sophisticated investors by facilitating governance freedom, then everyday ones are harmed. A single approach that applies regardless of investor type is therefore inherently problematic. I therefore recommend bifurcating LLC law to take into account the differing needs of everyday and sophisticated investors. Those owners that meet sophisticated investor standards can take advantage of the existing law's almost limitless contractual freedom to tailor individualized governance relationships, without mandatory rules or judicial intervention. Those owners that do not meet the standards will enjoy mandatory contractual safeguards similar to those of corporations. By separating the rules based on investor type — and therefore based on investors' need for protection — the qualified LLC system promises to protect owners who need it, while preserving flexibility for owners who can use it to achieve efficient firm governance. This Part fully develops the advantages of

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this system and shows how it might be implemented. Part IV then addresses several objections that might be raised, showing how the framework can mitigate most of the costs that might be expected to arise. I then conclude.

I. LLC CONTRACTUAL FREEDOM

Although business organization law is generally seen as enabling owners to set their own rules for internal governance, LLC statutes take this "enabling" approach to new heights. By discarding mandatory protections that apply to other organizational forms, LLCs are permitted more leeway to craft governance provisions that maximize the efficiency of governance relationships among owners and management.[16] This contractual freedom, however, comes with a risk, stemming from the fact that owners possess few mandatory protections; indeed, in Delaware (the leader for out-of-state LLC formations), owners possess almost *no* mandatory protections.[17] Problems arise when investors make their decision under a mistaken assumption that their stake will have standard protections. This Part provides a background of the LLC contractual freedom approach, discusses its potential benefits and risks, and shows the problems that have recently begun to manifest.

A. LLCs' Contractual Freedom Approach

Although their statutes vary, states generally follow a commitment to freedom of contract with LLC internal governance arrangements, giving owners and managers more leeway to set their own internal governance rules than other types of business organizations afford.[18] Delaware, which has arisen as the standard-bearer of this approach, requires only that owners and managers have an implied covenant of good faith and fair dealing, a remarkably weak constraint that curtails only the most arbitrary or unreasonable conduct.[19] Other familiar

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[16] *See, e.g.*, RIBSTEIN, *supra* note 5, at 132.

[17] Delaware requires that LLCs adopt only the obligation of good faith and fair dealing, a weak protection that is discussed *infra* Section IV.A.1.

[18] *See, e.g.*, LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. 9-6 (2016) (summarizing state LLC law fiduciary waiver provisions).

[19] *See* Nationwide Emerging Managers, LLC v. Northpointe Capital, LLC, 112 A.3d 878, 897 (Del. 2015) ("An interpreting court cannot use an implied covenant to re-write the agreement between the parties, and should be most chary about implying a contractual protection when the contract could easily have been drafted to expressly

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mandatory corporate law protections, such as fiduciary duties, the corporate opportunity rule, mandatory owner approval of fundamental transactions, the right to seek judicial dissolution, and the *Revlon/Unocal* takeover doctrines, apply merely by default to LLCs, with parties given the freedom to waive or modify these protections as desired to suit their individual circumstances.[20]

The justification for LLCs' contractual freedom rests on a recognition that mandatory protections have costs in addition to their benefits. The mandatory corporate opportunity rule from corporate law, for example, protects investors from management's seizure of profitable related activities, but it also effectively eliminates the ability to have the same management group heading related projects, undermining the way that financial and real estate investment funds do business. The mandatory duty of loyalty provides a remedy for self-dealing by management, but that remedy comes at the cost of expensive litigation and deterring actions that can benefit the firm.[21] In these instances where the costs of the protection exceed its benefits, mandatory rules from corporate law saddle firms with inefficient provisions that increase their costs of doing business.[22]

However, when these protections are merely defaults, as with LLCs, parties can eliminate or modify these protections when their costs would exceed their benefits. LLC statutes therefore open up the door to investors to achieve unparalleled heights in governance efficiency, giving them almost limitless freedom to tailor standard protections to their individual circumstances.[23] Profit interests, repeat relationships, and reputational considerations all can, at least sometimes, align

provide for it . . . . When a court implies a term in a contract, much less [a detailed] one, it must be very careful.").

[20] Again, states vary somewhat with their willingness to treat some of these fundamental protections as applying merely by default to LLCs. *See, e.g.*, RIBSTEIN & KEATINGE, *supra* note 18 (summarizing variation in contractual freedom for varying fiduciary duties). For convenience, I will generally consider the case of Delaware, which both permits the broadest range of contractual freedom and which has been the most successful state in attracting LLC formations. *See* Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 512 (2017) [hereinafter *Contracting Around Default Protections*].

[21] *See* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 549 (1997).

[22] For an analysis of how corporations have wielded their limited ability to restrict the corporate opportunity rule, see generally Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1119-40 (2017).

[23] *See* RIBSTEIN, *supra* note 5, at 132; Molk, *Contracting Around Default Protections*, *supra* note 20, at 510.

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owner-manager interests better than can the mandatory corporate law protections of fiduciary duties, the business opportunity rule, or the threat of seeking judicial dissolution.[24]

It is not unusual to see LLC members adopting these substitutes to their advantage.[25] Studies of both public and private LLCs reveal significant rates of cutting back such fundamental rights as traditional fiduciary duties of care and loyalty, the right to seek judicial dissolution, and the ability for management to compete directly with the firm or seize related business opportunities.[26]

Courts have also not been shy about enforcing aggressive waivers, recognizing that "a princip[al] attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business 'relationship' problems."[27] As a consequence, courts like Delaware's, which strongly support LLC contractual flexibility, have routinely upheld waivers of traditional investor protections in a belief that doing so facilitates efficient operating arrangements.[28]

This approach, however, is facing increasing pressure as it becomes clear that LLCs — and their concomitant ability to waive fundamental owner protections — often have *unsophisticated* owners, not just sophisticated ones. Enforcing waivers against unsophisticated owners who fail to protect their interests has the opposite effect, producing inefficient operating agreements that impose serious economic costs

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[24] *See* RIBSTEIN, *supra* note 5, at 153-82.

[25] *See, e.g.*, Limited Liability Company Operating Agreement of Base Village Snowmass Center Associates LLC, Mar. 1, 2007, § 6.4 (waiving liability for fiduciary duty breach in billion-dollar real estate development among repeat co-investors); Second Amended and Restated Limited Liability Company Agreement of Marconi Broadcasting Company, LLC, Mar. 3, 2008, §§ 7.9, 7.18 (waiving corporate opportunity and fiduciary duty protections for multi-million dollar radio broadcasting company).

[26] *See* Manesh, *Contractual Freedom*, *supra* note 7, at 572-83; Molk, *Contracting Around Default Protections*, *supra* note 20, at 522-49; Peter Molk & Verity Winship, *LLCs and the Private Ordering of Dispute Resolution*, 41 J. CORP. L. 795, 800-14 (2016) (examining modifications to the dispute resolution process).

[27] Haley v. Talcott, 864 A.2d 86, 88 (Del. Ch. 2004); *see also* R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318, at *4 (Del. Ch. Aug. 19, 2008) ("It is this flexibility that gives 'uncorporate' entities like limited liability companies their allure.").

[28] *See, e.g.*, Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839 (Del. Ch. 2012) (fiduciary duties); *R & R Capital*, 2008 WL 3846318 (judicial dissolution waiver); Fitzgerald v. Cantor, No. C.A. 16297, 1998 WL 326686 (Del. Ch. June 16, 1998) (waiver of prohibition against competing with LLC).

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not only on those owners, but also on society more broadly. This problem and the accompanying calls for reform are discussed next.

B. The Problems with Contractual Freedom

It is undoubtedly true that relying on individually tailored governance solutions rather than one-size-fits-all mandatory rules will, in some circumstances, promote more efficient governance arrangements. When owners and managers are sophisticated, they can add to and subtract from default protections to suit their individual circumstances most efficiently, rather than working around mandatory corporate-style protections.

Problems can arise, however, when some members of the LLC are less sophisticated investors, who may underestimate the value of contractual protections or might not even realize when they are giving up safeguards in the first place.[29] When protections apply merely by default, nothing prevents parties from reducing or waiving them even when the aggregate gains to members are dwarfed by costs.

But why would parties ever modify protections in a way that imposes more total costs than benefits? Rational parties will push for modifications as long as the personal benefit to those parties exceeds any costs to them, and personal benefits and costs need not track aggregate ones. A manager, for instance, may want a robust business opportunity rule waiver so that she can seize related profitable activities for herself; the LLC, on the other hand, may suffer in that case if she develops these personal profitable activities instead of creating gains for the company as a whole.[30] Yet if the manager can work the waiver into the operating agreement without investors' notice, she can extract gains at the cost of LLC efficiency.

While an efficient bargaining process would preclude this type of outcome — terms that decrease the joint surplus among parties will be bargained away[31] — the bargaining process among members and

[29] Other problems can result if owners *over*estimate the value of inefficient protections. However, these problems will arise regardless of whether protections are mandatory or default, and are therefore not unique to any of the situations discussed in this Article. Moreover, they can be dealt with fairly simply in most circumstances; the LLC is not required to take on prospective investors who overestimate the value of inefficient protections and could instead choose prospective owners who do not have an overestimation problem, assuming a sufficient number exists.

[30] *See, e.g.*, Pappas v. Tzolis, 982 N.E.2d 576 (N.Y. 2012) (involving allegations of this type of behavior).

[31] *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (showing that bargaining will produce efficient outcomes when transaction costs are

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managers to determine LLC governance can be anything but efficient. There is no "sophistication" requirement to become a member in an LLC,[32] and LLCs regularly feature a mix of investors from different backgrounds and levels of expertise.[33] This investor heterogeneity lays the groundwork for sophisticated majority owners to get governance waivers from minority owners who undervalue the protections or who may not even read or understand the documents that contain the contractual waivers. Even if owners choose to be represented by legal counsel, evidence suggests that lawyers may often prove an insufficient solution because of their lack of familiarity with basic LLC issues like governance modifications.[34]

When owners do not protect themselves either on their own or with the assistance of counsel, two significant problems result. First, firms with these investors will operate with inefficient governance provisions, yet, because the investors do not correctly price the governance terms, these firms' cost of capital will not rise to compensate for the organizational terms. In effect, these inefficient firms are subsidized by their less sophisticated owners. The resulting distortion in capital allocation means that investing dollars are not put to their best use, undermining one of the major goals of business and securities law.[35]

sufficiently small).

[32] This is assuming the LLC is not seeking to raise capital through an offering exempt from registration requirements via Rule 504 of SEC Regulation D, which places a $5 million limit on the amount of money raised in any twelve-month period, or via an intrastate offering exemption, which requires all offerees to reside in the offering company's home state. 17 C.F.R. § 230.504 (2018); 15 U.S.C. § 77c(a)(11) (2018); 17 C.F.R. § 230.504 (2018).

[33] *See, e.g.*, Amendment to the Operating Agreement of Alrose Carmine, LLC at 3, Ma Carmine, LLC v. Alrose Carmine, LLC, Docket No. 158625/2014 (N.Y. Sup. Ct. Oct. 16, 2014) (explaining that investors contributed amounts ranging from $10,000 to $500,000); Petition to Dissolve Alrose Carmine, LLC Together with Related Relief, Ma Carmine, LLC v. Alrose Carmine, LLC, Docket No. 158625/2014 (N.Y. Sup. Ct. Sept. 4, 2014) (discussing a venture with approximately sixteen different investors); Verified Complaint: Petition for Judicial Dissolution and Other Equitable Relief at 3, Dean, Dawson et al v. Heartland Ethanol LLC, No, 4421-VCL (Del. Ch. Mar. 13, 2009); Limited Liability Company Agreement of Heartland Ethanol, LLC, Aug. 16, 2007 (showing the investor makeup of an ethanol plant as comprised of a mixture of small farmers and large external investors).

[34] For example, Sandra Miller has found low levels of knowledge and appreciation of several basic LLC governance issues. *See, e.g.*, Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 357 (2003); Sandra K. Miller et al., *An Empirical Glance into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609, 631 (2006).

[35] *See, e.g.*, Hilary J. Allen, *The SEC as Financial Stability Regulator*, J. CORP. L.

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Second, in those cases where owners are later surprised by manager or majority owner behavior that was authorized under the operating agreement, those owners may be less inclined to invest in future companies in the future, fearing similar results to the ones just experienced.[36] When investors lose trust in the securities markets, the cost of capital goes up for all firms — even those that adopt efficient governance provisions — which reduces economic activity, undermining another goal of business and securities law.[37]

It is not difficult to find situations where enforcement of aggressive waivers and modifications have created potentially problematic results. For example, in *R & R Capital v. Buck & Doe Run Valley Farms*, the Delaware Chancery Court found itself confronted by a request for judicial dissolution of a series of LLCs formed to cultivate racehorses.[38] The petitioner investors alleged fraud and self-dealing by the LLCs' management, as well as refusal by management to provide an accounting of the LLCs' assets, leading to intractable problems justifying judicial dissolution.[39] Although judicial dissolution serves the invaluable function of providing a remedy of last resort, hence its mandatory presence in corporations,[40] the Chancery Court enforced

(forthcoming) (manuscript at 16) (noting securities statute amendments that direct the SEC to consider whether actions will affect "efficiency, competition, and capital formation"); Miller, *Experimentation*, *supra* note 14, at 584-85 (showing disparate levels of legal representation between controlling and minority investors).

[36] Alternatively, owners may learn from their mistakes and ensure that future investing projects do not authorize unexpected self-interest. Even if this were to happen — and, since we are concerned with less sophisticated owners, it may be unlikely — the costs associated with identifying and avoiding future problematic investments will be capitalized into higher expected returns demanded by investors, again increasing costs of capital for all firms.

[37] *See* Allen, *supra* note 35; Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L.J. S77, S81-82 (1993); Abraham J.B. Cable, *Mad Money: Rethinking Private Placements*, 71 WASH. & LEE L. REV. 2253, 2263 (2014) (stating that the goals of the regulatory apparatus are capital formation and investor protection); Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 UC DAVIS BUS. L.J. 207 (2013) (addressing the particular harms to investors that securities regulations are designed to prevent).

[38] R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008).

[39] *Id.*

[40] *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1687-88 (1989) (discussing whether courts have inherent judicial authority to dissolve corporate entities). Indeed, several states also require that LLCs have a mandatory judicial dissolution right. Molk, *Contracting Around Default Protections*, *supra* note 20, at 534.

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the LLCs' explicit judicial dissolution waiver, holding judicial dissolution merely a default provision that could be waived by contract.[41] Of course, even without a judicial dissolution remedy, investors often have other protections to safeguard their interests, such as actions for management's breaching fiduciary duties. Unfortunately for the *R & R Capital* investors, the LLCs' operating agreements eliminated these typical safeguards,[42] leaving them only with the weak protection offered by Delaware's single mandatory protection: the implied contractual covenant of good faith and fair dealing, which circumscribes only the most egregious conduct.[43] Unless the management's action rose to this level — a question unaddressed in the opinion[44] — the investors remained locked into the enterprise indefinitely, with no ability to exit.[45]

In another case, *Shapiro v. Ettinson*, the New York Appellate Division unanimously upheld the terms of a written operating agreement adopted two years after the LLC's formation, which apparently contradicted the parties' initial verbal agreement and did not have the consent of one of the LLC's three equal member-managers.[46] The newly adopted operating agreement allowed a

[41] *R & R Capital*, 2008 WL 3846318, at *1.

[42] *See, e.g.*, Buck & Doe Run Valley Farms, LLC Operating Agreement, Dec. 6, 2004, § 4.4 ("It is the intent of this Section 4.4 to restrict the fiduciary nature of the Manager's duties and liabilities hereunder to the maximum extent permitted under applicable law.").

[43] *R & R Capital*, 2008 WL 3846318, at *7; *see also* Molk, *Contracting Around Default Protections*, *supra* note 20, at 512.

[44] *R & R Capital*, 2008 WL 3846318, at *7.

[45] This is not the only case where courts have enforced a waiver of the right to seek judicial dissolution. For example, in *Huatuco v. Satellite Healthcare*, the Delaware Chancery Court held petitioner investors had no right to seek judicial dissolution where the operating agreement, in introductory language, stated that "[e]xcept as otherwise required by applicable law, the Members shall only have the power to exercise any and all rights expressly granted to the Members pursuant to the terms of this Agreement" and then did not grant an explicit judicial dissolution right. Huatuco v. Satellite Healthcare, No. 8465-VCG, 2013 WL 6460898, at *3 (Del. Ch. Dec. 9, 2013). Such a "waiver" is even more problematic for the unwary investor, as it functions as an implicit waiver that requires investors to know of the default judicial dissolution right for them to recognize it as a waiver, rather than the explicit waiver of *R & R Capital*. For an excellent discussion of this difference, see Peter Mahler, *Contractarianism Gone Wild?*, FARREL FRITZ ATT'YS (Jan. 6, 2014), http://www.nybusinessdivorce.com/2014/01/articles/delaware/contractarianism-gone-wild-in-delaware.

[46] Shapiro v. Ettinson, 45 N.Y.S.3d 439, 439 (N.Y. App. Div. 2017). For a summary of the case at its trial and appellate levels, see Peter Mahler, *Thinking About Becoming a Minority Member of a New York LLC Without an Operating Agreement?*

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majority of members to reduce the ownership interest of any member who did not satisfy new majority-approved capital calls.[47] The agreement also allowed a majority of member-managers to determine managerial salaries.[48] Contemporaneously with a falling-out, two member-managers voted to reduce the third's salary to zero and for a capital call that could reduce the third's ownership stake.[49] The Court upheld the validity of the agreement, reasoning that in New York, operating agreements by default can be adopted or amended by mere majority vote.[50] The effect of the ruling, therefore, was to lock the minority member into an investment that was completely subject to the whims of the majority members and apparently contrary to the initial agreement among the parties at the time the business was formed.[51]

These cases are not outliers; LLC operating agreements frequently reduce or eliminate fundamental owner protections,[52] with disputes over these modifications a regular matter.[53] The full range of problems familiar in corporate law, ranging from minority oppression, to self-dealing, to violating fiduciary duties, arises with a vengeance in LLCs, because the standard backstop protections of corporate law are not mandatory in permissive LLC states like Delaware. The consequence has been several cases with unsophisticated investors who find themselves locked into an unpleasant, unexpected investment with little meaningful means of extraction or protection.[54]

Think Again, FARREL FRITZ ATT'YS (Jan. 30, 2017), http://www.nybusinessdivorce.com/2017/01/articles/capital-call/thinking-becoming-minority-member-new-york-llc-without-operating-agreement-think.

[47] *Shapiro*, 45 N.Y.S.3d at 439.

[48] *Id.*

[49] Shapiro v. Ettenson, No. 653571/2014, 2015 WL 5096026, at *2 (N.Y. Sup. Ct. Aug. 16, 2015), *aff'd as modified*, 45 N.Y.S.3d 439 (2017).

[50] *Id.*

[51] *See id.* Notably, unlike Delaware, New York has not yet been willing to enforce waivers to seek judicial dissolution, although the issue has not yet been decided by its appellate courts. *See, e.g.*, Youngwall v. Youngwall Realty, No. 2266-07, 2008 WL 827916 (N.Y. Sup. Ct. Mar. 14, 2008) (granting the petitioner relief through dissolution).

[52] For a comprehensive analysis of these issues, see Molk, *Contracting Around Default Protections*, *supra* note 20.

[53] For particularly egregious examples of these disputes, see Peter Mahler's blogs in NEW YORK BUSINESS DIVORCE, http://www.nybusinessdivorce.com (last visited Jan. 15, 2018).

[54] *See generally* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11, 25-26 (Robert W. Hillman & Mark J.

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This problem has not gone unnoticed, spurring many to recommend corrective action of some sort. The following Part reviews the existing suggestions, showing the ways that these approaches are ultimately unsatisfying.

II. THE TRADITIONAL SOLUTIONS

Proposals for reform follow one of three general approaches. One approach is to do nothing. Another would impose on LLCs mandatory rules that provide the protection owners need. The third approach would maintain LLCs' nominal contractual freedom but subject them to judicial modification as needed, on a case-by-case basis.

As the following Part argues, none of these approaches is particularly satisfying. The first ignores the increasing problems that result from everyday investors participating in LLCs with a moth-eaten patchwork of protections. The second undermines a key LLC comparative advantage by unnecessarily sacrificing governance flexibility to protect certain unsophisticated owners. The third, while more narrowly tailored to those exceptional circumstances in which intervention is warranted, forfeits the predictability and stability that is so valuable in business law, while also offering a remedy only some of the times when it would be needed.

A. Do Nothing

The first response to calls for LLC reform is to ignore them and do nothing. Devotees of the contractual freedom approach advocate upholding the default protection system even in the face of its apparent costs, arguing that the benefits from efficient LLC operating agreements more than outweigh any alternative system that restricts this contractual freedom.[55]

Yet while preserving LLCs' flexible governance relationships brings undeniable benefits, the costs of this approach have grown increasingly visible and increasingly vexing. LLCs have mimicked their corporate law cousins in finding new and surprising ways to eliminate traditional owner safeguards, generating problems that have become increasingly visible in recent years.[56] LLCs have also

Lowenstein eds., 2015) ("[C]ontractual liability standards have generated judicial decisions that leave investors with no remedy because of the court's need to be faithful to the contract, even in circumstances when the court itself harbored serious doubt that the alternative entity had gotten a fair shake.").

[55] *See, e.g.*, *supra* note 13.

[56] For example, corporations have recently begun limiting shareholder litigation

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increasingly been used as an organizational tool by everyday investors, who have little regard for the governance implications from choosing the form.[57] The *R & R Capital* and *Shapiro* cases are just two prominent examples of the consequences that can result. As LLCs increase the space of provisions eligible for elimination, so too do the costs from utmost fidelity to contractual freedom.

Moreover, the "do nothing" response has become increasingly untenable as a practical matter. Delaware courts and jurists — historically the defenders of contractual flexibility — have now begun evidencing an apparent retreat from their earlier commitment to LLC contractual freedom. For example, Chief Justice Strine and Vice Chancellor Laster, in a recent academic work, lament how LLCs' default rule approach often leaves "invest[ors] without adequate protection against self-dealing" and propose a system with mandatory protections, including the duty of loyalty, for at least publicly traded LLCs.[58] And in 2015 the Delaware Chancery Court, in *In re Carlisle Etcetera*, refused to enforce an LLC's contractual waiver of the right to seek judicial dissolution, finding judicial dissolution to be a mandatory equitable right vested in the Court despite apparent statutory language to the contrary.[59] Several other recent cases reflect a similar willingness for judges to intervene and protect owners in warranted circumstances.[60] With Delaware Justices and Chancellors calling for reform and the courts apparently taking matters into their own hands, doing nothing may no longer be an option.

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through terms in their charters and bylaws. Verity Winship, *Shareholder Litigation by Contract*, 96 B.U. L. REV. 485, 487 (2016). For the ways that LLCs have followed suit, see Molk & Winship, *supra* note 26.

[57] *See* Chrisman, *supra* note 1 (documenting the rise of LLCs).

[58] Strine & Laster, *supra* note 54, at 12. Strine and Laster also contemplate extending these protections to certain private entities, as well as to LLCs more broadly. *Id.* at 13 n.5; *see also* Christine Hurt, *The Private Ordering of Publicly Traded Partnerships* (J. Reuben Clark Law Sch., Brigham Young Univ., Research Paper No. 17-13, 2017), https://ssrn.com/abstract=2969175 (arguing for special protections for publicly traded limited partnerships and LLCs).

[59] *In re* Carlisle Etcetera LLC, 114 A.3d 592, 594 (Del. Ch. 2015). *See generally* Mohsen Manesh, *Equity in LLC Law?*, 44 FL. ST. L. REV. (forthcoming 2017) [hereinafter *Equity*] (providing an excellent summary of the case and its implications).

[60] *See, e.g.*, Huatuco v. Satellite Healthcare, No. 8465-VCG, 2013 WL 6460898 (Del. Ch. Dec. 9, 2013) (alluding to a potential mandatory equitable dissolution right). *See generally* Mark J. Loewenstein, *Freedom of Contract for Alternative Entities in Delaware: Myth or Reality?*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS, *supra* note 54, at 28, 30-31 (identifying several examples of this tendency involving alternative entities).

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B. Mandatory Protections

The next conventional solution for the LLC problem would require mandatory minimum protections for LLCs across the board. These solutions tend to focus on mandatory fiduciary duties.[61] For example, Justice Strine and Vice Chancellor Laster have suggested imposing a mandatory duty of loyalty on LLCs.[62] Sandra Miller has argued for imposing mandatory fiduciary duties of loyalty and care, with a limited ability to tailor these duties to individual circumstances.[63] Daniel Kleinberger has similarly advocated in favor of mandatory fiduciary duties, arguing that contractual substitutes provide an insufficient constraint against management misconduct.[64]

Imposing mandatory protections on all LLCs ensures that all investors in these companies have at least a minimum baseline level of governance protections. If we are worried that *all* investors give up safeguards in inappropriate circumstances, then this solution makes sense, since it would completely prevent this undesirable outcome from occurring. Similarly, if only *some* investors fall victim to this problem, but it is difficult to identify those investors and the costs are severe, then a blanket rule that applies to all LLCs may also make sense, since its benefits could more than outweigh the costs of imposing protections on those who do not need them.

However, it appears that neither of these conditions holds. Investors across the board certainly do not need mandatory governance protections. LLCs are used in a range of business lines by very sophisticated players precisely because of those players' ability to fend for themselves and put in place more efficient, individualized governance protections than blanket mandatory ones could provide; the worry, then, is not about *all* investors.[65] Additionally, there are a

[61] Although they focus on the role of fiduciary duties, we might also imagine advocates recommending the introduction of other mandatory protections from corporate law, such as investors' right to approve certain fundamental business transactions, or dissenters' rights. For discussion of these protections applied in the LLC context, see *infra* Section III.C.

[62] Strine & Laster, *supra* note 54, at 27 (LLC operating agreements "seem to achieve little in terms of wealth creating efficiency beyond what can be achieved under current broadly enabling corporate law statutes . . . . [I]t is not clear why, as a matter of systemic efficiency, much less fairness, that the fiduciary duty principles of loyalty that apply in the corporate context should be subject to elimination."). They also consider a mandatory duty of loyalty for only publicly traded and certain privately held LLCs. *Id.*

[63] *See* Miller, *Experimentation*, *supra* note 14, at 600-14.

[64] Kleinberger, *supra* note 14, at 465-71.

[65] *See generally* RIBSTEIN, *supra* note 5, at 222-34 (discussing a range of

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variety of ways, discussed in Section III.C.1, that could do a reasonably good job identifying only those investors who need protections; the worry, then is also not that only *some* (hard to identify) investors need protecting.[66]

Moreover, there are real costs from a system that requires certain mandatory protections in all LLCs. LLCs have three main attractions: their limited liability, their tax treatment, and their contractual flexibility to tailor governance relationships to individual circumstances. Mandatory rules take the third attraction away, leaving LLCs as little more than corporations or limited liability partnerships with a different name. The dramatic rise of LLCs in a variety of industries, with sophisticated investors and individualized agreements,[67] suggests that this third attraction has significant value that should be eliminated only as a last resort. Mandatory protections for all, therefore, are not a very attractive solution.

C. Protection via the Judiciary

The third suggested way of addressing LLC governance relies on the judiciary to step in and prevent undesirable outcomes when they arise. Courts have evidenced an increased tendency to embrace this approach in recent years.[68]

For example, in *Huatuco v. Satellite Healthcare*, Delaware Vice Chancellor Glossock hinted at a willingness to provide a judicial dissolution backstop in the face of contractual waivers, noting that the alternative could leave "irreconcilable members locked away together forever like some alternative entity version of Sartre's Huis Clos."[69] Vice Chancellor Laster later explicitly upheld parties' ability to seek judicial dissolution as a mandatory right grounded in equity in *In re Carlisle Etcetera LLC*, available "when equity demands."[70]

circumstances where this is the case); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289 (2009) [hereinafter *Partnership Governance*] (analyzing private equity firms).

[66] *See infra* Section III.C.1.

[67] *See, e.g.*, Molk, *Contracting Around Default Protections*, *supra* note 20, at 556 ("[U]ndoubtedly some sophisticated parties are bargaining for efficient operating agreements, and the only way this bargain can be accomplished is through a system of default, but not mandatory, protections.").

[68] *See, e.g.*, Manesh, *Equity*, *supra* note 59 (discussing the history of Delaware courts' equitable intervention and predicting that Delaware courts will continue to exercise equitable remedies to modify operating agreements when needed).

[69] Huatuco v. Satellite Healthcare & Satellite Dialysis of Tracy, LLC, No. 8465-VCG, 2013 WL 6460898, at *1 n.2 (Del. Ch. Dec. 9, 2013).

[70] *In re* Carlisle Etcetera LLC, 114 A.3d 592, 605-06 (Del. Ch. 2015).

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As opposed to blanket mandatory protections, a case-by-case analysis by the judiciary offers the benefit of providing narrow protection only when warranted. In theory, a tailored judicial approach preserves governance flexibility for those who can handle it, while problems are still constrained by courts when necessary. Judicial intervention could therefore allow LLCs to continue as a flexible organizational form for sophisticated parties, with appropriate protections for those who require it to prevent inefficient or inequitable outcomes.

On the other hand, case-by-case judicial intervention introduces its own uncertainties. With judges' willingness to intervene determined by individualized facts and circumstances, it becomes difficult for investors to know whether their governance relationships could be completely upended with the stroke of a judicial pen.[71] Uncertainty in business law is, of course, undesirable, acting to undermine the advantages of flexible contracting that LLCs currently offer.[72]

Moreover, individualized judicial inquiry is expensive to administer. Parties must litigate not only to enforce their rights (as in a typical case) but also to determine what their rights even are, via a judge's willingness to intervene. These heightened costs not only increase the burden on the judiciary, but also increase the expected costs that LLC investors face, again reducing the attractiveness of the form.

Finally, there is the pragmatic worry that the judiciary may intervene too often, providing a remedy when not required, or that the judiciary will not intervene often enough, undercutting its effectiveness. Identifying cases where a remedy is appropriate is no easy feat, so we might expect a reasonable degree of judicial error. The more significant this error is, the less effective this approach will be.

Just as with mandatory protections, therefore, there are meaningful drawbacks with having the judiciary provide protections and remedies on a case-by-case basis. These downsides, particularly the loss in predictability that judicial uncertainty adds, could threaten the continued viability of the LLC form, particularly among sophisticated investors who choose it for creative governance arrangements. So again, this solution should be chosen only after alternatives have been carefully considered and discarded.

[71] *See* Steele, *Judicial Scrutiny*, *supra* note 8, at 31 ("[W]hy should courts seek to incorporate uncertainty, inconsistency, and unpredictability into the world of negotiated agreements?").

[72] *See id.*

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There are, of course, a variety of alternatives, several of which I develop and analyze in other work.[73] The remainder of this Article develops a new proposal that unites LLC law's twin goals of providing a form suitable for everyday and for sophisticated investors.

III. A QUALIFIED LLC SYSTEM

The inherent problem with LLCs stems from the form's attempting to accommodate two diametrically opposed interests. On the one hand, LLC law is designed to provide contractual flexibility explicitly aimed at sophisticated investors capable of protecting themselves without mandatory legal rules. On the other hand, any investor is allowed to participate in an LLC regardless of her sophistication level or ability to protect her interests. When framed this way, the problem presents two apparent solutions: restrict contractual flexibility to protect everyday investors, or restrict who can invest in potentially risky LLCs that have contractual flexibility.

As discussed above, solutions have focused on the first element by recommending restricting contractual flexibility in favor of mandatory protections or a judicial backstop. The potential solution of limiting who can invest in risky LLCs has been ignored. This oversight is surprising, because the exact same problem exists in another prominent area of business law: the offer and sale of securities offerings. The SEC requires that securities be registered before being sold to the public as a means of protecting everyday investors. Registration ensures that investors in these offerings have certain adequate minimum protections, through disclosure of various terms as well as the force of securities laws that apply to registered securities.[74] However, recognizing that some investors do not require the SEC's protection and that registration is expensive, certain securities can be "unregistered" and sold, without this protection, to sophisticated

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[73] *See, e.g.*, Peter Molk, *More Ways to Protect LLC Owners and Preserve LLC Flexibility*, 51 UC DAVIS L. REV. ONLINE 181 (2018) (analyzing the potential of self-regulation, market forces, lawyers, and disclosure systems to solve the problem).

[74] SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) ("The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions."). In addition to disclosure requirements, registration brings special anti-fraud and strict liability for failure to comply with registration requirements. *See, e.g.*, 15 U.S.C. §§ 77k, 77l(a)(1), 77l(a)(2) (2018). In addition, some state-based securities regulation laws explicitly engage in merit-based regulation, where securities deemed unsuitable for investment by the general public are not allowed. *E.g.*, Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 105 (1987).

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investors who can fend for themselves.[75] Investor eligibility to buy unregistered securities is accomplished primarily through the "accredited investor" standard, which effectively determines which investors are deemed sophisticated enough to participate in risky unregistered offerings, while shutting off these opportunities from unsophisticated investors.[76]

Given the similar problem existing for LLCs — some owners can fend for themselves when negotiating owner protections, and some cannot — it is not surprising that the solution that works so well in the securities context would also provide a solution for LLCs. This Part shows how adapting the securities law accredited investor approach provides an ideal way to both preserve contractual freedom for sophisticated LLC owners who most benefit from it, while ensuring that less sophisticated investors are still adequately protected. Such a system would continue LLC statutes' commitment to governance flexibility, but only when LLCs have exclusively sophisticated owners capable of protecting themselves — what we might think of as analogous to an unregistered securities offering. LLCs with sophisticated investors would be allowed to elect a "qualified" status in their organizational documents, much as closely held corporations in several states can elect "close corporation" status.[77] Opting into this status would provide its owners with the full panoply of contractual flexibility that LLCs currently have. On the other hand, this system would impose minimum mandatory protections if the LLC has owners unlikely to protect themselves or appropriately value governance modifications — analogous to registered securities offerings. LLCs with these owners would be ineligible for "qualified" treatment, and their owners would be protected by a set of mandatory rules that ensures a minimum safeguard against later management misconduct, much as exists for corporate law today.

This model would therefore bifurcate the market for LLCs into two segments. In this way, the model would harmonize the divergent interests of protecting LLC owners while preserving LLC efficiency. LLCs would remain available to all investors and entrepreneurs on the one hand, but only the sophisticated investors who presumably can

[75] *See, e.g.*, 17 C.F.R. §§ 230.504, .506 (2018) (allowing companies to sell unregistered securities after complying with particular rules).

[76] The term "accredited investor" is defined in Rule 501 of the 1933 Securities Act. 17 C.F.R. § 230.501(a) (2018).

[77] *See, e.g.*, CAL. CORP. CODE § 158 (2018) (allowing corporations to opt into close corporation statutes if it has at most thirty-five shareholders of record).

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better protect themselves would be able to alter fundamental owner protections.

The remainder of this Part expounds more fully on the similar problem faced by LLCs and securities registration, discusses rationales for the accredited investor standard in securities law, and shows how this standard could fruitfully be applied to LLCs.

A. The Sophistication Problem for LLCs and Securities Law

The central problem facing LLCs is that the law that facilitates efficient bargaining for governance terms by sophisticated owners also applies equally to everyday investors who do not appreciate or appropriately value owner protection waivers. LLCs' non-mandatory "protection by default" approach that facilitates individualized drafting means that these everyday investors may have no minimum baseline level of protection upon which they can rely. LLCs can thereby be thought of as the "Wild West" for investors, where almost anything goes for the suite of protections the firm chooses to adopt (or not).

The securities realm also has a "Wild West" of its own: unregistered offerings, which do not carry the full standard protections offered by the 1933 Securities Act. Certain securities transactions "not involving any public offering" are relieved from federal registration requirements because, among other reasons, there is little need for the Securities Act's protections to apply to these securities if investors are otherwise capable of protecting themselves.[78] Avoiding the costs associated with the registration process brings the potential for companies to raise funding on cheaper terms than would otherwise be possible through registered offerings.

Policymakers recognize that making unregistered securities available to any investor, including those lacking the sophistication or means to protect themselves, could have seriously negative results. Unlike the LLC context, however, federal securities law squarely addresses the problem, by restricting the purchase of unregistered securities to investors who are deemed to meet a minimum sophistication threshold generally determined by the accredited investor standard.[79] I discuss the mechanics of this accredited investor standard next.

[78] 15 U.S.C. § 77d(a)(2) (2018) (providing exemption); *see also* H.R. REP. NO. 73-85, at 2, 5 (1933) (articulating the original rationale for this exemption).

[79] Certain unregistered securities offerings can also be sold to non-accredited investors if they are relatively small in size: up to $5 million over a twelve-month period can be sold to an unlimited number of non-accredited investors. 17 C.F.R. § 230.504 (2018).

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B. Securities Law's Accredited Investor Standard

Ever since the Securities Act was initially passed in 1933, there has been a recognition that not all investors require the protections embodied in the Act.[80] Exempting securities offerings and sales to those investors from registration requirements allows for more efficient offerings by saving the costs associated with registration. Securities law has over eighty years' experience grappling with how to distinguish between investors who do and do not require the protection inherent in the Securities Act.

The goal of exempting certain offerings from the Securities Act's registration requirements is to separate out investors who could fend for themselves, allowing these investors to participate in unregistered securities offerings that lack the full protection of the Securities Act of 1933.[81] Early on, the SEC focused exemption only on attributes of the offering, including the size and manner of the offering, the number of offerees, and the relationships among offerees and between offerees and the issuer.[82] Characteristics of investors, such as their relative sophistication or their ability to protect themselves, were largely ignored.[83] The Supreme Court stepped into the fray in 1953 and began to focus attention on investors in *SEC v. Ralston Purina Co.*, where it held that registration requirements turned on whether the sale was to "those who are shown to be able to fend for themselves" and hence do not require the Securities Act's full protection.[84] According to the Supreme Court, these individuals could be identified as those who, among other things, "have access to the kind of information which registration would disclose."[85] Although access to information resolved the specific factual scenario before the court, the contours of additional investor characteristics that might justify exemption were left undefined.

After *Ralston Purina*, courts and the SEC continued to fill in the gaps of this doctrine, generally focusing on access to information and

[80] H.R. REP. NO. 73-85, at 2, 5 (noting that some transactions have "no practical need" or offer "public benefits [that] are too remote" to warrant protection).

[81] For additional discussion of the accredited investor standard's origins, see C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1120-24; Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3417-22 (2013).

[82] Determining Availability of Registration Exemption Under Second Clause of Section 4(1), Securities Act Release No. 33-285 (Jan. 24, 1935).

[83] *See id.*

[84] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

[85] *Id.* at 127.

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sophistication of the investor. For example, the Fifth Circuit, in *Doran v. Petroleum Management*, determined eligibility to participate in an unregistered offering by balancing access to and disclosure of information with the sophistication of parties, holding that some degree of both information disclosure and sophistication were required.[86] The SEC also promulgated Rule 146 in 1974, which looked to an investor's ability to afford a loss in investment value and whether the investor had the ability to evaluate the investment, either based on her own sophistication or on access to a financial advisor.[87] The goal of the Rule was to provide increased certainty for determining which investors qualify for exempt offerings,[88] but its subjectivity and ambiguity from failing to define "sophistication" left a need for certainty.

The SEC ultimately responded in 1982 by issuing Rule 506, which provided an objective safe harbor for the definition of "sophisticated investor" via the new "accredited investor" standard.[89] Rule 506 continues to be the main avenue by which exempt offerings are sold today. Under Rule 506, issuers could offer and sell an unlimited amount of securities to an unlimited number of investors who satisfy minimum wealth requirements,[90] currently those having either $1 million of assets excluding the value of their primary residence, or else those having individual incomes of at least $200,000 (or $300,000 joint spousal income) in each of the last two years with a reasonable expectation of the same in the current year.[91]

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[86] Doran v. Petroleum Mgmt., 545 F.2d 893, 905 (5th Cir. 1977).

[87] 17 C.F.R. § 230.146 (1976), *repealed and replaced by* 17 C.F.R. § 230.506 (1988).

[88] *See* Notice of Adoption of Rule 146, Securities Act Release No. 33-5487, 39 Fed. Reg. 15,261, 15,262 (May 2, 1974) (noting that the rule should "reduce uncertainty to the extent feasible and provide more objective standards upon which responsible businessmen may rely in raising capital").

[89] 17 C.F.R. § 230.506 (1988).

[90] *Id.* (2018).

[91] 17 C.F.R. §§ 230.501(a)(5), (a)(6) (2018). Rule 506 also permits sales to up to thirty-five investors who satisfy subjective sophistication requirements, but because of the uncertainty associated with a subjective standard and the consequences of failing to comply with registration requirements, these sales happen rarely. 17 C.F.R. § 230.506 (1988) (stating that each non-accredited investor must, either on his own or through a purchaser's representative, have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment"); Rodrigues, *supra* note 81, at 3421 (noting that "because of the[] risks, issuers have used [this exemption] sparingly").

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Rule 506 has thus transformed the accredited investor standard into a modern "equation of wealth and sophistication" by the SEC.[92] Those who meet wealth requirements are deemed able to participate in riskier, unregistered securities offerings, because wealthy investors are more likely to be sophisticated in their own right or, if not, at least more likely to seek sophisticated legal counsel to protect their interests.[93]

Although the wealth approach to exemption is easily implementable and offers much-needed predictability, money is a noisy proxy for sophistication.[94] Some wealthy investors could likely benefit from the Securities Act's protections, while some non-wealthy investors undoubtedly could handle unregistered offerings' risk. Unsurprisingly, alternative recommendations have been made to separate out more accurately those sophisticated investors who do not require full Securities Act protection, and who therefore should be allowed to participate in unregistered offerings.[95] Wealth continues as the

[92] Rodrigues, *supra* note 81, at 3422. The accredited investor standard is not the only place where wealth is used to divide sophisticated from regular investors. Both the qualified institutional buyer status (which allows for comparatively easy resale of unregistered securities) and the qualified purchaser status (which allows investment funds to avoid application of the Investment Company Act of 1940) are conditioned on wealth or assets. 15 U.S.C. § 80a-2(a)(51) (2018) (defining qualified purchaser status as requiring $5 million in investments); 17 C.F.R. § 230.144A(a) (2018) (defining qualified institutional buyer status, which requires a company to have $100 million in investments).

[93] *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" 2 (2015) (noting that the accredited investor definition was "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary"); Fletcher, *supra* note 81, at 1124 (claiming that "the SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naïve, do not need the protection of the 1933 Act's registration provisions"); Tao Guo et al., *The Unsophisticated Sophisticated: Old Age and the Accredited Investors Definition*, t.2 (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2634818 (finding accredited investors score higher than unaccredited investors on financial literacy tests); Seth C. Oranburg, *Democratizing Startups*, 68 RUTGERS U. L. REV. 1013, 1028 (2016) (describing the accredited investor standard as a "proxy for sophistication").

[94] *See* Rodrigues, *supra* note 81, at 3422 (noting the "underinclusiveness" and "overinclusiveness" from using wealth as a proxy for sophistication). *But cf. id.* at 3425 (summarizing most legal scholars' analysis as "arguing that, even if wealth is a weak proxy for sophistication, at least accredited investors . . . can bear the loss").

[95] One of the more popular alternatives would require investors to pass a financial literacy test before being allowed to invest in unregistered offerings. *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 311 (2000) (requiring a license prior to investing, which would be contingent upon

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separation tool of choice, however, as it provides a reasonable objective proxy for investor sophistication that is both readily verifiable and relatively inexpensive to administer. Through this accredited investor standard, securities law divides the marketplace into two types of investors, making risky investments available only to those more likely to be capable of protecting themselves.

Using a similar approach, LLC investors could also be divided into two types, making risky LLCs — those with almost limitless contractual freedom to alter investor protections — available only to those investors more likely to protect themselves. Adopting this approach allows for a robust protection of less sophisticated investors, while opening up contractual freedom to sophisticated investors who are most likely to use it to tailor efficient operating agreements. I develop this approach next.

C. *Designing the Qualified LLC System*

It is not surprising that the accredited investor standard has useful implications for addressing LLCs' investor problem. Securities law's accredited investor standard has been very successful, remaining in place relatively unchanged over three decades, and it has also been adopted by major economies around the world.[96] Given the similar

investors demonstrating sufficient knowledge about financial risks posed by issuers); Wallis K. Finger, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 759-60 (2009) (proposing a test to measure "an investor's knowledge and experience in financial and business matters"); Syed Haq, *Revisiting the Accredited Investor Standard*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 59, 77 (2015). This is not the exclusive bright-line alternative; indeed, Rule 506 allows a limited number of low-wealth investors to participate in unregistered offerings if they are executives at the company offering investments. *See* 17 C.F.R. § 230.501(a)(4) (2018) (defining accredited investors to include directors, executive officers, or general partners of the issuer). Others advocate a bright-line approach that allows *any* investor to buy unregistered offerings, with low caps placed on the amount of their wealth they could invest in this manner. *See* Cable, *supra* note 37, at 2281-84; Greg Oguss, *Should Size or Wealth Equal Sophistication in Federal Securities Laws?*, 107 NW. U. L. REV. 285, 314 (2012). This is the approach generally followed by new federal crowdfunding exemptions, but it would not be particularly helpful in the context of LLCs, since the form is commonly used by entrepreneurs who invest significant percentages of their net worth when starting up new enterprises. 17 C.F.R. § 227.100(a) (2018) (imposing limits of the greater of $2,200, or either five percent or ten percent of annual income or net worth).

[96] *See, e.g.*, Felipe G.C. Prado, *Restricted Offerings in the U.S. and in Brazil: A Comparative Analysis*, 48 INT'L L. 33, 47-50 (2014) (noting similarities between Rule 506 and Brazil's analogous system); Elan W. Silver, *Reaching the Right Investors: Comparing Investor Solicitation in the Private-Placement Regimes of the United States and the European Union*, 89 TUL. L. REV. 719, 730 (2015) (noting the similarity between the

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concerns about unsophisticated investors investing in unregistered securities and in LLCs, an LLC system modeled after the securities law accredited investor standard has great potential. This Section develops such a system, which I call the "qualified LLC system."

Broadly, the system would require a set of mandatory governance protections when an LLC has everyday LLC investors who are unlikely to fend for themselves with internal LLC governance protections. These investors are the LLC analogue of non-accredited investors from federal securities law. The mandatory protections for LLCs with these investors would resemble those from traditional corporate law, with the goal of protecting fundamental owner rights while still granting some flexibility to tailor internal governance to individual requirements. Providing a baseline of mandatory protections for these LLCs will assure everyday investors have a meaningful minimum level of protection, decreasing the costs arising from inefficient operating agreements or the misallocation of capital that the existing contractual freedom approach allows.[97]

However, LLCs with exclusively sophisticated LLC investors — the LLC analogue of securities law's accredited investors — could opt into a "qualified LLC" status under this system. Opting into a particular set of business laws should not appear unusual: corporations, for example, can opt into states' "close corporation" statutes upon meeting certain enumerated requirements,[98] which provides them with a specialized subset of corporate law specific to them.[99] Qualified LLCs resemble the unregistered securities from federal securities law, and just as unsophisticated investors are prohibited from investing in unregistered offerings, so too would they be prohibited from investing in qualified LLCs.

A qualified LLC system would thus effectively bifurcate the LLC organizational form and rules, creating one type of LLC (qualified LLCs) for exclusively sophisticated investors and one type of LLC for

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accredited investor standard and the European Union's qualified investor standard).

[97] *See supra* Section I.B.

[98] *See, e.g.*, CAL. CORP. CODE § 158 (2018) (allowing corporations to opt into close corporation statutes if it has at most thirty-five shareholders of record); DEL. CODE. ANN. tit. 8, § 342 (2018) (allowing corporations to opt into close corporation statutes if it has at most thirty shareholders of record and has certain ownership transfer restrictions).

[99] These rules generally allow close corporations to operate without some of the traditional corporate formalities, such as the requirement of a board of directors and of shareholder annual meetings for certain corporate activities. *See, e.g.*, CAL. CORP. CODE § 300(b) (2018) (allowing close corporations to eliminate many corporate formalities) (2018); DEL. CODE. ANN. tit. 8, § 351 (2018).

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all other situations. There would be substantial overlap in the law applying to both LLC types; the only differences would pertain to qualified LLCs' modifications to internal governance protections that would be prohibited by general LLCs. By separating the law on owner modifications based on owners' sophistication, this bifurcation grants contractual freedom when it is most likely to be used to craft efficient governance relationships, while preserving owner protections when it is most necessary. By doing so, this approach seeks to keep LLCs' fundamental advantage of governance flexibility, while addressing the increasing concern of misplaced expectations from unsophisticated owners.

Setting aside for the moment the political economy dynamics that would be required to implement this statutory change,[100] the qualified LLC system could be designed relatively easily. There are two main challenges that the system must confront. First, the system must separate "qualified" owners who can fend for themselves from unqualified owners who require mandatory protections. Next, after separating these owners, the system must identify which mandatory protections unqualified LLCs should have. Each is addressed below.

1. Separating Owners

The first challenge for a qualified LLC system is how to bifurcate the LLC market into qualified LLCs for owners more likely to translate contractual flexibility into economic efficiency, and general LLCs for all other situations. As argued earlier, LLCs' current problem stems from situations where unsophisticated owners relinquish traditional owner protections without pricing that relinquishment into their investment decision. A natural fix, therefore, would require mandatory protections when an LLC has even one unsophisticated owner, while allowing broad freedom to modify ownership rights when all owners

[100] I return to these dynamics in Section III.D. I note now, though, that there are reasons for optimism that a qualified LLC investor system could attract the broad support that could make adoption more likely. For one, the system should attract support from the many advocates who argue that some sort of protections are necessary for LLC owners who currently fail to protect themselves. *See supra* note 14. However, a qualified LLC investor system may also attract the support of contractarians who have traditionally argued against implementing mandatory rules. *See supra* note 13 and accompanying text. Although a qualified LLC system would impose mandatory rules, it would leave untouched the contractual freedom for sophisticated parties, which is the primary area that drives contractarian arguments. Moreover, this system would head off the emerging shift towards mandatory rules for all parties or unpredictable *ex post* intervention by courts, which otherwise poses significant concern for the contractarian framework.

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are sophisticated. This arrangement can be achieved with a system of mandatory protections for LLCs, but with the option for LLCs with exclusively sophisticated owners to opt into "qualified" status with a more permissive governance framework.

But how to separate sophisticated from unsophisticated owners? In an ideal world, the separation mechanism would identify as "unsophisticated" all those investors who underestimate the importance of owner protections. This underestimation could arise because the investor never reads an operating agreement and so does not recognize that rights are being modified; because the investor reads the operating agreement but does not spot how rights are being modified;[101] or because the investor notices that rights are being modified but nevertheless undervalues the significance of the modification.[102]

The precise method to separate these sophisticated and unsophisticated investors brings up a problem common to legal systems of all types: the choice between a rule and a standard. Rules tend to cost less than standards to administer, but result in more frequent "wrong" outcomes due to rules' inherent over- and under-inclusiveness.[103] The most accurate way to separate LLC owners would involve a standards-based individual inquiry into each investor's ability to judge the presence and value of owner protections. This approach, while perhaps doing the best job at identifying the universe of investors requiring mandatory protections, suffers from several

[101] Modifications to owner rights are not always easy to identify even when paying close attention to the operating agreement. *See, e.g.*, *supra* note 45 (discussing a case where "except as otherwise required" language in an operating agreement acted to eliminate the traditional right to seek judicial dissolution, despite the agreement's not containing an explicit judicial dissolution waiver); *see also* John Cunningham, *Practice Tip Concerning the Use of "Except as Otherwise Provided in this Agreement,"* JOHN CUNNINGHAM ON LIMITED LIABILITY COMPANY OPERATING AGREEMENTS (Feb. 24, 2017, 10:44 AM), http://www.cunninghamonoperatingagreements.com/?p=2273 (identifying this language as often appearing in LLC operating agreements).

[102] This underestimation is not uncommon; new businesses commonly underestimate the likelihood of a later breakdown among initial investors, which leads to a widespread failure to plan for later disagreements among owners. *See, e.g.*, Peter Mahler, *John Cunningham on Avoiding Deadlock in Two-Member LLCs*, N.Y. BUS. DIVORCE (July 11, 2016), http://www.nybusinessdivorce.com/2016/07/articles/deadlock/john-cunningham-avoiding-deadlock-two-member-llcs (describing the "recurrent problem" of LLC deadlock between two equal members).

[103] Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 577, 586 (1992). Of course, the precise tradeoff between a rule versus a standard is more complicated, involving other factors such as rules' relatively greater upfront drafting costs, the relative complexity between a rule and a comparable standard, and the relative predictability between a rule and a comparable standard. *See id.* at 590-91, 611.

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downsides. Perhaps most obviously, the costs of administering such a standards-based system would be prohibitive. LLCs already number well over two million and continue to grow at a rapid pace.[104] We could expect significant expenses from requiring promoters to determine individually the sophistication of each investor using a standards approach, or having a court make this determination each time an LLC dispute arises.

The lack of predictability that comes with a standard would also be problematic. Investor sophistication would affect whether core matters of internal governance could be waived or modified. An LLC's incorrect assessment of an investor's sophistication could therefore have dramatic ramifications on the company's operations when this incorrect assessment is later identified. With the large number of LLCs and LLC investors that exist today, we might regularly expect circumstances where a court later disagrees with an LLC's initial sophistication assessment. The unpredictable and significant potential costs that result from a standard would thereby either drive parties away from using LLCs' contractual freedom — long seen as a hallmark of the form — or else drive parties away from using LLCs entirely.[105]

Instead of a standard, how about a rule? The challenge when developing a rule is to balance a rule's simplicity and ease of administration against a rule's overinclusiveness (in this case, mistakenly categorizing unsophisticated policyholders as sophisticated) and underinclusiveness (failing to classify some sophisticated policyholders as sophisticated). With the large number of LLCs and LLC investors, the importance of an easily administrable rule is quite important. Given that this system is modeled after securities law's accredited investor standard, one possibility that springs naturally to mind is to separate investors based on wealth, as the securities laws do.[106] Investors with a minimum amount of assets would be treated as qualified LLC investors, potentially allowing the LLC to elect a qualified status with concomitant governance flexibility. There is evidence that wealthier individuals are more financially

[104] IRS, STATISTICS OF INCOME, PARTNERSHIP STATISTICS BY ENTITY TYPE, 2013–2014, https://www.irs.gov/pub/irs-soi/14pa08.xls (stating that 2.4 million LLCs existed in 2014); *see also* Chrisman, *supra* note 1, at 460 (describing the rate of new LLC formation).

[105] In analogous circumstances, the uncertainty surrounding what constitutes a non-accredited yet sophisticated investor under federal securities law has largely led firms to abandon these investors when raising money via a private offering exemption. *See* Rodrigues, *supra* note 81, at 3421.

[106] *See supra* notes 89–91 and accompanying text.

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sophisticated,[107] and they are also better able (and perhaps are more likely) to afford the costs of hiring an attorney to evaluate their protections. A wealth requirement is also easy to administer and is objectively measured, making the costs of this rule fairly low.

Just as in the securities space, however, wealth is only an imperfect proxy for the targeted attribute: namely, propensity to identify and not undervalue reductions to governance protections.[108] As cases like Bernie Madoff's Ponzi scheme vividly illustrate, some wealthy people are no better at identifying suspicious business activity than others.[109] Perhaps they will also be little better at evaluating governance terms. Moreover, some people with comparatively little wealth may be relatively capable at pricing governance terms.[110] In that case, we might be worried about downsides of a wealth rule's overinclusiveness and underinclusiveness.

However, a rule should be able to have some amount of overinclusiveness and underinclusiveness without too much concern. Recall that the two chief efficiency concerns with mispriced LLC governance terms are, one, that firms with weak governance rights will enjoy comparatively cheaper capital access, giving rise to capital allocation problems, and two, that capital costs for LLCs as a whole will be comparatively greater, as burned investors shy away from the form in the future.[111] On both these dimensions, a wealth rule's over- and under-inclusiveness problems may be small. For the overinclusiveness problem, wealthy people who nevertheless underestimate governance protections still give rise to capital allocation problems. But we might expect the additional downside of less money invested in capital markets to be relatively small. Relatively wealthy people are comparatively better positioned to weather an

[107] *See* Guo et al., *supra* note 93.

[108] As mentioned earlier, the concern here is about those investors who undervalue protections, rather than investors who overvalue protections. While overvaluation presents the potential for economic efficiency problems, market forces would push LLC interests away from overvaluing investors (who would place a lower price on the value of these interests) and towards investors who accurately value or who undervalue these interests. *See supra* note 29.

[109] *See* Felician Smith, *Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor*," 40 U. BALT. L. REV. 215, 253 (2010).

[110] This might be true if, for example, they have prior experience with an LLC startup. It might also be true if they are likely to have their interests protected by a lawyer, which I return to shortly.

[111] *See supra* notes 35–37 and accompanying text. As noted before, investors might also respond by seeking legal representation in situations where it is not warranted, which also raises capital costs for LLCs as a whole. *Id.* The analysis that follows addresses this response as well.

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investment downturn, which might make them less resistant to investing in future LLCs after a failed project.[112] For underinclusiveness — that some sophisticated but nonwealthy investors will not be classified as qualified investors — there are two potential costs. One, too few LLCs will be able to elect qualified status (because they have low-wealth but sophisticated investors), making their governance potentially more costly. Two, and perhaps more likely, low-wealth but sophisticated investors will be foreclosed from investing in LLCs that want qualified status, raising the cost of capital to qualified LLCs and restricting low-wealth investors' investment options. Unlike the overinclusiveness problem, there is little reason to suspect these downsides to be relatively less severe, which might point to using a non-wealth proxy for investor sophistication.

This naturally raises the question: can we do better than a rule that divides investors simply by their wealth? There are several possibilities that may not be much more difficult to administer. One possibility would augment a wealth threshold with an additional requirement that investors in qualified LLCs must invest beyond a minimum dollar amount for the LLC to be eligible for qualified status. This possibility is based on the intuition that investors, regardless of wealth or access to legal representation, may not accurately assess governance provisions if they are not investing much money, as the cost of figuring out and pricing the terms are likely to exceed any benefits.[113] By combining both a wealth requirement (thereby making it more likely that an investor *is capable of* fending for herself) and a minimum investment amount (thereby making it more likely that an investor *will* fend for herself), this rule reduces the wealth rule's overinclusiveness problem without imposing meaningfully greater administrative difficulties. It makes the underinclusiveness problem potentially more severe, however; indeed, each additional requirement imposed on a starting rule raises the potential for more underinclusiveness.

Another possibility could sort investors into qualified status if their investment amount exceeded a certain percentage relative to the investor's overall wealth. This condition is predicated on the idea that low wealth investors might still protect themselves if the investment is large relative to their overall assets, and high wealth investors might

[112] Indeed, this ability to weather bad investment is another justification for using wealth in securities law's accredited investor standard. *See* U.S. SEC. & EXCH. COMM'N, *supra* note 93.

[113] For additional discussion of this approach, as well as an application, see Molk, *Contracting Around Default Protections*, *supra* note 20, at 521.

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not protect themselves if the investment is small relative to their total wealth. Low wealth investors who invest a significant portion of their savings into a single venture might reasonably want to protect themselves against downside risk,[114] making it more likely that they would take steps to protect their interests, either by hiring a lawyer or investing effort themselves. Likewise, high wealth investors might not find it worthwhile to protect their interests if the amount they invest in any individual project is small. A sorting mechanism based on relative investment might therefore more accurately separate investors who will and will not accurately price governance terms than a simple wealth rule, without adding meaningfully to administrative difficulties since either way, only investor wealth will need to be determined by the LLC.

Yet another possibility might eschew wealth measures altogether, instead requiring that investors pass a governance sophistication test.[115] Such a test has the promise of better targeting investors who can correctly price governance modifications than can a wealth rule, thereby having lower overinclusiveness and underinclusiveness costs. In theory, this test could also be designed with little administrative burden on either LLCs or investors. The problem with a test, however, is the potential for investors to be able to learn just enough to pass without actually knowing enough to appropriately price an actual LLC's governance provisions. This is a familiar problem in other contexts: for example, critics of bar exams or driving tests contend these exams only loosely measure a test taker's future ability as a lawyer or driver. Should the same problem arise with LLCs, this rule may actually exacerbate overinclusiveness costs relative to a simple wealth requirement.[116]

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[114] For risk-averse investors with declining marginal utility of income, relatively large losses have disproportionately large effects on their well-being, making it more likely that the benefits from protecting their interests and assessing governance terms will exceed the costs. *See generally* ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 185-87 (1995) (discussing risk aversion models).

[115] Similar alternatives have been suggested in place of wealth for securities law's accredited investor standard. *See supra* note 95 for discussion of these approaches in the federal securities law accredited investor standard.

[116] The rule may also raise underinclusiveness problems. If a test only poorly measures an investor's ability to price governance terms, sophisticated investors may fail the test and be ineligible to invest in qualified LLCs. Of course, those investors could always study for the poorly designed test, but the burdens (financial and time commitment) of doing so will increase capital costs, as these investors either price these burdens into their investment decision or forego the investment altogether.

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Other possibilities might instead look to factors unrelated to the investors themselves. For instance, we might instead concentrate on market characteristics in which LLC investment interests are bought and sold. The price of interests that are traded on efficient markets is presumed to reflect the governance provisions for those respective LLCs, even if most investors are not explicitly aware of those provisions.[117] When prices accurately reflect governance terms, there are no longer capital allocation or pricing problems from LLC contractual flexibility. An alternative sorting mechanism might therefore treat LLCs as eligible for qualified status whenever the interests are traded on efficient markets. This rule would be admirably easy to implement; it would, however, produce very few qualified LLCs under current conditions, in which most LLCs are privately owned and traded.[118] It might therefore best be attached to one of the prior possibilities as an additional way that LLCs would be eligible for qualified status, rather than relied upon as an exclusive method for screening.

We could also look to whether the LLC was formed domestically, under the laws of the state in which it does business, or instead was formed as a foreign LLC under the laws of another state. When the home state's LLC statute and caselaw are relatively undeveloped, then by choosing to form under its home state's laws, an LLC sends a signal that its owners are relatively less sophisticated. Therefore, in a state that attracts relatively few foreign LLCs as a percentage of its LLC formations (which might be taken as a reasonable proxy for the developmental stage of that state's statute and caselaw), a screen might treat domestic LLCs as unqualified. Indeed, if the ratio of domestic to foreign LLCs is high enough, such a state might do well by adopting mandatory protections for *all* LLCs, under an assumption that very few sophisticated investors would be buying into LLCs subject to that

[117] *See* Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006) [hereinafter *Director Primacy*] ("The mechanism by which securities are priced 'ensures that the price reflects the terms of governance and operation' offered by the firm. If these governance terms are unfavorable, investors will discount the price they are willing to pay for that firm's securities."); *see also* Manesh, *Equity*, *supra* note 59 (manuscript at 59) (arguing that "market-based considerations associated with [publicly-traded LLCs] weigh against the judicial use of equitable discretion to protect investors").

[118] Manesh, *Equity*, *supra* note 59 (manuscript at 57) (stating that publicly held unincorporated businesses contribute less than 0.0002% of Delaware's annual taxes received from domestic LLCs and LPs). *But see* Ribstein, *Partnership Governance*, *supra* note 65, at 302-05 (analyzing publicly traded partnerships and their use of non-standard protections).

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state's law, so that the value in that state from contractual flexibility is small.[119]

For each of these potential screens, an exception could be created so that employees could receive incentive-based compensation in company ownership without jeopardizing the LLC's qualified status. Its wide prevalence suggests a significant appetite for, and value of, stock-based compensation that would be lost if qualified LLCs could not apply it to its traditional employees. It is worth noting, however, that an employee safe harbor begins to crack open the door to future problems, if employees are unlikely to protect their financial stakes. Nevertheless, the benefits of ownership-based compensation seem likely to outweigh these concerns. Moreover, if the concerns grow particularly severe, they could be mitigated through, among other techniques, requiring employees to have a purchaser representative or other entity to represent their interests, or limiting the size of interests that could be sold to unsophisticated employees without jeopardizing qualified status. Indeed, securities law's accredited investor standard allows a similar exemption to issue stock to non-accredited employees without registration.[120]

There are, of course, other screening options beyond those considered here. No single one of these approaches may be the best for all circumstances. A good screen depends on the characteristics of LLCs forming under a state's laws; the best screen for a state like Delaware, which attracts mostly foreign LLC formations, might not be optimal for another state that attracts mostly domestic LLCs.[121] Notice, however, that none of these approaches focuses on either an investor's bargaining power or an investor's percentage interest in the LLC. While some have worried about oppression or disenfranchisement

[119] In that case, the number of states that have adopted the Revised Uniform Limited Liability Company Act's provisions, which generally provide for corporate-like mandatory protections, should not be troubling, as long as those states fit the characteristics identified above. REVISED UNIF. LTD. LIABILITY CO. ACT § 110(c) (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2006); *Limited Liability Company (2016) (Last Amended 2013)*, UNIFORM LAW COMM'N, http://www.uniformlaws.org/Act.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013) (last visited Nov. 12, 2017) (listing the seventeen states that have adopted the uniform act). Indeed, these states might want to go beyond the Act's baseline, which allows for eliminating traditional protections in certain circumstances. *See* REVISED UNIF. LTD. LIABILITY CO. ACT § 110(c), (d) (authorizing reductions in the fiduciary duties of loyalty and good faith if not manifestly unreasonable).

[120] Rule 701, 17 C.F.R. § 230.701 (2018).

[121] *See supra* note 119 and accompanying text.

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when owners have little leverage to negotiate terms,[122] this is mainly a problem only if those minority owners have not priced that possibility into their original purchase decision. From an efficiency perspective, what matters is that operating agreements contain only those terms that are more beneficial to owners as a whole than their costs,[123] and an ability to price terms is entirely different from an ability to negotiate for terms. Efficient agreements can regularly arise where one party appears to have no negotiating power, as long as that party still prices terms accurately;[124] as long as that party has the option to walk away, a majority will be constrained by the need to attract minority capital. An effective screening mechanism, therefore, should focus on the likelihood that investment prices reflect governance provisions, rather than investors' ability to negotiate for those provisions.

Regardless of the screening mechanism that is chosen, an additional issue to address is whether the screen must be satisfied only once — when investors purchase their ownership stake — or repeatedly, even after an investor has bought in. If a wealth approach is chosen as the screening standard, for example, must existing investors continue to satisfy the standard every year, or only when they buy in?

The key is for investors to identify and price accurately governance provisions when they buy into a company, as those buy-in prices determine whether capital is misallocated across firms or whether the costs of capital rise across the board.[125] As long as investors can make that valuation at buy-in, there seems little to gain from requiring them to be capable of making that valuation indefinitely into the future as well. So, an initial screen, but not a repeated screen, seems sensible. Moreover, a repeated screen requirement could bring significant costs. A qualified LLC might lose its status in the future whenever a single investor dips below the sophistication standard, with the resulting potential to upend entirely the company's governance regime. This fragility is likely to bring far more costs than would be worthwhile.

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[122] *See supra* notes 61–64.

[123] Of course, this is the goal for any efficient contract, of which LLC operating agreements are a particular example.

[124] The success of publicly traded companies with dispersed small investors is a prominent example. Even though these small investors lack any meaningful bargaining power to negotiate governance terms, companies need to attract capital from these investors at favorable rates, which can pressure them to offer efficient provisions. *See* Bainbridge, *Director Primacy*, *supra* note 117 (arguing that governance terms will be reflected in the price that investors pay for securities, which in turn incentivizes firms to offer efficient terms).

[125] *See supra* Section I.B.

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Just because the screen need not apply repeatedly to existing investors does not mean that new investors should be exempt, however. If LLCs could retain their qualified status even if all original qualified investors immediately resold to non-qualified ones, then the system's protections for everyday investors could be worked around easily. Instead, to make sure that problems do not arise from ownership transfers or follow-on sales of new securities, the qualified screen should apply to transferee purchasers at time of transfer.[126] One consequence is that qualified LLCs would risk their status if an interest were sold to an unsophisticated investor. Qualified LLCs wishing to retain their status must therefore implement transfer restrictions into their operating agreements, but these restrictions are already a regular feature of LLCs and should not impose a significant burden.[127]

Having achieved a way to separate sophisticated from unsophisticated investors and determined when the separation mechanism should apply, the next step is to figure out which protections should apply to each group, and whether these protections should apply merely by default or instead be mandatory. I consider this next.

2. Determining Protections

After LLCs have been divided based on the likelihood that owners will appropriately price governance terms, we must next figure out which governance terms should be mandatory, which should apply by default, and which should be opt in provisions for each LLC type. It makes sense to give owners of qualified LLCs relatively more contractual freedom than nonqualified LLCs, but how far should this go, and what should the details be?

Let us examine qualified LLCs first. A natural starting point is to consider adopting the broad contractual freedom already followed by Delaware for LLCs today. Under the Delaware approach, only the contract law implied covenant of good faith and fair dealing is mandatory; everything else applies merely by default or must be

[126] Because the concern with contractual freedom stems from mispricing governance provisions, it seems worthwhile to treat charitable donations of ownership interests, ownership stakes that pass by intestacy, and other transfers without consideration as exempt from this requirement. Gratuitous transfers, given as a gift, have no chance for mispricing of governance terms by the beneficiary, since the beneficiary does not give up anything of value for them.

[127] Molk, *Contracting Around Default Protections*, *supra* note 20, at 538 (analyzing transfer restrictions in LLCs).

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affirmatively adopted.[128] The implied covenant of good faith and fair dealing is an interpretive tool that comes from contract law, requiring merely that the terms of an operating agreement be read and interpreted as a reasonable person would.[129] Qualified LLCs would benefit from having this implied covenant as a mandatory term, since it reduces contracting costs by forcing a reasonable objective standard of interpretation. Moreover, it is difficult to envision a circumstance where waiving this implied covenant actually makes all parties better off.[130]

Would qualified LLCs benefit from additional mandatory terms? Since qualified LLCs are structured to have comparatively sophisticated owners, imposing additional mandatory terms is probably not necessary and indeed could be problematic, assuming that the screening mechanism has a relatively high bar. Qualified LLCs are designed to resemble the idealized LLCs for which Delaware's contractual freedom approach was designed: sophisticated players who replace default business law protections with individually tailored private alternatives. Allowing parties wide space to craft individualized operating agreements specific to their individual needs provides for maximum governance efficiency and maximum benefits from adopting the LLC form.[131]

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[128] DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2018).

[129] Molk, *Contracting Around Default Protections*, *supra* note 20, at 512.

[130] One reason to waive the implied covenant might be to save on litigation expenses that arise if one party alleges a violation of this implied covenant. Like the duty of care, the actions that constitute a violation of this duty are difficult to identify ahead of time; the implied covenant lacks predictability and precise contours that define its outer boundary. *See* Douglas M. Branson, *Alternative Entities in Delaware – Reintroduction of Fiduciary Concepts by the Backdoor?*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS, *supra* note 54, at 55, 60 (likening the implied covenant to "fog everywhere"). Moreover, there is a worry that courts have a willingness to expand this covenant to encompass behavior that otherwise would be allowed under an operating agreement with significant owner protection waivers. Strine & Laster, *supra* note 54, at 26 ("We fear that judges faced with cases where faithful adherence to the broad exculpatory and safe harbor provisions of alternative entity agreements would seem to excuse unfair self-interested behavior . . . will be tempted to wield the implied covenant as a substitute for the very fiduciary duties that the agreements explicitly eliminated."). However, as discussed later, a benefit of the qualified LLC approach would be to relieve some of the pressure that the implied covenant currently bears to curb egregious conduct. This would allow the implied covenant to return to its contract law origins of a limited means of interpretation, in turn reducing the litigation risk and expense from having it as a mandatory term.

[131] *See supra* note 23 and accompanying text.

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Having considered qualified LLC mandatory terms, the next step is to determine whether other governance terms should apply by default to qualified LLCs, or whether they should have to be adopted affirmatively. The choice amounts to selecting an opt-out (default) system versus opt-in (affirmative adoption) system. The relative benefits from opt-in versus opt-out systems have been widely discussed in contract[132] and corporate[133] law as well as with LLCs specifically.[134] The choice matters when negotiating terms is costly;[135] when it becomes more difficult to bargain around the default arrangement, it becomes more likely that the ultimate operating agreement will include whatever inefficient terms do (or do not) apply by default. With LLCs, negotiating terms undeniably involves costs. However, LLCs with sophisticated investors often have very detailed operating agreements that set out in fine detail provisions on capital payment schedules, tax matters, capital accounts, and securities law matters. Layering governance terms on top of an existing negotiation process could be less costly than requiring parties to negotiate where negotiation is not already happening; lower-cost negotiation means the choice between an opt-in versus opt-out system could have little impact on parties' final governance relationships.[136]

However, if negotiation involves costs that make default terms comparatively sticky, then the choice between an opt-in versus opt-out system begins to matter. In that case, whether a governance term should apply to qualified LLCs by default will depend on many interacting factors, including the costliness of bargaining around that particular term,[137] whether one party has hidden information about

[132] *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (discussing how to set default rules for incomplete contracts).

[133] *See, e.g.*, Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUD. 279 (2009) (discussing the effect of nonmandatory state anti-takeover statutes); Brett H. McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. REV. 383 (2007) (discussing how the ease of opting-out of default rules affects various corporate issues).

[134] The LLC discussion has largely focused on whether fiduciary duties should apply by default or whether they must be affirmatively adopted. This debate has spanned both legal scholarship and case law. *See, e.g.*, Mohsen Manesh, *Damning Dictum: The Default Duty Debate in Delaware*, 39 J. CORP. L. 35 (2013) [hereinafter *Damning Dictum*] (summarizing and analyzing this debate).

[135] *See* Coase, *supra* note 31.

[136] *See id.* at 16 (arguing that a "delimitation of legal rights does have an effect on the efficiency with which the economic system operates").

[137] If one particular issue is comparatively difficult to negotiate, then whether a term applies by default gains increasing importance. As an example of such an issue, it

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that term,[138] the types of businesses that form as LLCs and the importance of particular governance provisions for those businesses,[139] and investors' ability and incentives to monitor management's behavior.[140] Just as with the qualified screen, then, there may be no "single" set of terms that should apply by default across all states; it may vary by state and over time. New York, for example, which seems to have relatively more real estate investment LLCs, might not choose to have the business opportunity rule apply by default given the importance this waiver has for those businesses, while other states with a more representative cross-section of LLCs would.[141] A good set of default provisions for states to consider would be the default and mandatory provisions of corporate law, including fiduciary duties, takeover and dissolution provisions, and voting rights. Deviating from these provisions may be appropriate because of the incomplete overlap between corporate and LLC governance problems.[142] Again, however, the experimentation allowed by state-based internal affairs regulation could allow for a variety of approaches to be adopted.

Let us now turn to non-qualified LLCs. These LLCs are ones that include investors who fail the sophistication screen; they may have only non-qualified investors or a mixture of qualified and non-qualified. In either case, relatively more governance protection is warranted than for qualified LLCs with exclusively sophisticated owners.

is often thought that matters related to management deadlock or irreconcilable differences are, as a practical matter, difficult to negotiate at the start of a business venture, making the choice of default provision particularly important here. *See* Mahler, *supra* note 102.

[138] Ayres & Gertner, *supra* note 132, at 94.

[139] For example, matters related to the business opportunity doctrine are particularly important for real estate investment and financial asset management. *See* RIBSTEIN, *supra* note 5.

[140] For instance, if investors are capable of deterring management misconduct through non-contractual means, the choice of governance terms may carry less importance. For some closely-held LLCs, this deterrence may be particularly likely; for other LLCs, such as those with a dispersed investor base or that do not rely on repeat relationships, this deterrence is less likely. *See* RIBSTEIN, *supra* note 5, at 153-82 (discussing non-contractual deterrents).

[141] Molk, *Contracting Around Default Protections*, *supra* note 20, at 519.

[142] The same corporate law applies to all corporations, regardless of owner sophistication or industry (with certain jurisdictions allowing some minor deviations for close corporations). If qualified LLCs diverge from the "typical" corporation — if they are relatively more likely to be closely held, or operate in industries that raise business opportunity questions, or have sophisticated investors — then deviating from corporate law defaults becomes increasingly appropriate.

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The worry with non-qualified LLCs is that wide latitude to set governance terms will result in inefficient governance arrangements, leading to the higher capital costs and misallocation of capital identified earlier.[143] This problem comes about because less sophisticated investors will more often misprice the governance arrangement, perhaps because they assume that certain protections apply; they underappreciate the significance of protections' being cut back or eliminated; or they just never read the operating agreement that sets forth their ownership rights. This problem can be addressed by identifying the provisions that lead to the most severe negative consequences and making those provisions mandatory protections.

Which provisions might this include? Much could be gained by looking first at the mandatory rights of corporate law. One clear contender is the right for minority investors to seek judicial dissolution. This mandatory corporate law right allows aggrieved investors to dissolve the company and cash out their interests when they might otherwise remain locked into a company indefinitely.[144] Judicial dissolution typically requires showing fraudulent, oppressive, or illegal conduct by majority shareholders — a high bar to match its stark remedy.[145] Nevertheless, it functions as an effective "nuclear option" that minority owners possess when all else fails, such that majority owners and management must still mind minority interests when running the firm. Preserving minority owners' right to exit in egregious circumstances provides a fundamental protection to minority owners,[146] deters particularly destructive behavior by

[143] *See supra* Section I.B.

[144] Molk, *Contracting Around Default Protections*, *supra* note 20, at 533-34.

[145] *E.g.*, DEL. CODE ANN. tit. 6, § 18-802 (2018) (authorizing judicial dissolution "whenever it is not reasonably practicable to carry on the business"); RIBSTEIN & KEATINGE, *supra* note 18, § 11.5 (providing an analysis of judicial dissolution); Manesh, *Equity*, *supra* note 59, at 16 n.68 ("Other mandatory provisions of the uniform LLC statutes likewise reserve room for the exercise of a court's equitable discretion, including the standards of 'oppressive' or 'not reasonably practicable to carry on' the LLC's business."); Larry E. Ribstein, *Close Corporation Remedies and the Evolution of the Closely Held Firm*, 33 W. NEW ENG. L. REV. 531, 549 (2011) (providing a case example of judicial dissolution).

[146] This remedy is often seen as particularly valuable in closely held companies, in which minority investors have no right to sell their ownership interests and commonly have no right to force regular cash dividend distributions. Molk, *Contracting Around Default Protections*, *supra* note 20, at 533. In these companies, investors may hold a valuable asset, yet because this asset cannot be sold and does not generate income (and may even generate tax liabilities under phantom income rules), those investors can find themselves either unable to capitalize on that asset, or else able to do so only on oppressive terms set by majority shareholders. The right to seek

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majority owners and management, solves some of the problems that contractual freedom can generate among everyday investors, and should therefore be a mandatory protection for non-qualified LLCs.

The duty of loyalty is also a contender for a non-qualified LLC mandatory term. A robust duty of loyalty constrains conduct related to management's putting its own interests ahead of the company's and, keeping in mind that we are considering LLCs with relatively less sophisticated investors, non-qualified LLCs would on the whole likely benefit from having the duty of loyalty as a mandatory term just as it is with corporations. This is particularly so when we observe that those companies that most benefit from cutting back on this fiduciary duty — real estate and investment management firms — will already have the qualified LLC outlet available to them to do so.[147]

Other mandatory rules from corporate law may also be appropriate in the non-qualified LLCs space. Most prominently among those mandatory rules are investor voting rights for certain fundamental transactions, like a merger or a sale of substantially all assets;[148] court limitations on takeover defenses;[149] statutory merger appraisal rights;[150] and entire fairness review for interested transactions.[151]

judicial dissolution provides these investors with one means of protecting themselves from this oppressive conduct. *See id.* However, judicial dissolution may also be valuable for non-closely held companies too. Although in these companies oppressed shareholders may have a right to sell their shares and exit an oppressive situation, those minority shares will sell at a steep discount, since any purchaser will inherit the seller's oppressed situation. A judicial dissolution right may allow these shareholders to receive a non-oppressed price for their interests, which again addresses some of the problems that contractual freedom can generate.

147 *See* RIBSTEIN, *supra* note 5. This assumes that publicly traded real estate and investment firms also are treated as qualified LLCs. *See supra* notes 117–18 and accompanying text (developing an argument for such a rule); Ribstein, *Partnership Governance*, *supra* note 65, at 302-05 (analyzing these companies).

148 DEL. CODE ANN. tit. 8, §§ 251(c), 271 (2018). Other fundamental decisions requiring owner approval include voluntary dissolution, *id.* § 275, amending the company's charter, *id.* § 242, and electing management, *id.* § 211(b).

149 *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994); Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946, 954 (Del. 1985) ("When a board addresses a pending takeover bid . . . . a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment." (footnote omitted)).

150 DEL. CODE ANN. tit. 8, § 262 (2018). For discussion of the importance of the appraisal remedy, see Charles R. Korsmo & Minor Myers, *Aggregation by Acquisition: Replacing Class Actions with a Market for Legal Claims*, 101 IOWA L. REV. 1323, 1370-73 (2016); Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1558-59 (2015).

151 *See, e.g.*, *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 614-18 (Del.

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These mandatory rules exist in corporate law to align management's incentives with investors. While LLCs are often thought to achieve this alignment in other, more efficient individualized ways,[152] it is primarily those LLCs with sophisticated owners that do so.[153] Consequently, non-qualified LLCs, with less sophisticated owners, could still benefit from mandatory rules to achieve this alignment for them. As before, whether a particular mandatory rule would benefit non-qualified LLCs as a whole will depend on the characteristics of a particular state's LLCs, LLC investors, and the sophistication screen; whether a particular term should be mandatory could therefore vary by state and over time.[154]

How about going beyond the mandatory rules of corporate law? One could argue that additional mandatory and default rules are more appropriate for non-qualified LLCs than corporations, given their different investor characteristics. By design, non-qualified LLCs will have comparatively unsophisticated investors. But because there is no similar separation of corporate law based on investor characteristics, corporations should reflect, on average, a relatively more sophisticated mixed pool of unsophisticated and sophisticated investors. In other words, more mandatory and default protections might be appropriate for non-qualified LLCs than for corporations.

One possible mandatory protection to consider is the corporate opportunity doctrine.[155] Corporate law has long allowed a waiver of

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Ch. 2005) (mandatory application of entire fairness review to all cash-out mergers with controlling shareholders).

[152] *See, e.g.*, Ribstein, *Partnership Governance*, *supra* note 65 (showing proper structural financial incentives help align interests).

[153] *Id.*

[154] In particular, states with a comparatively easy sophistication screen, that classify all but the most vulnerable as sophisticated, might benefit from a mandatory duty of care. The duty is most valuable when agency problems between managers and owners are most severe. Privately held companies — which cannot rely on market ownership prices to set incentives — and companies with less sophisticated owners — who may have difficulty in identifying or holding management accountable for incompetent behavior — are two examples where a duty of care's value is comparatively greater. *See* Holger Spamann, *Monetary Liability for Breach of the Duty of Care?*, 8 J. LEGAL ANALYSIS 337, 358 (2016) ("Liability may become desirable where other governance mechanisms are weaker, particularly if stock prices or other reliable public signals are not available; where courts have superior insight; or as the agency conflict becomes more severe.").

[155] Although formally a species of the duty of loyalty, the corporate opportunity doctrine is often treated as a separate beast, and I do so here. Molk, *Contracting Around Default Protections*, *supra* note 20, at 523. To the extent that LLCs adopted a robust mandatory duty of loyalty that precluded waivers of the corporate opportunity doctrine, however, the corporate opportunity doctrine would not need to be an

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management's duties not to compete with the corporation or to capitalize on profitable ventures related to the corporation's business, and many corporations take advantage of the chance.[156] Opting out of this rule allows the freedom for companies to allocate ventures between management and investors, potentially resulting in more efficient outcomes than a mandatory rule permits.[157] However, these opt-outs most promote efficiency when parties to the agreements are sophisticated players able to price and bargain for alternative protections.[158] By their nature, non-qualified LLCs are designed to have less sophisticated owners; therefore, the benefits from allowing parties to opt out of the business opportunity doctrine are relatively smaller, which supports the protection as a mandatory one for non-qualified LLCs.[159]

In addition to more mandatory protections, non-qualified LLCs might also benefit from more default protections than their corporate counterparts. We might consider a default right for investors to exit the LLC through selling their ownership stake to the company, absent an agreement to the contrary. This right is a default right in partnership law, although it has achieved little traction in LLC law[160]

additional mandatory duty. *Id.* at 523 ("[J]ust because conduct has no legal sanction does not mean managers will engage in it; social norms, shaming, not being fired, and the desire to maintain a good reputation also deter behavior.").

156 For an empirical study of public corporations' opting out of this duty, see Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1119-40 (2017).

157 *See, e.g.*, *id.* at 1104-19 (discussing the theoretical basis for corporate opportunity waivers' potential efficiency).

158 *See generally* Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L.J. 277, 310-36 (1998) (developing a theory for the corporate opportunity rule as a default rule whose success depends on, among other things, investors' ability to value correctly future corporate opportunities and to monitor management's compliance with contractual substitutes, both of which are suspect when investors lack sophistication).

159 Given the existence of publicly traded LLCs with corporate opportunity waivers, a mandatory business opportunity rule should be considered only if publicly traded LLCs were treated as qualified. *See* Ribstein, *Partnership Governance*, *supra* note 65, at 302-05 (analyzing investor protections in these companies); *supra* notes 117–18 and accompanying text (analyzing arguments for this approach).

160 Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 931-33 (2005) (describing change of this default right in response to tax law change); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 28 (1995) (describing states' initial adoption of a default right to exit LLCs at will and be paid the value of one's ownership interest).

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and is not even a default right in corporate law.[161] A right to sell provides investors with the means to cash out an otherwise illiquid ownership stake, permitting them to monetize a valuable asset that otherwise serves only as a tax liability.[162] The right to sell is also a valuable check on majority owners, since oppressed investors could exit at a price that might be somewhat insulated by the problematic conduct.[163] On the other hand, the right to sell one's ownership stake can make the company's existence much more fragile; since the company could conceivably be called upon to buy back ownership interests at any time, the company must either hold only liquid assets or else hold less liquid ones with a risk of a liquidity crisis. This in turn opens the door to new problems initiated by the selling investor, who might use a company's liquidity constraint to extract gains in exchange for not exercising her sell right.[164]

How the costs and benefits of a default sell right would play out for non-qualified LLCs is not certain. However, the ownership structure of many non-qualified LLCs is probably more likely to resemble the closely-held everyday investor characteristics of general partnerships for which the sell right was originally designed, rather than corporations. The less sophisticated nature of partnership and non-qualified LLC owners may make them less likely to use a sell right to create negative consequences from capitalizing on liquidity constraints, and more likely to benefit from a default right to exit, than the comparatively sophisticated corporation owners, who might more often take advantage of company illiquidity and bargain for exit opportunities.

There are of course other possible mandatory and default protections from which non-qualified LLCs could benefit beyond those considered here. The general analytical approach is the same as I have laid out above, with the appropriate question being whether the

[161] *E.g.*, John Morley, *Why Law Firms Collapse* 21 (Yale Law Sch. John M. Olin Ctr. for Law, Econ., & Pub. Policy, Research Paper No. 521, 2015), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2580616 ("[I]nvestors in ordinary companies cannot run because contractual commitments and corporate law prevent them from individually withdrawing.").

[162] LLC investors pay personal tax on their share of the LLC's earnings, even if the LLC makes no distributions in a tax year, when the LLC elects to be taxed as a partnership.

[163] This insulation would be particularly effective when the sell price is specified upfront as a fixed number or a number based on historical performance, which is not uncommon among agreements that permit transferability.

[164] *See generally* Morley, *supra* note 161 (discussing the problem of exit rights in law firms).

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costs of a default protection are more than outweighed by the benefits. State experimentation on these issues could provide useful information to answer this question more definitively over time.

D. Benefits from the Approach

LLCs have been facing increasing pressure because the form is designed to appeal to two very different constituencies. Their governance flexibility is attractive for sophisticated owners, while their convenient package of tax advantages and limited liability appeals to everyday entrepreneurs and businesses. Problems have arisen because when there is too much devotion to governance flexibility, the form becomes less suitable for unsophisticated investors, who find themselves participating in ventures unsuitable for their characteristics. On the other hand, the suggested reforms that ratchet up minimum protections across the board, in turn sacrificing governance flexibility, make LLCs less attractive to those sophisticated parties that can achieve better governance without traditional corporate law protections. Existing calls for reform, then, inevitably must forego at least some of the benefits of LLCs' contractual flexibility in exchange for protecting less sophisticated owners.

By contrast, in targeting only those owners who need protection, the approach described here achieves the business law equivalent of having one's cake and eating it too. Wide latitude to craft governance terms is still retained for those parties who can most benefit from contractual freedom. This preserves one of the fundamental comparative advantages of the LLC organizational form, which is to offer the potential for greater economic efficiency than alternative forms.[165] However, robust mandatory protections will be required when LLCs have less sophisticated parties, providing those investors with the governance terms that, on the whole, should reduce the costs that maximal contractual freedom has produced. These mandatory protections mean that LLCs will remain an appropriate organizational form for everyday investors, which preserves LLCs' second comparative advantage as a relatively simple, low-cost way for businesses to achieve limited liability protection and single taxation of company profits.[166] By separating LLC organizational law based on parties' suspected sophistication, therefore, the qualified LLC approach can accomplish the diametrically opposed goals of providing efficient governance through contractual freedom as well as a simple

[165] *See supra* note 23 and accompanying text.
[166] *See supra* note 2 and accompanying text.

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form suitable to everyday investors, without sacrificing one goal in favor of the other. Moreover, the better the approach can separate out sophisticated parties who can protect their own interests from parties that benefit from mandatory protections, the better these opposed goals can be harmonized.

By providing protections for sympathetic owners, this approach accomplishes one of the main goals of LLC reform seekers. But this approach should also be attractive even to those who do not think LLCs are in need of reform. Although there is good evidence that LLCs could benefit from mandatory governance protections in at least some circumstances, not everyone believes that revamping the LLC statutory framework is a good idea because of the costs associated with restricting freedom of contract for internal governance terms.[167] However, the calls for reform have grown louder in recent years, and now that those calls are buttressed by influential luminaries from the Delaware bench,[168] it may be only a matter of time until some type of change is enacted.[169] The qualified LLC approach I have described should satisfy those who see a need for change. At the same time, unlike popular alternatives, the approach preserves wide contractual freedom and predictability for sophisticated enterprises, which achieves the main goal of those who disfavor LLC reform.

As a consequence, the qualified LLC approach not only offers a sensible reform as a policy matter, but it also should attract the necessary support from multiple constituencies that can help to push meaningful reform ahead.[170] Indeed, we might expect such a proposal to gain the backing of the comparatively small number of high-dollar LLCs with sophisticated investors, who have much to lose if alternative, broader calls for reform are enacted. Such a discrete set of

[167] *See supra* note 13.

[168] *See supra* notes 58–60 and accompanying text.

[169] *See, e.g.*, Strine & Laster, *supra* note 54 (proposing changes that would keep the main benefits of LPs and LLCs yet fix several problems, such as contractual overcomplexities).

[170] *See, e.g.*, JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES (2d ed. 2002) (discussing the conditions necessary for policy change). The problems that arise when few people must bear a disproportionate burden is, of course, not unique to politics. *See, e.g.*, MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 48 (1965) (examining how public goods problems keep groups from achieving optimal outcomes); Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 930-35 (2014) (theorizing how this problem keeps many cooperative firms from forming).

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influential firms might be precisely the type of group that could steward a proposal like this one through the political process.[171]

This is not to say that there will be no opposition. There are at least two groups that stand to be harmed from this reform. First, LLCs that modify operating agreements with an expectation that it will go unnoticed by investors will be worse off under a system with mandatory governance terms. Mandatory protections will decrease the private gains that majority owners of these firms can extract. Second, parties that could currently modify governance protections to achieve efficient arrangements, but not under a qualified LLC system, will also be harmed. These parties constitute the underinclusiveness "false positives" problem from the sophistication sorting mechanism: parties that accurately assess and price governance modifications, but who nevertheless fail the screen that separates sophisticated from unsophisticated investors. A well-designed sorting mechanism can minimize the size — and therefore opposition — from this latter group. Opposition from the former group, however, cannot be minimized; after all, one of the primary goals of this reform is to eliminate this problem. We can hope that the push for reform from its projected advocates will outweigh any arguments that this group might bring to bear.

To summarize, the benefits from a qualified LLC system that targets only those investors in need of mandatory protections are appreciable, allowing LLCs to achieve both contractual freedom as well as a simple form of limited liability and single taxation for everyday businesses. In addition, the prospects for passing such a system appear good; it provides needed protection, while relieving the pressure for more heavy-handed measures that might needlessly restrict the options for sophisticated parties. As with any significant reform, there are a number of concerns that could be levied against a qualified LLC approach. I proactively deal with several of them next.

IV. ADDRESSING CONCERNS AND CRITICISMS

Although a qualified LLC investor system has significant upside, that does not mean it is free from potential criticisms. Below, I

[171] Large, disparate groups that individually have little to gain or lose from a proposal are unlikely to bear the burden of pushing through such a proposal, unless they have a particularly effective interest group that concentrates the diffuse gains and advocates on their behalf. *See* OLSON, *supra* note 170, at 46-48. On the other hand, comparatively small groups comprised of members that have significant finances at stake are precisely the types of groups that have the incentive to enact change. *See* KINGDON, *supra* note 170, at 46-67; OLSON, *supra* note 170, at 46-48.

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preemptively address several concerns that might arise. First, I take up the criticism that reform is unnecessary, because existing legal doctrines beyond LLC-specific laws already provide investors with adequate protection.

A. Existing Law Obviates the Need for Reform

Some might argue that the need for any reform, not to mention the reform advocated here, is unnecessary because of existing legal rules that already deter undesirable conduct. I consider three potential deterrents here and show how each is insufficient to deter the problems that LLC contractual freedom permits. I first examine the implied obligation of good faith and fair dealing, a contract law rule that LLC statutes require of LLC operating agreements, before then turning to other contract law constraints and securities law rules.

1. The Mandatory Implied Covenant of Good Faith and Fair Dealing

Delaware, as well as other states following its permissive approach, requires that LLC operating agreements adhere to the implied covenant of good faith and fair dealing.[172] In Delaware, this is the lone mandatory protection; all other governance terms can be altered by the parties.[173] Perhaps, then, this implied covenant is a sufficient deterrent? Several academics, plaintiffs, and courts have pointed to this lone mandatory provision as providing a central protection.[174] In the words of a recent Delaware opinion, "[i]t is the unwaivable protection of the implied covenant that allows the vast majority of the remainder of the LLC Act to be so flexible."[175] To discern the implied

172 DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2018).

173 *Id.*

174 *See, e.g.*, R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. CIV.A.3803-CC, 2008 WL 3846318, at *7 (Del. Ch. Aug. 19, 2008) ("[T]he freedom of contract principle must be assiduously guarded lest the courts erode the primary attraction of limited liability companies."); Branson, *supra* note 130, at 2-3 (arguing that the implied obligation may reintroduce fiduciary duty-like obligations); Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1059-62 (arguing that "an LLC . . . agreement that completely abjured fiduciary obligation would, in the absence of a robust implied obligation of good faith, resemble a gift of members' property to those in control of the enterprise who would be free to use the entity's property as they saw fit"); Strine & Laster, *supra* note 54 ("In the corporate fiduciary context, good faith is the state of mind of a loyal fiduciary bound to advance the best interests of the stockholders.").

175 *R & R Capital*, 2008 WL 3846318, at *7.

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covenant's value, we must first determine what the implied covenant encompasses.

The implied covenant of good faith and fair dealing is a doctrine from contract law that applies to all contracts, including LLC operating agreements.[176] Although the implied covenant lacks sharp contours, it generally is described as a gap-filling tool of contract interpretation to cover situations the parties did not anticipate.[177] Conduct that is not explicitly addressed in the operating agreement, then, might fall within the scope of the operating agreement. In addition to being an unanticipated situation, to violate the implied covenant one party must have acted "arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected."[178]

We could imagine, then, that an aggrieved LLC owner might point to the implied covenant and plead that she is being denied the reasonably expected fruits of her investment. Indeed, this argument is often already brought by plaintiffs' attorneys.[179] If this argument were regularly successful, then the central problems contemplated by this Article would largely already have a legal remedy. The downfall of this argument, however, is that it requires showing that *both* parties did not anticipate the situation. While the unhappy investor may be able to make out such a showing (assuming there is no obligation to read and understand the operating agreement), our defendant could merely argue that *she* nevertheless anticipated the conduct, pointing to the permissive language in the operating agreement as evidence. Court opinions are rife with language that limits the scope of the implied covenant only to situations where *all* parties failed to foresee the later

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[176] DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2018); REVISED UNIF. LTD. LIAB. CO. ACT § 409(d) (UNIF. LAW COMM'N 2006); Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 168 n.17 (Del. 2002) ("[T]he implied covenant of good faith and fair dealing . . . inheres in every contract."). For an argument of how the doctrine could be used to deter problems in corporate law, see generally Albert H. Choi & Geeyoung Min, *Amending Corporate Charters and Bylaws* (on file with University of Pennsylvania Legal Scholarship Repository), http://scholarship.law.upenn.edu/faculty_scholarship/1898.

[177] *See, e.g.*, Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC, 112 A.3d 878, 897 (Del. 2015); Nemec v. Shrader, 991 A.2d 1120, 1125 (Del. 2010).

[178] *Nationwide Emerging Managers, LLC*, 112 A.3d at 897 n.76; *Nemec*, 991 A.2d at 1125-26.

[179] Peter Mahler, *Can't Get Rid of Those Nooks and Crannies: Delaware Supreme Court Clarifies Implied Covenant of Good Faith and Fair Dealing*, N.Y. BUS. DIVORCE (June 17, 2013), http://www.nybusinessdivorce.com/2013/06/articles/delaware/of-nooks-and-crannies-delaware-supreme-court-clarifies-implied-covenant-of-good-faith-and-fair-dealing.

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developments.[180] Where undesirable situations later arise that nevertheless fall within the scope of the operating agreement's authorizing language, courts have been unwilling to step in via the implied covenant.

Therefore, the implied covenant actually provides little if any protection in the context of the problems from contractually authorized behavior that was unexpected by investors.[181] Commentators have recognized the weak protection that the covenant offers, describing the implied covenant's protection in terms ranging from meager[182] to measured[183] to maligning.[184] The implied covenant

[180] *See, e.g.*, *Nationwide Emerging Managers*, 112 A.3d at 897 ("An interpreting court cannot use an implied covenant to re-write the agreement between the parties, and 'should be most chary about implying a contractual protection when the contract could easily have been drafted to expressly provide for it.' . . . When a court implies a term in a contract, much less [a detailed] one, it must be very careful."); Winshall v. Viacom Int'l, Inc., 76 A.3d 808, 816 (Del. 2013) ("The implied covenant of good faith and fair dealing cannot properly be applied to give plaintiffs contractual protections that 'they failed to secure for themselves at the bargaining table.'"); *Nemec*, 991 A.2d at 1126 ("[W]e must assess the parties' reasonable expectations at the time of contracting and not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal. Parties have a right to enter into good and bad contracts, the law enforces both."); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 637 (Del. Ch. 2011) ("[T]he implied covenant is not a license to rewrite contractual language . . . . Rather, a party may only invoke the protections of the covenant when it is clear from the underlying contract that 'the contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate with respect to that matter.'").

[181] While courts might apply the implied covenant in the face of a silent operating agreement, the worry throughout this Article has been with terms of agreements that explicitly sanction later behavior, but which go unpriced or underpriced by investors. *See, e.g.*, James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Mgmt., LLC, No. CIV.A.5:11-374-DCR, 2014 WL 2113096, at *9 (E.D. Ky. May 20, 2014) ("[A] party may act in its own interest and not breach the covenant of good faith and fair dealing, as long as its discretion is not used in a way that is contrary to the spirit of the agreement.").

[182] *See* Kleinberger, *supra* note 14, at 470 ("In short, to rely on the contractual duty of good faith as a substitute for fiduciary duty is akin to replacing heavy cream with skim milk.").

[183] Thomas E. Rutledge & Katharine M. Sagan, *An Amendment Too Far?: Limits on the Ability of Less than All Members to Amend the Operating Agreement*, 16 FLA. ST. U. BUS. REV. 1, 42 (2017).

[184] Stephen Bainbridge, *What's the Point of the Implied Covenant of Good Faith? Other than Generating Fees for Lawyers?*, PROFESSORBAINBRIDGE.COM (Mar. 31, 2015, 12:54 PM), http://www.professorbainbridge.com/professorbainbridgecom/2015/03/whas-the-point-of-the-implied-covenant-of-good-faith.html ("In sum, I have come to believe that the [implied covenant of good faith and fair dealing] is a judicially created tax on transactions for the benefit of lawyers. It generates a lot of litigation, but rarely changes outcomes, so it does the parties no good, while costing them huge legal fees.

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cannot solve the problems that LLCs currently face, without a dramatic expansion of its scope. And while the implied covenant's scope has never been precisely demarcated, a dramatic expansion and its concomitant unpredictability would be undesirable as a normative matter[185] and unlikely as a legal matter, given the precedent that emphasizes its limited nature.[186] In other words, the implied covenant of good faith and fair dealing does not obviate the need for reform.

Note that the implied covenant *could* be used to deter behavior when operating agreements are silent on the matter. However, this is not where LLCs have a particular problem: silences in operating agreements are already filled by the fairly robust default protections that LLC statutes impose. Rather, the worry throughout this Article has been where LLCs explicitly reduce or eliminate protections, authorizing value-reducing behavior that goes unpriced in investment decisions. The implied covenant is insufficient to deal with these situations.

2. Other Contract Law Doctrines

LLC operating agreements are a contract among investors governed by standard contract law doctrines; perhaps, therefore, tools from contract law might provide needed protections. The implied obligation of good faith and fair dealing is one of these. Two other particular contenders are, one, the doctrine of contra proferentem and, two, public policy restrictions.

The contra proferentem doctrine specifies that ambiguous contract provisions should be interpreted against the drafting party. The doctrine is widely used in insurance contract interpretation to expand coverage in favor of policyholders, who do not generally draft insurance contracts,[187] but it is a general contract doctrine that applies whenever one party has drafted the ambiguous contractual provision at issue.[188] In the context of LLCs, the doctrine could potentially be

And, of course, the risk of ICGF litigation justifies ex ante lawyering by transactional lawyers. Kill it. Kill it now.").

[185] *See, e.g.*, Strine & Laster, *supra* note 54, at 26 (noting that an expansion of the implied covenant "could render contractual expectations less predictable, thereby raising the cost of contracting and deterring the formation of some relationships").

[186] *See supra* note 180 (collecting cases that stress the implied covenant's limited nature).

[187] *See* Daniel Schwarcz, *Coverage Information in Insurance Law*, 101 MINN. L. REV. 1457, 1471-72 (2017) (referring to contra proferentem as the "first rule" of insurance law).

[188] Joyner v. Adams, 361 S.E.2d 902, 905-06 (N.C. Ct. App. 1987); RESTATEMENT

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used to protect minority owners, who often have had no hand in writing the operating agreements by which the LLC is governed.[189]

The problem with relying on contra proferentem, however, is that the doctrine applies only when language in the operating agreement is ambiguous. Unfortunately for this doctrine, operating agreements are often quite explicit and clear about how they modify governance protections, rendering contra proferentem inapplicable to those situations. The issue that the qualified LLC system attempts to remedy is rather that these modifications (whether clear or not) are mispriced by investors. So, although the doctrine could nominally be applied to LLCs,[190] the bulk of LLCs with unambiguous operating agreements will be unaffected by it, leaving unhappy investors still unhappy.

Relying on public policy to restrict governance modifications is also similarly unattractive. There are two ways that public policy could operate to limit governance contracting. Public policy might place a blanket limitation on parties' ability to alter certain governance terms, as in the doctrine of unconscionability.[191] For instance, contracts to achieve an illegal purpose are void on public policy grounds across the board; maybe operating agreements that eliminate the right to seek judicial dissolution, or that reduce some other fundamental term, would also be determined to be void for public policy reasons.[192]

The problem with this solution, however, is that across-the-board public policy restrictions effectively operate to make the governance term a mandatory term for all LLCs, which violates the contractual flexibility purpose of LLCs. While protecting parties in some circumstances may be appropriate, LLCs also arise with exclusively sophisticated investors who are more than capable of protecting

(SECOND) OF CONTRACTS § 206 (AM. LAW INST. 1981).

[189] Aleynikov v. Goldman Sachs Grp., Inc., C.A. No. 10636-VCL, 2016 WL 3763246, at *2-3 (Del. Ch. July 13, 2016) (applying contra proferentum to interpret corporation's bylaws against drafting corporation); Strine & Laster, *supra* note 54, at 11-13.

[190] *See, e.g.*, Manesh, *Equity*, *supra* note 59 (collecting cases).

[191] *See, e.g.*, Peter Mahler, *WWDD (What Would Delaware Do) with an In Terrorem LLC Dissolution Waiver Clause?*, N.Y. BUS. DIVORCE (Sept. 1, 2008), http://www.nybusinessdivorce.com/2008/09/articles/llcs/wwdd-what-would-delaware-do-with-an-in-terrorem-llc-dissolution-waiver-clause (discussing a New York Supreme Court decision that stated "to absolutely prohibit judicial dissolution is void and unenforceable as against public policy").

[192] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 178; Adam B. Badawi, *Harm, Ambiguity, and the Regulation of Illegal Contracts*, 17 GEO. MASON L. REV. 483, 487 (2010) (analyzing remedies for illegal contracts); David Adam Friedman, *Bringing Order to Contracts Against Public Policy*, 39 FLA. ST. U. L. REV. 563, 580-611 (2012) (studying cases employing the public policy defense).

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themselves. Mandatory rules in that circumstance could eliminate efficient relationships these parties might otherwise be able to achieve.

How about public policy that instead restricts contractual governance modifications in individualized circumstances, such as when unconscionable modifications are enacted against particularly sympathetic investors,[193] or when investors could not be expected to understand or appreciate the restriction? The first circumstance then begins to resemble the situation of judicial-implemented protections, discussed earlier.[194] For the same reasons discussed earlier — the loss in predictability, the administrative costs, and the incompleteness of investors being protected — this approach is not only undesirable, but also fails to solve completely the problem addressed by a qualified LLC system. And the second circumstance begins to resemble the qualified LLC system, but with less predictability and therefore less benefit.

3. Securities Law

Since the qualified LLC system is modeled after the securities law accredited investor standard, a natural question to ask is whether securities law already provides sufficient protections, either through its accredited investor standard or some other method. If so, perhaps LLC reform again is unnecessary.

It is first worth contemplating whether federal securities law even applies to LLC investment interests. Under the *Howey* investment contract test put forth by the Supreme Court, holders of investment interests must exert little or no effort for those interests to constitute a security.[195] Since LLC investments can require "mixed" investments of both financial and human capital, some LLC ownership interests have been held to fall outside the scope of securities law.[196] Of course, if securities law does not apply, neither do its protections.

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[193] *See* Choi & Min, *supra* note 176, at 16-17 (comparing unconscionability to the covenant of good faith).

[194] *See supra* Section II.C.

[195] SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) (enunciating the test for investment contracts).

[196] *See* Robinson v. Glynn, 349 F.3d 166, 174 (4th Cir. 2003) ("Precisely because LLCs lack standardized membership rights or organizational structures, they can assume an almost unlimited variety of forms. It becomes, then, exceedingly difficult to declare that LLCs, whatever their form, either possess or lack the economic characteristics associated with investment contracts."). *See generally* Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992) (analyzing this general issue).

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But let us assume federal securities law does apply and consider the case of the accredited investor standard. This standard relieves issuers of securities from complying with registration requirements when those securities are sold to accredited investors, who are generally individuals of high net worth.[197] Registration requirements are essentially information-disclosing requirements; when companies register, they must disclose various pieces of information that typical investors would find useful in making their investment decisions, with antifraud liability for falsely disclosed information.[198] Avoiding registration allows companies to save these compliance costs and to keep certain information private that might otherwise have to be disclosed.

Although the LLC investor sorting mechanism might end up bearing some resemblance to the accredited investor standard sorting mechanism, the goals of the two systems are quite different. The accredited investor standard relieves firms from having to disclose required information to sophisticated investors, while forcing disclosure when the standard is not satisfied. On the other hand, the qualified LLC system provides flexibility for sophisticated investors (with sophistication perhaps determined differently) to set their own governance terms, while requiring mandatory minimum protections when the standard is not satisfied. The LLC problem is not a disclosure problem; LLC investors receive, often in excruciating detail, an operating agreement that lays out the rules for internal governance, including precisely how the standard governance rules are modified. Instead, the problem that the qualified LLC system addresses is that these disclosures are not processed, or are processed incorrectly, such that investors fail to price them accurately. Therefore, even though both the securities law accredited investor standard and the qualified LLC system differentiate between sophisticated and unsophisticated investors, the problems that each tackles are very different, such that the accredited investor standard does nothing to address the problems handled by the qualified LLC system.

The second main component of federal securities law is its general anti-fraud liability provisions. These provisions augment state common law fraud actions by providing alternative avenues for recovery when those frauds involve securities.[199] However, the problem with LLCs is not a problem of fraud, nor does the qualified

[197] *See supra* notes 89–93 and accompanying text.

[198] *See supra* note 74 and accompanying text.

[199] *See, e.g.*, 17 C.F.R. § 240.10b-5 (2018) (constituting the general anti-fraud provision of securities laws).

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LLC system attempt to deal with fraud. Since operating agreements are often explicit about the ways that traditional protections are cut back or eliminated, the deception element needed for fraud is missing.[200] Instead, the qualified LLC reform addresses the problem of governance modifications' not being priced, leading to inefficient allocations of capital and higher capital costs generally.

B. *Shutting Out Investors from Investments*

An additional concern that has been raised in other circumstances, and which is certainly applicable here, is that the qualified LLC approach will effectively shut out everyday investors from some money-making investment opportunities, exacerbating existing wealth imbalances. This concern arises because LLCs might react to a qualified LLC system by refusing to have any non-qualified investors. Ensuring that they have only qualified investors allows these LLCs to preserve flexibility in setting their governance terms and avoid the costs of adopting mandatory protections, but it means that non-qualified investors might be foreclosed from certain investments. A similar reaction has been seen in federal securities law, where a desire to seek an exemption from registration requirements has meant that non-accredited investors cannot participate in some profitable investment opportunities.[201]

While it is undoubtedly true that non-qualified investors will be barred from investing in certain LLCs, this is not necessarily a bad outcome as a policy matter. If LLCs are seeking qualified status to sanction behavior that initially goes unpriced by unsophisticated investors, then foreclosing these investments to everyday investors saves those investors from later losses. On the other hand, when LLCs

[200] *See generally* Molk, *Contracting Around Default Protections*, *supra* note 20 (analyzing the ways that operating agreements explicitly allow deviations from standard protections).

[201] *See* Oranburg, *supra* note 93, at 1033-40 (raising this concern for investing in large private companies); Rodrigues, *supra* note 81, at 3389 (recommending opening up investment in non-public companies to ordinary investors because of a concern that, among other reasons, the existing approach "has created an investing climate that lets the rich get richer, while the poor get left behind"). In recent years, investment by public companies in private enterprises, and the going-public of some formerly private equity companies, has opened up some of these investments to everyday investors. Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1343 (2017); *see, e.g.*, *Our History*, BLACKROCK, https://www.blackrock.com/corporate/en-us/about-us/blackrock-history (last visited Aug. 8, 2017).

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seek qualified status to enable flexible governance arrangements in pursuit of efficiency, non-qualified investors miss out, but there is reason to think that any problems from these lost opportunities will be comparatively small. First, there is no reason to think that qualified LLCs will, as a group, offer superior risk-adjusted investment returns to non-qualified LLCs,[202] and if the returns to qualified LLCs are no better, then there is no financial harm from foreclosing these investments to certain investors. Second, investors may already be foreclosed from investing in qualified LLCs under federal securities law, if those LLCs have issued securities through a Rule 506 accredited investor exemption.[203] Many of the firms traditionally seen as offering the potential for superior returns utilize this exemption when selling investment interests,[204] and to the extent there is overlap between the accredited investor standard and the standard chosen for the qualified LLC system, there will be little additional harm if non-qualified investors cannot participate.

C. Changing the Rules for Existing LLCs

The final critique that I consider is that meaningful change to LLC law, as contemplated by the qualified LLC system, will have negative disruptive effects on existing LLCs. These LLCs would have been formed with one set of rules in mind, only to find themselves later subjected to another. This problem from changing the rules on incumbents is certainly not unique to business law; it arises whenever well-settled expectations are disrupted due to legal change.[205] However, disruption could be particularly burdensome in this case, since for many LLCs, essential, long-term matters of business governance could be fundamentally changed with the stroke of a statutory pen.

There are several ways that this problem could be tempered. One common approach in other circumstances is to grandfather incumbent

[202] It seems likely, however, that private equity and venture capital firms will choose qualified-LLC status to enable the business opportunity waivers and other governance modifications that they traditionally utilize. Ribstein, *Partnership Governance*, *supra* note 65 (analyzing private equity and venture capital LLCs' use of these modifications). But whether these firms present superior investment opportunities over the long term is by no means clear.

[203] *See supra* text accompanying notes 89–93.

[204] Rodrigues, *supra* note 81 (addressing this issue).

[205] *See* Peter Molk & Arden Rowell, *Reregulation and the Regulatory Timeline*, 101 IOWA L. REV. 1497, 1530-31 (2016) (discussing the importance of grandfather clauses for corporate long-term planning).

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players, relieving them from the rule change for a period of time or indefinitely, which preserves these incumbents' original expectations. Another is to compensate incumbents for the costs of disruption. But in business law, fundamental governance changes happen with reasonable frequency, typically without any sort of grandfathering or compensation despite challenges by unhappy investors.[206] Indeed, the LLC space has already experienced uncompensated, retroactive, fundamental statutory change.[207]

Moreover, LLCs' cost of disruption could be relatively small.[208] The most meaningful costs will come from LLCs with at least some non-qualified investors that also modified governance provisions to achieve efficient governance relationships. Under a qualified LLC system, these relationships would now have mandatory protections applied to them, which can introduce undesirable friction into the internal governance. This is the overinclusive problem of legal rules. However, if these costs are meaningful, LLCs could avoid them by buying out non-qualified investors' interests to preserve their existing governance relationships, depending on the LLCs' access to capital as well as non-qualified investors' role in managing the business.

Finally, LLCs that already have exclusively investors that will be deemed qualified under the qualified system will experience only good things from the reform. Assuming the reform is structured to preserve their contracting flexibility, then these LLCs will not see their operating arrangements disrupted at all. Moreover, by relieving the building pressure to implement less tailored or less predictable

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[206] *See, e.g.*, A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 587-90 (N.J. 1953) (retroactively applying a statutory change to an existing corporation); *cf.* Auriga Capital Corp. v. Gatz Props., 40 A.3d 839, 854-55 (Del. Ch. 2012) (identifying protecting investors' reasonable expectations as a reason to preserve existing law).

[207] Most recently, Delaware's Supreme Court identified a statutory ambiguity for whether fiduciary duties applied by default to LLCs, or not even by default. The ruling drew a quick legislative response making fiduciary duties applicable by default. DEL. CODE ANN. tit. 6, §§ 18-1101(c), 1104 (2018). Section 1104 was amended in 2013 to say that fiduciary duties apply by default; prior to the amendment, it was not clear whether fiduciary duties applied by default, or only if parties expressly adopted them. Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1219 (Del. 2012) ("[R]easonable minds arguably could conclude that the statute . . . is consciously ambiguous."); Manesh, *Damning Dictum*, *supra* note 134 (analyzing this issue).

[208] Indeed, there is an argument that the costs from disruption in general circumstances is small. *See* Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 550-52 (1986) (arguing that uncompensated retroactive changes will, among other things, encourage industry players to anticipate legal change rather than to unreasonably rely on existing rules). *But see* Molk & Rowell, *supra* note 205, at 1517 n.40 (discussing the conditions needed for this argument to hold).

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proposals, these LLCs can continue to operate knowing that their governance relationships will remain stable into the future.

To summarize, the qualified LLC system has the potential to offer significant value in spite of existing deterrents and several potential criticisms. Existing legal forces provide, at best, an incomplete solution to the problems that arise when everyday investors buy into entities with contractual freedom meant for sophisticated players. And while it is true that reform will include certain costs, there is good reason to believe that these costs can be mitigated to levels far below expected benefits.

CONCLUSION

LLCs, when subject to one single set of rules, cannot meet their twin goals of providing for governance flexibility *and* ensuring sufficient protections for everyday investors. Instead, the key to unlocking LLCs' potential rests in dividing the rules in two, with mandatory minimum required protections for less sophisticated investors and broad flexibility for sophisticated parties. By preserving contractual freedom for investors that can protect themselves, LLCs will continue to offer the maximum potential for efficient governance relationships. In addition, by providing a robust set of protections for everyday investors, LLCs will remain an appropriate form for those parties seeking a simple, low-cost means of achieving limited liability and preferential tax treatment. The qualified LLC system can ensure that LLCs continue as a dominant form of business enterprise long into the future.

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