U N I V E R S I T Y *of* H O U S T O N

Public Law and Legal Theory Series 2006-A-01

Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History

DOUGLAS K. MOLL

THE UNIVERSITY OF HOUSTON
LAW CENTER

MINORITY OPPRESSION & THE LIMITED LIABILITY COMPANY: LEARNING (OR NOT) FROM CLOSE CORPORATION HISTORY

*Douglas K. Moll**

The problems of minority shareholder oppression have long been a part of the close corporation setting. Largely due to the principle of majority rule and the lack of a market exit, minority shareholders of close corporations are peculiarly vulnerable to abuse. Perhaps not surprisingly, therefore, judicial precedents and statutory provisions in many jurisdictions afford some protection to the close corporation minority investor from the improper exercise of majority control.

Many closely held businesses today, however, are structured not as close corporations, but as limited liability companies ("LLCs"). As a consequence, it is important to ask whether the LLC form of business organization poses the same risks of oppression to minority owners, and, if so, whether judicial and legislative assistance is needed. The author explores these questions and concludes that the problems of minority oppression are likely to arise in the LLC setting as well. Because the "seeds" of oppression are also present in the LLC, in other words, the author argues that LLC minority owners will need a protective oppression doctrine just like their close corporation brethren.

I. INTRODUCTION

For decades, the law has struggled with the plight of the close corporation minority investor.[1] Possessed with financial and

* Associate Professor of Law, University of Houston Law Center. B.S. 1991, University of Virginia; J.D. 1994, Harvard Law School. The author wishes to thank Asher Moll, Samara Moll, Stefanie Moll, Zelda Moll, and Robert Ragazzo for their helpful comments.

1. The terms "majority" and "minority" are used in this Article to "distinguish those shareholders who possess the actual power to control the

participatory expectations, but powerless in a majority rule and "no exit" environment, the close corporation minority shareholder is peculiarly vulnerable to abuse.[2] Indeed, when dissension breaks out among close corporation investors, the majority shareholder can use its control to harm or "oppress" the minority shareholder.[3] Common oppressive acts include the termination of the minority's employment, the removal of the minority from management, and the exclusion of the minority from the profits of the venture.[4]

Over the years, repeated calls for reform have gradually altered the traditional indifference to the problem of minority shareholder oppression.[5] In many jurisdictions today, the doctrine of shareholder oppression provides some protection to the close corporation minority investor from the improper exercise of majority control. When a minority shareholder claims abuse at the hands of a majority investor, courts applying the oppression doctrine will subject the majority's conduct to a considerable amount of scrutiny.[6]

---

operations of the firm from those who do not." J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 5 n.7 (1977). Such power is "most often determined by the size of the shareholdings." *Id.*

2. *See infra* Part II.A (discussing the nature of the close corporation).

3. *See, e.g.*, Meiselman v. Meiselman, 309 N.C. 279, 290, 307 S.E.2d 551, 558 (1983) ("[W]hen the personal relationships among the participants break down, the majority shareholder, because of his greater voting power, is in a position to terminate the minority shareholder's employment and to exclude him from participation in management decisions."); *infra* notes 19-22 and accompanying text (discussing majority rule).

4. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (concluding that the controlling group breached a fiduciary duty owed to the plaintiff minority shareholder by "severing [the minority] from the payroll of the corporation" and "refusing to reelect [the minority] as a salaried officer and director"); *infra* notes 22-27 and accompanying text (describing common oppressive actions).

5. *See, e.g.*, F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 884-85 (1978) (stating that "courts may well consider intervention to protect minority shareholders in a close corporation against oppressive action by the directors" and observing that "[l]egislation might be helpful that directs the courts, even in the absence of an express agreement, to protect the reasonable expectations of persons acquiring an interest in a close corporation, *e.g.*, their expectation to participate in management or to be employed by the company"); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 193 (1988) ("Although Professor O'Neal has not been alone in writing about close corporations, he, more than anyone else, established close corporations as a separate field of academic study and *led legislatures and courts to pay particular attention to the special needs of close corporations and their shareholders, especially minority shareholders*.") (emphasis added).

6. *See, e.g.*, Douglas K. Moll, *Shareholder Oppression & Dividend Policy in*

Because the oppression problem originated in the close corporation, it is not surprising that the oppression doctrine is applied in close corporation disputes. Whether the doctrine should protect minority owners in other business structures, however, is a question that courts have yet to answer. In recent years, this question has taken on critical importance, as the LLC has emerged as the favored business structure for many closely held enterprises.[7] An LLC is a noncorporate business form that provides its owners, known as "members," with limited liability for the venture's obligations, favorable partnership tax treatment, and extensive freedom to contractually arrange the business.[8] Because of this

---

the Close Corporation, 60 WASH. & LEE L. REV. 841, 870 (2003).

> [T]he oppression doctrine calls for legitimate scrutiny of a majority's decision[s] . . . . The doctrine conveys . . . that such [majority] decisions require a more probing judicial review than the conventional business judgment rule allows. Thus, the thrust of the shareholder oppression doctrine is at odds with a judicial approach that gives great deference to the majority's actions.

Id. (footnote omitted). In some jurisdictions, that scrutiny is doctrinally articulated as an inquiry into whether the majority's conduct has frustrated the "reasonable expectations" of the minority investor. *See, e.g.*, *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (equating oppression with conduct that "defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise"); *infra* notes 32-33 and accompanying text (discussing oppression-triggered dissolution statutes). In other jurisdictions, the scrutiny takes the doctrinal form of an inquiry into whether the majority shareholder has breached a duty of "utmost good faith and loyalty" that is owed to the minority investor. *See infra* notes 37-39 and accompanying text (discussing the fiduciary duty that some courts impose between close corporation investors).

7. *See, e.g.*, Larry E. Ribstein, *LLCs: Is the Future Here? A History and Prognosis*, BUS. LAW TODAY, Nov./Dec. 2003, at 11, 13 [hereinafter Ribstein, *Future*] ("LLCs are gradually replacing corporations and limited partnerships as the leading business entity."); *infra* text accompanying note 13 (stating that the LLC is the preferred choice for many businesses); *see also* Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43, 48 (1994) ("Because of the unique combination of tax benefits with limited liability, limited liability companies are likely to become the organizational form of choice for many closely held businesses."); Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 331-33 (1997) [hereinafter Ribstein, *New Choice*] (noting that "the corporate form is doomed for closely held firms"); *cf.* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1:1, at 1-1 (2d ed. 2004) ("The limited liability company (LLC) as a United States form of organization dates back to 1977, although it did not receive significant attention until disadvantageous federal income tax treatment to which it had been subject in its early years was changed in 1988.").

8. *See, e.g.*, Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. 1999) (stating that the Delaware LLC statute is designed "to permit persons or

ideal combination of attributes, use of the LLC has exploded.[9] Over the 1992-1996 time period, for example, new registrations for corporations and limited partnerships increased by 13 percent and 15 percent, respectively, while new registrations for LLCs grew by more than 2,300 percent.[10] Firms in a wide variety of industries are now using the LLC structure,[11] and growth in the usage of the form is expected to continue.[12] Simply put, within a relatively short period of time, the LLC has become "the preferred choice for many businesses."[13]

entities ('members') to join together in an environment of private ordering to form and operate the enterprise under an LLC agreement with tax benefits akin to a partnership and limited liability akin to the corporate form"); *infra* Part IV.A (providing an overview of the limited liability company).

9. *See, e.g.*, Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation from Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 ALA. L. REV. 909, 909 (1998) ("The rise of the domestic limited liability company (LLC) . . . occurred because it represented the first domestic business entity offering the corporate characteristic of limited liability combined with the favorable tax treatment afforded partnerships."); Conrad S. Ciccotello & C. Terry Grant, *LLCs and LLPs: Organizing to Deliver Professional Services*, BUS. HORIZONS, Mar.-Apr. 1999, at 85, 89 ("The LLC is gaining popularity because other organizational forms do not offer the same combination of benefits.").

10. Ciccotello & Grant, *supra* note 9, at 87; *see also* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1:1, at 1-1 n.1 (2d ed. 2003) (indicating that the number of LLCs increased from 17,000 in 1993 to 589,403 in 1999); *id.* at vii (noting that "the number of LLCs [has] grown geometrically over the past few years"); Ciccotello & Grant, *supra* note 9, at 85, 87 (describing the nationwide growth rate in LLC registrations as "phenomenal" and "explosive"); Ribstein, *Future*, *supra* note 7, at 13 ("While LLC filings were rising by 47,000 from 2000 to 2001, domestic for-profit business and professional corporation filings were dropping about 30,000 and limited partnership filings were dropping about 7,000."); *infra* note 142 and accompanying text (noting that the number of LLCs in operation is growing rapidly).

11. *See, e.g.*, Ciccotello & Grant, *supra* note 9, at 89 (collecting data on 1252 LLCs and observing that "[e]ngineering and management support companies make up about 26 percent of the sample, real estate businesses 19 percent, construction 12 percent, and investment companies 9 percent" while "[t]he remaining one-third of the sample is spread over a number of different industries"); *see also* 1 RIBSTEIN & KEATINGE, *supra* note 10, at vii (noting that "the uses to which LLCs are being put have expanded dramatically").

12. *See, e.g.*, Ciccotello & Grant, *supra* note 9, at 90-91 ("In offering both pass-through tax treatment and liability protection, [the LLC and the limited liability partnership] dominate other organizational forms. To use a biological metaphor, they represent a new hybrid with properties superior to existing forms. So their rapid growth will likely continue.").

13. 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:1, at 1-1; *see supra* note 7 and accompanying text (noting that the LLC is the favored business structure for many closely held enterprises).

In light of the tremendous growth and popularity of the LLC, it is vitally important to return to the unanswered question—i.e., should the oppression doctrine apply to disputes in the LLC setting as well? After all, the close corporation experience suggests that dissension is inevitable in many LLCs. Are there distinctions between the close corporation and the LLC forms that would minimize the potential for abusive majority behavior, or are the factors underlying the oppression problem in the close corporation also present in the LLC context? By exploring these issues, one can assess whether state legislatures have learned from close corporation history, and one can make a normative judgment about whether the oppression doctrine has a place in the LLC.

Part II of this Article discusses the nature of the close corporation and explains the development of the doctrine of shareholder oppression. Part III examines the underlying "seeds" of the oppression problem in the close corporation. As mentioned, the absence of exit rights coupled with the norm of majority rule places the close corporation minority shareholder in a precarious situation. When the deference of the business judgment rule and the usual lack of advance planning are added to the mix, the stage is set for oppression.

Part IV provides needed background information on the LLC's operation and development. Part V explores whether the factors giving rise to the oppression problem in the close corporation setting are also present in the LLC context. Although early versions of state LLC statutes contained protections against oppressive majority behavior, most amended versions have eliminated those protections, largely in pursuit of tax objectives. Unfortunately, this effort to meet the tax goals of some will come at a high price for many, as the LLC structure is now poised to repeat the oppression experience of the close corporation. By ignoring close corporation history, in other words, state legislatures have created the need for an oppression doctrine in the LLC setting as well.

Part VI discusses whether the oppression doctrine can easily "transplant" to the LLC context. Because LLC statutes provide investors with great freedom to privately order their affairs, courts may be reluctant to assist oppressed members who, ex ante, could have protected themselves. Given that a number of LLC statutes specify that members owe a fiduciary duty to one another, however, there is some legislative impetus for courts to scrutinize majority conduct that detrimentally affects a minority investor's interests. Part VII looks briefly to the future of business structures, as it offers some suggestions for combating the oppression problem in new (and existing) business forms.

II. THE CLOSE CORPORATION AND THE DOCTRINE OF SHAREHOLDER OPPRESSION

A. *The Nature of the Close Corporation*

A close corporation is a business organization typified by a small number of stockholders, the absence of a market for the corporation's stock, and substantial shareholder participation in the management of the corporation.[14] In the traditional public corporation, the shareholder is normally a detached investor who neither contributes labor to the corporation nor takes part in management responsibilities.[15] In contrast, within a close corporation, "a more intimate and intense relationship exists between capital and labor."[16] Close corporation shareholders "usually expect employment and a meaningful role in management, as well as a return on the money paid for [their] shares."[17] Further,

---

14. *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975) (describing the typical characteristics of a close corporation); Daniel S. Kleinberger, *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 WM. MITCHELL L. REV. 1143, 1148 (1990) ("Close corporations have a limited number of shareholders, and most, if not all, of the shareholders are active in the corporation's day-to-day business.").

There is some variation in the definition of a close corporation. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 338 (8th ed. 2000).

> Exactly what constitutes a close corporation is a matter of theoretical dispute. Some authorities emphasize the number of shareholders, some emphasize the presence of owner-management, some emphasize the lack of a market for the corporation's stock, and some emphasize the existence of formal restrictions on the transferability of the corporation's shares.

Id.; 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS: LAW AND PRACTICE § 1.2, at 1-4 to 1-7 (3d ed. 2002) [hereinafter CLOSE CORPORATIONS] (noting the following possible definitions of a "close corporation": a corporation with relatively few shareholders; a corporation whose shares are not generally traded in the securities markets; a corporation in which the participants consider themselves partners *inter se*; a corporation in which management and ownership are substantially identical; and any corporation which elects to place itself in a close corporation grouping). Nevertheless, the typical close corporation possesses most, if not all, of the attributes described in these various definitions.

15. *See, e.g.*, 1 CLOSE CORPORATIONS, *supra* note 14, § 1.8, at 1-31 to 1-32.

16. Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 702 (1993).

17. *Id.*; *see also* Pedro v. Pedro, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990) ("[T]he primary expectations of minority shareholders include an active voice in management of the corporation and input as an employee."); 1 CLOSE CORPORATIONS, *supra* note 14, § 7.2, at 7-4 ("Ownership and management frequently coalesce in closely held corporations, where not uncommonly all the

close corporation investors are often linked by family or other personal relationships that result in a familiarity between the participants.[18]

Conventional corporate law norms of majority rule and centralized control can lead to serious problems for the close corporation minority shareholder.[19] Traditionally, most corporate power is centralized in the hands of a board of directors.[20] In a close corporation, the board is ordinarily controlled "by the shareholder or shareholders holding a majority of the voting power."[21] Through this control of the board, the majority shareholder has the ability to take actions that are harmful to the minority shareholder's interests.[22]

principal shareholders devote full time to corporate affairs. Even where one or two shareholders may be inactive, the business is normally conducted by the others without aid from nonshareholder managers."); Bahls, *supra* note 7, at 49 (observing that "[i]n close corporations, most shareholders commonly serve both on the board of directors and as officers" and stating that "ownership and management are nearly identical in most closely held businesses").

18. *See, e.g.*, Thompson, *supra* note 5, at 196 (discussing relationships between close corporation participants); *infra* note 102 and accompanying text (noting that close corporation investors often share family or personal ties); *see also* Bostock v. High Tech Elevator Indus., 616 A.2d 1314, 1320-21 (N.J. Super. Ct. App. Div. 1992) ("[A] close[] corporation frequently originates in the context of personal relationships. Often such business entities are formed by family members or friends.") (citation omitted).

19. *See* 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 1:2, at 1-3 to 1-4 (2d ed. 1997) [hereinafter OPPRESSION] (characterizing majority rule and centralized management as the "traditional pattern of corporate management" and noting the dangers that this management pattern presents to close corporation minority shareholders); Thompson, *supra* note 16, at 702-03 ("In a closed setting, the corporate norms of centralized control and majority rule easily can become instruments of oppression.").

20. *See* REVISED MODEL BUS. CORP. ACT § 8.01(b) (1994) [hereinafter RMBCA] ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . ."); Kleinberger, *supra* note 14, at 1152 ("In traditional theory, ultimate authority resides with the board of directors . . . .").

21. Kleinberger, *supra* note 14, at 1151-52; *see, e.g.*, 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3 ("Indeed, in most closely held corporations, majority shareholders elect themselves and their relatives to all or most of the positions on the board.").

22. *See, e.g.*, *Bostock*, 616 A.2d at 1320 ("[B]ased upon its voting power, 'the majority is able to dictate to the minority the manner in which the [close] corporation is run.'") (quoting Orchard v. Covelli, 590 F. Supp. 1548, 1557 (W.D. Pa. 1984)); Meiselman v. Meiselman, 309 N.C. 279, 290, 307 S.E.2d 551, 558 (1983) ("[W]hen the personal relationships among the participants break down, the majority shareholder, because of his greater voting power, is in a position to terminate the minority shareholder's employment and to exclude him from participation in management decisions."); Kiriakides v. Atlas Food Sys. &

Such actions are often referred to as "freeze-out" or "squeeze-out" techniques[23] that "oppress"[24] the close corporation minority shareholder. Standard freeze-out techniques include the refusal to declare dividends, the termination of a minority shareholder's employment, the removal of a minority shareholder from a position of management, and the siphoning off of corporate earnings through high compensation to the majority shareholder.[25] Quite often, these tactics are used in combination. For example, the close corporation investor generally looks to salary rather than dividends for a share of the business returns because the "[e]arnings of a close corporation often are distributed in major part in salaries, bonuses and retirement benefits."[26] When actual dividends are not paid,

---

Servs., Inc., 541 S.E.2d 257, 267 (S.C. 2001) ("This unequal balance of power often leads to a 'squeeze out' or 'freeze out' of the minority by the majority shareholders.") (footnote omitted); *see also* Fix v. Fix Material Co., 538 S.W.2d 351, 358 (Mo. Ct. App. 1976) ("In the instant case [a group of four shareholders], acting in concert, control a majority of the outstanding stock, though no single shareholder owns 51%."); *id.* ("Because this control carries the power to destroy or impair the interests of minority owners, the law imposes equitable limitations on the rights of dominant shareholders to act in their own self-interest.").

23. *See* 1 OPPRESSION, *supra* note 19, § 1:1, at 1-3 n.2 ("The term 'freeze-out' is often used as a synonym for 'squeeze-out.'"). It has been noted that the term "squeeze-out" means "the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants." *Id.* at 1-1. Similarly, a "partial squeeze-out" is defined as "action which reduces the participation or powers of a group of participants in the enterprise, diminishes their claim on earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled." *Id.* at 1-1 to 1-2. *See generally* 1, 2 OPPRESSION, *supra* note 19, §§ 3:1-3:20, at 3-1 to 3-211, 4:1-4:6, at 4-1 to 4-43, 5:1-5:36, at 5-1 to 5-309, 6:1-6:10, at 6-1 to 6-65 (discussing various squeeze-out techniques).

24. *See infra* notes 33, 38 and accompanying text (describing judicial definitions of "oppression").

25. *See* 1 OPPRESSION, *supra* note 19, §§ 3:4, 3:6, 3:7, at 3-13 to 3-20, 3-37 to 3-58 (discussing freeze-outs); *see also* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513 (Mass. 1975) (noting some of the possible freeze-out techniques); Bahls, *supra* note 7, at 83 ("Common 'freeze out' techniques include restricting the minority shareholder's access to management, information, dividends, and distributions.").

26. 1 CLOSE CORPORATIONS, *supra* note 14, § 1.8, at 1-32; *see* Kleinberger, *supra* note 14, at 1148 ("Payout is frequently in the form of salary rather than dividends.").

When calculating its taxable income, a close corporation can deduct reasonable salaries paid to its employees to "reduce the amount of income tax that the company pays." Thompson, *supra* note 5, at 197 n.12 (citing I.R.C. § 162 (1986)). A close corporation cannot, however, deduct any dividends paid therefore, a minority shareholder who is discharged from employment and removed from the board of directors is effectively denied any return on its investment as well as any input into the management of the business.[27] Once the minority shareholder is faced with this "indefinite future with no return on the capital he or she contributed to the enterprise,"[28] the majority often proposes to purchase the shares of the minority shareholder at an unfairly low price.[29]

In the public corporation, the minority shareholder can escape these abuses of power by simply selling its shares on the market. By definition, however, there is no ready market for the stock of a close corporation.[30] Thus, when a close corporation shareholder is

to its shareholders. As a consequence, corporate income paid as dividends is subject to double taxation—once as business income at the corporate level, and once as personal income at the shareholder level. *See id.* at 197 n.12. Because of "[t]he tax system's discouragement of dividends" in favor of salaries, "most close corporations provide a return to participants in the form of salary or other employee-related benefits." Thompson, *supra* note 16, at 714 n.90; *see also* 1 OPPRESSION, *supra* note 19, § 1:3, at 1-4 to 1-5 ("[A] close corporation, in order to avoid so-called 'double taxation,' usually pays out most of its earnings in the form of salaries rather than as dividends.").

27. *See, e.g.*, Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987) ("Balvik was ultimately fired as an employee of the corporation, thus destroying the primary mode of return on his investment."); *id.* ("Any slim hope of gaining a return on his investment and remaining involved in the operation of the business was dashed when Sylvester removed Balvik as a director and officer of the corporation."); 1 CLOSE CORPORATIONS, *supra* note 14, § 1.15, at 1-89 (observing that a close corporation minority shareholder who expects to receive a return on investment through salary "face[s] the risk that, after a falling out among the participants, the directors [will] terminate the minority shareholder's employment and deprive that investor of any return on the investment in the corporation"); *see also* Naito v. Naito, 35 P.3d 1068, 1072 (Or. Ct. App. 2001) ("Employment with the corporation was, as a practical matter, the only way that shareholders could receive any immediate benefit from their shares.").

28. Thompson, *supra* note 16, at 703; *see* 1 CLOSE CORPORATIONS, *supra* note 14, § 1.16, at 1-96 ("If, for example, the minority shareholder is fired from the employment that was providing the return on the investment in the close corporation, the minority may face an indefinite period with no return on the investment.").

29. *See, e.g.*, *Donahue*, 328 N.E.2d at 515 ("Majority 'freeze-out' schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. When the minority stockholder agrees to sell out at less than fair value, the majority has won.") (citations omitted); 2 CLOSE CORPORATIONS, *supra* note 14, § 9:2, at 9-8 ("A squeeze-out usually does not offer fair payment to the 'squeezees' for the interests, rights or powers which they lose."); Thompson, *supra* note 16, at 703-04 (noting that in a classic freeze-out, "the majority first denies the minority shareholder any return and then proposes to buy the shares at a very low price").

30. *See, e.g.*, *Donahue*, 328 N.E.2d at 514 ("In a large public corporation,

treated unfairly, the investor "cannot escape the unfairness simply by selling out at a fair price."[31]

B. The Cause of Action for Oppression

Over the years, state legislatures and courts have developed two significant avenues of relief for the "oppressed" close corporation shareholder. First, many state legislatures have amended their corporate dissolution statutes to include "oppression" by the controlling shareholder as a ground for involuntary dissolution of the corporation.[32] In jurisdictions with such dissolution for oppression statutes, "oppression" is typically defined as majority conduct that frustrates the "reasonable expectations" of a minority investor.[33] Moreover, when oppressive conduct has occurred, actual

---

the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation."); Brenner v. Berkowitz, 634 A.2d 1019, 1027 (N.J. 1993) ("[U]nlike shareholders in larger corporations, minority shareholders in a close corporation cannot readily sell their shares when they become dissatisfied with the management of the corporation."); Bostock v. High Tech Elevator Indus., 616 A.2d 1314, 1320 (N.J. Super. Ct. App. Div. 1992) ("[A] minority interest in a close[] corporation is difficult to value because the shares are not publicly traded and a fair market is often not available."); 2 CLOSE CORPORATIONS, *supra* note 14, § 9.2, at 9-4 to 9-5 ("[A] shareholder in a close corporation does not have the exit option available to a shareholder in a publicly held corporation, who can sell his shares in a securities market if dissatisfied with the way the corporation is being operated."); Thompson, *supra* note 16, at 702 ("[T]he economic reality of no public market deprives investors in close corporations of the same liquidity and ability to adapt available to investors in public corporations.").

31. Kleinberger, *supra* note 14, at 1149; *cf.* Walensky v. Jonathan Royce Int'l, Inc., 624 A.2d 613, 615 (N.J. Super. Ct. App. Div. 1993) ("The interest owned by a minority shareholder in a closely held corporation is often a precarious one. In fact, it has been characterized by this court as being one of 'acute vulnerability.'" (quoting *Bostock*, 616 A.2d at 1314)).

32. *See* Thompson, *supra* note 16, at 708 (discussing the dissolution statutes). *See generally* Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 452-61 (1990) (describing the development of oppression as a ground for dissolution).

33. *See, e.g., In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (equating oppression with conduct that "defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise"); 2 CLOSE CORPORATIONS, *supra* note 14, § 9.28, at 9-199 to 9-212 (discussing reasonable expectations); Bahls, *supra* note 7, at 83 ("Many courts have created a remedy for these shareholders by finding that minority shareholders have been oppressed when majority shareholders violate their reasonable expectations.").

dissolution is not the only remedy at the court's disposal. Both state statutes and judicial precedents have authorized alternative remedies that are less drastic than dissolution (e.g., buyouts and provisional directors).[34] As the alternative forms of relief have broadened over the years, orders of actual dissolution have become

The highest courts of several states have adopted the reasonable expectations standard, and a number of intermediate appellate courts have adopted it as well. *See infra* note 247 (citing cases that have adopted the reasonable expectations framework). *But see* Kiriakides v. Atlas Food Sys. & Servs., Inc., 541 S.E.2d 257, 265-66 (S.C. 2001) ("We find [that] adoption of the 'reasonable expectations' standard is inconsistent with [the South Carolina oppression-triggered dissolution statute], which places an emphasis not upon the minority's expectations but, rather, on the actions of the majority."). Commentators have also been in favor of the reasonable expectations definition. *See* Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25, 37 (1986) ("The third definition of oppression, initially derived from English case law, and long advocated by Dean F. Hodge O'Neal as well as other leading close corporation experts, is conduct which frustrates the reasonable expectations of the investors.") (footnotes omitted); Thompson, *supra* note 5, at 211 ("Recognition of the intimate, illiquid relationship within a close corporation therefore provides the necessary foundation for judging whether relief should be granted and, if so, what relief is appropriate; the shareholders' reasonable expectations has become the standard which best facilitates that approach.").

Aside from the prevalent reasonable expectations standard, some courts define oppression as "burdensome, harsh and wrongful conduct, . . . a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." Thompson, *supra* note 16, at 711-12 (quoting Fix v. Fix Material Co., 538 S.W.2d 351, 358 (Mo. Ct. App. 1976)); *see, e.g.*, Skierka v. Skierka Bros., Inc., 629 P.2d 214, 221 (Mont. 1981) (citing the "burdensome, harsh and wrongful conduct" definition of oppression); *see also* Haynsworth, *supra*, at 36-39 (describing judicial definitions of oppression).

34. *See, e.g.*, MINN. STAT. ANN. § 302A.751 subd. 1 (West Supp. 2000) (authorizing any equitable relief and specifically authorizing a buyout of the shareholder's interest); N.J. STAT. ANN. § 14A:12-7 (West Supp. 1999) (providing a nonexclusive list of possible relief that includes the order of a buyout and the appointment of a provisional director or custodian); *Brenner*, 634 A.2d at 1033 ("Importantly, courts are not limited to the statutory remedies [for oppression], but have a wide array of equitable remedies available to them."); Balvik v. Sylvester, 411 N.W.2d 383, 388-89 (N.D. 1987) (listing alternative forms of relief for oppressive conduct such as appointing a receiver, granting a buyout, and ordering the declaration of a dividend); Masinter v. Webco Co., 262 S.E.2d 433, 441-42 n.12 (W. Va. 1980) (listing ten possible forms of relief for oppressive conduct such as ordering the reduction of excessive salaries and issuing an injunction against further oppressive acts); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 395-96 (Or. 1973) (same). *But see* Giannotti v. Hamway, 387 S.E.2d 725, 733 (Va. 1990) (stating that the dissolution remedy for oppression is "exclusive" and concluding that the trial court is not permitted "to fashion other . . . equitable remedies").

less frequent.[35] Thus, "oppression" has evolved from a statutory ground for involuntary dissolution to a statutory ground for a wide variety of relief.[36]

Second, particularly in states without an oppression-triggered dissolution statute, some courts have imposed a fiduciary duty between close corporation shareholders and have allowed an oppressed shareholder to bring a direct cause of action for breach of this duty.[37] In the seminal decision of *Donahue v. Rodd Electrotype Co.*, the Massachusetts Supreme Judicial Court adopted such a standard:

> [W]e hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty." Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.[38]

35. *See* Thompson, *supra* note 16, at 708 (discussing dissolution orders); *cf.* Haynsworth, *supra* note 33, at 50-53 (finding that courts ordered remedies other than dissolution in the majority of thirty-seven involuntary dissolution cases studied). *See generally* Murdock, *supra* note 32, at 461-64 (discussing the development of alternative remedies).

36. *See* 2 CLOSE Corporations, *supra* note 14, § 9.27, at 9-186 to 9-187 ("The inclusion of 'oppression' and similar grounds as a basis for involuntary dissolution or alternative remedies has opened up a much broader avenue of relief for minority shareholders caught in a close corporation wracked with dissension."); Thompson, *supra* note 16, at 708-09 ("[I]t makes more sense to view oppression not as a ground for dissolution, but as a remedy for shareholder dissension.").

37. *See* Thompson, *supra* note 16, at 726 (discussing the fiduciary duty between shareholders); *see also id.* at 739 ("It should not be surprising that the direct cause of action is developed particularly in states without an oppression statute and provides a vehicle for relief for minority shareholders in a close corporation where the statutory norms reflect no consideration for the special needs of such enterprises."). *See generally* Murdock, *supra* note 32, at 433-40 (discussing the development of the shareholder fiduciary duty).

38. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975) (citations and footnotes omitted). The *Donahue* duty of "utmost good faith and loyalty," however, was later scaled back by the same court. Due to concerns that the "untempered application of the strict good faith standard enunciated in *Donahue* . . . [would] result in the imposition of limitations on legitimate action by the controlling group in a close corporation which [would] unduly hamper its

Following the lead of the *Donahue* court, several courts outside of Massachusetts have also imposed a fiduciary duty running directly from shareholder to shareholder in a close corporation.[39]

The development of the statutory cause of action and the direct fiduciary duty reflect "the same underlying concerns for the position of minority shareholders, particularly in close corporations after harmony no longer reigns."[40] Because of the similarities between the two remedial schemes, it has been suggested that "it makes sense to think of them as two manifestations of a minority shareholder's cause of action for oppression."[41] In the close corporation context, therefore, it is sensible to view the parallel development of the statutory action and the fiduciary duty action as two sides of the same coin—i.e., the shareholder's cause of action for oppression.

III. THE "SEEDS" OF OPPRESSION IN THE CLOSE CORPORATION

Minority oppression is presently viewed by courts as a problem that arises solely in the close corporation setting.[42] The premise of

effectiveness in managing the corporation in the best interests of all concerned," the Supreme Judicial Court of Massachusetts suggested a balancing test in Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976). If the controlling group can establish a "legitimate business purpose" for its actions, no breach of fiduciary duty will be found unless the minority shareholder can demonstrate that "the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest." *Id.* at 663.

39. *See, e.g.*, Guy v. Duff & Phelps, Inc., 672 F. Supp. 1086, 1090 (N.D. Ill. 1987) (discussing the fiduciary duty between shareholders); Orchard v. Covelli, 590 F. Supp. 1548, 1556-59 (W.D. Pa. 1984) (same); W & W Equip. Co. v. Mink, 568 N.E.2d 564, 570-71 (Ind. Ct. App. 1991) (same); Evans v. Blesi, 345 N.W.2d 775, 779 (Minn. Ct. App. 1984) (same); Fought v. Morris, 543 So. 2d 167, 170-71 (Miss. 1989) (same); Crosby v. Beam, 548 N.E.2d 217, 220-21 (Ohio 1989) (same); Estate of Schroer v. Stamco Supply, Inc., 482 N.E.2d 975, 981 (Ohio Ct. App. 1984) (same).

40. Thompson, *supra* note 16, at 739.

41. *Id.* at 700. *See generally id.* at 738-45 (describing the "combined cause of action for oppression").

42. *See, e.g.*, *Donahue*, 328 N.E.2d at 513-16 (discussing the special problems faced by close corporation minority owners and adopting the shareholder oppression doctrine in response); *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179-81 (N.Y. 1984) (same); *see also Donahue*, 328 N.E.2d at 515 ("[W]e hold that *stockholders in the close corporation* owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. . . . *Stockholders in close corporations* must discharge their management and stockholder responsibilities in conformity with this strict good faith standard.") (footnotes omitted) (emphasis added); *Kemp & Beatley*, 473 N.E.2d at 1179 ("Given the nature of *close corporations* . . . this court holds that utilizing a complaining shareholder's 'reasonable expectations' as a means of identifying and measuring conduct alleged to be oppressive is

this article, however, is that the oppression problem is not inextricably linked to the close corporation structure. The remedial oppression doctrine, therefore, should have a broader application. More specifically, this article contends that the problem of oppression is "portable" to the LLC context, as the LLC shares certain core features of the close corporation. To understand this contention, the "seeds" of oppression in the close corporation context—i.e., the factors giving rise to the oppression problem in the close corporation environment—must be identified and examined in greater detail. The lack of exit rights, the norm of majority rule, the deference of the business judgment rule, and the absence of advance planning will all be discussed in turn.

A. The Lack of Exit Rights

Exit rights for the owners of any business enterprise are useful in two major respects. First, an exit allows an owner to liquidate its investment and to recover the value of its invested capital.[43] Second, the threat of exit in large numbers tends to restrain managers from taking action that harms the interests of owners.[44] Significantly, without exit rights, an owner's invested capital is indefinitely "locked-into" the entity and, in general, the capital can be used as the controlling owner sees fit.[45] Where exit rights are absent, therefore, oppressive conduct can result in the "effective confiscation" of the minority's investment.[46]

appropriate.") (emphasis added).

43. *See, e.g.*, *Donahue*, 328 N.E.2d at 514 (observing that a market exit allows a shareholder to "sell his stock in order to extricate some of his invested capital"); 1 OPPRESSION, *supra* note 19, § 2:15, at 2-38 (noting that a market exit "tend[s] to assure the dissatisfied shareholder of a reasonable price when he liquidates his investment"); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:5, at 11-15 (stating that a dissolution exit "provide[s] liquidity for the members' interests").

44. *See infra* note 217 (discussing the disciplinary effect of a market).

45. *See, e.g.*, Murdock, *supra* note 32, at 447 ("[T]he primary vulnerability of a minority shareholder is the spectre of being 'locked-in,' that is, having a perpetual investment in an entity without any expectation of ever receiving a return on that investment."); *infra* note 46 (observing that oppressive conduct allows the majority to use the minority's investment for the majority's own purposes).

46. Edwin J. Bradley, *An Analysis of the Model Close Corporation Act and a Proposed Legislative Strategy*, 10 J. CORP. L. 817, 840 (1985) ("Never should the minority participant [in an oppression context] be understood as assenting to the effective confiscation of his or her investment . . . ."); *see, e.g.*, Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 817 n.267 (2000) ("In this [oppression] context, the majority shareholder should be viewed as simply appropriating a portion of the minority's investment to further the majority's own interests.");

For minority shareholders in close corporations, the absence of exit rights is a reality. This absence manifests itself at many levels, as close corporation minority owners are, for all practical purposes, unable to sell, unable to demand a buyout, and unable to cause a dissolution of the company.

1. The Inability to Sell

By definition, there is no securities market for the stock of a close corporation.[47] In a publicly held company, a shareholder dissatisfied with the conduct of management can sell its holdings on a securities market and recover the value of its investment.[48] This ability to liquidate protects public corporation investors from the conduct of those in control.[49] In the close corporation, however, the "minority shareholders' capital is, in effect, held hostage by those in control of the corporation because there is no marketplace in which minority shareholders may sell their shares."[50] As a consequence, the minority investor of a close corporation is in a vulnerable

O'Neal, *supra* note 5, at 887 ("Not to provide a remedy in [oppressive] circumstances of this kind is to permit the majority shareholders to exploit the minority shareholder's investment solely for their own benefit."); D. Prentice, *Protection of Minority Shareholders*, 1972 CURRENT LEGAL PROBS. 124, 134 (1972) (same).

47. *See supra* notes 30-31 and accompanying text (noting that a close corporation lacks a market for its stock).

48. *See, e.g.*, RMBCA § 14.34 cmt.1 (1994) ("Shareholders of publicly-traded firms are protected by their right to sell out if they are dissatisfied with current management . . . ."); *Donahue*, 328 N.E.2d at 514 ("In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital."); 2 CLOSE CORPORATIONS, *supra* note 14, § 9.2, at 9-4 to 9-5 ("[A] shareholder in a close corporation does not have the exit option available to a shareholder in a publicly held corporation, who can sell his shares in a securities market if dissatisfied with the way the corporation is being operated."); 1 OPPRESSION, *supra* note 19, § 2:15, at 1-38 (noting that "[i]n a large public-issue corporation, a shareholder who is dissatisfied with the way the business is being operated can sell his stock at no great financial loss"); *see also id.* (observing that "in a public-issue corporation the sensitivity of management to the market price for the stock and the fact that stock prices are highly responsive to corporate earnings tend to assure the dissatisfied shareholder of a reasonable price when he liquidates his investment through the market") (internal quotation omitted).

49. *See* Thompson, *supra* note 5, at 237 ("Shareholders [in close corporations] thus have more at risk from the conduct of those in control of the corporation *without the protection and the exit option that the market offers shareholders in publicly held corporations*.") (emphasis added).

50. Sandra L. Schlafge, Comment, Pedro v. Pedro*: Consequences for Closely Held Corporations and the At-Will Doctrine in Minnesota*, 76 MINN. L. REV. 1071, 1076 (1992) (footnote omitted); *see supra* notes 30-31 and accompanying text (noting that a close corporation lacks a market for its stock).

position, as it cannot escape abusive majority conduct by selling into a well-developed market.[51]

Even if a minority shareholder could locate prospective outside investors, a minority ownership position in a close corporation is unlikely to garner much interest. A minority ownership position lacks sufficient voting power to control the operations of the firm.[52] As a result, a minority interest is far less appealing (as well as less valuable) to outside investors.[53] Where the company has a track

51. *See, e.g.*, Brenner v. Berkowitz, 634 A.2d 1019, 1027 (N.J. 1993) ("[U]nlike shareholders in larger corporations, minority shareholders in a close corporation cannot readily sell their shares when they become dissatisfied with the management of the corporation."); 1 CLOSE CORPORATIONS, *supra* note 14, § 7.20, at 7-90 ("[T]he lack of a market for the shares of a close corporation . . . leaves a minority shareholder vulnerable in a way that is distinct from the position of a shareholder in a publicly held corporation."); Hetherington & Dooley, *supra* note 1, at 6 ("The position of the minority in the close corporation is as unique as it is precarious: no other form of business organization subjects an owner to the dual hazards of a complete loss of liquidity and an indefinite exclusion from sharing in the profitability of the firm."); Kleinberger, *supra* note 14, at 1149 (noting that a close corporation investor "cannot escape the unfairness simply by selling out at a fair price"); Thompson, *supra* note 16, at 702 ("[T]he economic reality of no public market deprives investors in close corporations of the same liquidity and ability to adapt available to investors in public corporations.").

52. *See, e.g.*, John D. Emory, Jr., Comment, *The Role of Discounts in Determining "Fair Value" Under Wisconsin's Dissenters' Rights Statutes: The Case for Discounts*, 1995 WIS. L. REV. 1155, 1160 (1995) ("Minority interests lack the power of controlling interests to dictate corporate management and policies."); Hetherington & Dooley, *supra* note 1, at 5 n.7 (defining a "minority" shareholder as a shareholder who does not "possess the actual power to control the operations of the firm").

53. *See, e.g.*, *Donahue*, 328 N.E.2d at 515 ("No outsider would knowingly assume the position of the disadvantaged minority [in a close corporation]. The outsider would have the same difficulties."); Raynolds v. Diamond Mills Paper Co., 60 A. 941, 945 (N.J. Ch. 1905) ("In the case of [close] corporations of this class[,] sales of stock outside of the small coterie of officers and managers are generally hard to make, excepting upon disadvantageous terms."); Emory, *supra* note 52, at 1160 ("[I]nvestors value the ability to direct management and thus would not be willing to pay as much for shares on a minority basis as they would for shares that convey a controlling interest . . . ."); Steven Stern, Comment, *Proposals to Help the Minority Stockholder Receive Fairer Dividend Treatment from the Closely Held Corporation*, 56 NW. U. L. REV. 503, 508 n.36 (1961) ("The corporate investor, however, seldom has an interest in the shares of an unlisted, closely held corporation since the purchase of such shares would place him in the same position as the minority shareholder who sells out."); *id.* ("Such an investor cannot depend upon dividend declarations by the controlling interests . . . . The minority shareholder has no . . . control to offer . . . ."); *id.* at 508 ("[T]he minority shareholder in a closely held corporation may not find anyone willing to purchase his stock since few investors will want to take on his

record of oppressive majority conduct, a minority interest is even less attractive.[54] Moreover, because all close corporation shares lack the liquidity that a ready securities market would provide,[55] outside investors tend to be less interested in close corporation stock, at least in comparison to easily-traded public corporation stock.[56] In short, an effort to escape abusive majority conduct by selling shares is unlikely to be successful for a close corporation minority investor. The lack of an active securities market for the stock and the relative undesirability of a minority position effectively doom any effort to sell.[57]

---

unfavorable bargaining position."); 2 CLOSE CORPORATIONS, *supra* note 14, § 9.20, at 9-96 to 9-97 ("The holder of a minority interest in a close corporation may not be able to find anyone willing to purchase that interest at any serious price.").

54. *See, e.g.*, Orchard v. Covelli, 590 F. Supp. 1548, 1557 (W.D. Pa. 1984) ("Dissension within the close corporation tends to make the minority interest even more unattractive to a prospective purchaser."); Balvik v. Sylvester, 411 N.W.2d 383, 386 (N.D. 1987) (noting the "natural reluctance of potential investors to purchase a noncontrolling interest in a close corporation that has been marked by dissension"); 1 OPPRESSION, *supra* note 19, § 2:15, at 2-38 ("[I]f there is dissension in the corporation, a minority interest is likely to appear even less inviting to a prospective purchaser.").

55. *See supra* notes 30-31 and accompanying text (noting that a close corporation lacks a market for its stock).

56. *See, e.g.*, SHANNON P. PRATT ET AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 334 (3d ed. 1996) ("[T]he universe of realistically potential buyers for most closely held minority ownership securities is an infinitesimally small fraction of the universe of potential buyers for publicly traded securities."). As one noted valuation authority observed:

> The market for securities in the United States is the most liquid market for any kind of property anywhere in the world. This is one of the major reasons companies are able to raise investment capital from both institutional and individual investors: the ability to liquidate the investment immediately, at little cost, and with virtual certainty as to realization of the widely publicized market price. Empirical evidence demonstrates that investors are willing to pay a high premium for this level of liquidity, or, conversely, extract a high discount relative to actively traded securities for stocks or other investment interests that lack this high degree of liquidity.

Id. at 333; *see, e.g.*, Advanced Communication Design, Inc. v. Follett, 615 N.W.2d 285, 291 (Minn. 2000) ("[S]hares in a closely held corporation cannot be sold as readily as shares in a corporation with securities traded over an exchange or in an established market and therefore investors tend to pay less, and sometimes significantly less, for such shares.").

57. Indeed, "[o]ften the only prospective buyer of a minority interest in a close corporation is the majority shareholder." 1 OPPRESSION, *supra* note 19, § 2:15, at 2-38. The majority, however, "is likely to offer far less than the seller considers minimally acceptable." *Id.*

2. *The Inability to Demand a Buyout*

Despite the lack of a market and the difficulty of attracting outside purchasers, close corporation minority shareholders would still have effective exit rights if they could force the corporation (or the controlling shareholder) to purchase their shares on demand.[58] A default buyout right would insure that a minority shareholder could recover the value of its investment and would thwart any controlling shareholder effort to confiscate the minority's capital. No state's corporation law, however, provides such a right.[59] Without an explicit buyout provision in a stockholder's agreement or the company's organizational documents, corporate shareholders have no right to compel a redemption of their holdings.[60]

3. *The Inability to Dissolve*

Dissolution provides liquidity to business owners by requiring

---

Sales of close corporation stock are also hindered by the frequent use of contractual restrictions on the transferability of shares. *See, e.g.*, *id.* (noting that it is "often the case" that stock transfer restrictions are present in close corporations).

58. *See, e.g.*, Hetherington & Dooley, *supra* note 1, at 1-6 (proposing that close corporation minority shareholders should be given a right to a mandatory buyout of their shares upon demand); *id.* at 6 ("[W]e [propose that the law should require] the majority to repurchase the minority's interest at the request of the latter and subject to appropriate safeguards.").

59. *See infra* note 60 and accompanying text (discussing the absence of mandatory buyout rights in corporate law).

60. As one court states:

> In the absence of an agreement among shareholders or between the corporation and the shareholder, or a provision in the corporation's articles of organization or by-laws, neither the corporation nor a majority of shareholders is under any obligation to purchase the shares of minority shareholders when minority shareholders wish to dispose of their interest in the corporation.

Goode v. Ryan, 489 N.E.2d 1001, 1004 (Mass. 1986); *see, e.g.*, 1 OPPRESSION, *supra* note 19, § 2:15, at 2-49 ("Neither the controlling shareholder nor the corporation has an obligation to purchase the shares of minority shareholders who wish to dispose of their shares in the absence of a provision in the corporation's bylaws or a shareholder's agreement."); 2 OPPRESSION, *supra* note 19, § 7:5, at 7-43 ("Courts . . . have not gone so far as the automatic buyout proposal proposed by Hetherington and Dooley . . . ."); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:15, at 11-53 ("[A] shareholder ordinarily has no right against a standard form corporation to be paid for his or her shares . . . ."); Farrar & Hamill, *supra* note 9, at 923 ("The corporate statutes generally provide no rights for individual shareholders to dissolve the corporation or demand the corporation to redeem their shares."); *cf.* MODEL STAT. CLOSE CORP. SUPP. § 14(a), *reprinted in* EISENBERG, *supra* note 14, at 987-88 (providing for a mandatory buyout at the death of a shareholder, but only if the buyout right is stated in the company's articles of incorporation).

the sale of the company and by allocating to each owner its proportionate share of the company's sale value.[61] If a close corporation minority shareholder had the right to compel dissolution, a mechanism for recovering the value of the invested capital would exist and the problems of "lock-in" would largely dissipate.[62]

The partnership form of business organization nicely exemplifies this point. Under the Uniform Partnership Act (the "UPA"), each partner is given a statutory right to dissolve the partnership at any time—i.e., dissolution can be caused by the partner's "express will."[63] So long as the dissolution is rightful, the dissolution-causing partner can demand that the business be sold (assuming that there is no contrary agreement calling for the continuation of the partnership's operations).[64] Once the business is

61. *See, e.g.*, Brenner v. Berkowitz, 634 A.2d 1019, 1031 (N.J. 1993) ("In the case of dissolution, a distribution [of assets] results in the termination of the corporation's business, with its assets being proportionately distributed to the stockholders."); HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 348, at 992 (3d ed. 1983) (describing the process of dissolution and noting that "[t]he shareholders, subject to any applicable liquidation preferences and other rights, share proportionately in the net assets remaining after the satisfaction of corporate creditors") (footnote omitted); Murdock, *supra* note 32, at 483 ("Similarly, with respect to distributions pursuant to dissolution statutes, the essence of shares of the same class is that each share is entitled to a pro rata portion of that class's claim on the corporation's assets."); *see also* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:5, at 11-15 (stating that "[t]he function of dissolution at will is to provide liquidity for the members' interests").

62. *See supra* notes 45-46 and accompanying text (discussing "lock-in").

63. *See, e.g.*, UNIF. P'SHIP ACT § 31(1)(b) (1914) ("[Dissolution is caused] [w]ithout violation of the agreement between the partners . . . [b]y the express will of any partner when no definite term or particular undertaking is specified."); *id.* § 31(2) ("[Dissolution is caused] [i]n contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time."). As one commentator explains:

> In a general partnership [under the UPA], the dissociation of any general partner for any reason causes the immediate dissolution of the partnership notwithstanding any agreement to the contrary. Partner dissociation occurs as a result of the end of an individual partner's ongoing relationship with fellow partners because of death, bankruptcy, expulsion, or resignation or withdrawal.

Carter G. Bishop, *Treatment of Members Upon Their Death and Withdrawal from a Limited Liability Company: The Case for a Uniform Paradigm*, 25 STETSON L. REV. 255, 279 (1995) (footnotes omitted).

64. *See, e.g.*, UNIF. P'SHIP ACT § 38(1) (1914) ("When dissolution is caused in any way, except in contravention of the partnership agreement, each partner . . . unless otherwise agreed, may have the partnership property applied

sold, each partner receives its share of any sale proceeds that remain after payment of the partnership's creditors.[65] Where the dissolution is wrongful, the remaining partners can avoid selling the business, but they must purchase the ownership interest of the wrongfully-dissolving partner.[66] The statutory right to dissolve the partnership, therefore, allows a partner to recover the value of its investment—either through the sale of the entire business, or through the buyout of its individual partnership interest.[67]

to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners."); EISENBERG, *supra* note 14, at 85 ("Under the UPA, upon the occurrence of dissolution—which . . . means simply that any partner ceases to be a partner—then unless otherwise agreed the partnership normally must sell its assets for cash and distribute the proceeds of the sale among all the partners."); Farrar & Hamill, *supra* note 9, at 916 (noting the "right of every partner to unilaterally dissolve the partnership and demand a judicial sale of the assets" under the UPA); Franklin A. Gevurtz, *Squeeze-Outs and Freeze-Outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497, 502 (1995) ("Barring other agreement, each partner in an ordinary partnership has the right to dissolve the firm at any time and demand liquidation of the business."); *see also* EISENBERG, *supra* note 14, at 85 ("[T]he partnership agreement can provide that after the termination of a person's status as a partner (and, therefore, after the dissolution of the partnership under the UPA) the remaining partners can continue the partnership *business*, even if the partnership has been dissolved and the dissolution is rightfully caused."). Where there is an agreement calling for the continuation of the business, it typically includes "the terms on which the partner who causes dissolution (or his estate) will be compensated for his partnership interest." *Id.*

65. *See* UNIF. P'SHIP ACT § 38(1) (1914) (stating that, when a partnership is dissolved, the partnership property is first applied to the "discharge [of] its liabilities," and any surplus is then "applied to pay in cash the net amount owing to the respective partners"); *cf. supra* note 61 and accompanying text (describing the operation of corporate dissolution).

66. *See, e.g.*, UNIF. P'SHIP ACT § 38(2) (1914) (detailing the effects of a wrongful dissolution). As Professor Eisenberg explains:

> If . . . a partner . . . *wrongfully* causes dissolution, UPA § 38(2)(b) provides that although the *partnership* is dissolved, the remaining partners can continue the partnership's *business*. To do so, the remaining partners must either: (i) Pay [the wrongfully-dissolving partner] the value of her partnership interest (but without counting the value of the partnership's good will), minus any damages caused by the dissolution; or (ii) Put up a bond to secure such a payment, and indemnify [the wrongfully-dissolving partner] against present and future partnership liabilities.

EISENBERG, *supra* note 14, at 85; *see also* Farrar & Hamill, *supra* note 9, at 916 ("[T]he partners not responsible for the wrongful dissolution can avoid a judicial sale and continue the business in a new partnership after buying out the wrongful partner."); *id.* ("In addition to subtracting damages from the buyout price, the wrongful partner receives no compensation for a share of good will in the continuing partnership.").

In the close corporation setting, however, the minority shareholder has no default right to dissolve the corporation by "express will." In most states, a right to voluntarily dissolve a corporation (i.e., to dissolve without a judicial order) is granted only to shareholders who own, individually or collectively, at least a majority of the outstanding voting stock of the corporation.[68] (Even then, voluntary dissolution typically requires the agreement of the board of directors as well.)[69]

Of course, involuntary dissolution statutes also provide the possibility of exit, as a court can order the dissolution of a company when a minority shareholder establishes particular grounds. Such grounds typically include fraud, illegality, deadlock, or misconduct by those in control[70]—grounds that are certainly harder for a

67. Under the Revised Uniform Partnership Act (the "RUPA"), a partner's ability to demand liquidation of the business is narrowed. Nevertheless, the RUPA still provides a partner with the ability to recover the value of its investment through either the sale of the entire business, or through the buyout of its individual partnership interest. REVISED UNIF. P'SHIP ACT § 701(b) (1997). As Professors Farrar and Hamill explain:

> Rather than always expressing the departure of a partner as a dissolution, RUPA defines a partner's death, retirement, bankruptcy, withdrawal or other separation from the partnership as a dissociation, not necessarily leading to a dissolution. . . . Because not all dissociations trigger dissolutions, RUPA sharply limits those circumstances where a partner has the accompanying right to demand a judicial sale [of the business] . . . . If a dissociation event does not cause a dissolution the dissociated partner has a right to be redeemed at fair market value, leaving the legal existence of the partnership intact.

Farrar & Hamill, *supra* note 9, at 919 (footnotes omitted); *see* Bishop, *supra* note 63, at 286-87 ("Generally, the [RUPA] partnership must purchase every dissociated partner's interest if the partnership does not dissolve and wind up its business.").

68. *See, e.g.*, Thompson, *supra* note 5, at 200 ("In most states a majority vote of outstanding shares is required to voluntarily dissolve a corporation, but in a significant number of states, a two-thirds vote is required for this fundamental corporate change."); *see also* Hetherington & Dooley, *supra* note 1, at 3 ("The voluntary dissolution of a corporation . . . requires the assent of at least a majority of the outstanding shares.").

69. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:15, at 11-54 ("A standard form corporation ordinarily dissolves on a resolution proposed by the board of directors and approved by the shareholders . . . . Indeed, even a majority of the shareholders may not be able to [dissolve a corporation by will or by withdrawing] unless the board of directors agrees.") (footnote omitted); Thompson, *supra* note 5, at 200 ("All states provide for voluntary dissolution of the corporation, usually by action of the board of directors and approval by the shareholders.").

70. *See, e.g.*, RMBCA § 14.30 (1994) (stating that a court may dissolve a corporation on a number of grounds, such as when a shareholder establishes

shareholder to establish than the mere desire, or "express will," to dissolve. In addition, even if a statute provided for the possibility of dissolution upon some showing of misconduct, courts historically failed to use that ground to protect minority shareholders from the abusive actions often involved in oppression disputes (e.g., terminations of employment and exclusions from dividends).[71] Before the advent of the modern shareholder oppression doctrine, therefore, a "dissolution exit" was essentially nonexistent for close corporation minority investors.[72]

In short, effective exit rights are absent in the close corporation structure.[73] The business entity itself leads to an inability to sell given the lack of a securities market and the relative undesirability of a close corporation minority position. No legal right to demand a buyout or to voluntarily dissolve exists for a minority investor, and involuntary dissolution was historically of little practical use. If the controlling shareholder unjustifiably terminates the minority from employment, excludes the minority from dividends, or engages in other abusive conduct, the minority shareholder has no ability to exit with its investment and to escape from the oppressive

---

director deadlock, shareholder deadlock, waste of corporate assets, or "illegal, oppressive, or fraudulent" conduct by "directors or those in control of the corporation"); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:15, at 11-54 ("The corporation also may be dissolved by judicial decree on petition by the attorney general based on breach of duties owed to the state, [or] by one or more shareholders for deadlock or misconduct by those in control . . . .").

71. *See, e.g.*, Hetherington & Dooley, *supra* note 1, at 12 ("In interpreting the statutory grounds of fraud, illegality, waste, and misapplication of assets, courts . . . have recognized the common law antecedents and have been influenced by traditional common law attitudes emphasizing deference to management decisions and proof of harm to the corporation as distinguished from the interests of individual shareholders."); *id.* at 11 (discussing involuntary dissolution on the grounds of "fraud, illegality, waste, or misapplication of assets" and observing both that "a broad spectrum of management conduct may not be sufficiently culpable to constitute grounds under the statute," and that "[e]ven cases in these latter categories often involve disputable value judgments where courts are traditionally reluctant to interfere with management decisions"); *infra* Part III.C (discussing the business judgment rule and the accompanying deference that courts give to managerial decisions); *see also* Thompson, *supra* note 16, at 708 (noting that "[modern] state legislation authorizes more remedies as alternatives to dissolution than previously were provided by corporations codes, and courts are more inclined to use these alternative remedies").

72. *See* Thompson, *supra* note 16, at 707 (mentioning the "formerly narrow involuntary dissolution statutes" and noting that the statutes "have given way to a much broader cause of action for oppression").

73. *See, e.g.*, 1 OPPRESSION, *supra* note 19, § 2:15, at 2-38 ("A 'way out' is usually not available to an unhappy shareholder in a close corporation.").

situation.[74] Thus, the absence of exit rights is a factor that significantly contributes to the oppression problem, as minority owners cannot liquidate their investments if they become dissatisfied with the management of the company. Simply put, where exit rights are lacking, the potential for oppression is great.[75]

B. *The Norm of Majority Rule*

Even with the lack of exit rights, the oppression problem (as well as the need for an oppression doctrine) would not exist if the minority investor could block harmful majority decisions. Traditional corporate law, however, defaults to norms of majority rule and centralized control[76]—norms that leave a minority investor unable to veto most decisions that affect its financial and participatory interests. As mentioned, corporate power is typically centralized in the hands of a board of directors.[77] The directors "determine corporate policies, select corporate officers and sometimes key employees, and supervise the normal operation of the corporation."[78] Ordinarily, the board acts by majority vote of the directors.[79] As a consequence, the person with the ability to control the majority of the board has control over the decisions of the corporation—including employment, management, and dividend

74. As one article observed:

> [S]hareholders of closely held corporations without a ready market for their shares often found themselves trapped in the corporation. Problems typically arise when a particular shareholder has trouble getting along with the rest of the shareholders, who, as a group, have the power of the majority block to elect the entire board of directors and appoint the officers. The majority shareholders through their control of the board typically withhold all dividends, exclude the minority shareholder from the corporate payroll, while paying themselves large salaries as officers.

Farrar & Hamill, *supra* note 9, at 924 (footnote omitted).

75. Indeed, commentators have asserted that the lack of exit rights is the primary cause of the oppression problem and is the factor driving the need for judicial oversight. *See infra* note 268 and accompanying text (suggesting that the absence of exit rights is the primary cause of the oppression problem).

76. *See supra* note 19 and accompanying text (noting that centralized control and majority rule are traditional characteristics of a corporation's structure).

77. *See supra* note 20 and accompanying text (discussing the board of directors).

78. 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3.

79. *See, e.g.*, JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 9.01, at 136 (2d ed. 2003) (stating that "the board of directors usually acts by majority vote of directors present and voting"); 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3 ("[T]he board of directors usually acts by majority vote."); Thompson, *supra* note 5, at 194-95 (observing that "the board normally act[s] by majority rule").

decisions that can significantly affect a minority shareholder's ownership position.[80]

Directors are elected by shareholder vote.[81] The majority shareholder, by definition, has the voting power to elect a majority (and possibly all) of the directors.[82] Because "as a rule, directors are responsive to the wishes of shareholders who elected them,"[83] the majority shareholder's power to elect the board effectively gives it the power to control the board.[84] Indeed, even if a minority shareholder serves on the board of directors, it cannot block decisions supported by the majority shareholder since the majority can typically secure the requisite majority vote of the board members to override the minority's wishes.[85]

One way for a minority shareholder to avoid the norm of majority rule is to contract around it. For example, before committing its capital, a minority shareholder might insist on a bylaw provision calling for board decisions to be made by a

80. *See supra* note 22 and accompanying text (discussing the majority shareholder's control); *cf.* Thompson, *supra* note 5, at 194 ("The typical corporation statute . . . centralized most corporate power in the hands of the board of directors, including decisions particularly important to minority investors in a small enterprise, such as employment, salary, and dividends.").

81. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216(3) (1998) ("Directors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors . . . ."); RMBCA § 7.28(a) (1994) ("Unless otherwise provided in the articles of incorporation, directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present.").

82. *See, e.g.*, JAMES D. COX ET AL., CORPORATIONS § 11.10, at 250-51 (1st ed. 1997) ("[A] controlling shareholder is someone whose power includes the ability to secure the election of a majority of the board of directors."); COX & HAZEN, *supra* note 79, § 9.01, at 136 (stating that the "holders of a majority of the voting shares elect the directors, or most of them"); 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3 ("Persons holding a majority of the voting shares have the power to elect all the directors, or in cases of cumulative voting, at least a majority of the board.") (footnote omitted); Thompson, *supra* note 5, at 194, 195 n.2 (noting that "[h]olders of a majority of the voting shares could elect all or most of the board" and observing that "[c]umulative voting, if applicable in a particular state or corporation, provides minority shareholders with the possibility of board representation but still leaves them in a minority position on the board").

83. 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3.

84. In fact, "in most closely held corporations, majority shareholders elect themselves and their relatives to all or most of the positions on the board." *Id.* § 1:2, at 1-3.

85. *See supra* notes 82-84 and accompanying text (explaining that the majority shareholder has the power to control the decisions of the board of directors).

greater-than-majority vote.[86] Alternatively, a minority shareholder might require a shareholders' agreement that commits the board to a specified course of action.[87] Historically, however, corporate law prohibited any contractual arrangements that deviated from the majority rule and centralized control norms.[88] Although these prohibitions have largely been eliminated,[89] close corporation shareholders typically fail to engage in advance planning and fail to contract for protection from dissension.[90] The default norm of majority rule, therefore, is still the governing principle for many (if not most) close corporations. Because that norm gives a majority shareholder control over the decisions of a corporation—including decisions that can severely harm a minority investor—it is a factor that contributes to the creation of the oppression problem itself.[91]

86. *See, e.g.*, Benintendi v. Kenton Hotel, 60 N.E.2d 829, 830 (N.Y. 1945) (involving a bylaw requiring that "no action should be taken by the directors except by unanimous vote of all of them").

87. *See, e.g.*, McQuade v. Stoneham, 189 N.E. 234, 235-36 (N.Y. 1934) (involving a shareholders' agreement that specified the identity of the corporation's directors and officers, and that set the salaries of the officers).

88. *See infra* note 242 and accompanying text (discussing the historical prohibitions on certain contractual arrangements between shareholders).

89. *See infra* notes 243-46 and accompanying text (discussing the elimination of many of the historical prohibitions on certain contractual arrangements between shareholders).

90. *See infra* Part III.D (discussing the failure of close corporation shareholders to engage in advance planning).

91. *See, e.g.*, Gevurtz, *supra* note 64, at 504 ("In the corporate context, the majority of the board generally has the power to decide whether to distribute dividends, who shall be the officers or even employees of the corporation, and what compensation officers and employees shall receive. It is this power which provides the ammunition for a squeeze-out.") (footnotes omitted); *see also* Meiselman v. Meiselman, 309 N.C. 279, 290, 307 S.E.2d 551, 558 (1983) ("In other words, when the personal relationships among the participants break down, the majority shareholder, because of his greater voting power, is in a position to terminate the minority shareholder's employment and to exclude him from participation in management decisions."); 1 OPPRESSION, *supra* note 19, § 1:2, at 1-3 ("Under this pattern of corporate control, majority interests can deprive minority interests of any effective voice in the operation of the business. Further, the danger is always present that majority shareholders will use their power to further their own interests to the detriment of minority shareholders."); *id.* § 3:3, at 3-5 to 3-6 ("The statutory structure provided for corporations permits majority owners to control the enterprise. . . ."); *id.* ("Thus the majority owners are positioned, after harmony between the parties has disappeared, to cut off the minority investors from salary or other return from the enterprise and to cause the corporation to take actions that increase their own return or otherwise favor only the majority."); Thompson, *supra* note 5, at 196-97 (noting that "the corporate norms of centralized control and majority rule can easily become instruments of oppression" and observing that "[t]he minority participant who has fallen out with the majority faces the prospect of

C. The Deference of the Business Judgment Rule

Despite the lack of exit rights and the norm of majority rule, the potential harm from oppressive conduct would be minimized if judicial oversight offered adequate protection to the minority shareholder. After all, directors, officers, and controlling shareholders owe fiduciary duties to the corporation that ostensibly constrain abusive exercises of control.[92] The actual protection offered by traditional fiduciary duty principles, however, is significantly limited by the business judgment rule.[93] The business judgment rule operates to shield a manager from liability so long as the manager's decision was made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[94] Under the rule, courts review the substantive business decisions of those in control with considerable deference and with a correspondingly minimal amount of scrutiny.[95]

---

the majority having indefinite use of any capital he or she has contributed to the enterprise with no immediate return"); *id.* at 199 (stating that "centralized power and majority rule create a likely potential for abuse of minority shareholders").

92. *See, e.g.*, Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984) (observing that directors owe fiduciary duties to the corporation); Schautteet v. Chester State Bank, 707 F. Supp. 885, 888 (E.D. Tex. 1988) (stating that officers and directors owe fiduciary duties to the corporation); *id.* at 889 (noting that the majority shareholder owes a fiduciary duty to the corporation); Hoggett v. Brown, 971 S.W.2d 472, 488 n.13 (Tex. App. 1997) (same). As one authority explains:

> Fiduciary duties in a business firm are a set of rules that constrain conduct by managers and members that may injure the firm or its owners. In general, fiduciary duties help to insure that owners and managers act consistently with the interests of the firm or its members rather than in their own interests . . . . Fiduciary duties are . . . important in ensuring that managers, or the majority of members, act consistently with the interests of the firm and all of its owners rather than carelessly or selfishly.

1 RIBSTEIN & KEATINGE, *supra* note 7, § 9:1, at 9-2.

93. *See, e.g.*, Thompson, *supra* note 5, at 195 (observing that "[t]he effectiveness of this fiduciary norm in protecting minority shareholders was limited by the liberal judicial use of the business judgment rule"); *id.* at 197 n.14 ("Minority shareholders seeking to challenge on-going action as a breach of fiduciary duty face the hurdle of the judicial inclination to use the business judgment rule . . . ."); *infra* notes 94-95 and accompanying text (defining the business judgment rule).

94. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

95. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 93 (1991) ("Statements of the [business judgment] rule vary; its terms are far less important than the fact that there is a specially deferential approach."); 1 OPPRESSION, *supra* note 19, § 3:3, at 3-8 ("The business judgment rule operates to protect directors in taking corporate

As a consequence, majority shareholder decisions involving

actions. It embodies a broad judicial deference to a corporation's board of directors to determine business policy and to conduct corporate affairs."); James D. Cox, *Equal Treatment for Shareholders: An Essay*, 19 CARDOZO L. REV. 615, 628 (1997) (mentioning the "deferential presumptions dictated by the business judgment rule"); Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relevant Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 45 n.139 (1982) ("A court may also show great tolerance towards those in control by justifying questionable conduct as within the business judgment of the directors and officers."); Thompson, *supra* note 5, at 195 (describing the business judgment rule as "a doctrine which embodies a broad judicial deference to the corporation's board of directors to determine business policy and to conduct corporate affairs" and noting that "courts 'hesitate to substitute their judgment on complicated questions of business policy for that of the elected managers of the business and have limited the scope of judicial review which they are willing to undertake'").

Professors Cary and Eisenberg observe that "under the [business judgment] rule the substance or quality of the director's or officer's decision will be reviewed, not under the basic standard of conduct to determine whether the decision was prudent or reasonable, but only under a much more limited standard." WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 603 (7th ed. 1995). In general, that more limited standard is mere rationality—i.e., a substantive business decision need only be "rational," as opposed to "reasonable," to be considered proper. *See id.* ("[T]he prevalent formulation of the standard of review of a substantive decision under the business-judgment rule is that the decision must be 'rational.'"); Cox, *supra*, at 629 (noting that "the standard business judgment rule approach . . . uphold[s] unequal treatment on a showing of rational business judgment"). Under such a minimal standard of review, almost any justification advanced by the majority to defend its allegedly oppressive actions will survive judicial scrutiny. *See* CARY & EISENBERG, *supra*, at 604 ("The rationality standard of review is much easier for a defendant to satisfy than a prudence or reasonability standard. . . . It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational."); 1 OPPRESSION, *supra* note 19, § 3:3, at 3-9 ("[I]f the business judgment rule applies, the court's review is cursory; almost any reason supporting the directors' action will usually suffice."); Krishnan S. Chittur, *Resolving Close Corporation Conflicts: A Fresh Approach*, 10 HARV. J.L. & PUB. POL'Y 129, 154 (1987) ("So long as the controlling stockholder's conduct is not outrageous—that is, a plausible business reason can be articulated—his decisions are protected by the business judgment rule."); *id.* at 155 (noting that, under the business judgment rule, "[c]orporate management has never been obliged to disclose its true motivation, and can 'easily manufacture a 'legitimate' corporate purpose for its action'" (footnote omitted)); *see also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809 (N.Y. Sup. Ct. 1976), *aff'd* 387 N.Y.S.2d 993 (N.Y. App. Div. 1976) (granting defendants' motion to dismiss on business judgment rule grounds).

employment, management, or dividend matters—internal decisions that form the core of many shareholder oppression disputes—are largely insulated from judicial oversight.[96] Because of the deference to majority decisionmaking associated with the business judgment rule,[97] traditional fiduciary duty principles tend to offer inadequate protection to the oppressed close corporation shareholder.[98] When combined with the "no exit" and majority rule attributes of the close corporation, the judiciary's frequent invocation of the business judgment rule helps give rise to the problem of oppression and to the

96. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) ("[C]ourts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control."); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513 (Mass. 1975) ("[T]he plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors." (footnote omitted)); *see also* 1 OPPRESSION, *supra* note 19, § 3:3, at 3-6 ("In general, courts will begin with the lax business judgment standard to review directors' decisions in selecting corporate officers and employees, fixing salaries, declaring or withholding dividends, authorizing contracts or otherwise fixing business policies and determining the course of corporate affairs."); David Michael Israel, Note, *The Business Judgment Rule and the Declaration of Corporate Dividends: A Reappraisal*, 4 HOFSTRA L. REV. 73, 73 (1975) ("The application of the business judgment rule to the declaration of corporate dividends is one of the oldest and most widely accepted principles of corporation law." (footnotes omitted)); Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 469 (1985) ("The declaration of dividends is always at the discretion of the board of directors. The business judgment rule protects such a decision." (footnote omitted)); *id.* at 477 ("The hiring, firing, and compensation of employees are ultimately board decisions and have always qualified as management decisions protected by the business judgment rule."); Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1125 n.126 (1999) ("The business judgment rule is seldom overcome on dividend questions.").

97. *See, e.g.*, 1 OPPRESSION, *supra* note 19, § 3:3, at 3-8 (stating that the business judgment rule "supports the majority rule principle . . . by preventing every corporate transaction from being subject to judicial review at the request of a dissenting shareholder"); *supra* notes 95-96 and accompanying text (discussing the business judgment rule).

98. Aside from the effect of the business judgment rule, courts have traditionally stated that the fiduciary duties owed by directors, officers, and controlling shareholders run to the corporation and not to an individual shareholder. *See infra* notes 256-57 and accompanying text (discussing fiduciary duties). Consequently, a close corporation minority investor may have difficulty challenging a termination of employment or a removal from management on fiduciary duty grounds, since a court may require that harm to the corporation—rather than harm merely to the minority investor—be shown.

accompanying need for an oppression doctrine.[99]

D. The Absence of Advance Planning

The oppression problem would be far less acute if minority investors were likely to contract for protection before committing their capital to a close corporation. Employment contracts, buy/sell agreements, and supermajority provisions, for example, are all useful in safeguarding the minority shareholder from oppression.[100] If the majority shareholder refused to consent to some or all of these protective arrangements, the minority shareholder could refuse to invest in the venture.

Despite this apparent opportunity for ex ante bargaining, it is widely recognized that close corporation investors typically fail to engage in such contracting.[101] A number of reasons have been

99. *See, e.g.*, Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 456 (2001) ("Historically, governance by majority rule, particularly when coupled with the business judgment rule, has created a fertile ground for minority oppression.").

100. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 9:7, at 9-19 ("A person who is taking a minority interest can to some extent protect against the loss of employment with the company by insisting on a long-term employment contract."); *id.* § 9:3, at 9-7 to 9-8 (discussing the benefits of buy-out arrangements); *id.* § 9:8, at 9-23 ("Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter or bylaw a provision requiring unanimity or a high vote for shareholder, director and officer action."). *See also* Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1343 (2003) ("[S]hareholders can adopt employment agreements to delineate the tasks that each shareholder will perform, set forth how salaries will be determined, and reduce the ability of the majority shareholder to fire the minority shareholder opportunistically."); *id.* ("[S]hareholders can enter into contracts to allocate power within the venture by, for example, giving the minority shareholder veto power over certain decisions . . . .").

101. *See, e.g.*, 1 OPPRESSION, *supra* note 19, § 2:17, at 2-46 ("The litigated cases show that important arrangements among participants in small business enterprises are often oral and sometimes nothing more than vague understandings, never even definitely stated orally.") (footnote omitted); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (2001) (noting that "participants in closely held corporations often decline to draft complex contracts to control their future dealings, instead preferring to deal with conflicts informally as they arise"); Chittur, *supra* note 95, at 131 (observing that "people generally avoid complex and expensive planning in small businesses"); O'Neal, *supra* note 5, at 883 ("A person taking a minority position in a close corporation often leaves himself vulnerable to squeeze-out or oppression by failing to insist upon a shareholders' agreement or appropriate charter or bylaw provisions . . . ."); *id.* at 886 ("The participants typically enter into 'agreements' among themselves, which sometimes are reduced to writing in

advanced for this failure. Because close corporation owners are frequently linked by family or other personal relationships, there is often an initial atmosphere of mutual trust that diminishes the sense that contractual protection is needed.[102] Commentators have also argued that close corporation owners are often unsophisticated in business and legal matters such that the need for contractual protection is rarely recognized.[103]

---

the form of a formal preincorporation agreement or a shareholders' agreement, but which often are oral, perhaps just vague and half-articulated understandings."); *id.* at 881 (noting the "widespread failure of [close corporation] minority shareholders to use self-help"); *see also* Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979) (noting that "[t]he expectations of the parties in the instant suit with regard to their participation in corporate affairs are not established by any agreement"); *cf.* Hetherington & Dooley, *supra* note 1, at 36 (noting "the difficulties of contracting for adequate protection" in the close corporation).

102. *See, e.g.*, Meiselman v. Meiselman, 309 N.C. 279, 291, 307 S.E.2d 551, 558 (1983) (observing that "close corporations are often formed by friends or family members who simply may not believe that disagreements could ever arise") (internal quotation omitted); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 274 (1986) ("Participants in closely held corporations frequently have familial or other personal relations . . . [that constrain] conflicts of interest."); Hetherington & Dooley, *supra* note 1, at 36 ("[T]he potential close corporation investor deals with someone on a personal basis to whom he has conveniently informal access and in whom he has trust and confidence."); *id.* ("If the majority cannot be trusted to behave equitably under the restraints of such intimacy, it cannot be trusted at all, and the prospective shareholder is more likely to forego investing than to reduce his expectations."); Paul G. Mahoney, *Trust and Opportunism in Close Corporations*, *in* CONCENTRATED CORPORATE OWNERSHIP 177, 177 (Randall K. Morck ed., 2000) (suggesting that shareholder opportunism is constrained in close corporations "by the possibility of nonlegal sanctions, including family or social disapproval and loss of reputation"); Thompson, *supra* note 16, at 705 ("Investors often . . . demonstrate an overly optimistic trust in those with whom they are undertaking the venture."); *supra* note 18 and accompanying text (noting that close corporation investors are often linked by family or other personal relationships); *see also Meiselman*, 309 N.C. at 289, 307 S.E.2d at 558 (observing that "many close corporations are companies based on personal relationships"); *cf.* Hetherington & Dooley, *supra* note 1, at 36 n.114 ("Even if the minority is fully aware of the controlling faction's exploitative potential, it may quite reasonably expect the majority not to exploit.").

103. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:3, at 8-10 ("[I]n a closely held business, agreements may poorly protect the parties because of such problems as . . . the parties' lack of sophistication, . . . and careless reliance on forms."); Blair & Stout, *supra* note 101, at 1805 (suggesting that a failure to draft contracts in close corporations "may . . . reflect ignorance, lack of imagination, or poor legal advice"); Farrar & Hamill, *supra* note 9, at 931 (noting that close corporation shareholders "did not and for the most part, due to their level of sophistication, will not, bargain ahead of time to address separations from the business"); O'Neal, *supra* note 5, at 884 ("[M]any

Even if an investor did recognize that planning for dissension was useful, barriers to effective contracting would still exist.[104] In light of the countless ways in which oppressive conduct can occur, it is quite difficult to foresee all (if not most) of the situations that may require contractual protection.[105] This inability to appreciate the

participants in closely held corporations are 'little people,' unsophisticated in business and financial matters."); Utset, *supra* note 100, at 1345 (noting that commentators have asserted that "minority shareholders generally fail to enter into protective shareholder contracts because they are overly trusting of majority shareholders" or they lack information about "the applicable legal rules, the types of potential shareholder conflicts, and the consequences of the majority shareholder's control of the corporation and the minority shareholder's high exit costs"); *id.* at 1349 (noting that some commentators claim that minority shareholders "fail to protect themselves contractually due to 'ignorance'"); *see also* Bradley, *supra* note 46, at 840 ("Minority shareholders should not be understood as having agreed that the venture is to be operated strictly as a majority-rule entity with the economic chips falling as they may. Rather the correct explanation is a *naive complacency*, an overly trusting nature, bad legal advice or a blunder.") (emphasis added); O'Neal, *supra* note 5, at 881 ("As minority participants in a close corporation may not anticipate dissension or oppression, and indeed may be unaware of their vulnerability, they frequently fail to bargain for adequate protection against mistreatment."); *id.* at 883 (noting that close corporation shareholders "may be unaware of the risks involved, or [their] bargaining position may be so weak that [they are] unable to negotiate for protection"); Thompson, *supra* note 16, at 705 ("Investors often fail to anticipate the failure of their enterprise . . . .").

104. *Cf.* Hetherington & Dooley, *supra* note 1, at 37 ("Even if the minority shareholder appreciates the risks of future dissension and attempts to protect his interest from its effects, bargaining for adequate contractual protections is no easy matter.").

105. *See, e.g.*, William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U. L.Q. 1, 59-60 (1987) ("Investors in closely held enterprises are likely to be subject to conditions of bounded rationality, under which they either fail to perceive the complete set of problems that may occur later, or underestimate the probability of their occurrence."); Chittur, *supra* note 95, at 139 ("[I]nadequately planned close corporations will always remain part of the picture. The most careful plan may fail to visualize some conflicts, even if it does not generate novel ones of its own."); Hetherington & Dooley, *supra* note 1, at 37 ("Given the limitations of human foresight and knowledge, any attempt to describe the majority's duties and obligations precisely is likely to leave the minority vulnerable to some overlooked form of exploitation . . . ."); Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 467 (1995) ("[T]he long-term nature of these business relationships often means that the circumstances leading to the current dispute were not foreseeable (or in any event not foreseen) at the formation stage."); Terry A. O'Neill, *Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations*, 22 SETON HALL L. REV. 646, 659 (1992) ("[T]he contract [among shareholders and managers of a corporation] is necessarily incomplete; the parties cannot engage in explicit

universe of potential problems may result in incomplete contracting or, possibly, in no contracting at all.[106] Further, the typical decision to invest in a close corporation venture is, for all intents and purposes, a decision to engage in a long-term association with other shareholders that will involve significant personal interaction in the future.[107] Effective contracting for protection is particularly challenging in such a setting, as the parties usually seek to avoid harming their relationship during the contracting process. Indeed, a minority shareholder may be hesitant to even raise the topic of dissension because of a fear that it will damage the trust between the shareholders—trust that is critical to the operation of any small business.[108] This hesitation may result in no planning for dissension

---

bargaining over many aspects of their interaction because they cannot foresee every possible contingency that might befall their venture."); *see also* Thompson, *supra* note 5, at 224 (commenting on the "seemingly open-ended nature of trying to protect all participants' interests from all possible evils"); *cf.* Karjala, *supra*, at 477 ("[O]ver the long term the implementation of even bargained-for initial agreements may work an injustice, as the needs and expectations of the parties change or their interests pass on to successors.").

106. *See supra* notes 103, 105, and accompanying text (discussing the problems that lack of foresight can create).

107. *See, e.g.*, *Meiselman*, 309 N.C. at 289, 307 S.E.2d at 557-58 (discussing the close corporation and stating that "[a]n organizational structure of this nature—in which the investment interests are interwoven with *continuous, often daily, interaction among the principals*—necessarily requires substantial trust among the individuals") (emphasis added) (internal quotation omitted); Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 754-56 (2002) (noting that "the investment bargains entered into by close corporation shareholders reflect the characteristics of relational contracts" and observing that relational contracts "are typified 'by long duration, personal involvement by the parties and the exchange, at least in part, of things difficult to monetize or otherwise measure'").

108. *See, e.g.*, Hetherington & Dooley, *supra* note 1, at 36-37 ("[T]he minority investor may be hesitant to raise too many reservations for fear of demonstrating too little confidence in the majority and thereby queering the deal. Introducing the subject of future dissension may produce present discontent and prevent the firm from being organized.") (footnote omitted); *id.* at 37 n.115 ("Legal counsel which dwells too strongly on the hazards can only cause apprehension in a human situation which calls for the best of good will and mutual trust."); Thompson, *supra* note 5, at 224 ("A prolonged focus on the 'downside' may seem inconsistent with the mutual trust on which the business must depend."); Utset, *supra* note 100, at 1348 ("[S]hareholders may opt not to adopt shareholder contracts because they choose to rely on their mutual trustworthiness, *and because proposing and bargaining over these contracts can undermine the often fragile trust that exists at the beginning of ventures*.") (emphasis added); *see also* JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 534 (1995) ("[T]he relationship among the stockholders [of a close corporation] must be one of trust, confidence and absolute loyalty if the

at all.

Even if the topic of dissension is broached, a similar concern exists that any "hard feelings" created by the bargaining process will hinder the parties' abilities to work together in the future.[109] Given this concern and the related desire to preserve as much goodwill between the shareholders as possible, a minority investor at the outset of a close corporation venture is likely to feel constrained in its ability to freely exercise any bargaining advantage that it has—i.e., constrained in its ability to fully "flex" its bargaining "muscle" against the majority shareholder.[110] When the typical familiarity

enterprise is to succeed."); Blair & Stout, *supra* note 101, at 1806 ("Suppose a potential business partner shows up armed with a lawyer and a ten-page contract loaded with fine print. What does that behavior suggest? Most obviously, a reluctance to trust."); *id*. ("And given the empirical association between a willingness to trust and a willingness to behave trustworthily, revealing a fear to trust unavoidably signals one's own untrustworthiness."); *id*. at 1806 n.206 ("It also seems likely that explicit contracting can undermine trust between two individuals who each view the other as potentially trustworthy because it frames their developing relationship as an arm's-length one that calls for competitive rather than cooperative behavior."); Hetherington & Dooley, *supra* note 1, at 2 (noting that, in close corporations, "[w]hether the parties adopt special contractual arrangements is much less important than their ability to sustain a close, harmonious relationship over time" and observing that "[t]he continuance of such a relationship is crucial").

109. *See, e.g.*, Hetherington & Dooley, *supra* note 1, at 38 (discussing the possibility of a minority shareholder insisting on a contractual right to withdraw its capital, and noting that "[t]he majority is . . . likely to resent the implications about its trustworthiness and competence in the minority's demand for the right to withdraw"); *supra* note 108 and accompanying text (observing that a focus on protection from dissension may undermine the trust between the parties that is important to the operation of the business).

110. *See supra* note 108 and accompanying text (observing that a focus on protection from dissension may undermine the trust between the parties that is important to the operation of the business).

At the outset of a close corporation venture, a minority investor may actually have some bargaining leverage. As the author has previously observed:

> [T]he close corporation investor, *ex ante*, has the bargaining leverage to demand such [protective] terms. After all, a prospective shareholder-employee of a close corporation has viable alternative options if the majority shareholder refuses to enter into a protective bargain. For example, the prospective shareholder-employee can invest his or her capital in other close corporations willing to provide more favorable terms, or the shareholder-employee can avoid close corporations all together by simply entrusting his or her capital to the stock or bond markets. In addition, given that the pool of potential investors for a particular close corporation (with its own particular line of business) is, presumably, relatively small, the majority shareholder has an incentive to make concessions to secure the

between close corporation participants is factored into the analysis,[111] the minority shareholder is likely to feel even more constrained, as the shareholder will be concerned that fair (but hard) bargaining may harm both a business *and* a family/friendship relationship. Unlike discrete, single-interaction transactions, therefore, effective contracting in the close corporation setting is frequently hindered by relationship-oriented concerns. As a result, contractual protection for the minority shareholder is often incomplete or nonexistent.

For all of these reasons, it is rare for effective ex ante contracting to occur between close corporation investors.[112] This systemic failure to "self-protect" exacerbates the oppression problem and underscores the need for a judicial response.

E. Summary

In the close corporation setting, four primary factors form the "seeds" of the oppression problem—the lack of exit rights, the norm of majority rule, the deference of the business judgment rule, and the absence of advance planning. Standing alone, the existence of any one of these factors in a particular business setting might be insufficient to warrant a special remedial doctrine. In combination, however, the existence of all of these factors in the same business

> potential investor's much-needed capital, as another prospective investor for that particular venture may not come along for quite some time (if ever). Simply put, because the bargaining leverage at the outset favors the prospective shareholder-employee, nothing compels the shareholder-employee to invest on unfavorable terms.

Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1074-75 (2001) (footnote omitted); *see also* O'Neill, *supra* note 105, at 663 ("At the outset, the shareholder faces an extremely diverse array of other . . . investment opportunities encompassing not only stock in other . . . corporations, but also interests in mutual funds and debt securities of corporations, financial institutions and governmental authorities.").

111. *See supra* notes 18, 102, and accompanying text (noting that close corporation owners are frequently linked by family or other personal relationships).

112. It should also be noted that ex ante contracting is expensive, as it often requires the assistance of an attorney. In fact, effective ex ante contracting may require the services of multiple attorneys—one (or more) representing the majority's interests, and one (or more) representing the minority's interests. This level of expense may be prohibitive for many small businesses, especially at their inception. *See, e.g.*, Karjala, *supra* note 105, at 477 ("Many small businesses . . . will elect not to assume the expense of negotiating, and hiring an attorney to draft, a carefully worded operating agreement."); Ribstein, *New Choice*, *supra* note 7, at 328 (noting "the high costs of anticipating and planning for remote eventualities in closely held firms").

context creates a great potential for abuse of minority investors. Undoubtedly, the presence of these factors in the close corporation environment spurred the need for judicial oversight and prompted the development of the modern-day shareholder oppression doctrine.

By identifying the factors giving rise to the oppression problem in the close corporation, one can raise structural questions about the LLC. Can these oppression "seeds" be mapped to the LLC context? Put differently, are the factors giving rise to the oppression problem in the close corporation also present in the LLC? If so, is a special oppression doctrine warranted for the LLC setting as well? Before these questions can be addressed, some background on the LLC is necessary.

IV. THE LIMITED LIABILITY COMPANY

A. An Overview of the Limited Liability Company

An LLC is a noncorporate business structure that provides its owners, known as "members," with limited liability for the venture's obligations and with great freedom to structure their internal arrangements by agreement.[113] Equally as important (if not more so), the LLC structure allows its members to choose a "pass-through" partnership tax treatment.[114] LLC statutes typically

113. *See, e.g.*, EISENBERG, *supra* note 14, at 498 ("Limited liability companies (LLCs) are noncorporate entities . . . . As under corporation law, the owners (members) of LLCs have limited liability. As under partnership law, an LLC has great freedom to structure its internal governance by agreement.") (emphasis omitted). Another authority provides the following definition:

> [A]n LLC may be generally defined as an unincorporated entity . . . [where] the members and managers . . . do not have vicarious liability for the obligations of the entity, and the relationship of the members, managers and the entity is largely governed by an agreement among them or, where the parties have not agreed to the contrary, by the default rules of the state statute.

1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:3, at 1-10; *see also* EISENBERG, *supra* note 14, at 502 ("All of the LLC statutes provide that the members and managers of an LLC are not liable for the LLC's debts, obligations, and other liabilities."); CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 51 (4th ed. 2003) ("In the LLC, limited liability is the norm for both members and managers. Additionally, members may participate fully in the management of the firm without forfeiting limited liability."); *id.* (noting that '[m]embers' are the LLC's residual claimants"); Robert B. Keatinge, *New Gang in Town*, BUS. LAW TODAY, Mar./Apr. 1995, at 5, 5 ("A limited liability company is an organization in which the owners, known as members, are not individually liable for the obligations and liabilities of the organization.") (emphasis omitted); *id.* (noting that "[a] member is the owner of an interest in the LLC").

114. *See infra* notes 124-26, 130, and accompanying text (discussing

provide for partnership-like management by members ("member-managed" LLCs), or for corporate-like management by managers ("manager-managed" LLCs).[115] In member-managed LLCs, "members have statutorily granted agency and the authority to make management decisions."[116] By contrast, in manager-managed LLCs, "members are not agents of the LLC and, generally, have the authority to make only major decisions,"[117] while managers (who are not required to be members) have the authority to bind the LLC and to make day-to-day management determinations.[118]

pass-through tax treatment for an LLC).

115. *See, e.g.*, EISENBERG, *supra* note 14, at 498 ("LLCs come in two flavors: member-managed LLCs, which are managed by their members, and manager-managed LLCs, which are managed by managers who may or may not be members."); O'KELLEY & THOMPSON, *supra* note 113, at 51 ("LLC statutory default rules normally assign all management functions to members, who, as a result, have powers similar to those of partners in a general partnership."); *id.* ("LLC statutes normally provide a set of fall-back rules assigning management powers to 'managers' and taking away most of the management powers and authority that members would otherwise possess."); *id.* ("In effect, then, current LLC statutes provide two governance forms . . . one analogous to the general partnership as the normal default rule [member-managed], and one more analogous to the corporation or limited partnership as the normal second choice [manager-managed]."); *see also* Keatinge, *supra* note 113, at 6 ("A member-managed LLC is similar to a partnership in this respect since its owners are agents of the organization for carrying on its usual business. In this respect, a manager-managed LLC in which the managers are periodically elected resembles a corporation.").

116. Keatinge, *supra* note 113, at 5. As Professor Eisenberg observes:

> Under a majority of the statutes, the apparent authority of a member of a member-managed LLC is comparable to the apparent authority of a partner—that is, each member has power to bind the LLC for any act that is for apparently carrying on the business of the LLC in the usual or ordinary way.

EISENBERG, *supra* note 14, at 500.

117. Keatinge, *supra* note 113, at 5.

118. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 404(b)(2) (1996) [hereinafter ULLCA] ("In a manager-managed company . . . any matter relating to the business of the company may be exclusively decided by the manager or, if there is more than one manager, by a majority of the managers . . . ."); *id.* § 404 cmt. ("In a manager-managed company, the members, unless also managers, have no rights in the management and conduct of the company's business unless otherwise provided in an operating agreement."); EISENBERG, *supra* note 14, at 500 ("In manager-managed firms, . . . typically only the managers have apparent authority to bind the firm. Members of a manager-managed LLC have no apparent authority to bind the LLC."); O'KELLEY & THOMPSON, *supra* note 113, at 51 (noting that manager-managed LLCs "assign[] management powers to 'managers' and tak[e] away most of the management powers and authority that members would otherwise possess"); Ribstein, *New Choice*, *supra*

An LLC is formed by filing a relatively skeletal "articles of organization" with the state.[119] Detail on the governance of the LLC is typically contained in a separate document known as the "operating agreement." The operating agreement is simply "an agreement among the members concerning the LLC's affairs,"[120] and it sets forth the rights and duties of the members and managers.[121]

---

note 7, at 337 ("LLC statutes permit an LLC to elect to be centrally managed by managers. This means that managers clearly have the power to bind the firm as to ordinary matters, and that non-managers do not have this power."); *supra* note 115 and accompanying text (discussing manager-managed LLCs); *see also* VA. CODE ANN. § 13.1-1024(B) (Michie 2002) ("Managers [of a manager-managed LLC] need not be residents of this Commonwealth or members of the limited liability company unless the articles of organization or an operating agreement so require."); Bahls, *supra* note 7, at 67 ("The statutes governing [LLCs] . . . borrow from . . . the corporate scheme of permitting managers who may, or may not, be owners.").

119. *See, e.g.*, EISENBERG, *supra* note 14, at 499 ("An LLC is formed by filing articles of organization in a designated state office—usually, the office of the Secretary of State."); *id.* (noting that "[a]n LLC's articles of organization are usually very sketchy"); O'KELLEY & THOMPSON, *supra* note 113, at 51 ("Like a limited partnership, a limited liability company is formed by filing a 'constitution,' usually termed 'articles of organization,' with the secretary of state."); Keatinge, *supra* note 113, at 5 ("The articles of organization is a filed document that creates the LLC, provides certain information about it, and, under some statutes, constitutes a superagreement among the members.") (emphasis omitted); *see also* EISENBERG, *supra* note 14, at 499 (stating that "[s]ome statutes use the term certificate of organization rather than the term articles of organization") (emphasis omitted). Regarding the content of the articles, Professor Eisenberg states the following:

> The articles must include the name of the LLC, the address of its principal place of business or registered office in the State, and the name and address of its agent for service of process. Many or most statutes also require the articles to state: (1) The purpose of the LLC. (2) If the LLC is to be manager-managed, the names of the initial managers. If the LLC is to be member-managed, the names of its initial members. (3) The duration of the LLC or the latest date on which it is to dissolve. Many statutes also require the articles to include various kinds of additional information, the nature of which varies considerably.

EISENBERG, *supra* note 14, at 499.

120. EISENBERG, *supra* note 14, at 499.

121. *See, e.g.*, O'KELLEY & THOMPSON, *supra* note 113, at 51 ("LLCs also should adopt operating agreements, nonpublic documents similar to corporate by-laws, that specify in more detail the particular rights, obligations, and duties of the LLCs's managers and members."); Keatinge, *supra* note 113, at 5 ("The operating agreement (sometimes known as 'regulations,' 'limited liability company agreement,' or 'member control agreement') is the agreement among the members setting forth their rights and duties."); Joseph M. Mona, *Advantages of Using a Limited Liability Company in an Estate Plan*, 25 EST. PLAN. 167, 168 n.7 (1998) (defining "operating agreement" as "[t]he LLC

Most LLC statutes provide that, with limited exceptions, "the operating agreement may establish any rules that the members desire, with the statutes providing 'default rules' that govern the LLC where the members have not provided otherwise . . . ."[122] Freedom of contract, in other words, is at the core of the LLC structure.[123]

B. *The Development of the Limited Liability Company*

Two or more persons seeking to engage in a commercial venture traditionally chose between the partnership and corporation forms. One of the primary advantages to conducting business as a partnership was (and still is) the avoidance of the "double tax" that is imposed on corporations.[124] Partnership income is taxed only at the owner (partner) level, rather than also taxed at the entity

---

organizational document that is comparable to a partnership agreement or the bylaws of a corporation"); *see also* EISENBERG, *supra* note 14, at 499 ("The operating agreement typically provides for the governance of the LLC, its capitalization, the admission and withdrawal of members, and distributions."); Keatinge, *supra* note 113, at 8 ("Rather than setting forth the relationship among the owners and employees . . . in articles of incorporation, bylaws, buy-sell agreements and employment contracts as is the case with a corporation, the members of an LLC may deal with all of these matters in a single consistent document—the operating agreement.").

122. WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 11 (7th ed. Supp. 1999); *see also* Keatinge, *supra* note 113, at 5 ("To a far greater extent than is true of the corporation, an LLC may be organized in accordance with the agreement of the members.").

123. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(b) (1998) ("It is the policy of this chapter [on LLCs] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); Keatinge, *supra* note 113, at 6 (noting that "the principle of freedom of contract underlies all LLCs" and observing that "some statutes expressly refer to the public policy favoring the enforcement of the operating agreement among the members"); *see also* Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) (stating that the Delaware LLC statute "generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act"); *id.* ("The policy of freedom of contract underlies . . . the [LLC] Act . . . ."); Walker v. Res. Dev. Co. Ltd., 791 A.2d 799, 813 (Del. Ch. 2000) ("Once members exercise their contractual freedom in their limited liability company agreement, they can be virtually certain that the agreement will be enforced in accordance with its terms."); Karjala, *supra* note 105, at 456 ("[P]articipants in these [LLC] enterprises, together with their attorneys, can allocate the economic and political rights and duties among themselves in essentially any manner they choose.").

124. *See infra* notes 125-29 and accompanying text (discussing taxation in the partnership and corporation forms).

(partnership) level.[125] This taxation scheme is referred to as "pass-through" or "flow-through" taxation—i.e., the partnership's income "passes through" the entity and is taxed only at the individual partner level.[126] Unfortunately, this favorable tax status comes at a price, as partnerships also subject their owners to unlimited personal liability for the debts and obligations of the business.[127]

In contrast to a partnership, the earnings of a corporation are subject to the "double tax," as the firm's profits are taxed once at the entity (corporation) level and, upon the payment of dividends, are taxed again at the owner (shareholder) level.[128] A corporation, however, provides its owners with limited liability for the corporation's debts and obligations.[129]

Given this "pass-through" taxation/limited liability trade-off, it was only a matter of time before business owners wanted to have their cake and eat it too. Indeed, commentators have noted that "[t]he limited liability company came into existence in response to a demand for an organization that affords its owners limited liability but is not subject to the double tax regime applicable to corporations."[130] In 1977, Wyoming passed the first LLC statute in

125. *See, e.g.*, Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1460 (1998) ("The partnership tax provisions only impose one level of tax at the owner level . . . .").

126. *See infra* note 130 (discussing "pass-through" or "flow-through" taxation).

127. *See, e.g.*, REV. UNIF. P'SHIP ACT § 306(a) (1997) ("Except as otherwise provided . . . all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.").

128. *See, e.g.*, Hamill, *supra* note 125, at 1460 ("The corporate tax provisions . . . either require all corporations to bear two levels of tax, once at the entity level and again at the shareholder level, or allow S corporations a flow-through regime with many restrictions not faced by partnerships."); Ribstein, *New Choice*, *supra* note 7, at 327 ("The tax disadvantage of incorporation is . . . that the parties are subject to double taxation of profits at the corporate level and then again when distributed to the owners.").

129. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(6) (1998) (stating the default rule that "the stockholders or members of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts"); Hamill, *supra* note 125, at 1460 (noting that "before the LLC's invention, corporations were the only domestic business entity offering complete statutory limited liability").

130. 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-2; *see* Five Star Concrete v. Klink, 693 N.E.2d 583, 586 (Ind. Ct. App. 1998) (noting that "LLCs offer the same limited liability as the corporate form of business organization, but they are treated by federal and state taxing bodies in the same way as partnerships, that is, income 'passes through' the entity and is taxed to the member"); 1 CLOSE CORPORATIONS, *supra* note 14, § 2.06.10, at 2-52 ("This new

response to a demand by the Hamilton Brothers Oil Company.[131] Hamilton Brothers sought a domestic entity that was comparable to a Panamanian business structure known as a "Limitada"—an entity that possessed both limited liability and favorable pass-through tax treatment.[132] Upon the passage of the LLC statute in Wyoming,

[LLC] form makes limited liability and pass-through . . . treatment available to entities that could not qualify for chapter S; for example, if they had more than 75 shareholders, or an alien shareholder or a . . . complicated financial structure that would not meet the one class of stock restriction . . . ."); 2 OPPRESSION, *supra* note 19, § 6:2, at 6-2 (noting that LLCs "were attractive to investors because they provided a combination of limited liability for participants and pass-through tax treatment to entities that could not qualify for that combination as an S corporation or otherwise"); Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L.Q. 433, 434 (1995) ("In general, the purpose of forming a limited liability company is to create an entity that offers investors the protections of limited liability and the flow-through tax status of partnerships."); Miller, *supra* note 99, at 427-28 ("The *raison d'etre* of the LLC was to combine in a single business entity the benefit of limited liability with the advantage of flow-through taxation as a partnership."); Mona, *supra* note 121, at 167 ("This universal adoption of LLCs confirms the strong interest in a new legal entity that combines the limited liability of a corporation with the advantageous tax regime of a partnership, better than either an S corporation or a limited partnership."); *cf*. Keatinge, *supra* note 113, at 6 ("The concept of a contractual arrangement that affords limited liability . . . but also provides the freedom to establish ownership and management relationships based on the contract of the parties and that is treated as a partnership for tax purposes has long been considered to be the ideal business vehicle."); *see also* Hamill, *supra* note 125, at 1460 ("The Wyoming Limited Liability Company (LLC), created in 1977, represents the first domestic unincorporated business entity combining statutory limited liability protection with the ability to be taxed as a partnership for federal income tax purposes." (footnote omitted)). *But see* 1 CLOSE CORPORATIONS, *supra* note 14, § 2.06.10 at 2-55 ("While LLC's receive pass-through tax treatment at the federal level, they are taxed as corporations in some states. In addition, LLCs cannot gain some benefits available to S corporations such as favorable treatment as to self-employment tax." (footnote omitted))

131. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-5 to 1-6 (discussing the Wyoming LLC statute). *See generally* Hamill, *supra* note 125, at 1463-69 (discussing the evolution of the Wyoming LLC statute and the involvement of Hamilton Brothers).

132. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-5 to 1-6 (discussing the Wyoming LLC statute); Hamill, *supra* note 125, at 1464 ("Because no viable domestic entity existed, like the foreign limitada, which combined limited liability and partnership taxation, the representatives of Hamilton Brothers Oil Company created an unincorporated domestic entity resembling the foreign limitada. . . ."); *id*. ("The newly created LLC . . . offered for the first time the potential for a domestic entity to combine the tax advantages of a partnership with direct limited liability commonly associated with corporations."). *See generally* Hamill, *supra* note 125, at 1463-69 (discussing the evolution of the Wyoming LLC statute and the involvement of Hamilton Brothers).

Hamilton Brothers sought a private letter ruling from the Internal Revenue Service (the "IRS") seeking confirmation that a Wyoming LLC would be classified as a partnership for federal income tax purposes.[133] After more than three years, the IRS ruled in November 1980 that a Wyoming LLC would be taxed as a partnership.[134] Around the same time, however, the IRS issued proposed regulations that called for taxation of all LLCs as corporations.[135]

Despite the confusion surrounding the LLC's tax status, Florida enacted the second LLC statute in 1982, presumably in an effort to attract investment capital.[136] In 1983, the IRS withdrew its proposed regulations calling for corporate taxation of LLCs, and it simultaneously indicated that it was studying the issue of LLC classification for tax purposes.[137] This announcement further

133. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-2 to 1-7 (describing the origins of the LLC); Hamill, *supra* note 125, at 1466 ("Armed with the enacted LLC legislation, the Hamilton Brothers Oil Company, on May 25, 1977, filed a request with the IRS, the federal agency vested with the authority to determine which unincorporated businesses avoid association status, asking for a favorable partnership classification ruling.") (footnote omitted).

134. *See* Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980) (classifying the Wyoming LLC as a partnership). As Professor Hamill explains:

> After a great deal of correspondence between Hamilton Brothers Oil Company's representatives and the IRS, an additional request for a ruling filed by the Wyoming Secretary of State and supported by the Governor, as well as another correspondence involving the Commissioner of the IRS and Wyoming Senators, the IRS finally issued a favorable private letter ruling to Hamilton Brothers Oil Company regarding its Wyoming LLC on November 18, 1980, more than three years after the initial request.

Hamill, *supra* note 125, at 1466-67 (footnotes omitted).

135. *See* Hamill, *supra* note 125, at 1467-68 ("Also in 1980, on the eve of the private letter ruling's release, the IRS issued proposed amendments to the partnership classification regulations that would automatically tax all limited liability companies as corporations, revealing the conflicting views that undoubtedly existed among IRS officials."); *id.* at 1469 (noting that the proposed regulations "rendered the LLC useless on a practical level").

136. *See* Florida Limited Liability Company Act, FLA. STAT. ANN. § 608.401-608.471 (West Supp. 1982); *see also* Hamill, *supra* note 125, at 1468-69 ("Despite the firestorm surrounding these proposed regulations . . . Florida enacted an LLC statute in 1982, presumably to lure capital into the state.").

137. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-6 ("In 1983, the IRS withdrew the proposed amendments [treating LLCs as corporations for federal income tax purposes], stating that it was studying the issue of classification of LLCs."); Hamill, *supra* note 125, at 1469 ("Although the power to issue the 1980 regulations clearly fell within the IRS's authority, the IRS withdrew its position in early 1983 and stated that it would study the effect

heightened the uncertainty surrounding the LLC's tax status, and, predictably, the development of LLCs stalled.[138] In 1988, the IRS clearly indicated that properly-organized LLCs would be classified as partnerships for federal income tax purposes.[139] As a result of this newly-created certainty, LLC statutes proliferated.[140] Today, all fifty states and the District of Columbia have enacted statutes allowing for the creation of LLCs.[141] Moreover, the number of LLCs

limited liability should have on entity classification.") (footnote omitted).

138. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-6 ("Presumably as a result of the uncertainty as to both tax treatment and the members' protection from personal liability, no other state enacted an LLC statute until 1990."); Bahls, *supra* note 7, at 47 ("Before 1986, only two states, Wyoming and Florida, had enacted [LLC] legislation, probably because much doubt existed as to whether limited liability companies would receive the benefit of taxation as partnerships."); Hamill, *supra* note 125, at 1469 ("That [IRS] study [regarding LLC classification for tax purposes] took over five years and predictably, while its tax status remained in limbo, further growth in LLC legislation and businesses using LLCs stopped; no other states enacted statutes and few businesses (less than one hundred) chose to become LLCs."); *id.* ("As long as its ability to be taxed as a partnership remained questionable, the LLC stood no chance of expanding throughout the country."); Keatinge, *supra* note 113, at 6 ("Wyoming enacted the first limited liability company statute in 1977 and Florida the second in 1982. However, because of uncertainty about tax treatment, it was not until 1988 that they began to attract widespread attention.").

139. *See* Rev. Rul. 88-76, 1988-2 C.B. 360 (classifying LLCs as partnerships for federal income tax purposes so long as certain criteria were met); *see also* Hamill, *supra* note 125, at 1469-70 ("On September 2, 1988, the IRS issued Revenue Ruling 88-76, a public interpretation of the law all taxpayers can rely upon, permitting the Wyoming LLC to secure partnership classification despite the presence of limited liability." (footnote omitted)); *id.* at 1470 ("By concluding that the presence of corporate limited liability protection did not by itself mandate corporate taxation for unincorporated entities, the IRS released its total control over the LLC's future viability and allowed the states to realistically consider the LLC form."); Keatinge, *supra* note 113, at 6 (noting that after eight years of study, the IRS ruled in Revenue Ruling 88-76 that "an LLC created according to the Wyoming act would be treated as a partnership for tax purposes," and stating that the "ruling marked a significant shift in the IRS' policy with respect to entities in which the liability of the owners is limited to the owners' investment").

140. *See, e.g.*, Ribstein, *New Choice*, *supra* note 7, at 328 ("[T]his new flexibility [from the 1988 Revenue Ruling] set off a rush by the states to adopt LLC statutes."); *see also* Bahls, *supra* note 7, at 47 (noting that the 1988 Revenue Ruling "settled many doubts about the future of [LLCs] and broke the way for other states to begin legislation in this area").

141. *See, e.g.*, O'KELLEY & THOMPSON, *supra* note 113, at 52 ("All 50 states and the District of Columbia have now adopted LLC statutes."); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:2, at 1-7 ("After 1988, when the [IRS] stated clearly that properly organized limited liability companies would be treated as partnerships, all of the remaining states adopted limited liability company

in operation appears to be growing rapidly.[142]

V. MAPPING THE "SEEDS": OPPRESSION AND THE LIMITED LIABILITY COMPANY

In light of the widespread adoption of LLC statutes and the increasing number of LLCs in operation, it is important to ask whether the factors giving rise to the oppression problem in the close corporation setting are also present in the LLC context. Following the organization of the close corporation discussion, each factor will be examined in turn.

A. Exit Rights

1. Sale Possibilities

For tax purposes, a publicly-traded LLC is likely to be treated as a corporation.[143] Because the desire to avoid the corporate "double tax" motivates, in large part, the founders' decision to choose an LLC structure, publicly-traded LLCs will be rare.[144] Indeed,

statutes."); *id.* at 1-7 to 1-9 (stating that "[a]ll 50 states and the District of Columbia now have enacted statutes allowing the organization of LLCs," and providing citations to each statute); Ribstein, *New Choice*, *supra* note 7, at 328 ("By mid-1996, all 51 U.S. jurisdictions had LLC statutes."). As Professor Hamill observes:

> In sum, as of December 31, 1995[,] over 210,000 business ventures had chosen the LLC form since the IRS recognized the LLC's ability to be classified as a partnership in 1988. In an incredible stampede that took less than twenty years, most of it occurring from 1990 through 1996, LLCs traveled from an obscure unknown business form in 1977 to a well-recognized alternative for doing business.

Hamill, *supra* note 125, at 1477-78 (footnote omitted).

142. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 1:1, at 1-1 to 1-2 n.1 (providing 2002 data and noting that "the number of new LLCs being formed increased by . . . [ten percent] . . . , while the number of new corporations decreased by . . . eight percent . . . , and the number of new limited partnerships being formed increased by . . . two percent"); *supra* notes 10-13 and accompanying text (discussing the rapid growth of LLCs); *see also* Farrar & Hamill, *supra* note 9, at 909 (describing the LLC as the "newest and fastest growing business form").

143. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-4 & n.6 ("LLCs probably will continue not to be publicly traded because this would cause them to be taxed as corporations.") (citing I.R.C. § 7704); *id.* § 8:15, at 8-44 n.19 (noting "the fact that publicly traded LLCs are taxed as corporations").

144. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:4, at 8-12 ("[E]ven centrally managed LLCs can be expected to be closely held in order to avoid corporate-type taxation as a publicly-traded partnership."); Gevurtz, *supra* note 64, at 516 n.101 ("Publicly traded firms cannot obtain partnership tax

commentators have noted that the LLC is primarily used as a business structure for closely held ventures.[145] As a result, a well-developed market for LLC ownership interests is typically nonexistent and, correspondingly, there is little possibility of sale.[146] Moreover, even if a minority member could locate prospective outside purchasers, it would still be difficult to sell an LLC ownership position. Just as in the close corporation, the lack of control and lack of liquidity (at least compared to publicly-traded stock) associated with a minority LLC interest will severely reduce the likelihood of sale.[147]

2. *Withdrawal, Buyout, and Dissolution Rights*

When the first LLC statutes were passed, most included provisions that provided liquidity to members if they chose to exit the business. These provisions took two forms. First, the majority of LLC statutes provided that members had the power to withdraw from the business in the absence of a contrary provision in the operating agreement.[148] Upon withdrawal, the member was entitled

treatment . . . and hence will probably continue to use the corporate form. Thus, most LLCs will be closely held.") (citation omitted); *supra* note 130 and accompanying text (discussing the desire to avoid the corporate double tax).

145. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:4, at 8-12 (stating that "even centrally managed LLCs can be expected to be closely held"); *id.* § 9:2, at 9-6 (stating that LLCs "are usually closely held"); *id.* § 9:10, at 9-39 (noting that "most LLCs, even those that are centrally managed, can be expected to be closely held"); *id.* § 9:11, at 9-49 ("Like partnerships, LLCs are likely to be closely held because of the lack of free transferability of management rights."); Gevurtz, *supra* note 64, at 516 (noting that a "closely held business" is "typical for an LLC"); *id.* at 516 n.101 (observing that "most LLCs will be closely held").

146. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 6:2, at 6-4 (discussing the LLC and noting that "like other closely held businesses, there is no market to provide liquidity").

147. *See supra* notes 52-57 and accompanying text (discussing the difficulties associated with selling a minority interest in a closely held business).

148. *See, e.g.*, Gevurtz, *supra* note 64, at 514 ("[T]he LLC statutes generally follow the limited partnership model by allowing LLC members, in the absence of contrary agreement, to withdraw and cash out at any time or on thirty days', ninety days', or six months' notice (depending on the statute)."); Keatinge, *supra* note 113, at 8 ("Under most LLC statutes, members have the right to withdraw at any time and demand payment for their interest. This right to 'put' an interest back into the LLC is similar to the rule that applies to partnerships."); Miller, *supra* note 99, at 427 ("Prior to the enactment of the Check-the-Box Regulations, a majority of states gave LLC members an optional default power to withdraw from the LLC unless the operating agreement provided otherwise."); *see also* Bishop, *supra* note 63, at 297 ("By way of . . . summary, a majority of jurisdictions provide that a member has an optional

to be paid the fair value of its ownership interest less any damages caused by a wrongful withdrawal.[149] Second, most of the LLC statutes provided for dissolution of the LLC upon the member's withdrawal or other dissociation from the venture (e.g., dissociation due to a member's death, bankruptcy, or incompetency).[150] An actual

---

default power to withdraw from the company unless the operating agreement eliminates this power. Thirteen states provide that a member has the absolute power to withdraw and that the power may not be eliminated.") (footnote omitted). *But see id.* ("Four states provide that a member does not have the power to withdraw unless that power is granted by the operating agreement.").

149. The actual distribution payable to a withdrawn member varied considerably among the statutes. As Professor Bishop explains:

> [T]here are five separate categories that characterize the distribution rights of a member when the power to withdraw is [exercised]. The most common distribution option, that of seventeen states and the District of Columbia, provides that dissociated members are entitled to receive the fair value of their interest less any damages caused by wrongful withdrawal. Eleven states provide that dissociated members simply receive the fair value of their interest if they have the power to withdraw, providing no wrongful dissociation damages. Eight states provide that a dissociated member is not entitled to any distribution prior to dissolution of the entity. Seven states provide that a dissociated member is simply entitled to receive a return of contribution. Finally, three states provide that dissociated members receive the liquidation value of their interest upon dissociation.

Bishop, *supra* note 63, at 297-98 (footnotes omitted); *see also* Lieberman v. Wyoming.com, LLC, 11 P.3d 353, 359 (Wyo. 2000) ("Numerous LLC acts from other states do allow a member to receive the fair market value (or fair value) of the member's interest [upon dissociation]."); Gevurtz, *supra* note 64, at 514 n.95 (stating that "[t]he LLC statutes also vary with respect to what the withdrawing member will receive," and indicating that most of the state statutes provide for a "fair market value" distribution); Miller, *supra* note 99, at 427 ("Under most statutes, dissociated members would receive the fair market value of their interest reduced by any damages for wrongful conduct.").

It should be noted that there is often a significant difference between a "fair value" distribution and a "fair market value" distribution due to the valuation discounts that a fair market value appraisal typically incorporates. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 8933 (West 2003) (providing for a "fair value" buyout of a member's interest upon withdrawal); *id.* at § 8933 cmt. ("'[F]air value' . . . is to be fixed generally with reference to the [member's] right . . . to share in distributions from the company. . . . [I]t should not include discounts for lack of marketability or minority interest and thus is different from 'fair market value,' which term has been specifically avoided."). *See generally* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293, 294-99, 310-18 (2004) (discussing the differences between "fair value" and "fair market value" appraisals).

150. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:1, at 11-2 ("As initially adopted, LLCs resembled partnerships, in the sense that members had the power to withdraw and be paid the value of their interests, and that the

liquidation of the business could be avoided, however, if all (or a majority under some statutes) of the remaining members elected to continue the venture.[151] Even if liquidation were averted, the withdrawing member was still entitled to a buyout of its ownership interest.[152]

The inclusion of these provisions in the statutory scheme of the LLC was no accident. Before 1997, the IRS applied the "corporate resemblance" test to determine whether an LLC would be classified as a partnership or a corporation for tax purposes.[153] Under that test, an LLC was "taxed like a partnership unless it possesse[d] three or more of the four corporate characteristics, including continuity of life, centralized management, limited liability, and free

---

firm dissolved on the withdrawal, or other dissociation of a member."); Gevurtz, *supra* note 64, at 513 ("As with the withdrawal of a general partner from a limited partnership, departure of a member from an LLC will trigger dissolution under most LLC statutes unless otherwise agreed or all (or, under some statutes, a majority) of the remaining members consent to continue the company without dissolution.") (footnote omitted). Similarly, Professor Miller states the following:

> Initially, most LLC statutes contained withdrawal rights and dissolution rules based on a partnership paradigm . . . . Partnership-like contingent dissolution provisions were typically employed, requiring that the LLC dissolve upon the occurrence of stated events such as bankruptcy, death, or incompetency, unless all of the remaining members agreed to continue the LLC or a majority in interest agreed to continue.

Miller, *supra* note 99, at 426 (footnotes omitted).

151. *See, e.g.*, Gevurtz, *supra* note 64, at 525 ("[F]ollowing the pattern of the limited partnership acts, the remaining members of the firm (assuming no other agreement) may generally avoid dissolution and liquidation upon a member's withdrawal by unanimous (or, under some statutes, majority) consent to continue."); *supra* note 150 (discussing the avoidance of liquidation).

152. *See, e.g.*, CAL. CORP. CODE § 17252(c) (West 1996) (stating that "[u]pon a permitted withdrawal that does not cause dissolution of the limited liability company," a withdrawing member is still entitled, as a default rule, to receive the fair market value of its interest). Similarly, the Connecticut statute provided:

> Upon the occurrence of an event of dissociation . . . which does not cause dissolution, . . . a dissociating member is entitled to receive . . . within a reasonable time after dissociation, the fair value of the member's interest in the limited liability company as of the date of dissociation based upon the member's right to share in distributions from the limited liability company.

CONN. GEN. STAT. ANN. § 34-159 (West 1996); *see also* Gevurtz, *supra* note 64, at 513-14 ("Avoiding dissolution and liquidation, however, does not render a member's interest illiquid. Instead, the LLC statutes generally follow the limited partnership model by allowing LLC members, in the absence of contrary agreement, to withdraw and cash out . . . .").

153. Miller, *supra* note 99, at 427.

transferability of interests."[154] Because LLCs possess limited liability,[155] a state's statutory scheme needed to deny two of the remaining corporate characteristics to insure partnership tax status. Many statutes provided for manager-managed LLCs if the members desired, raising at least the possibility that centralized management would be found.[156] Thus, the LLC statutes needed to deny the free transferability of interests and continuity of life characteristics

---

154. Bishop, *supra* note 63, at 259 (footnotes omitted); *see* Miller, *supra* note 99, at 427 ("Under prior IRS Regulation 301.7701-2(a)(3), an unincorporated entity would not be taxable as a corporation unless the organization possessed more *corporate* than *non-corporate* characteristics. The four operative factors were: continuity of life, centralization of management, limited liability, and free transferability of interests.").

"Continuity of life" refers to the fact that "[t]he legal existence of a corporation is perpetual, unless a shorter term is stated in the certificate of incorporation." EISENBERG, *supra* note 14, at 100. "Centralized management" refers to the notion that, "[u]nder the corporate statutes, a corporation is normally managed by or under the direction of a board of directors, and a shareholder as such has no right to participate in management." *Id.* "Limited liability" is the concept that the owners are not personally liable for the obligations of the business. *See id.* (discussing limited liability in the corporation context). "Free transferability of ownership interests" refers to the fact that ownership interests in the business can be freely exchanged and transferred to others. *See id.* (discussing free transferability of ownership interests in the corporation context); Robert R. Keatinge, *Universal Business Organization Legislation: Will it Happen? Why and When*, 23 DEL. J. CORP. L. 29, 44 (1998) ("An organization lacks free transferability of interests when [owners] cannot grant a transferee all of the [owner's] rights without the consent of the other [owners] of the organization.").

155. For example, section 303(a) of the Uniform LLC Act states the following:

> Except as otherwise provided, . . . the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager.

ULLCA § 303(a) (1996); *supra* note 113 and accompanying text (noting that LLCs provide limited liability to their members).

156. *See, e.g.*, 2 RIBSTEIN & KEATINGE, *supra* note 7, at Appendix D-3-16 (noting that, under the ULLCA, "an LLC that does not specifically designate itself as manager-managed is managed directly by members," and presuming that the "primary reason for this default rule was to avoid the corporate tax classification feature of centralized management"); Gevurtz, *supra* note 64, at 515 n.96 (observing that if LLCs are "run by managers rather than members, an LLC likely has central management"); Hamill, *supra* note 125, at 1478 (noting that the IRS was not "prepared to recognize an LLC as lacking centralized management under any circumstances if managers had been appointed").

possessed by the traditional corporation.[157]

Most LLC statutes restricted the members' ability to transfer their ownership interests in an effort to rebut a free transferability finding.[158] Similarly, the provisions calling for the LLC's dissolution upon the member's withdrawal or other dissociation from the business were designed to resist a continuity of life finding.[159] Treasury Regulations at the time provided that "[i]f the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist."[160] As a result, most LLC statutory schemes included a dissolution provision with triggers that closely tracked the language of the Treasury Regulations.[161]

157. *See, e.g.*, Gevurtz, *supra* note 64, at 517 n.104 (noting that "[r]estricting free transfer may be necessary in order to obtain partnership tax treatment"); Miller, *supra* note 99, at 426-27 ("Under these now obsolete rules, in order to be classified as a partnership for tax purposes, it was helpful and sometimes critical for the LLC to lack the corporate characteristic of continuity of life."); *infra* notes 158-61 and accompanying text (discussing the need to deny the free transferability of interests and continuity of life characteristics).

158. As Professor Bishop explains:

> Many first generation state acts were designed to assure that partnership tax classification was "bullet proof" for limited liability companies organized under those statutes. This system eliminated drafting flexibility with regard to the critical corporate characteristics of free transferability of interests and continuity of life. Members could not alter this outcome by private agreement. A limited liability company formed under such statutes lacked (1) free transferability of interests because a transferee of a member's membership interest could not be admitted as a member without the consent of all the remaining members, and (2) continuity of life because the dissociation of a member caused the dissolution of the company unless all the remaining members agreed, within 90 days after the dissociation, to continue the business of the company.

Bishop, *supra* note 63, at 259 n.10; *id.* at 260 n.17 ("Most limited liability companies are classified as partnerships for federal tax purposes because they lack continuity of life and free transferability of interests.").

159. *See supra* note 158 (discussing the need to resist a continuity of life finding); *see also* Miller, *supra* note 99, at 428 (noting that "[l]egislators sought to ensure that the LLC would lack the corporate characteristic of continuity of life").

160. Treas. Reg. § 301.7701-2(b)(1) (1993). Conversely, the Treasury stated that "[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization." *Id.*

161. *See, e.g.*, CAL. CORP. CODE § 17350(d) (West 1996) (noting that "[e]xcept as otherwise provided in the articles of organization or a written operating agreement," dissolution of an LLC was triggered "upon the death, withdrawal, resignation, expulsion, bankruptcy, or dissolution of a member, unless the business of the limited liability company is continued by a vote of all the

In the first wave of LLC statutes, therefore, the inclusion of withdrawal and dissolution provisions provided exit rights and accompanying liquidity to LLC investors.[162] The withdrawal provisions obviously provided liquidity by typically stating that a member would receive the fair value of its ownership interest upon withdrawal.[163] The dissolution provisions provided liquidity by requiring the company to be sold (in the event of liquidation) and by allocating to each member its proportionate share of the company's sale value.[164] If liquidation were avoided, the minority member was still entitled to its buyout upon withdrawal.[165]

In late 1996, however, the IRS significantly altered the regulatory scheme that applied to LLCs. Besieged by requests seeking confirmation that LLCs operating under a myriad of different circumstances qualified for partnership tax treatment (because they lacked sufficient "corporate-ness"), the IRS scrapped the corporate resemblance test in favor of a more easily administered scheme.[166] Under the new "check-the-box" regulations, an unincorporated business entity, including an LLC, can simply

remaining members within 90 days of the happening of that event."); Miller, *supra* note 99, at 428 ("Most LLC statutes tracked some or all of the language of [the Treasury Regulations pertaining to dissolution] in an effort to ensure the absence of the corporate characteristic of continuity of life."); *see also* Miller, *supra* note 99, at 426 ("Partnership-like contingent dissolution provisions were typically employed, requiring that the LLC dissolve upon the occurrence of stated events such as bankruptcy, death, or incompetency . . . .").

162. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:1, at 11-2 ("As initially adopted, LLCs resembled partnerships, in the sense that members had the power to withdraw and be paid the value of their interests, and that the firm dissolved on the withdrawal, or other dissociation of a member. *These provisions ensured some liquidity for members interests* . . . .") (emphasis added).

163. *See supra* notes 148-49 and accompanying text (discussing the withdrawal provisions).

164. *See, e.g.*, Lieberman v. Wyoming.com, LLC, 11 P.3d 353, 357-58 (Wyo. 2000) (suggesting that if an LLC was dissolved, a member would be "entitled to distribution of assets"); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11:5, at 11-15 (stating that "[t]he function of dissolution at will is to provide liquidity for the members' interests"); *supra* notes 61, 150-52 and accompanying text (discussing the effect of dissolution and liquidation).

165. *See supra* note 152 and accompanying text (discussing withdrawal and the avoidance of liquidation).

166. *See, e.g.*, Miller, *supra* note 99, at 428-29 ("The IRS became inundated with private letter ruling requests, and eventually realized that its mandatory tax classification rules created an administrative nightmare."); Ribstein, *Future*, *supra* note 7, at 12-13 ("The IRS, forced to deal with ever more complications under the classification rules, and facing universal acceptance of the LLC form, finally gave up trying to put business entities in tax boxes."); *infra* notes 167-69 and accompanying text (discussing the "check-the-box" regulations).

choose whether it wants to be taxed as a corporation or a partnership.[167] Instead of the case-by-case inquiry called for by the corporate resemblance test,[168] in other words, the federal income tax treatment of LLCs is now determined by a simple taxpayer choice.[169]

Following the passage of the "check-the-box" regulations, there was no longer a tax-driven need for state statutes to deny the LLC

167. *See, e.g.*, Treas. Reg. §§ 301.7701-1 to 301.7701-3 (1996) (providing the "check-the-box" regulations); 2 OPPRESSION, *supra* note 19, § 6:2, at 6-3 ("Under what has been termed 'check the box' regulations, an LLC or other unincorporated entity can simply elect pass-through tax treatment without the need to show any noncorporate characteristics."); Hamill, *supra* note 125, at 1483 ("On March 30, 1995, the IRS announced a proposal to eliminate the partnership classification rules by allowing certain unincorporated businesses, including domestic LLCs, to elect partnership or corporate taxation . . . ."); *id.* ("[O]n May 13, 1996, the IRS issued proposed regulations, and on December 17, 1996, the final regulations, dubbed the 'Check-the-Box' regulations, permanently eliminated all partnership classification considerations for LLCs and all other domestic unincorporated entities.") (footnote omitted); Ribstein, *Future*, *supra* note 7, at 13 ("Under Treasury Regulation 301.7701-1-3, effective Jan. 1, 1997, firms could decide for themselves—that is, 'check the box'—whether they wanted to be taxed as partnerships [or] corporations.").

Under the check-the-box regulations, an LLC automatically receives partnership tax treatment unless it affirmatively elects otherwise. *See* Treas. Reg. § 301.7701-3 (2004) (stating that "[a] business entity that is not classified as a corporation . . . can elect its classification for federal tax purposes as provided in this section," adding that "this section provides a default classification for an eligible entity that does not make an election" and specifying that "unless the entity elects otherwise, a domestic eligible entity is . . . [a] partnership if it has two or more members . . . ."); Farrar & Hamill, *supra* note 9, at 912 n.8 ("The final regulations treat domestic unincorporated business organizations as partnerships by default. In other words, unincorporated business firms must affirmatively elect to be taxed as corporations.") (citation omitted); *id.* ("Although most unincorporated business firms will prefer partnership taxation, thus making any affirmative election unnecessary, these regulations acquired the label 'check-the-box' during their development."); Miller, *supra* note 99, at 429 ("Finally, nearly twenty years after the recognition of the first LLC, the IRS jettisoned its mandatory tax classification scheme and enacted the so-called 'Check-the-Box' regulations that automatically treat unincorporated business entities, including LLCs, as partnerships."); Ribstein, *New Choice*, *supra* note 7, at 330 ("In its so-called 'check the box' rule, the I.R.S. determined that a domestic 'eligible entity' (which includes business firms other than corporations, joint stock companies, insurance companies or banks) is not treated as a corporation for income tax purposes unless it elects this treatment.") (footnote omitted).

168. *See supra* note 154 and accompanying text (discussing the corporate resemblance test).

169. Technically, LLC owners seeking classification as a partnership for federal income tax purposes do not have to "choose" partnership status, as the regulations default to partnership classification. *See supra* note 167 (describing the "check-the-box" regulations).

certain "corporate" characteristics. In response, many state legislatures eliminated or restricted the withdrawal and dissolution rights that had served to combat a continuity of life finding.[170] With respect to withdrawal rights, for example, California's LLC statute previously provided the following:

> Upon a permitted withdrawal that does not cause dissolution of the limited liability company, any withdrawing member is entitled to receive any distribution to which that member is entitled under the operating agreement and, if not otherwise provided in the operating agreement, the member is entitled to receive, within a reasonable time after withdrawal, the fair market value of the member's interest in the limited liability company as of the date of withdrawal based upon the member's right to share in distributions from the limited liability company.[171]

The 1997 version of the statute, however, eliminated this buyout right:

> [U]nless the articles of organization or written operating agreement provide otherwise, the withdrawn member shall not be entitled to payment for the member's interest in the limited liability company, and, beginning on the date of the withdrawal, the withdrawn member shall have only the right of a holder of an economic interest with respect to that withdrawn member's interest in the limited liability company . . . .[172]

---

170. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 6:2, at 6-3 to 6-4 (noting that since the "check-the-box" regulations took effect, "there has been a distinct movement by the states to make their LLC statutes more corporate," and observing that "a member's dissociation, which could be triggered by death [or] withdrawal, no longer triggers dissolution of the LLC in many states"); O'KELLEY & THOMPSON, *supra* note 113, at 51 ("After the Internal Revenue Service abandoned its reliance on partnership governance norms as a condition for granting pass-through tax treatment, the default rules in many LLC statutes were amended to reduce the easy exit that characterizes the default rules of general partnership law."); Hamill, *supra* note 125, at 1483 n.106 ("In response to the elimination of the partnership classification regulations, in July of 1996 the Uniform LLC Act was amended to eliminate dissolution upon a member's dissociation."); *infra* notes 171-74 and accompanying text (discussing the elimination of withdrawal and dissolution rights).

171. CAL. CORP. CODE § 17252(c) (West 1996).

172. CAL. CORP. CODE § 17252(a) (West 1997). This language remains in the statute today. *See* CAL. CORP. CODE § 17252(a) (West 2004) (citing the language). Other jurisdictions have similarly amended their LLC statutes to eliminate default "buyout-upon-withdrawal" rights. *See, e.g.*, ALA. CODE

Similarly, California's LLC statute previously provided that dissolution of an LLC would occur "upon the death, withdrawal, resignation, expulsion, bankruptcy, or dissolution of a member, unless the business of the limited liability company is continued by a vote of all the remaining members within 90 days of the

§ 10-12-30(c) (1995) (providing for a buyout upon withdrawal with a price set at "the amount that would have been distributable to the dissociating member" if, when the dissociation occurred, "the assets of the [LLC] were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated member, and the [LLC] were wound up as of that date"); ALA. CODE § 10-12-30 (1998) (eliminating the default buyout right upon withdrawal); *id.* cmt. ("This section makes a major change in the limited liability company law by providing that the company is not obligated to buy the interest of a withdrawing member unless the articles or the operating agreement provide for a buyout."); *id.* ("This reverses the previous rule, which provided for a buyout and provided terms for the buyout if the operating agreement did not have such terms."); ARIZ. REV. STAT. ANN. § 29-707 (West 1996) (providing for a "fair value" buyout upon withdrawal); ARIZ. REV. STAT. ANN. § 29-707 (West 1997) (eliminating the default buyout right upon withdrawal); CONN. GEN. STAT. ANN. § 34-159 (West 1996) (providing for a "fair value" buyout upon withdrawal); CONN. GEN. STAT. ANN. § 34-159 (West 1998) (eliminating the default buyout right upon withdrawal); R.I. GEN. LAWS § 7-16-29 (1996) (providing for a "fair value" buyout upon withdrawal); R.I. GEN. LAWS § 7-16-29 (1997) (eliminating the default buyout right upon withdrawal); *see also* 1 CLOSE CORPORATIONS, *supra* note 14, § 2:7, at 2-56 to 2-57 ("[S]tatutes are changing so that the departing member has no ability to get out, i.e., no right to make the LLC buy the departing member's interest."); 2 OPPRESSION, *supra* note 19, § 6:4, at 6-8 ("Many LLC statutes now deny a departing member a right to get money out of the enterprise or seek other relief except as set forth in the operating agreement.").

Significantly, a number of other states do not expressly eliminate default "buyout-upon-withdrawal" rights, but they do restrict a member's ability to withdraw before the dissolution of the LLC. These statutes, therefore, have the same effect of "locking-in" a minority member for the duration of the venture. *See, e.g.*, DEL. CODE ANN. tit. 6, §§ 18-603, 18-604 (1998) (providing a default rule that, upon resignation any resigning member is entitled to receive "the fair value of such member's [LLC] interest," but also stating that "unless [an LLC] agreement provides otherwise, a member may not resign from [an LLC] prior to the dissolution and winding up of the [LLC]"); FLA. STAT. ANN. § 608.427 (West 2001) (stating, as a default rule, that a "withdrawing member is entitled to receive . . . the fair value of the withdrawing member's interest," but also providing that "unless the articles of organization or operating agreement provides otherwise, a member may not resign from [an LLC] prior to the dissolution and winding up of the [LLC]"); N.Y. LTD. LIAB. CO. LAW §§ 509, 606(a) (McKinney 2003) (stating, as a default rule, that "any withdrawing member is entitled to receive . . . the fair value of his or her membership interest," but also providing that "unless an operating agreement provides otherwise, a member may not withdraw from [an LLC] prior to the dissolution and winding up of the [LLC]").

happening of that event."[173] This language, however, was subsequently removed from the statute, and the grounds for dissolution were substantially narrowed. Since 1999, the statute has read as follows:

> A limited liability company shall be dissolved and its affairs shall be wound up upon the happening of the first to occur of the following: (a) At the time specified in the articles of organization, if any, or upon the happening of the events, if any, specified in the articles of organization or a written operating agreement. (b) By the vote of a majority in interest of the members, or a greater percentage of the voting interests of members as may be specified in the articles of organization or a written operating agreement. (c) Entry of a decree of judicial dissolution pursuant to Section 17351 [an involuntary dissolution provision].[174]

173. CAL. CORP. CODE § 17350(d) (West 1996). These grounds for dissolution were only default rules. *See id.*

174. CAL. CORP. CODE § 17350 (West 1998). This language remains in the statute today. *See* CAL. CORP. CODE § 17350 (West 2004) (citing the language). Other jurisdictions have substantially narrowed their dissolution grounds as well. *See, e.g.*, ALA. CODE §§ 10-12-36 to 10-12-37 (1995) (providing for dissolution upon "an event of dissociation of a member," and defining those events to include, among others, withdrawal, death, and bankruptcy); ALA. CODE § 10-12-37 (1998) (eliminating the dissolution upon dissociation of a member ground); *id.* cmt. ("This section has been amended to eliminate the rule that a limited liability company will dissolve upon the withdrawal of a member. Unless the articles of organization or the operating agreement provide otherwise, the withdrawal of a member has no effect on the company."); ARIZ. REV. STAT. ANN. §§ 29-733, 29-781 (West 1996) (providing for dissolution upon "[a]n event of withdrawal of a member," and defining those events to include, among others, withdrawal, death, and bankruptcy); ARIZ. REV. STAT. ANN. § 29-781 (West 1998) (eliminating the dissolution upon withdrawal of a member ground); CONN. GEN. STAT. ANN. §§ 34-180, 34-206 (West 1996) (providing for dissolution upon "an event of dissociation of a member," and defining those events to include, among others, withdrawal, death, and bankruptcy); CONN. GEN. STAT. ANN. § 34-206 (West 1998) (eliminating the dissolution upon dissociation of a member ground); R.I. GEN. LAWS § 7-16-39 (1996) (providing for dissolution upon "the death, resignation, expulsion, bankruptcy, or dissolution of a member"); R.I. GEN. LAWS § 7-16-39 (1997) (retaining the dissolution triggers but adding that, even if a trigger occurs, dissolution is caused only "[u]pon the written consent of a majority of the capital values of the remaining members"); *see also* 1 CLOSE CORPORATIONS, *supra* note 14, § 2:7, at 2-56 ("[A] member's dissociation, which could be triggered by death or withdrawal, no longer triggers dissolution of the LLC in most states; rather, the entity continues (i.e., permanent duration).") (footnote omitted).

It should be noted that the California LLC statute does have an involuntary dissolution provision that allows a minority member to petition a

Although one could attempt to justify the curbing of withdrawal and dissolution rights on the ground that "locking-in" capital helps to facilitate business development,[175] the movement to restrict exit rights appears to be motivated primarily by a desire to make the family-owned LLC an attractive business structure for estate and gift tax purposes.[176] To minimize the tax value of an ownership interest in a closely held business, an investor will frequently claim that the value of its ownership position should be reduced to reflect (1) that the interest is difficult to liquidate, and (2) that purchasers will generally pay less for illiquid positions.[177] This well-accepted

court for dissolution on a number of grounds, including that "[d]issolution is reasonably necessary for the protection of the rights or interests of the complaining members," "the management of the [LLC] is . . . subject to internal dissension," and "[t]hose in control of the company have been guilty of, or have knowingly countenanced persistent and pervasive . . . abuse of authority." CAL. CORP. CODE § 17351 (West 2004). LLC statutes in a handful of other jurisdictions include similar language. *See infra* note 271 and accompanying text (discussing involuntary dissolution provisions in LLC statutes). By definition, of course, involuntary dissolution statutes provide far more limited exit rights than withdrawal-triggered dissolution or buyout provisions. *Cf.* Karjala, *supra* note 105, at 471 (noting that Arizona, Delaware, and Oregon have statutes allowing a court to order dissolution if a member establishes that it is "'not reasonably practicable to carry on the business' according to the articles or an operating agreement," but observing that "it is often possible to carry on the business while freezing a minority interest out of any return") (footnote omitted).

175. *See, e.g.*, Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387 (2003) ("While this ability to lock in capital has occasionally led to abuses, the ability to commit capital generally helped promote and protect the interests of shareholders as a group by making it possible for the entity to invest in long-term, highly specific investments."); *id.* ("It also helped protect a wide range of enterprise participants who made specialized investments in reliance on the continued existence and financial viability of the corporation."); Farrar & Hamill, *supra* note 9, at 911-12 ("The need to trigger a possible dissolution every time a member withdrew or otherwise became separated from the business . . . created a highly unstable business environment.").

It has also been argued that the curbing of dissolution rights is beneficial because it eliminates the potential for abusive dissolutions where "[a] partner with limited economic resources could lose his share of the business at an unfairly low price." Farrar & Hamill, *supra* note 9, at 916; *see infra* note 269 (discussing the effect of restricting dissolution rights).

176. *See infra* notes 179, 181 and accompanying text (discussing valuation of LLC ownership interests for estate and gift tax purposes, and noting that such issues are the driving force behind the amendments to the LLC statutes).

177. *See, e.g.*, *In re* Watts v. Comm'r, 823 F.2d 483, 484-85 (11th Cir. 1987) (involving a taxpayer's partnership interest whose value was reduced by thirty-five percent for lack of marketability); *In re* Hall v. Commissioner, 92 T.C. 312, 341 (1989) (involving a taxpayer-petitioner who sought an illiquidity discount); *infra* note 178 and accompanying text (discussing the illiquidity, or "marketability," discount); *see also* 1 CLOSE CORPORATIONS, *supra* note 14, § 2:7,

"marketability discount" is premised on empirical evidence indicating that investors will "extract a high discount relative to actively traded securities for stocks or other investment interests that lack [a] high degree of liquidity."[178] To qualify for a marketability discount in a family-owned LLC, however, state law must restrict an owner's ability to cash out of a business through withdrawal or dissolution.[179] As a result, and with the blessing of

at 2-57 ("[L]ack of liquidity is presented as a way to get lower valuation (and thus lower estate taxes) when ownership interest is passed to the next generation."); Farrar & Hamill, *supra* note 9, at 935 ("When valuing an ownership interest in a corporation, partnership or LLC for purposes of the estate and gift tax, generally the inability to transfer or liquidate the interest results in a valuation discount from the true fair market value which translates into less tax."); Harry J. Haynsworth, IV, *Valuation of Business Interests*, 33 MERCER L. REV. 457, 489 (1982) (noting that "[d]iscounts are appropriate . . . in tax valuation cases, in which the standard is what a willing buyer would pay a willing seller in an arm's length transaction," and stating that "[a]n astute investor will pay less for an interest that cannot be freely traded").

178. PRATT ET AL., *supra* note 56, at 333; *see* Advanced Communication Design, Inc. v. Follett, 615 N.W.2d 285, 291 (Minn. 2000) ("A marketability discount 'adjusts for a lack of liquidity in one's interest in an entity' and should be distinguished from a minority discount, which adjusts for lack of control of the corporation.") (quoting Balsamides v. Protameen Chems., 734 A.2d 721, 733 (N.J. 1999); Haynsworth, *supra* note 177, at 489 (noting that "[s]ince interests in closely held businesses cannot readily be sold, they are less marketable and, therefore, less valuable than equivalent interests in companies whose securities are regularly traded in a recognized market" and stating that "[a] discount to compensate for this illiquidity factor is well established"); *supra* note 56 and accompanying text (discussing the marketability discount); *cf.* Pueblo Bancorporation v. Lindoe, Inc., 63 P.3d 353, 357 n.2 (Colo. 2003) ("A marketability discount adjusts the value of specific shares to reflect the fact that there is no ready trading market for the shares."); *id.* ("Because there are a small number of potential buyers of closely-held corporate stock, a shareholder may be unable to secure a willing buyer if he decides to cash out of his investment."); Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 302 (1990) (noting that a marketability discount is often imposed because, "due to the difficulty and expense associated with selling the stock at a later date, investors are not willing to pay as much for close corporation stock").

179. As one commentator explains:

> Transfer taxes are imposed on the fair market value of property transferred either by gift or at death. The interest in an organization that holds property may be less than a corresponding interest in the property itself as a result of marketability and minority discounts. Thus, one estate planning technique to reduce transfer taxes is to place property into an organization and transfer interests in the organization. The amount of the discount will be increased to the extent the holder of an interest is restricted in his or her ability to liquidate the interest by having the interest redeemed for the fair market value of the percentage of the property represented by the

estate tax planners,[180] many jurisdictions amended their LLC

> interest or through the complete liquidation of the organization.

Keatinge, *supra* note 154, at 52 (footnote omitted). In 1990, however, Congress took action to combat this tax reduction strategy.

> In order to reduce the use of this tax reduction technique, in 1990, Congress adopted I.R.C. section 2704(b) . . . . Under section 2704(b), if there is a transfer of an interest in a business organization among family members, and the transferor and members of the transferor's family control the business organization, certain restrictions on the transferor's liquidation rights will be dismissed. The restrictions on liquidation rights which will be disregarded ([known as] applicable restrictions) are limitations on the ability to liquidate the organization (in whole or in part) that are more restrictive than the limitations that would apply as a *default* under the state law generally applicable to the organization in the absence of the restriction.
>
> . . . Thus, the valuation under I.R.C. section 2704(b) will be determined by reference to the default provisions of the organic statute pursuant to which form of organization is formed, rather than by considering the extent to which the owners could actually create liquidation rights less restrictive than those imposed by the organic statute or could actually liquidate the interest. *As such, I.R.C. section 2704(b) encourages the development of organic statutes which contain default rules that restrict or eliminate the right of an individual to liquidate the individual's interest.*

Id. at 53 (footnotes omitted) (emphasis added); *see* 2 RIBSTEIN & KEATINGE, *supra* note 7, § 18:13, at 18-40 ("If the default rule[] under LLC statutes is that the death or withdrawal of a member will not cause a dissolution and that there is no default right to be repaid a contribution, the LLC should be effective to obtain a discount notwithstanding IRC § 2704(b)."); Farrar & Hamill, *supra* note 9, at 935-36 (stating that "the Internal Revenue Code when dictating which transfers of business interests among family members can qualify for discounted valuation makes a sharp distinction based on the state statutory default provisions governing the ability to dissociate and receive buyout rights" and noting that "LLCs organized in states where the statutory default provisions provide dissociation rights can never qualify for discounted valuation if interests are gifted or bequeathed among family members," even if "the relevant LLC operating agreement eliminates the statutory dissociation rights, rendering the member legally in the same position as a close corporation shareholder or a member of a LLC that never had dissociation rights in the statute"). Similarly, as Professor Miller explains:

> Section 2704(b) provides that if there is a transfer of an interest among family members, and the transferor and his family control the organization, the restrictions on the transferor's liquidation rights will be entirely ignored for valuation purposes to the extent that they are *more* restrictive than the limitations that would apply under state law in the absence of an express private agreement. Thus, there is now a tax incentive to create restrictive state law provisions regarding the ability to sell, redeem, or otherwise liquidate an ownership interest in a business entity.

Miller, *supra* note 99, at 415-16 n.7 (citation omitted).

180. *See, e.g.*, Miller, *supra* note 99, at 432 ("Estate and gift tax planners

statutes to restrict a member's ability to liquidate its ownership position.[181] While perhaps accomplishing an estate tax goal, the elimination of default withdrawal and dissolution rights leaves

now suggest that states modify their limited partnership and limited liability company laws to contain restrictions on the ability of an investor to liquidate his or her interest."); *see also* Farrar & Hamill, *supra* note 9, at 936 ("In order to use LLCs as gift and estate tax planning vehicles, practitioners are understandably lobbying their state legislatures to eliminate all dissociation rights in the statute.").

181. *See, e.g.*, 1 CLOSE CORPORATIONS, *supra* note 14, § 2:7, at 2-56 to 2-57 (noting that "[LLC] statutes are changing so that the departing member has no ability to get out, i.e., no right to make the LLC buy the departing member's interest," and observing that "[t]his change . . . reflects a response to tax incentive"); *id.* ("This lack of liquidity is presented as a way to get lower valuation (and thus lower estate taxes) when ownership interest is passed to the next generation."); Farrar & Hamill, *supra* note 9, at 915 ("In order to render the LLC suitable for family gift and estate tax planning, Alabama, and many other states have eliminated all dissociation rights in the statutory default provisions, causing closely held LLCs to be subject to the same perils currently faced by minority shareholders of close corporations."); *id.* at 934 n.106 ("Several states other than Alabama have recently passed legislation or have bills pending that do away with all dissociation rights, rendering LLC members indistinguishable from close corporation shareholders."); *id.* at 936 ("The overly formalistic emphasis in . . . 2704(b) on the source of the transfer and liquidation restrictions (restrictions originating in the statute can produce valid discounts while contractual restrictions cannot) has replaced the partnership classification requirements as the *DRIVING FORCE* dictating the provisions governing individual rights to withdraw from the business.") (emphasis added); Miller, *supra* note 99, at 415 ("The new restrictions on the LLC member's withdrawal and distribution rights are designed to enhance the limited liability company as an estate and gift tax-planning vehicle. The *driving force* behind the reforms is to facilitate estate and gift tax valuation discounts for minority interests in family-owned limited liability companies.") (emphasis added); Mona, *supra* note 121, at 167 ("These state statutory amendments were also motivated by the perceived restrictions imposed by . . . Section 2704(b) . . . which could affect valuation adjustments (i.e., discounts) on transfers of LLC membership interests for transfer tax purposes."); *id.* at 169 ("[T]hese valuation concerns [over whether valuation discounts could be taken] have prompted widespread efforts across the country to amend the default liquidation provisions of state LLC statutes."); *supra* notes 172, 174 and accompanying text (citing statutory examples); *see also* Farrar & Hamill, *supra* note 9, at 936-37 ("Alabama and all other state legislatures that have revised or are revising their LLC statutes to eliminate the dissolution and dissociation provisions once again experience the tax rules dictating substantive business provisions that should be drafted to further larger business policy concerns."); *id.* at 939 ("As long as the gift and estate tax valuation rules artificially focus on the state law statutory default provision as the iron-clad dividing line separating LLC interests that can and cannot qualify for discounted valuation, the trend to eliminate all dissociation rights in the LLC statutes will continue.").

minority members vulnerable to oppressive majority actions since the minority can no longer easily exit the venture with the value of its investment.[182]

B. Management Norms

As mentioned, an owner of an LLC—analogous to a shareholder in the corporation structure—is referred to as a "member."[183] The vast majority of LLC statutes assign all management functions to members.[184] A few statutes provide a contrary rule indicating that

182. *See, e.g.*, 1 CLOSE CORPORATIONS, *supra* note 14, § 2:7, at 2-57 ("What is overlooked or assumed away is that when harmony among the parties breaks down (as long experience with human nature suggests will happen) the new [withdrawal and dissolution] default rules facilitate a majority using its power to exclude the minority indefinitely from any return on the investment in the enterprise."); 2 OPPRESSION, *supra* note 19, § 6:2, at 6-4 (noting that the elimination of dissolution and withdrawal rights has left "no way out via statute and like other closely held businesses there is no market to provide liquidity"); Farrar & Hamill, *supra* note 9, at 937 ("Although Congress' emphasis on the state law statutory default provisions will do little to further the gift and estate tax policy, this formalistic distinction will encourage legislators to eliminate statutory dissociation rights, thus exposing unsophisticated business participants to all of the risks minority shareholders of close corporations currently face."); *id.* at 939 ("[A] large number of LLC members not engaged in estate and gift tax planning will become vulnerable to the close corporation squeeze-out tactics . . . ."); Miller, *supra* note 99, at 433 ("The elimination of default buy-out rights arguably benefits those minority investors who will create family limited partnerships and/or LLCs. . . . The elimination of default exit rights could create a trap for the unwary minority LLC owner without adequate protection under an LLC agreement."); *id.* at 436 ("LLC owners have been regarded as less vulnerable than their corporate counterparts precisely because the dissatisfied LLC participant has typically had the statutory default right to receive the fair market value of his or her interest upon withdrawal.").

It should be noted that LLC statutes in some jurisdictions do include involuntary dissolution provisions. The exit rights provided by such provisions, of course, are far more limited than the withdrawal-triggered dissolution and buyout rights that previously existed under many LLC statutes. *See supra* note 174 (discussing involuntary dissolution statutes); *infra* note 271 and accompanying text (same).

183. *See supra* note 113 and accompanying text (defining "member").

184. *See, e.g.*, O'KELLEY & THOMPSON, *supra* note 113, at 51 ("LLC statutory default rules normally assign all management functions to members, who, as a result, have powers similar to those of partners in a general partnership."); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-4 (noting that "decentralized management is the general rule in LLCs and centralized management the exception"); *id.* App. 8-2, at 8-56 to 8-57 (providing a state-by-state chart that indicates that the majority of state LLC statutes default to management by members); Gevurtz, *supra* note 64, at 506 ("The LLC statutes typically provide, barring other agreement, for management by all members . . . ."); *infra* note 185 and accompanying text (discussing management by managers).

an LLC is to be managed by managers.[185] Because these are only default rules, member-managed jurisdictions typically allow the owners to elect manager-managed governance, and manager-managed jurisdictions typically allow the owners to elect member-managed governance.[186]

1. The Member-Managed LLC

In a member-managed LLC, majority rule is the norm.[187] At least for ordinary business decisions—which would presumably include employment, management, and dividend decisions that form the basis of many oppression disputes—a majority vote is required to approve the action.[188] Interestingly, about half of the LLC statutes default to members voting on a per capita (one vote per member) basis,[189] while the other half default to members voting on

185. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-2 ("Minnesota, North Dakota, Oklahoma, and Texas provide for management by separate managers, as in corporations."); *id*. App. 8-2, at 8-56 to 8-57 (providing a state-by-state chart that lists LLC statutes defaulting to management by managers, and indicating that only a small handful of statutes actually do so).

186. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-3 ("Members may elect to manage directly, even if the default is for management by managers. Most statutes allowing a choice provide that opting out from the statutory default must be embodied in the articles of organization, although some allow opting out in the operating agreement . . . ."); *id*. § 8:3, at 8-4 ("An LLC may be managed by members if the statute so provides and the members do not contract around the statutory default rules . . . ."); *id*. § 8:4, at 8-10 ("An LLC may be centrally managed if it is formed under a statute that provides for centralized management unless the parties contract around it . . . .").

187. *See infra* notes 188-90 and accompanying text (discussing majority rule in LLCs).

188. *See, e.g.*, EISENBERG, *supra* note 14, at 500 ("Normally, members act by majority vote, per capita or pro rata as the case may be. However, some of the statutes require a unanimous vote for certain designated actions."); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:3, at 8-5 ("The LLC statutes that specify the vote of the members that is necessary to authorize a transaction generally require a majority vote (either pro rata or per capita depending on the statute's voting rule), at least for ordinary actions."); *id*. ("It seems likely that, in the absence of contrary agreement, action by LLCs can be taken by a majority vote for ordinary transactions."); *infra* note 194 and accompanying text (noting that a decision to declare distributions (i.e., dividends) requires a majority vote).

189. *See* EISENBERG, *supra* note 14, at 500 ("About half the statutes provide as a default rule that members vote per capita—that is, one vote per member—unless otherwise agreed."); 1 RIBSTEIN & KEATINGE, *supra* note 7, App. 8-4, at 8-61 to 8-62 (providing a state-by-state chart indicating that twenty-five states (plus the Uniform LLC Act and the Prototype LLC Act) default to per capita member voting); *see also* 1 *id*., § 8:16, at 8-49 (describing voting "per capita" as voting "equally"). Per capita voting is also the default rule for voting in a partnership. *See* REV. UNIF. P'SHIP ACT § 401(j) (1997) ("A difference arising as

a pro rata (by financial interest) basis.[190]

The structure of a member-managed LLC helps to insure that all owners have a role in management. In a member-managed LLC, "each member has equal rights in the management and conduct of the company's business . . . ."[191] In closely held businesses, an owner typically desires a management role to help it monitor its capital investment, as it cannot "cash out" if it is dissatisfied with the operation of the business.[192] This desire helps to explain why the

to a matter in the ordinary course of business of a partnership may be decided by a majority *of the partners*.") (emphasis added).

190. *See* EISENBERG, *supra* note 14, at 500 ("About half [the states] provide that members vote pro rata, that is, by financial interest, unless otherwise agreed."); 1 RIBSTEIN & KEATINGE, *supra* note 7, App. 8-4, at 8-61 to 8-62 (providing a state-by-state chart indicating that twenty-three states plus the District of Columbia default to "pro rata by financial interests" voting and indicating that two states have no default provision for member voting); *see also* 1 *id.*, § 8:3, at 8-8 (describing pro rata voting as "members vote according to their capital contributions"). Pro rata voting is also the default rule for shareholder voting in corporations. *See, e.g.*, EISENBERG, *supra* note 14, at 500 (observing that pro rata voting "is the usual rule in corporations"). As mentioned, these LLC voting statutes are only default rules. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:3, at 8-9 ("The LLC statutes that provide for management by members and for voting rules permit members to contract around the statutory default rules. Thus, the parties can agree to vote per capita or to provide for majority, supermajority, or unanimous voting even if the statute provides a different rule.").

191. ULLCA § 404(a)(1) (1996); *see also* Bahls, *supra* note 7, at 74 ("In limited liability companies, unless otherwise provided in the articles of organization, the right to participate in management is a right that cannot be taken away from a member.").

A member's right to participate in management typically ceases upon the member's dissociation from an LLC. *See, e.g.*, ULLCA § 603(b)(1) (1996) ("Upon a member's dissociation from a limited liability company . . . the member's right to participate in the management and conduct of the company's business terminates, . . . and the member ceases to be a member . . . ."). In a corporation, a minority's management position can, as a default rule, be involuntarily terminated at the will of the majority. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(k) (1998) ("Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors . . . ."); RMBCA § 8.43(b) (1994) ("An officer may be removed at any time with or without cause by . . . the board of directors . . . ."). By contrast, in a member-managed LLC, members have no default power to involuntarily dissociate another member (and thereby terminate that member's management rights) based solely on their desire to do so. *See* ULLCA § 601 (1996) (listing events that cause dissociation).

192. *See, e.g.*, Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1321 (N.Y. 1989) (Hancock, J., dissenting) ("The same features of the [close corporation] minority owner-participant's status which make him particularly vulnerable to action by the majority obviously work to compel him to stay on the

removal of a shareholder from a management position is commonly seen as an oppressive act in the close corporation setting.[193] To the extent that an owner's management role is more assured in a member-managed LLC, the LLC structure is less susceptible to classic "management-ousting" oppressive actions.

Unfortunately, this more assured role in management does not combat the more important "seed" of oppression—the fact that minority owners cannot block majority decisions that affect the minority's financial interests (e.g., a decision to withhold dividends).[194] In those jurisdictions that default to majority rule on a

job. *He needs to do so to protect his investment* and to share in any increase in its value.") (emphasis added); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-3 ("[B]ecause LLC interests are not freely transferable, members who are dissatisfied with their investments must resort to active involvement rather than simply exiting the firm like public corporation holders."); *id.* § 8:2, at 8-4 ("[D]irect member participation in management is appropriate for nonpublicly-traded firms, in which members must take a relatively active role in management because they cannot easily sell their shares."); 1 OPPRESSION, *supra* note 19, § 3:6, at 3-38 ("[R]emoval of a [close corporation] minority shareholder from the board reduces [his] access to information on what is going on in the corporation and thereby [his] ability to protect against squeeze plays.").

193. *See supra* note 25 and accompanying text (noting that the removal of a minority shareholder from a position of management is a common freeze-out technique); *see also* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663-64 (Mass. 1976) (concluding that the controlling group breached a fiduciary duty owed to the plaintiff minority shareholder, in part because the controlling group could not show a legitimate business purpose "for refusing to reelect [the minority] as a salaried officer and director"); *id.* at 662-63 (observing that "by severing [a minority shareholder] from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture"); Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987) (finding oppression by the majority shareholder, in part because "[a]ny slim hope of gaining a return on [the minority's] investment and remaining involved in the operations of the business was dashed when [the majority] removed [the minority] as a director and officer of the corporation").

194. *See infra* notes 195-201 and accompanying text (discussing the effect of majority rule). For example, many state statutes provide that a majority vote is needed to authorize the payment of distributions (i.e., dividends). A minority member, in other words, cannot compel dividends if the majority votes to withhold them. *See, e.g.*, ARK. CODE ANN. §§ 4-32-403, 4-32-601 (Michie 2003) (stating that "[a] member is entitled to receive distributions . . . from a limited liability company to the extent and at the times or upon the happening of the events specified in an operating agreement or at the times determined by the members or managers pursuant to § 4-32-403," and providing, in section 4-32-403, for decisions to be made by majority rule); IND. CODE ANN. § 23-18-5-4 (West 2003) ("A member is entitled to receive distributions . . . from [an LLC] to the extent and at the times or upon the happening of the events specified in an operating agreement or at the times determined by the members or managers,

pro rata basis,[195] the majority member will always get its way. By definition, the majority member owns a majority financial interest in the LLC.[196] Even in those jurisdictions that default to majority rule on a per capita basis,[197] the potential for oppression is still present. While it is true that, in a per capita jurisdiction, no individual member holds greater voting power than another individual member,[198] courts have found oppression in the close corporation by ascribing oppressive conduct to a controlling group—i.e., by ascribing oppressive conduct to multiple shareholders who lack control on an individual basis, but who possess control on an aggregate basis.[199] In a business with three equivalent owners, for

if any, voting under IC 23-18-4-3."); *id.* § 23-18-4-3 (providing for decisions to be made by majority rule); MO. ANN. STAT. § 347.101(1) (West 2003) (providing that an LLC "shall make distributions of cash or other property to its members . . . upon the happening of the events specified in the operating agreement or, if [it] does not so specify, then at such times as may be approved by a majority by number of the authorized persons"); PROTOTYPE LTD. LIAB. CO. ACT §§ 403, 601 (1992) (stating that "[a] member is entitled to receive distributions . . . from a limited liability company to the extent and at the times or upon the happening of the events specified in an operating agreement or at the times determined by the members or managers pursuant to § 403," and providing, in section 403, for decisions to be made by majority rule); Gevurtz, *supra* note 64, at 509 (noting that "[m]any acts . . . provide for majority rule on this [interim distributions] issue in the absence of other agreement," and that "[t]his, of course, provides the potential for a squeeze-out").

195. *See supra* note 190 and accompanying text (discussing voting on a pro rata basis).

196. *See, e.g.*, CAL. CORP. CODE §§ 17001(v), 17202 (West 2003) (defining "majority in interest of the members" as "more than 50 percent of the interests of members in current profits of the limited liability company" and noting that "[i]f the operating agreement does not otherwise provide, profits and losses shall be allocated in proportion to the contributions of each member"); *cf.* Hetherington & Dooley, *supra* note 1, at 5 n.7 (using the terms "majority" and "minority" to "distinguish those shareholders who possess the actual power to control the operations of the firm from those who do not," and noting that such power "is most often determined by the size of [the] shareholdings").

197. *See supra* note 189 and accompanying text (discussing voting on a per capita basis).

198. In a per capita jurisdiction, each member has an equal vote in the management of the business. *See supra* note 189 (discussing voting on a per capita basis).

199. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663-64 (Mass. 1976) (referring to three of four equal shareholders (twenty-five percent each) as the "majority stockholders" in a close corporation, and finding that the "majority stockholders" breached a fiduciary duty that they owed to the plaintiff minority shareholder); *see also* Fix v. Fix Material Co., 538 S.W.2d 351 (Mo. Ct. App. 1976) ("In the instant case [a group of four shareholders], acting in concert, control a majority of the outstanding stock, though no single shareholder owns 51%."); *id.* ("Because this control carries the power to destroy

example, the ability of two owners to routinely and systematically outvote the third is a concern that has prompted judicial action in the close corporation setting.[200] Presumably, this concern would carry over to the LLC context as well, even in LLCs with per capita voting, as the same potential exists for multiple owners to collectively abuse their control. Just as in the close corporation, therefore, the norm of majority rule in the member-managed LLC can be used as an instrument of oppression, as a minority member is, in many instances, unable to veto decisions that negatively affect its ownership position.[201]

2. *The Manager-Managed LLC*

A manager-managed LLC possesses the centralized management characteristic of a corporation.[202] Control is not necessarily tied to ownership, as those in control of the business may not be the entity's owners.[203] A minority member of a manager-managed LLC has no assurance of a management role, as a minority member will frequently lack the voting power to insure its manager status. Indeed, LLC statutes generally provide that a majority vote of the members is needed to elect (as well as to remove) a manager.[204] Where the members vote on a pro rata basis,

---

or impair the interests of minority owners, the law imposes equitable limitations on the rights of dominant shareholders to act in their own self-interest."); Farrar & Hamill, *supra* note 9, at 924 ("Problems typically arise when a particular shareholder has trouble getting along with the rest of the shareholders, *who, as a group, have the power of the majority block* to elect the entire board of directors and appoint the officers.") (emphasis added).

200. *Cf. Wilkes*, 353 N.E.2d at 663-64 (finding, in a business with four equivalent owners, that three of the owners breached their fiduciary duty to the fourth owner by voting together to terminate the fourth owner's employment and to remove him from officer and director positions).

201. *See, e.g.*, Karjala, *supra* note 105, at 461 n.19 (noting that "Delaware's default position, . . . makes a greater than 50% interest controlling on all matters," and stating that "[i]n . . . Delaware limited liability companies, therefore, a minority interest . . . may be vulnerable to freezeouts from employment and other activity in the company").

202. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:15, at 8-43 (noting that "[c]entralized management by a board of directors is the default form of corporate governance," and observing that "a standard form corporation is generally similar to an LLC that has adopted centralized management"); *supra* notes 115-18 and accompanying text (discussing manager-managed LLCs).

203. *See, e.g.*, VA. CODE ANN. § 13.1-1024(B) (Michie 2002) ("Managers [of a manager-managed LLC] need not be residents of this Commonwealth *or members of the limited liability company* unless the articles of organization or an operating agreement so require.") (emphasis added); *supra* note 118 and accompanying text (discussing manager-managed LLCs).

204. *See, e.g.*, Child Care v. Facchina, No. Civ. A. 16227, 1998 WL 409363, at

the majority member[205] will have the ability to eliminate the minority's management role, either by removal or by not electing the minority in the first place.[206] Where the members vote on a per capita basis, the minority's management role is still subject to the discretion of a group of members who, collectively, can marshal a majority vote.[207] Simply put, as a result of the majority rule norm, the potential for oppressive "management-ousting" behavior does exist in a manager-managed LLC.

More importantly, and to broaden the prior point, a minority member of a manager-managed LLC lacks the ability to block majority decisions that affect the minority's financial and participatory interests. LLC statutes generally provide that ordinary business decisions (e.g., terminations of employment and refusals to declare dividends) in a manager-managed firm are decided by a majority vote of the managers (by number).[208] Acting

---

*4 (Del. Ch. July 15, 1998) ("[T]he proposition that in the absence of an LLC agreement, the majority of an LLC's members have a default right to terminate the [general manager] . . . incorporat[es] straightforward statutory interpretation."); *infra* notes 205-06 and accompanying text (discussing the election and removal of managers).

205. Once again, the majority member, by definition, owns a majority financial interest in the LLC. *See supra* note 196 and accompanying text (defining a "majority" member).

206. *See, e.g.*, CAL. CORP. CODE § 17152(b) (West 2003) (stating that "[a]ny or all managers may be removed, with or without cause, by the vote of a majority in interest of the members at a meeting called expressly for that purpose"); *id.* § 17152(a) (stating that "[e]lection of managers to fill initial positions or vacancies shall be by the affirmative vote of a majority in interest of the members"); N.Y. P'SHIP LAW § 414 (McKinney 2003) ("Except as provided in the operating agreement, any or all managers of a limited liability company may be removed or replaced with or without cause by a vote of a majority in interest of the members entitled to vote thereon."); *id.* §§ 402(a), 402(f), 413(a), 503 (providing that the election of managers shall occur by a majority vote of the members on a pro rata basis).

207. *See, e.g.*, MO. ANN. STAT. § 347.079(2) (West 2002) (stating that, unless otherwise provided in an operating agreement, managers "shall be designated, appointed, elected, removed or replaced by the vote of a majority *by number* of the members") (emphasis added); PROTOTYPE LTD. LIAB. CO. ACT (1992) § 401(b)(1) (noting that, unless otherwise provided in an operating agreement, managers "shall be designated, appointed, elected, removed or replaced by a vote, approval or consent of more than one half *by number* of the members" (emphasis added)).

208. *See, e.g.*, CAL. CORP. CODE § 17156 (West 2003) ("Except as otherwise provided in the articles of organization or the operating agreement, if the members have appointed more than one manager, decisions of the managers shall be made by majority vote of the managers if at a meeting . . . ."); N.Y. PARTNERSHIP LAW § 408(b) (McKinney 2003) ("Except as provided in the operating agreement . . . the managers shall manage the limited liability

together, therefore, a group of managers can routinely and systematically garner a majority to outvote a minority owner-manager on issues that directly affect the minority's ownership position.[209] Where this power is exercised in an abusive fashion, an oppressive situation is present, as there is no "market exit" through which the minority owner can escape the situation.[210] When the minority lacks a manager position, of course, the potential for abuse is even more apparent, as the minority has no ability to participate in a manager vote at all.[211] Just as in the close corporation, therefore, the presence of the majority rule norm—in both member-managed and manager-managed LLCs—helps to create the setting for oppression.[212]

C. The Business Judgment Rule

LLC statutes typically provide that managers (and members in a member-managed LLC) owe fiduciary duties of loyalty and care to the company.[213] Moreover, the statutes often provide that managers (and members in a member-managed LLC) must discharge their duties and exercise any rights "consistently with the obligation of

---

company by the affirmative vote of a majority of the managers."); ULLCA § 404(b)(2) (1996) (noting that, with limited exceptions, "any matter relating to the business of the company may be exclusively decided by the manager or, if there is more than one manager, by a majority of the managers"); *see also* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:4, at 8-13 (stating that "[t]he more sensible rule . . . is that multiple managers can act in all matters by majority vote unless a contrary agreement has been reached").

209. This assumes, of course, that the removal of the minority from its management role has not already occurred. *See supra* notes 204-07 and accompanying text (discussing removal). If removal has already occurred, the minority would have no ability to participate in a manager vote at all. *See supra* note 208 and accompanying text (discussing voting in a manager-managed LLC).

210. *See supra* Part V.A.1 (observing that a market for LLC ownership interests is typically non-existent).

211. *See supra* note 208 and accompanying text (discussing voting in a manager-managed LLC).

212. *See, e.g.*, Miller, *supra* note 99, at 437 (observing that "the minority's vulnerability" in an LLC stems from several sources, including "the majority's ultimate power to control LLC business decisions").

213. *See, e.g.*, ULLCA § 409(a) (1996) ("The only fiduciary duties a member owes *to a member-managed company* . . . are the duty of loyalty and the duty of care . . . .") (emphasis added); *id.* § 409(h)(2) (prescribing the same duties for managers of a manager-managed LLC); *id.* § 409 cmt. ("[M]embers and managers . . . owe to the company . . . the fiduciary duties of loyalty and care . . . ."); *infra* note 262 and accompanying text (citing statutes addressing fiduciary duty in an LLC).

good faith and fair dealing."[214] Although LLC case law is still in its infancy, it is likely that these principles will offer only limited protection to oppressed investors because of the effect of the business judgment rule.

As a closely held business, the LLC has no well-established market to provide an easy exit for owners.[215] Similarly, exit rights through withdrawal and dissolution are lacking.[216] Thus, the LLC has no market-oriented device to constrain abusive majority behavior.[217] In such a context, the need for judicial scrutiny is more compelling, and, correspondingly, the case for business judgment

214. ULLCA § 409(d) (1996); *see id.* § 409(h)(2) (imposing the same standard on managers of a manager-managed LLC); *id.* § 409 cmt. ("[M]embers and managers . . . owe to the company . . . the obligation of good faith and fair dealing . . . ."); *infra* note 262 and accompanying text (citing statutes addressing the obligation of good faith and fair dealing in an LLC).

215. *See supra* Part V.A.1 (observing that a market for LLC ownership interests is typically non-existent).

216. *See supra* notes 170-82 and accompanying text (discussing the lack of exit rights in the LLC statutes of many states).

217. Many commentators have argued that the existence of a market helps to combat the abusive exercise of control. Professors Hetherington & Dooley, for example, state the following:

> Market restraints are most visible and workable in the case of publicly held corporations. If management is inefficient, indulges its own preferences, or otherwise acts contrary to shareholder interests, dissatisfied shareholders will sell their shares and move to more attractive investment opportunities. As more shareholders express their dissatisfaction by selling, the market price of the company's shares will decline to the point where existing management is exposed to the risk of being displaced through a corporate takeover . . . . The mere threat of displacement, whether or not realized, is a powerful incentive for managers of publicly held corporations to promote their shareholders' interests so as to keep the price of the company's shares as high and their own positions as secure as possible.

Hetherington & Dooley, *supra* note 1, at 39-40 (footnote omitted). Similarly, as Professor Bahls observes:

> A public market creates significant and powerful incentives for managers to manage corporations in a way that maximizes profits and owners' returns. A public market for stock allows dissatisfied shareholders to sell their shares. Sales of a significant number of shares depress stock prices, making way for new owners (sometimes corporate raiders) to buy stock and oust incompetent incumbent management. Similarly, the management of publicly held corporations is more carefully monitored by persons outside the corporation, including independent directors, accountants, and investment bankers. As a result, the market creates incentives for managers to align their interests with the interests of shareholders.

Bahls, *supra* note 7, at 76-77 (footnote omitted); *see* Chittur, *supra* note 95, at 158 (describing the disciplinary effect of a market).

rule deference is weaker.[218] The same lack of market-oriented

218. *See, e.g.*, Bahls, *supra* note 7, at 77 ("[M]arket incentives are lacking for most limited liability companies. One could argue that because market incentives are lacking, courts should supply other incentives to managers in the form of stricter fiduciary duties."); *cf.* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 9:1, at 9-3 to 9-4 ("[I]n LLCs [before the "check-the-box" regulations], unlike in standard form corporations, the members may be able to exit freely by withdrawing and, perhaps, causing the firm to dissolve and liquidate."); *id.* ("[This] distinction might cause the level of fiduciary duties of LLC managers to be somewhat less intense than those of general partners or corporate directors."). As Professors Easterbrook and Fischel observe:

> It could be argued that judges should treat the acts of managers of close corporations with suspicion . . . because of the absence of the disciplinary effects of the stock market and other market mechanisms. One rationale for the business judgment rule is that managers who make errors (and even those who engage in self-dealing) are penalized by market forces while judges who make errors are not. Thus managers have better incentives to make correct business decisions than do judges. *But if neither managers nor courts are disciplined by market forces, this justification has less force.*
>
> . . . .
>
> . . . For example, the decision to terminate an employee in a publicly held corporation is a classic example of the exercise of business judgment that a court would not second guess. In a closely held corporation, by contrast, termination of an employee can be a way to appropriate a disproportionate share of the firm's earnings. It makes sense, therefore, to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgment rule. *The same approach could be used with salary, dividend, and employment decisions in closely held corporations where the risks of conflicts of interest are greater.*

Easterbrook & Fischel, *supra* note 102, at 291-93 (emphasis added); *see* Chittur, *supra* note 95, at 158 ("The close corporation is not comparably reviewed or controlled by the market because it has no publicly traded stock. There is little possibility of a proxy fight or a takeover bid. . . . The absence of judicial review remains unsubstituted.") (footnote omitted); *id.* ("Because of the absence of judicial review [in a close corporation], the business judgment rule is not an expression of faith in the free market; worse, it is often an abdication of judicial responsibility to protect the powerless."); *id.* at 156-61 (arguing that the business judgment rule is inappropriate for the close corporation); O'Neal, *supra* note 5, at 884-85 (criticizing the application of the business judgment rule to close corporations); *see also* Hetherington & Dooley, *supra* note 1, at 48 ("The preferred status of the majority [in a close corporation] is more likely to be an inadvertent product of a failure to appreciate the importance of market forces in the regulatory scheme for business organizations."). *But see* Easterbrook & Fischel, *supra* note 102, at 291-92 ("On the other hand, the smaller number of participants in closely held corporations ensures that managers bear more of the costs of their actions and facilitates contractual arrangements between the parties to reduce the likelihood of self-dealing."); *id.* at 292 ("The differences between publicly and closely held corporations, in other words, do not suggest discipline applies to the close corporation as well since close corporations lack a market for their shares and possess limited withdrawal and dissolution rights.[219] Nevertheless, many courts still invoke the business judgment rule in the close corporation structure, citing, among other reasons, the need to avoid judicial second-guessing of management and the relative incompetence of courts to regulate business decisions.[220] Such rationales are, of

unambiguously that the level of judicial scrutiny should vary or, if it does, in what direction.").

219. *See, e.g.*, Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1262 n.18 (Conn. 1994) ("The market for corporate control serves to constrain managers' conduct that does not maximize shareholder wealth. It therefore serves to align the interests of managers more closely with the interests of shareholders in publicly traded corporations."); *id.* ("The market for corporate control does not affect, however, the incentives of managers of closely held corporations."); *supra* Part III.A (discussing the lack of exit rights in the close corporation).

220. *See, e.g.*, Rosenthal v. Rosenthal, 543 A.2d 348, 353-54 (Me. 1988) (invoking the business judgment rule in a dispute over whether a close corporation minority shareholder was wrongfully frozen-out of the family business and stating that "[m]any courts, including our own, have long recognized that it falls outside the proper judicial domain to inquire into and second-guess the prudence of particular business decisions honestly reached by those entrusted with the authority to determine what course of action best advances the well-being of the enterprise"); Zidell v. Zidell, Inc., 560 P.2d 1086, 1088-89 (Or. 1977) (invoking the business judgment rule in a close corporation dividends dispute and finding that "[a]bsent any bad faith, fraud, breach of fiduciary duty or abuse of discretion, no wrong cognizable by or correctable in the Courts has occurred") (quoting Gay v. Gay's Super Mkts., Inc., 343 A.2d 577, 580 (Me. 1975)); *id.* at 1089 ("[I]t is not the province of this court to act as general manager of a private corporation or to assume the regulation of its internal affairs.") (quoting *Gay*, 343 A.2d, at 580 (quoting Bates St. Shirt Co. v. Waite, 156 A. 293, 298 (Me. 1931)); Willis v. Bydalek, 997 S.W.2d 798, 802 (Tex. App. 1999) (concluding that the termination of a close corporation shareholder's employment was not oppressive, in part because of the "broad range of business judgment allowed by law to directors"); *see also* Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979) ("[T]he business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped . . . to evaluate what are and must be essentially business judgments . . . ."); *id.* ("[I]nescapably there can be no available objective standard by which the correctness of every corporate decision may be measured, by the courts or otherwise."); *id.* ("[B]y definition the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility."); Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 99 n.43 (1980) ("[S]uch regulation would require judicial or administrative assessment of managerial judgments about expected returns and risks involved in proposed investment opportunities—matters within the special competence of management, but not of courts or administrative agencies."); Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 716 (1981) (noting that "managers are better equipped to make business decisions than

course, equally applicable to business decisions in the LLC context. As a consequence, even with the LLC, courts are likely to continue affording substantial deference to majority employment, management, and dividend decisions, largely insulating such decisions from meaningful judicial review.[221]

uninformed and inexperienced judges or shareholders"); Israel, *supra* note 96, at 76 ("[A]s an institution, the judiciary is fundamentally ill-equipped to make business decisions or to evaluate the wisdom of such decisions made by others.").

221. In Oklahoma, for example, the business judgment rule is explicitly applicable, by statute, to the LLC structure. *See* OKLA. STAT. ANN. tit. 18, § 2016(4) (2004) ("A manager is not liable for any action taken as a manager, or any failure to take any action, if the manager performed the duties of the office in compliance with the business judgment rule as applied to directors and officers of a corporation."); *see also* PROTOTYPE LTD. LIAB. CO. ACT § 402 cmt. ("In general, as long as managers avoid self-interested and grossly negligent conduct, their actions are protected by the business judgment rule."); 1 RIBSTEIN & KEATINGE, *supra* note 7, § 9:2, at 9-5 (discussing the LLC structure and observing that "as long as managers avoid self-interested and grossly negligent conduct, their actions are protected by the business judgment rule"); *id.* § 9:9, at 9-30 to 9-31 (noting that "LLC managers' fiduciary duties in such [manager-managed LLCs] probably will be based closely on the developed law concerning the duties of general partners in limited partnerships," and observing that "[a] general partner in a limited partnership is entitled to the protection of the business judgment rule"); *id.* § 9:10, at 9-39 ("Centrally-managed LLCs closely resemble standard form board-managed corporations. Accordingly, it is likely that managers' fiduciary duties will be similar in the two contexts."); Bahls, *supra* note 7, at 79-80 ("[W]hether limited liability companies are more similar to partnerships than to corporations, the business judgment rule is appropriate. As a consensus develops that the business judgment rule is necessary to encourage the spirit of entrepreneurship . . . it would be appropriate to extend that rule to limited liability companies."); *supra* note 96 and accompanying text (noting that employment, management, and dividend decisions in the close corporation are largely insulated from judicial review).

To be clear, the majority deference embodied in the business judgment rule is by no means objectionable in all instances. In both the close corporation and the LLC structures, the majority's discretion should be limited only for decisions that impact the rights of individual owners. For more general decisions, such as the choosing of one business opportunity over another, deference to the majority and, relatedly, limited judicial scrutiny of the decision, is appropriate. As Professor Cox observes:

> Though great flexibility should be accorded managers on matters related to the conduct of the corporation's business, this is not necessarily the case regarding decisions that impact the relative rights of owners' interests in the firm. The former is more clearly the type of business activity which is best lodged with the firm's managers; the latter is not.

Cox, *supra* note 95, at 631 (footnote omitted).

D. Advance Planning

There is no apparent reason to believe that minority members of LLCs are more likely to engage in advance planning for dissension than minority shareholders of close corporations. If "over-trust" (due to family or friendship ties) and unsophistication help to explain the failure of close corporation owners to recognize that contractual protections are needed,[222] those rationales would seem to apply to LLC owners as well. After all, just like a close corporation, an LLC is typically a closely held venture with relatively few owners.[223] In such a small business environment, the owners will frequently be linked by family or friendship bonds,[224] and the owners' business and legal "savvy" may differ widely. Put differently, the LLC is, at bottom, simply another structure within which a small business can be operated. To the extent that the typical characteristics of small business owners help to explain the lack of planning for dissension, those characteristics are quite likely to be found in the LLC context as well.

Even if a minority member of an LLC did recognize the utility of advance planning for dissension, the inability to foresee all (if not most) of the situations that may require contractual protection can erode the effectiveness of any planning that does occur.[225]

222. *See supra* notes 102-03 and accompanying text (offering explanations for why close corporation shareholders rarely engage in advance planning for dissension).

223. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:15, at 8-44 (characterizing "most LLCs" as "firms with relatively few members"); *id.* § 9:9, at 9-36 (noting that "LLCs may be smaller on average"); *supra* notes 144-45 and accompanying text (observing that LLCs are usually closely held businesses); *see also* Ciccotello & Grant, *supra* note 9, at 90 (noting that "[t]he LLC was created to be a flexible, tax-advantaged vehicle for small businesses," and stating that "the LLC was created to be a flexible organizational vehicle with a small business niche"); Miller, *supra* note 99, at 460 (mentioning "the intended use of the LLC as a vehicle for small, informal business ventures").

224. *See, e.g.*, Miller, *supra* note 99, at 438 ("[M]any small businesses are staffed by friends or family members who have such a close personal relationship that they may not consider that disputes could arise at a later time.").

225. *See supra* notes 105-06 and accompanying text (discussing the limitations of human foresight). The Delaware opinion of *VGS, Inc. v. Castiel*, No. C.A. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000), nicely illustrates that, because of the limitations of human foresight, a need will always exist for the judiciary to police abuses in closely held businesses, even where the parties have contracted for some protection. In *VGS*, a manager-managed LLC was formed with three members—Virtual Geosatellite Holdings, Inc. ("Holdings"), Ellipso, Inc. ("Ellipso"), and Sahagen Satellite Technology Group LLC ("Sahagen Satellite"). *See id.* at *1. David Castiel controlled both Holdings and Ellipso, and Peter Sahagen controlled Sahagen Satellite. *See id.* Holdings, the

majority member, owned 63.46 percent of the LLC, while Sahagen Satellite and Ellipso owned 25 percent and 11.54 percent of the LLC respectively. *See id.*

As the party that controlled the majority member, Castiel had apparently bargained for some protection from dissension. The opinion noted that "[a]s the majority unitholder, Castiel had the power [in the operating agreement] to appoint, remove, and replace two of the three members of the Board of Managers," and that "Castiel, therefore, had the power to prevent any board decision with which he disagreed." *Id.* Castiel named himself and Tom Quinn as managers, while Sahagen named himself as the third manager. *See id.*

After the LLC was formed, friction arose between Castiel and Sahagen. According to the court, "Sahagen ultimately convinced Quinn that Castiel must be ousted from leadership in order for the LLC to prosper." *Id.* at *2. Without giving Castiel any notice, "Quinn and Sahagen acted by written consent to merge the LLC under Delaware law into VGS, Inc. ("VGS"), a Delaware corporation. . . . VGS became the LLC's legal successor-in-interest." *Id.* Sahagen and Quinn named themselves, but not Castiel, to the VGS board. *See id.* As a result of the merger, "Holdings and Ellipso went from having a 75% controlling combined ownership interest in the LLC to having only a 37.5% interest in VGS," while "Sahagen and Sahagen Satellite went from owning 25% of the LLC to owning 62.5% of VGS." *Id.*

The Delaware Chancery Court acknowledged that the LLC statute "[did] not require notice to Castiel before Sahagen and Quinn could act by written consent." *Id.* at *4. Nevertheless, the court held that Sahagen and Quinn's actions violated a duty of loyalty that they owed to Castiel:

> Sahagen and Quinn knew what would happen if they notified Castiel of their intention to act by written consent to merge the LLC into VGS, Inc. Castiel would have attempted to remove Quinn, and block the planned action. Regardless of his motivation in doing so, removal of Quinn in that circumstance would have been within Castiel's rights as the LLC's controlling owner under the Agreement.
>
> . . . The General Assembly never intended, I am quite confident, to enable two managers to deprive, clandestinely and surreptitiously, a third manager representing the majority interest in the LLC of an opportunity to protect that interest by taking an action that the third manager's member would surely have opposed if he had knowledge of it . . . .
>
> . . . Instead the drafters [of the LLC Agreement] made the critical assumption, known to all the players here, that the holder of the majority equity interest has the right to appoint and remove two managers, ostensibly guaranteeing control over a three member board. When Sahagen and Quinn, fully recognizing that this was Castiel's protection against actions adverse to his majority interest, acted in secret, without notice, they failed to discharge their duty of loyalty to him in good faith.

Id. at *4.

VGS is an example of a court coming to the aid of an investor—a majority investor no less—who, despite advance planning, was unable to foresee the consequences of a governance structure that it agreed to. The opinion suggests that, due to the limitations of human foresight, the potential for oppressive conduct will likely remain—even in ventures owned by diligent ex ante planners.

Regardless of business structure, in other words, the same limitations of human foresight exist, and the same incomplete contracting is likely.[226] Further, as in any small business where the owners tend to work closely together and have significant personal interactions over the course of the venture, LLC owners are apt to have relationship-oriented concerns that distinguish bargaining in the LLC setting from bargaining in a discrete, arms-length context. A fear of harming the members' relationships is likely to inhibit minority LLC members from broaching the topic of future dissension or, if broached, from fully exercising any leverage that the minority may possess.[227]

Although the impediments to effective contracting in the close corporation seem equally applicable to the LLC, perhaps one could argue that the LLC structure itself is more conducive to ex ante contractual arrangements, as the parties will typically need to draft an operating agreement to address the relative absence of default rules in many LLC statutes.[228] The need for the parties to engage in contracting, in other words, is often front and center at the formation of an LLC, possibly combating some of the obstacles to

226. *See supra* notes 105-06, 225 and accompanying text (discussing the limitations of human foresight).

227. *See supra* notes 107-11 and accompanying text (discussing relationship-oriented impediments to contracting).

228. *See, e.g.*, O'KELLEY & THOMPSON, *supra* note 113, at 468 (observing that "a contract is more essential to a[n] LLC" because "[t]he default rules spelled out in the statute are less comprehensive than in corporation law . . . and there is as yet relatively little precedent to help fill any gaps that might occur"); *see also* ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 138 (6th ed. 1998) ("LLC statutes provide extreme flexibility with respect to all aspects of internal organization and financing of an LLC; there are relatively few mandatory statutory requirements, and internal relationships are largely governed by contract rather than by statutory provision."); ROBERT W. HAMILTON & JONATHAN R. MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 206 (8th ed. 2003) ("The flexibility of the LLC . . . requires numerous choices and decisions, and perhaps a carefully tailored operating agreement . . . . In contrast, a corporation is a familiar business form that requires relatively few choices and provides numerous default rules that are likely to be acceptable to the founders of the new business."); *id.* (noting that "LLCs are inherently more complex than corporations"); 2 OPPRESSION, *supra* note 19, § 9:11, at 9-31 (stating that "operating agreements in LLC[s] tend to be longer and more complicated than many agreements for corporations").

Provisions in the operating agreement can also change some of the statutory default rules that do exist, allowing the owners to tailor the LLC's operation to their own personal preferences. *See, e.g.*, O'KELLEY & THOMPSON, *supra* note 113, at 468 ("Even those default rules that do exist may not be appropriate for many LLCs.").

effective planning that would otherwise exist.[229]

The need to engage in contracting to fill in some default rules, however, is far from a directive to engage in advance planning for dissension. Drafting operating agreement provisions to deal with the frequency of member and manager meetings,[230] for example, may not trigger the need to bargain over employment and management guarantees. More importantly, discussions about relatively routine matters (e.g., meetings) are different in kind from discussions about the outbreak of dissension, and they may not sufficiently "break the ice" to facilitate dissension-related negotiations. (Even if they did, the limitations of human foresight and the relationship-oriented constraints on "hard" bargaining would still be present, resulting, most likely, in inadequate protection for the minority).[231] Thus, the fact that the LLC structure is likely to produce some *ex ante* bargaining between the members is no guarantee that effective planning for dissension will occur.[232]

As a final note, one can question whether any contracting or bargaining is actually occurring at the inception of an LLC venture, even over routine matters. Empirical evidence gathered by one

229. *But see* Miller, *supra* note 99, at 437 ("Although some limited liability companies may be subject to detailed operating agreements that have been negotiated at arms length, others may not have extensive agreements that establish the parties' rights and responsibilities. Some limited liability companies may not have an agreement at all.").

230. *See, e.g.*, 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:3, at 8-9 (noting that "[t]he LLC statutes generally do not include default provisions for meetings or other formal governance procedures in member-managed LLCs, although the members can provide for these procedures in the operating agreement").

231. *See supra* notes 105-11 and accompanying text (discussing impediments to effective contracting in the closely held business setting).

232. Perhaps the same reasoning could be applied to the corporation context. Some ex ante bargaining arguably occurs between shareholders at the inception of a close corporation venture, as the bylaws governing that venture need to be drafted and basic decisions about, for example, the identity of the officers, need to be made. *See, e.g.*, RMBCA § 2.06(a) (1994) ("The incorporators or board of directors of a corporation shall adopt initial bylaws for the corporation."). Just because some negotiating is likely to occur, of course, is no guarantee that dissension-related negotiations will occur. Admittedly, corporate bylaws tend to be far more standard and require less firm-by-firm decision-making than LLC operating agreements, *see supra* note 228, but some basic choices (e.g., officer identities) still need to be made. Thus, even the close corporation, one could argue, generates some level of ex ante bargaining between the owners at the time of inception. Nevertheless, it is widely recognized that adequate planning for dissension rarely occurs in the close corporation setting. *See supra* Part III.D (discussing the usual absence of advance planning in a close corporation). Once again, the fact that some bargaining between the owners is likely to occur is no guarantee that adequate minority protections will be negotiated.

commentator indicates that many LLC operating agreements are "based on form agreements that are not extensively negotiated."[233] Perhaps more importantly, the empirical evidence suggests that at least some minority protections against dissension (i.e., buyout rights and dissolution rights) are rarely included in the "usual" operating agreement.[234] Based on these findings, it is not entirely clear that the LLC structure does, in fact, produce meaningful bargaining between the members at the time of formation. For any bargaining that does occur, one can question whether it results in adequate dissension-related protection for minority members.

In short, the factors that contribute to a failure to effectively contract for protection in the close corporation are likely to produce the same outcome in the LLC. Those factors stem primarily from the traits of small business owners and the small business setting itself, rather than from the characteristics of the legal structure that is used to conduct the business.

E. Summary

Although generalizations are dangerous due to the wide variety of LLC statutes,[235] the "seeds" of oppression are, in many jurisdictions, present in the LLC setting. The same combination of "no exit" and majority rule—a combination that has left minority shareholders vulnerable in the close corporation for decades—exists in the LLC. Further, the deference of the business judgment rule and the likely absence of contractual safeguards will stymie most minority efforts to obtain relief. Given this setting, and based on the close corporation experience, it is inevitable that some majority

233. Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 357 (2003); *see id.* at 422 (providing empirical data regarding form operating agreements); *id.* at 357 ("In supplementary comments, many practitioners expressed concern about the prevalence of form LLC agreements."); *cf.* Karjala, *supra* note 105, at 477 ("Many small businesses . . . will elect not to assume the expense of negotiating, and hiring an attorney to draft, a carefully worded operating agreement.").

234. *See* Miller, *supra* note 99, at 416-17, 421 (indicating that operating agreements do not typically provide minority owners with certain buyout and dissolution rights); *see also id.* at 437-38 (stating that some LLCs, "including some small [LLCs], may be subject to boilerplate agreements that do not contain detailed provisions dealing with deadlocks or disputes among owners and/or managers").

235. *See, e.g.*, Karjala, *supra* note 105, at 455 (noting that state LLC statutes "show a good deal of individuality"). *Compare supra* notes 170-72 and accompanying text (discussing the elimination of withdrawal rights in LLC statutes as a result of the "check-the-box" regulations), *with* 15 PA. CONS. STAT. ANN. § 8933 (West 2003) (retaining a member's right to be bought out at "fair value" upon withdrawal).

owners will abuse their control at the expense of minority investors.[236] Just as in the close corporation, legitimate judicial scrutiny of majority conduct is needed. The oppression doctrine, in other words, has a place in the LLC structure as well.[237]

VI. TRANSPLANTING THE OPPRESSION DOCTRINE: POTENTIAL PROBLEMS, POTENTIAL AIDS

Certain characteristics of the LLC may influence the judiciary's willingness to apply the oppression doctrine in the LLC setting. Because the LLC statutes provide members with significant contractual flexibility, courts may be reluctant to impose an oppression doctrine on a business structure where the owners could have protected themselves.[238] On the other hand, in many jurisdictions it may be easier to justify the application of the oppression doctrine to the LLC given that many statutes indicate that fiduciary duties are owed directly to the individual members.

236. Professors Hetherington & Dooley, for example, state that:

> To expect the majority not to take some advantage of the exploitative potential of its position is unreasonable and unrealistic. The question is not simply one of good or bad conduct; it is a question of how much exploitation will occur. The failure, and indeed the inability, of the law to set administrable limits on managerial prerogatives gives the majority opportunities to enhance its own interests which it cannot be expected to resist entirely, even if it does not exploit them fully.

Hetherington & Dooley, *supra* note 1, at 35; *see also* Miller, *supra* note 99, at 439 ("The history of dispute resolution among business participants illustrates that there will be failures in contractual agreements as well as failures in human relationships in the context of LLCs, as in other private business entities. Difficulties between majority and minority LLC members, therefore, should be anticipated.") (footnotes omitted).

237. *See, e.g.*, Bahls, *supra* note 7, at 84 ("When majority members in limited liability companies commit acts of oppression, courts should consider dissolving the limited liability companies or consider ordering other equitable remedies."); *see also id.* at 87-90 (arguing that even if exit rights existed in LLCs, the oppression doctrine might still be needed in certain circumstances).

238. That is, although there are a number of factors that will likely impede effective contracting in the LLC, those factors are not created by the LLC statutes themselves. *See supra* Part V.D (discussing the "over-trust," unsophistication, lack of foresight, and relationship-oriented impediments to planning for dissension in an LLC). To the contrary, the LLC statutes provide owners with a tremendous freedom of contract. *See supra* notes 122-23 and accompanying text (discussing freedom of contract in an LLC). It is conceivable, therefore, that a court will refuse to apply the oppression doctrine to the LLC on the grounds that minority investors have the statutory tools to protect themselves from abuse. *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1379-80 (Del. 1993) (refusing to apply the oppression doctrine to close corporations, in part because close corporation investors can protect themselves via statutorily-permitted contractual arrangements).

An examination of both of these arguments is helpful.

A. The Ability to Contract in the Limited Liability Company

The LLC statutes often convey a clear legislative intent that members are to be afforded an extensive freedom of contract. The Delaware LLC statute, for example, states rather directly that "[i]t is the policy of this chapter [on LLCs] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[239] Because the members have such a broad ability to privately order their affairs, one could argue that an "intrusive" judicial doctrine, such as the oppression remedy, is unnecessary. After all, the parties can protect their employment, management, dividend, and other valuable rights through contractual arrangements.[240] If they choose to invest in the venture without such arrangements, they live with the consequences. Most notably, the Delaware Supreme Court relied on this rationale as part of its justification for rejecting the oppression doctrine in the close corporation setting:

> A stockholder who bargains for stock in a closely held corporation and who pays for those shares . . . can make a business judgment whether to buy into such a minority position, and if so on what terms. One could bargain for definitive provisions of self-ordering permitted to a Delaware corporation through the certificate of incorporation or by-laws . . . . Moreover, in addition to such mechanisms, a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive stockholder agreements, and such agreements may provide for elaborate earnings tests, buy-out provisions, voting trusts, or other voting agreements.
>
> The tools of good corporate practice are designed to give a

239. DEL. CODE ANN. tit. 6, § 18-1101(b) (1998); *see supra* note 123 and accompanying text (noting that freedom of contract is at the core of the LLC structure).

240. *See, e.g.*, Weinmann v. Duhon, 818 So. 2d 206, 208, 210 (La. Ct. App. 2002) (describing a "side agreement" where two LLC members sold portions of their ownership interests to two new members on the condition that "[n]either [of the two new members] shall vote their respective interest[s] to remove [the selling members] as either a Member or as a Member-Manager of the Company" and stating that "there is nothing unlawful in [the selling members] admitting [the two new members] as members of the company only on the condition that they not vote to expel these original members"); *infra* notes 244-46 and accompanying text (discussing a shareholder's ability to contract for protection).

> purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.[241]

The *Nixon* decision accurately describes the ability of close corporation shareholders to contract for protection. Although corporate law formerly prohibited any contractual arrangements that deviated from the centralized control and majority rule norms,[242] such prohibitions have largely fallen by the wayside.[243]

241. *Nixon*, 626 A.2d at 1379-80 (citations omitted); *see also* Hunt v. Data Mgmt. Res., Inc., 985 P.2d 730, 733 (Kan. Ct. App. 1999) (adopting *Nixon* in a close corporation dispute and stating that "appellants were not powerless to protect their interests," as they could have contracted for protection under the Kansas statutes by, for example, "requir[ing] prior approval of any transfer or transferee," or "prohibit[ing] transfers to reasonably designated classes of persons").

242. *See, e.g.*, Benintendi v. Kenton Hotel, 60 N.E.2d 829, 830-32 (N.Y. 1945) (striking down a bylaw requiring that "no action should be taken by the directors except by unanimous vote of all of them" on the grounds that it "sets up a scheme of management utterly inconsistent with [the majority-rule norm in the New York statute]"); McQuade v. Stoneham, 189 N.E. 234, 235-36 (N.Y. 1934) (striking down a shareholders' agreement that specified the identity of the corporation's directors and officers, and that set the salaries of the officers, on the grounds that it interfered with the province of the board, stating that "the stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them"); *see also* 2 OPPRESSION, *supra* note 19, § 9:7, at 9-20 ("Long term employment contracts can run up against traditional corporate law doctrine that seeks to avoid tying the directors hands in future governance of the corporation."); Thompson, *supra* note 5, at 195 ("If a minority shareholder attempted to contract for protection against majority rule, the courts struck down the contract as an unlawful interference with the unfettered discretion that the 'statutory norm' required for directors.").

243. For example, the Delaware statute states the following:

> A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote, . . . is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors.

DEL. CODE ANN. tit. 8, § 350 (1998); *see, e.g.*, N.Y. BUS. CORP. LAW § 709(a)(2) (McKinney 2003) ("The certificate of incorporation may contain provisions specifying . . . [t]hat the proportion of votes of directors that shall be necessary for the transaction of business . . . shall be greater than the proportion prescribed by this chapter in the absence of such provision."); *see also* 2 OPPRESSION, *supra* note 19, § 9:7, at 9-19 ("Earlier legal hostility toward recognizing agreements among shareholders as able to control things like

Minority investors in modern-day close corporations have the ability to enter into a wide variety of protective contractual arrangements, including shareholder agreements to safeguard their employment, management, and dividend rights,[244] and buy/sell agreements to provide an exit and accompanying liquidity.[245] In many states, even decentralized management is possible, as the board of directors can be eliminated.[246]

Despite this broad ability to contract in the close corporation,

employment that traditionally are within the powers of the directors has dissipated . . . ."); Karjala, *supra* note 105, at 455 ("Today, both special statutory schemes applicable to 'close corporations' and modern general corporation laws allow essentially complete freedom to the participants in these corporate entities to fashion enforceable managerial arrangements as they choose."); *id.* at 457 ("Over the years, however, even the general corporation laws of most states have been liberalized, so that almost any internal allocation of powers, rights, and duties may be effected by the parties under those statutes, provided that they follow appropriate formalities."); Thompson, *supra* note 5, at 198 (observing that "[m]ost state corporation codes now permit shareholders to limit the power of the board of directors," and noting that "[h]igh vote requirements for shareholders and director action and other veto arrangements are now generally permitted so that participants can contract around the majority rule norm and provide additional protection for minority investors"). *But see* O'Neal, *supra* note 5, at 880-81 (observing that "[e]ven under the modern statutes, a number of restrictions remain on the contractual freedom of close corporation participants to set up control patterns they desire," and discussing those restrictions).

244. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 9:5, at 9-13 (discussing "provisions which might be included in a shareholders' agreement to help forestall squeeze-outs," and mentioning "specified shareholders or their nominees are to constitute the board of directors," "each shareholder is to be employed in a key position by the corporation at a specified salary," and "whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to the shareholders"); *supra* notes 100, 243 and accompanying text (discussing contractual arrangements between shareholders and observing that such arrangements are, in general, enforceable).

245. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 9:3, at 9-7 ("Stock-purchase agreements (providing for purchase by the corporation) and buy-and-sell agreements (providing for purchase by the other shareholders) are now widely used."); *supra* notes 100, 243 and accompanying text (discussing contractual arrangements between shareholders and observing that such arrangements are, in general, enforceable).

246. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1998) ("The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors."); *see also id.* § 141(a) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, *except as may be otherwise provided . . . in its certificate of incorporation*.") (emphasis added).

most jurisdictions have concluded that a need still exists for a judicial "backstop"—i.e., a need exists for a special shareholder oppression doctrine.[247] This conclusion is presumably driven by the recognition that an ability to contract does not necessarily translate into the actual occurrence of effective contracting, even where such contracting is needed. This disconnect is due in no small part to the factors previously discussed that hinder effective bargaining (e.g., "over-trust" due to family or friendship bonds, lack of sophistication, lack of foresight, relationship-oriented concerns).[248] Moreover, as even the Delaware Supreme Court observed, the ability to contract for protection is illusory for minority investors who receive their ownership interests through gift or inheritance.[249] For these

247. *See, e.g.*, Stefano v. Coppock, 705 P.2d 443, 446 n.3 (Alaska 1985) (adopting the shareholder oppression doctrine in the close corporation setting and applying the "reasonable expectations" standard to determine whether oppressive conduct has occurred); Maschmeier v. Southside Press, Ltd., 435 N.W.2d 377, 380 (Iowa Ct. App. 1988) (same); Fox v. 7L Bar Ranch Co., 645 P.2d 929, 933-34 (Mont. 1982) (same); Brenner v. Berkowitz, 634 A.2d 1019, 1029 (N.J. 1993) (same); McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 237 (N.M. Ct. App. 1986) (same); *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (same); Meiselman v. Meiselman, 309 N.C. 279, 299-301, 307 S.E.2d 551, 563-64 (1983) (same); Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987) (same); Landstrom v. Shaver, 561 N.W.2d 1, 11-12 (S.D. 1997) (same); Davis v. Sheerin, 754 S.W.2d 375, 382 (Tex. App. 1988) (same); Masinter v. Webco Co., 262 S.E.2d 433, 442 (W. Va. 1980) (same); 2 CLOSE CORPORATIONS, *supra* note 14, § 9.28, at 9-199 ("One of the most significant trends in the law of close corporations in recent years is the increasing willingness of courts to look to the reasonable expectations of shareholders to determine whether 'oppression' or similar grounds exist as a justification for involuntary dissolution or another remedy."); *supra* Part II.B (discussing the development of the shareholder oppression doctrine in the close corporation); *see also* 2 CLOSE CORPORATIONS, *supra* note 14, § 9.27, at 9-185 n.6 ("Thirty-nine states base relief on oppression, or language that would be at least as likely to provide relief to petitioning shareholders.").

248. *See supra* Parts III.D and V.D (discussing impediments to effective contracting in close corporations and LLCs).

249. *See* Nixon v. Blackwell, 626 A.2d 1366, 1379-80 (Del. 1993) ("A stockholder who bargains for stock in a closely held corporation and who pays for those shares *(unlike the plaintiffs in this case who acquired their stock through gift)* can make a business judgment whether to buy into such a minority position, and if so on what terms.") (emphasis added); *Meiselman*, 309 N.C. at 291, 307 S.E.2d at 558-59 ("[W]hen a minority shareholder receives his shares in a close corporation from another in the form of a gift or inheritance, [he] never had the opportunity to negotiate for any sort of protection with respect to the "reasonable expectations" he had or hoped to enjoy in the close corporation.").

In the close corporation, oppression disputes involving minority investors who received their shares via gift or inheritance are common. *See, e.g.*, Maul v. Van Keppel, 714 N.E.2d 707, 711-12 (Ind. Ct. App. 1999) (gift/inheritance);

"involuntary" owners, there is no "opportunity to bargain for protection before parting with consideration"[250] and, as a result, the ability to contract is useless to them.

By analogy to the close corporation, therefore, the ability to contract should not be viewed as a sufficient justification for rejecting the oppression doctrine in the LLC setting. If the failure of minority owners to plan for dissension was due to problems with the close corporation structure itself—e.g., if contracting around the majority rule norm was prohibited under corporate law[251]—the freedom of contract provided by LLC statutes would arguably diminish the need for a judicial oppression doctrine (at least outside of the gift or inheritance setting). As mentioned, however, the failure of minority owners to plan for dissension is due more to the traits of small business owners and to the small business environment itself, rather than to the constraints of the legal entity that is used.[252] Just as most courts recognize that the ability to bargain for protection does not obviate the need for judicial oversight in the close corporation context, so too should courts recognize that the contractual freedom available in the LLC does not eliminate the need for an oppression doctrine in that setting.

B. The Explicitness of Fiduciary Duty in the Limited Liability Company

Corporation statutes historically failed to articulate the concept of fiduciary duty.[253] Instead, corporate fiduciary duty principles

Bonavita v. Corbo, 692 A.2d 119, 120-22 (N.J. Super. Ct. Ch. Div. 1996) (inheritance); *In re* Schlachter, 546 N.Y.S.2d 891, 892 (App. Div. 1989) (gift); *In re* Smith, 546 N.Y.S.2d 382, 383 (App. Div. 1989) (inheritance); *In re* Gunzberg v. Art-Lloyd Metal Prods. Corp., 492 N.Y.S.2d 83, 86 (App. Div. 1985) (gift); Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1019 (Sup. Ct. 1984) (gift/inheritance); *Meiselman*, 309 N.C. at 282, 307 S.E.2d at 553 (gift); Ferber v. Am. Lamp Corp., 469 A.2d 1046, 1050 (Pa. 1983) (inheritance). *See generally* Moll, *supra* note 107, at 763-87 (discussing the applicability of the shareholder oppression doctrine to "non-investing" shareholders who received their stock via gift or inheritance).

250. *Nixon*, 626 A.2d at 1380.

251. *See supra* note 242 and accompanying text (discussing historical prohibitions on contractual arrangements between shareholders).

252. *See, e.g.*, Karjala, *supra* note 105, at 458 ("The limited liability company form provides no additional internal structural freedom not already available under the modern corporation and partnership statutes."); *supra* Parts III.D and V.D (discussing impediments to effective contracting in close corporations and LLCs).

253. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141-145 (1998) (covering issues relating to directors and officers, but not stating that such parties owe fiduciary duties); TEX. BUS. CORP. ACT ANN. arts. 2.31-2.43 (Vernon 2003) (same); *infra*

emerged largely as a matter of common law.[254] Unfortunately, the fiduciary duty doctrine that developed was, in many instances, unhelpful to the close corporation minority shareholder. As mentioned, this unhelpfulness stemmed in large part from the application of the business judgment rule.[255] At least to some extent, however, this unhelpfulness was also caused by the traditional notion that fiduciary duties run to the corporation (or to the shareholders collectively), but do not run to an individual shareholder.[256] As a general rule, therefore, majority shareholder decisions to, for example, terminate employees or remove

note 254 and accompanying text (noting that fiduciary duty principles largely developed as a matter of common law).

254. *See, e.g.*, Thompson, *supra* note 5, at 195 (mentioning the "fiduciary duty that each director owed to the corporation to act in the best interests of all shareholders," and noting that "[a]lthough many states have now codified this duty, historically it was an obligation imposed by common law"); *see also* 20 ROBERT W. HAMILTON, TEX. PRAC. SERIES § 37.2 (2004) ("The basic relationship between a corporation and its directors, officers, and agents traditionally has been established by common law decision rather than statute. Many of the duties owed by such persons to the corporation therefore are common law in origin . . . .").

255. *See supra* Part III.C (discussing the application of the business judgment rule to the close corporation context).

256. *See, e.g.*, Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 721 (5th Cir. 1984) (observing that "directors' duties of loyalty and care run to the corporation, not to individual shareholders or even to a majority of the shareholders"); Schautteet v. Chester State Bank, 707 F. Supp. 885, 888 (E.D. Tex. 1988) ("Officers and directors owe fiduciary duties only to the corporation. Therefore, [a minority shareholder] has no individual fiduciary right to enforce against any officer or director of [the company].") (citations omitted); *id.* at 889 (noting that "most abuses of majority control constitute breaches of the fiduciary duties the majority owes to the corporation, just as officers and directors owe fiduciary duties solely to the corporation"); Hoggett v. Brown, 971 S.W.2d 472, 488 (Tex. App. 1997) ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders."); *id.* at 488 n.13 (stating that "a majority shareholder's fiduciary duty ordinarily runs to the corporation"); Faour v. Faour, 789 S.W.2d 620, 621-22 (Tex. App. 1990) ("A corporate officer owes a fiduciary duty to the shareholders collectively, i.e. the corporation, but he does not occupy a fiduciary relationship with an *individual* shareholder, unless some contract or special relationship exists between them in addition to the corporate relationship."); Hetherington & Dooley, *supra* note 1, at 12 & n.30 (mentioning the traditional view that duties run "solely between the majority and the corporation," and observing that "[t]he notion that the fiduciary obligations of management run only to the corporation provides the minority in close corporations virtually no protection against oppression and exploitation by the control group"); *see also* *id.* at 12 ("[C]ourts undoubtedly . . . have been influenced by traditional common law attitudes emphasizing . . . proof of harm to the corporation, as distinguished from the interests of individual shareholders.").

managers—decisions that form the grist of many modern shareholder oppression disputes[257]—could be challenged on fiduciary duty grounds only if a harm to the corporation, rather than a harm to the minority investor, was established.

Against this backdrop, it is easier to understand the significance of judicial decisions like *Donahue v. Rodd Electrotype Co.*[258] As mentioned, in *Donahue*, the Supreme Judicial Court of Massachusetts explicitly held that a duty of "utmost good faith and loyalty" ran from shareholder to shareholder in a close corporation, just as partners owe a fiduciary duty to one another in a partnership.[259] The decision made clear, in other words, that a majority shareholder needed to consider not only the interests of the company, but also the interests of the individual shareholders, when exercising its control.[260] This view of fiduciary duty in the close corporation—the notion that the majority shareholder's duty runs directly to an individual owner and encompasses the interests of that individual owner—forms the basis of the modern-day shareholder oppression doctrine.[261]

---

257. *See supra* note 25 and accompanying text (noting that employment terminations and management removals are common oppressive acts).

258. 328 N.E.2d 505 (Mass. 1975).

259. *Id.* at 515; *supra* notes 38-39 and accompanying text (discussing the *Donahue* opinion).

260. Even though the *Donahue* duty of "utmost good faith and loyalty" was scaled back by the decision of Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976), a majority shareholder still needs to consider an individual minority shareholder's interests. According to *Wilkes*, even if a majority shareholder establishes a legitimate business purpose for its actions, a breach of the *Donahue* duty will still occur if the minority demonstrates that "the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest." *Wilkes*, 353 N.E.2d at 663; *see supra* note 38 (discussing the *Wilkes* modification of the *Donahue* duty of utmost good faith and loyalty).

261. *See supra* notes 37-39 and accompanying text (noting that courts have imposed a fiduciary duty between close corporation shareholders and have allowed an oppressed shareholder to bring a direct cause of action for breach of that duty). Even in jurisdictions where the oppression doctrine derives from involuntary dissolution statutes rather than from fiduciary duty principles, the interests of an individual minority investor are still central to the doctrine. *See supra* notes 32-36 and accompanying text (discussing the statutory cause of action for oppression). Indeed, the involuntary dissolution ground of "oppression" is usually defined as majority conduct that frustrates the "reasonable expectations" of a minority investor. *See, e.g.*, *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (equating oppression under the involuntary dissolution statute with "conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise"); 2 CLOSE CORPORATIONS, *supra* note 14, § 9:28, at 9-199 ("One of the most significant trends in the law of close

Unlike corporation statutes, a number of LLC statutes address the concept of fiduciary duty. Significantly, many of the statutes explicitly indicate that fiduciary duties run to the individual members as well as to the LLC entity.[262] This statutory explicitness may make it easier for the oppression doctrine to "take root" in the LLC context, as courts can use the statutory language to justify a more member-centered, rather than firm-centered, fiduciary duty analysis.[263] Similarly, because the case law of many states

corporations in recent years is the increasing willingness of courts to look to the reasonable expectations of shareholders to determine whether 'oppression' or similar grounds exist as a justification for involuntary dissolution or another remedy.").

262. *See, e.g.*, CAL. CORP. CODE § 17153 (West 1996) ("The fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership."); *id.* § 17150 (imposing the same fiduciary duties on members in a member-managed LLC); FLA. STAT. ANN. § 608.4225(1) (West 2001) ("[E]ach manager and managing member shall owe a duty of loyalty and a duty of care to the limited liability company and the other members of the limited liability company."); *id.* § 608.4225(1)(c) ("Each manager and managing member shall discharge the duties to the limited liability company and other members . . . and exercise any rights consistent with the obligation of good faith and fair dealing."); 805 ILL. COMP. STAT. ANN. § 180/15-3(a) (West 2002) ("The fiduciary duties a member owes to a member-managed company and its other members include the duty of loyalty and the duty of care . . . ."); *id.* § 180/15-3(d) ("A member shall discharge his or her duties to a member-managed company and its other members . . . and exercise any rights consistent with the obligation of good faith and fair dealing."); *id.* § 180/15-3(g)(2) (imposing the same duties and obligations on managers of a manager-managed LLC); McConnell v. Hunt Sports Enters., 725 N.E.2d 1193, 1216 (Ohio Ct. App. 1999) ("In general terms, members of limited liability companies owe one another the duty of utmost trust and loyalty."); ULLCA § 409(a) (1996) ("The only fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care . . . ."); *id.* § 409(d) ("A member shall discharge the duties to a member-managed company and its other members . . . and exercise any rights consistently with the obligation of good faith and fair dealing."); *id.* § 409(h)(2) (imposing the same duties and obligations on managers of a manager-managed LLC). *But see* McGee v. Best, 106 S.W.3d 48, 64 (Tenn. Ct. App. 2002) ("The [Tennessee LLC] statute in question defines the fiduciary duty of members of a member-managed LLC as one owing to the LLC, not to individual members."). In theory, this notion of a duty between the members allows a minority member to challenge, on fiduciary duty grounds, a decision that harms the minority owner itself, even if the decision is not one that would directly injure the LLC.

263. Under some statutory articulations, the fiduciary duty language may be less useful for combating oppression, as the scope of the fiduciary duties is limited. For example, although the ULLCA states that members and managers owe a fiduciary duty of loyalty to the company and the other members, the scope of that duty is expressly "limited to the following":

(1) to account to the company and to hold as trustee for it any

> property, profit, or benefit derived by the member [or manager in a manager-managed LLC] in the conduct or winding up of the company's business or derived from a use by the member [or manager in a manager-managed LLC] of the company's property, including the appropriation of a corporate opportunity;
>
> (2) to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
>
> (3) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.

ULLCA § 409(b) (1996).

On its face, one wonders whether this language would constrain garden-variety acts of oppression, such as the removal of a member (in a manager-managed LLC) from a management role. Such decisions do not necessarily involve profit derivation, interests adverse to the company, or competition with the company. Further, such decisions may not rise to the level of gross negligence or recklessness—the level of fault that is statutorily required to establish a breach of the duty of care. *See id.* § 409(c) ("A member's duty of care to a member-managed company and its other members in the conduct of and winding up of the company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."). Perhaps the obligation of good faith and fair dealing would independently function to constrain such decisions, but that is far from clear. *See id.* § 409(d) ("A member shall discharge the duties to a member-managed company and its other members . . . and exercise any rights consistently with the obligation of good faith and fair dealing.").

Interestingly, other jurisdictions that follow the ULLCA approach avoid such restrictive articulations of fiduciary duty. *Compare* ULLCA § 409(a), (b) (1996) (declaring that "[t]he *only* fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care," and further stating that "[a] member's duty of loyalty to a member-managed company and its other members *is limited*" to the profit-derivation, adverse interests, and competition prohibitions cited above) (emphasis added), *with* FLA. STAT. ANN. § 608.4225(1) (West 2002) (declaring that "each manager and managing member shall owe a duty of loyalty and a duty of care to the limited liability company and the other members of the limited liability company," and further stating that "[t]he duty of loyalty includes, *without limitation* [the profit-derivation, adverse interest, and competition prohibitions]" (emphasis added)), *and* 805 ILL. COMP. STAT. ANN. § 180/15-3(a), (b) (West 2002) (declaring that "[t]he fiduciary duties a member owes to a member-managed company and its other members *include* the duty of loyalty and the duty of care," and further stating that "[a] member's duty of loyalty to a member-managed company and its other members *includes the following* [profit-derivation, adverse interest, and competition prohibitions]") (emphasis added).

Finally, efforts to combat oppression may be further weakened by the statutory language in some jurisdictions declaring that a member or manager "does not violate a duty or obligation under this [Act] or under the operating agreement merely because the member's conduct furthers the member's own interest." ULLCA § 409(e) (1996); *see* FLA. STAT. ANN. § 608.4225(1)(d) (West 2002) ("A manager or managing member does not violate a duty or obligation recognizes a *Donahue*-like fiduciary duty between close corporation owners,[264] there is a pre-existing common law basis for analogously imposing fiduciary duties between LLC owners. This too may help the "transplanting" of the oppression doctrine to the LLC context, as courts can use their common law precedent to justify a more member-centered fiduciary duty analysis. Indeed, some of the published decisions suggest that courts are relying on such statutory and common law authority to police abusive conduct in the LLC.[265]

VII. THE FUTURE OF BUSINESS STRUCTURES: LESSONS TO BE LEARNED

As the multitude of close corporation disputes has

under this chapter or under the articles of organization or operating agreement merely because the manager's or managing member's conduct furthers such manager's or managing member's own interest."); *see also* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 9:3, at 9-8 n.1 (citing ULLCA § 409(e) and stating that "[i]t is not clear to what extent this limits the members' duty of loyalty"). As an example, the ULLCA comment states that "a member's refusal to vote for an interim distribution because of negative tax implications to that member does not violate that member's obligation of good faith to the other members," and the comment further observes that "a member may vote against a proposal by the company to open a shopping center that would directly compete with another shopping center in which the member owns an interest." ULLCA § 409 cmt.

264. *See supra* note 39 and accompanying text (noting that a number of courts have imposed a fiduciary duty between close corporation shareholders).

265. *See, e.g.*, Anest v. Audino, 773 N.E.2d 202, 209-11 (Ill. App. Ct. 2002) (finding that a member of a member-managed LLC owed a fiduciary duty to another member based in part on the common law notion that "[s]hareholders in a close corporation owe to each other fiduciary duties similar to those of partners in a partnership," and remanding for a consideration of whether the duty had been breached by the usurpation of an alleged LLC opportunity); *see also* Credentials Plus, L.L.C. v. Calderone, 230 F. Supp. 2d 890, 898-99 (N.D. Ind. 2002) (analogizing an LLC to a close corporation and a partnership and stating that "'Indiana courts have characterized closely held corporations as 'incorporated partnerships' and as such have imposed a fiduciary duty upon shareholding 'partners' to deal fairly not only with the corporation but with fellow shareholders as well'") (quoting Melrose v. Capitol City Motor Lodge, Inc., 705 N.E.2d 985, 991 (Ind. 1998); SunTech Processing Sys. v. Sun Communications, Inc., No. 05-99-00213-CV, 2000 WL 1780236, at *6-7 (Tex. App. Dec. 5, 2000) (analogizing fiduciary duties between members in an LLC to fiduciary duties between shareholders in a close corporation, but stating that a fiduciary duty in both contexts does not exist as a matter of law); *cf.* VGS, Inc. v. Castiel, No. C.A. 17995, 2000 WL 1277372, at *4 (Del. Ch. Ct. Aug. 31, 2000) (finding that two LLC members violated a duty of loyalty owed to a third member by failing to notify the third member of their intention to effectuate a merger, and grounding the decision in large part on equitable maxims, such as "equity regards and treats that as done which in good conscience ought to be done").

demonstrated, minority investors lacking both exit rights and veto power are particularly vulnerable to abusive conduct by majority owners. When the deference of the business judgment rule and the likely absence of advance planning are also considered, the minority investor's position is even more precarious. Unfortunately, little wisdom appears to have been gained from dealing with oppressive conduct in the close corporation context, as the LLC seems poised to repeat the close corporation experience. Consequently, some guidelines for policymakers considering future business structures (or changes to existing business structures) may be useful.

First, policymakers should recognize that a statute with no default protections for minority investors (but giving the owners the ability to add them) is vastly different from a statute with default protections for minority investors (but giving the owners the ability to remove them). If one accepts that ventures with inadequate planning for dissension will always remain a part of the business landscape,[266] then one must also acknowledge that a statute's dissension-related default rules will become the operational provisions for a substantial number of enterprises.[267] Where those statutes provide little or no default protections for minority owners, a breeding ground for oppression is created.

Second, and relatedly, policymakers should consider including default protections for minority owners in their business organization statutes. Providing default exit rights is the most effective way to accomplish this objective, as the inability to "cash out" of a venture is widely viewed as the primary cause of the oppression problem.[268] A default buyout upon withdrawal provision,

266. *See, e.g.*, Chittur, *supra* note 95, at 139 (stating that "inadequately planned close corporations will always remain part of the picture"); *supra* Parts III.D and V.D (discussing impediments to effective contracting in close corporations and LLCs).

267. *See, e.g.*, Farrar & Hamill, *supra* note 9, at 932 ("The policy behind drafting statutory default provisions should seek to provide a set of rules addressing the needs of the intended users of the business form who are least likely to plan ahead of time."); *cf.* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:2, at 8-4 (noting that "the statutory default rule should be designed for relatively informal firms"); Farrar & Hamill, *supra* note 9, at 914 ("Statutory default provisions for LLCs, as well as other business forms historically used by small business, should be written for the unsophisticated business participants who will rarely seek adequate legal advice in advance.").

268. *See, e.g.*, Farrar & Hamill, *supra* note 9, at 924 n.64 (noting that "the most significant problem faced by the shareholders [of a close corporation]," is "that of no liquidity of shares"); Kleinberger, *supra* note 14, at 1149 ("More than any other characteristic, this 'no exit' phenomenon has pushed the law into developing special rules for shareholders in close corporations."); Thompson, *supra* note 5, at 225 ("Once a corporation's shares are publicly traded, minority

for example, as was included in many LLC statutes in the pre-check-the-box era, is an option that should strongly be considered.[269] Admittedly, the potential exists for a minority

shareholders, even if they are also employees, are not subjected to the risks that are common to the close corporation and which inspired the modern legislative and judicial remedies.").

269. *See, e.g.*, ULLCA § 701(a)(1) (1996) (providing default buyout rights); Miller, *supra* note 99, at 416 (mentioning "the continued importance of giving the LLC member a right to withdraw from the LLC and receive the fair market value of his or her interest in the absence of an agreement to the contrary"); *supra* notes 149-50, 162-63 and accompanying text (discussing the buyout upon withdrawal provisions that were present in the majority of LLC statutes before the "check-the-box" regulations); Larry E. Ribstein, *A Critique of the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 311, 365 (1995) ("The strongest justification for the buyout right is that even in an LLC, illiquid minority members may be subject to potential oppression by majority members. Such problems have given rise to special remedies in close corporations which have triggered much litigation and unsatisfactory judicial lawmaking."); *id.* at 366 ("The same problems would arise under LLC statutes that do not provide for a default buyout right."); *id.* ("If the statute provides . . . a [buyout] right by default, the majority would have to make the absence of a buyout right clear to the minority by specifying it in the operating agreement. This would eliminate judicial guesswork about whether . . . the members agreed to the absence of a buyout."); *see also* Farrar & Hamill, *supra* note 9, at 914 ("[T]he legal authorities addressing the oppression of minority shareholders in close corporations suggest that the presence of dissociation rights, effectively evening out the bargaining power between the minority and majority owners, help small business owners more easily settle their differences without resorting to litigation."); *id.* at 932 ("Leaving rights of all members to dissociate in the statute will allow unsophisticated members who have fallen out of favor with the majority group some bargaining power when negotiating a settlement, and should reduce the amount of litigation."). *See generally* Hetherington & Dooley, *supra* note 1, at 1-6 (proposing that close corporation minority shareholders should be given a right to a mandatory buyout of their shares upon demand). *But see* Hillman, *supra* note 95, at 70-75 (referring to the "[m]yth of the [p]ainless [b]uy-[o]ut," and discussing problems associated with a mandatory buyout rule).

Although a unilateral dissolution right (e.g., dissolution upon an investor's withdrawal or resignation) would also provide a suitable exit, *see supra* notes 61-62 and accompanying text (discussing dissolution rights), the instability caused by such an easy dissolution provision is problematic. *See, e.g.*, Farrar & Hamill, *supra* note 9, at 911-12 ("The need to trigger a possible dissolution every time a member withdrew from or otherwise became separated from the business . . . created a highly unstable business environment.") (footnote omitted); Miller, *supra* note 99, at 434 (noting the "policy interest in providing stable business relationships"). Further, as the partnership experience demonstrates, such easy dissolution provisions can also be used as instruments of oppression, as a wealthy majority investor can force dissolution in an effort to appropriate a minority investor's share of the business. *See, e.g.*, Farrar & Hamill, *supra* note 9, at 916 (arguing that the curbing of dissolution rights is investor to abuse such a buyout right (e.g., threaten withdrawal to gain concessions or withdrawal when the company is experiencing cash flow difficulties), but these scenarios could presumably be handled by statute as well.[270] At the very least, policymakers should

beneficial because it eliminates the potential for abusive dissolutions where "[a] partner with limited economic resources could lose his share of the business at an unfairly low price"); *id.* (stating that "[a]s long as a withdrawing partner with sufficient assets to purchase the entire business avoided being classified as a wrongful dissolver, such partner's bid conclusively set the fair market value of the entire business and each partner's rights in the liquidation," and observing that "[i]f the other partner lacked the economic resources to counterbid for the business, the withdrawing partner had no incentive to bid a fair price"); *id.* at 922-23 ("The elimination of all statutory dissolutions of Alabama LLCs by the new legislation represents sound business policy. The right to compel dissolution serves no meaningful goal and sets up the opportunity for an economically powerful member to purchase the entire business from the others at an unfairly low price."). Finally, "[b]ecause LLCs offer limited liability protection to all members, no reason exists to allow LLC members the absolute right to dissolve the LLC." *Id.* at 923; *see id.* (noting that "[i]n a general partnership, the personal liability exposure of each general partner justifies allowing each partner the right to dissolve an at-will partnership," and explaining that "[b]ecause only a dissolution eliminates the entity and any liabilities up to that time, a partner no longer wanting to associate with the others needs the ability to dissolve the entity in order to avoid being held personally liable for debts allegedly incurred before the partner's withdrawal").

Even if default exit rights were provided in a business organization statute, some commentators have argued that a need for a remedial oppression doctrine would still exist. *See, e.g.*, Bahls, *supra* note 7, at 87-90 (arguing that even if exit rights existed in LLCs, the oppression doctrine might still be needed in certain circumstances).

270. For example, a statute could require that withdrawal rights be exercised in good faith, or a statute could provide a court with discretion to delay payment or to provide for installment payments in certain situations. *See, e.g.*, Bahls, *supra* note 178, at 328 n.258 ("Several [close corporation] state statutes permit the courts to order installment payments."); Farrar & Hamill, *supra* note 9, at 933 ("Statutory dissociation rights can be tailored in a way to minimize the opportunities for the individual member to abuse the power to dissociate."); *id.* ("Members of LLCs with actual or implied terms or undertakings should be required to wait until the term or undertaking expires before any redemption rights materialize. In addition to the delay of payment until the end of the term or undertaking, members dissociating prematurely should be liable for damages . . . .") (footnote omitted); *id.* at 934 ("Any remaining abuses of the power to dissociate can be largely curtailed by retaining general concepts of wrongful dissociation if the power is used in a manner that breaches fiduciary duty to the other members."); Hetherington & Dooley, *supra* note 1, at 51 (proposing a statute that would provide close corporation shareholders with a right to a mandatory buyout upon demand, but noting that "the corporation and the remaining shareholders are protected against sudden cash drains by a provision authorizing the court . . . to provide for installment payments of the purchase price for a period of time not

provide an involuntary dissolution provision that allows a minority investor to petition a court for dissolution (or other less drastic remedy) on the grounds of oppression or misconduct by those in control.[271] Such a statute provides a vehicle for courts to scrutinize the conduct of the majority owner.[272] As with existing close corporation oppression statutes, however, the protection from such a

exceeding five years," and further imposing a two-year holding period for newly-acquired shares that is "intended primarily to protect new businesses where a withdrawal in the formative stages might be particularly disruptive"); *id.* at 49 (refusing to allow a close corporation shareholder to demand a mandatory buyout "if the corporation would thereby be rendered insolvent"); Hillman, *supra* note 95, at 83 (discussing buyouts in the shareholder oppression context and noting the possibility of "structur[ing] installment payments with a commercially reasonable rate of interest over an extended period of time"); *cf.* Bonavita v. Corbo, 692 A.2d 119, 130 (N.J. Super. Ct. Ch. Div. 1996) (appointing a "special fiscal agent" to consider the appropriate terms and conditions for a court-ordered buyout, including the interest rate, the payment schedule, and the need for any security); Meiselman v. Meiselman, 309 N.C. 279, 316, 307 S.E.2d 551, 572-73 (1983) (Martin, J., concurring) (stating, in a close corporation shareholder oppression dispute, that "[i]f it is determined that the granting of relief will be unduly burdensome to the corporation or other shareholders, the trial court should consider this in determining whether to grant relief and, if so, whether this should affect the purchase price or value attached to plaintiff's shares or the method of payment").

271. *See, e.g.*, Miller, *supra* note 99, at 460 (advocating the enactment of a statutory "mechanism for seeking a dissolution or buy-out if there is deadlock or if the managers or members in control of the company have engaged in certain types of misconduct . . . , i.e., illegal or fraudulent conduct, unfairly prejudicial conduct, or possibly oppressive conduct"). A few LLC statutes include such involuntary dissolution provisions. *See id.* at 417 (noting that "relatively few [state LLC statutes] provide an equitable remedy for a dissolution or buy-out in the event of certain illegal or fraudulent acts or other misconduct"); *id.* at 460-61 (stating that "a growing number of states provide the remedy of a judicial dissolution upon a showing of certain majority misconduct," and citing the LLC statutes of Alaska, California, Florida, Idaho, Kansas, Maine, Minnesota, and Ohio); ULLCA § 801(4)(v) (1996) (stating that, upon application by a member, a court can order dissolution of an LLC if "the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner"); *see also* Karjala, *supra* note 105, at 469 (noting "the absence in many LLC statutes of fair and reasonable provisions for judicial dissolution"); Miller, *supra* note 99, at 431 (noting that "the minority LLC member is potentially more vulnerable to a squeeze-out than a minority shareholder in a closely held corporation" given that "many corporate statutes follow the Revised Business Corporation Act's statutory mechanism for providing dissolution or buy-out in lieu of dissolution where there is deadlock, where those in control have engaged in illegal, fraudulent, or oppressive conduct, or where there is a wasting of corporate assets").

272. *See supra* notes 32-36 and accompanying text (discussing close corporation "dissolution for oppression" statutes).

statute is variable and is highly dependent on a particular court's willingness to defer to the business judgment of the majority.[273] In addition, such a statute obviously affords more limited exit rights than an "on-demand" buyout provision.

In conjunction with exit rights, policymakers should consider other default statutory provisions that provide protection to minority investors from oppressive majority conduct. Provisions addressing fiduciary duty,[274] supermajority requirements,[275] and mandatory distributions of surplus,[276] for example, are all useful in

273. *Compare* Brenner v. Berkowitz, 634 A.2d 1019, 1033 (N.J. 1993) (noting, in a statutory oppression dispute, that "the court is hesitant to overturn the corporation's valued exercise of its business judgment," and observing that "[t]he Chancery Division properly concluded that it could not second-guess the corporation's exercise of its business-judgment"), *and* Willis v. Bydalek, 997 S.W.2d 798, 802 (Tex. App. 1999) (concluding that the termination of a close corporation shareholder's employment was not oppressive, in part because of the "broad range of business judgment allowed by law to directors"), *with* Grato v. Grato, 639 A.2d 390, 396 (N.J. Super. Ct. App. Div. 1994) (noting, in a statutory oppression dispute, that "judicial consideration of a claim of majority oppression or freeze-out in a closely held corporation is guided by considerations broader than those espoused in defendants' version of the 'business judgment rule'"), *and* Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979) (stating that "the statutory language [providing relief when those in control have acted "oppressively"] embodies a legislative determination that freeze-out maneuvers in close corporations constitute an abuse of corporate power," noting that "[t]raditional principles of corporate law, such as the business judgment rule, have failed to curb this abuse," and concluding that "[c]onsequently, actions of close corporations that conform with these principles cannot be immune from scrutiny").

274. *See supra* notes 262-63 and accompanying text (noting that some LLC statutes explicitly address the concept of fiduciary duty).

275. *See, e.g.* Miller, *supra* note 99, at 456 (noting that "some states provide a default rule requiring unanimity for amending the operating agreement," presumably because "[t]he capacity to amend the operating agreement . . . by majority vote . . . has been regarded as a potential weapon in the hands of a majority owner").

276. *See, e.g.*, 2 OPPRESSION, *supra* note 19, § 10:8, at 10-47 to 10-48 ("A statute requiring directors to declare and pay dividends in a specified amount at periodic intervals if consistent with state law is an obvious way to combat squeeze-outs which utilize the dividend-withholding technique."); *id.* at 10-50 to 10-51 (stating that the authors "are persuaded that . . . policy . . . support[s] a tightly drawn statute empowering holders of a substantial block of shares (say 20 or 25 percent of a corporation's outstanding shares) to require the corporation to pay . . . as dividends a modest part of its annual earnings (perhaps up to 30 or 35 percent)"); *id.* (proposing a statute where a close corporation could be required to pay out 30 percent of its earnings "in the absence of a convincing showing by corporate management that the corporation needs to retain all of its earnings"); Israel, *supra* note 96, at 99 (proposing that "[i]f the board of directors failed to declare a dividend or declared a dividend of

safeguarding minority interests. Moreover, as default rules, they can be altered by sophisticated parties who may determine that the provisions do not "fit" the operation of their contemplated venture.[277]

Third, policymakers should resist allowing the needs of a subset of business owners to dictate important default rules that apply well beyond that subset. It has been noted that "the LLC is serving the needs of a broad base of the business community," and its use has spread far beyond the family-owned business context.[278] To the extent that the elimination of exit rights in LLC statutes is driven by estate and gift tax concerns for family businesses,[279] policymakers

less than 50 percent of net earnings . . . the burden of proof would be on management to prove the reasonableness of their policy"); *id.* at 99 n.108 ("Although retention of 50 percent of earnings may be excessive in certain instances, it does strike a workable balance between avoidance of shareholder oppression and conservation of judicial resources."). *See generally* 2 OPPRESSION, *supra* note 19, § 10:8, at 10-47 to 10-52 (discussing mandatory dividend statutes). *But see* Ernest L. Folk, III, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C. L. REV. 768, 842-45 (1965) (criticizing North Carolina's former mandatory dividend statute); Keatinge, *supra* note 154, at 42 ("LLC statutes do not provide for periodic distributions because it is very difficult to design a default rule on this matter. Timing will depend on such matters as the members' tax situations and the nature of the firm.") (internal quotation omitted).

277. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 8:3, at 8-7 ("[T]he potential harm from a statutory default rule is mitigated by the fact that parties can draft around the rule.").

Perhaps fiduciary duty principles should not be treated as waivable default rules. The issue is beyond the scope of this Article, but it should be noted that there is considerable debate on the matter. *Compare* EASTERBROOK & FISCHEL, *supra* note 95, at 1-39 (arguing that fiduciary duties are contractual in nature and are waivable), *and* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) (same), *and* Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. LAW 5 (1996) (same), *with* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (arguing that waivers of fiduciary duty should be restricted), *and* John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988) (same), *and* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (1988) (same).

278. Miller, *supra* note 99, at 442; *see id.* at 441 (noting that "a substantial number of LLCs are not, in fact, formed for use as a family held investment," and observing that "the LLC was enacted to serve as the business entity of choice for a broad array of privately owned businesses"); *id.* (stating that "LLCs are housing a wide variety of business enterprises," and further noting that "[i]t thus does not appear that LLCs are being used for the relatively narrow purpose of holding family investments").

279. *See supra* notes 175-82 and accompanying text (discussing the estate

must recognize that their accomplishment of a tax goal for some also creates an oppression setting for many.[280] For an issue as important as exit rights, legislative decisions should be premised on what is sensible business policy for investors in the aggregate, rather than what is sensible tax policy for a mere subset of investors.

Finally, even if family-business tax concerns are viewed by policymakers as issues of paramount importance, the elimination of default exit rights in *all* of a particular business structure seems unnecessarily overbroad. States could presumably achieve their gift and estate tax goals by eliminating default exit rights only for "family-held" ventures using that structure, rather than for all ventures conducting business in that form. Just as states have passed special close corporation statutes that apply only to companies that "qualify" and "elect" to use those provisions,[281] so too could states add a "family-held" supplement to the statutes of the

---

and gift tax issues motivating the elimination of exit rights in LLC statutes).

280. *See, e.g.*, Farrar & Hamill, *supra* note 9, at 936 ("Unfortunately, the elimination of statutory dissociation rights will negatively affect many unsophisticated small business users of LLCs who are in no way engaging in complex gift and estate tax planning."); *supra* notes 182 and accompanying text (noting that the elimination of default exit rights for estate and gift tax purposes leaves minority members vulnerable to oppressive majority actions); *cf.* Ribstein, *New Choice*, *supra* note 7, at 340 ("[A]t least one type of statute should be kept 'safe' for non-family firms that do not have tax reasons to restrict member exit.").

281. *See, e.g.*, CAL. CORP. CODE § 158(a) (West 2002) (defining a "close corporation" as "a corporation whose articles contain . . . a provision that all of the corporation's issued shares of all classes shall be held of record by not more than a specified number of persons, not exceeding 35, and a statement 'This corporation is a close corporation'"); *id.* §§ 300(b), 300(e), 1800(a)(2) (imposing statutory protections that apply only to a "close corporation" as defined in the statute); DEL. CODE ANN. tit. 8, §§ 341-356 (1998) (providing a subchapter of "special provisions" for close corporations that meet the statutory definition and that elect to be governed by the subchapter); *id.* § 341(a) ("This subchapter applies to all close corporations, as defined in section 342 . . . . Unless a corporation elects to become a close corporation under this subchapter in the manner prescribed . . . , it shall be subject in all respects to the provisions of this chapter, except the provisions of this subchapter."); *see also* EISENBERG, *supra* note 14, at 350 ("[T]he Delaware statute also contains an integrated set of provisions, Subchapter XIV (§§ 341-356), which are explicitly made applicable *only* to corporations that both qualify for and formally elect statutory close corporation status."); *id.* at 351 ("The California strategy is comparable to that of Delaware—that is, it involves a combination of (i) unified provisions that are particularly useful for close corporations, but are not restricted to such corporations, and (ii) a systematic set of provisions applicable only to statutory close corporations."); *id.* ("In contrast to the Delaware legislation, however, California's statutory-close-corporation provisions are scattered throughout the statute, rather than integrated in a single subchapter.").

relevant business structure—a supplement that eliminates default exit rights only for firms that qualify and elect to use the supplementary provisions.[282] For those firms, exit rights will be restricted by state law (which is needed to pass IRS scrutiny),[283] but default exit rights could remain available under the "general" statutory provisions for any non-qualifying or non-electing enterprise.[284]

---

282. Arizona's former LLC statute had provisions applicable only to "family controlled" LLCs:

> If the business of the limited liability company is not continued . . . and if the withdrawn member is a family member of a family controlled limited liability company, then the distributions which the withdrawn member is entitled to receive in the absence of any provision in an operating agreement shall be based upon the lesser of his right to share in distributions if the limited liability company had completed winding up pursuant to § 29-708 as of the date of withdrawal or his right to share in reasonably anticipated future distributions if the limited liability company were to continue for twenty-five years. For purposes of this subsection, "family controlled limited liability company" means a limited liability company which, immediately before the event of withdrawal, is controlled by the withdrawn "family member" and the "members of his family" as defined in § 2704[] of the [I]nternal [R]evenue [C]ode . . . .

ARIZ. REV. STAT. ANN. § 29-707(B) (West 1997).

283. *See* I.R.C. § 2704(b) (West 2003) (stating that an "applicable restriction [that] shall be disregarded in determining the value of the transferred interest . . . shall not include . . . any restriction imposed, or required to be imposed, by any Federal or State law"); Farrar & Hamill, *supra* note 9, at 935 ("Under section 2704(b)(2)(B) gifts or bequests of corporate shares, partnership or LLC interests among family members can qualify for discounted valuation, if the relevant statute governing the business organization restricts the recipient's ability to transfer or liquidate the interest in the business organization."); *supra* notes 175-82 and accompanying text (discussing IRS limitations on discounts in family-owned LLCs).

284. *See, e.g.*, DEL. CODE ANN. tit. 8, § 341(a) (1998) ("Unless a corporation elects to become a close corporation under this subchapter [covering only statutory close corporations] in the manner prescribed in this subchapter, it shall be subject in all respects to the provisions of this chapter [covering all corporations, whether closely held or publicly held], except the provisions of this subchapter.")

Commentators have similarly suggested that states should use an entity other than the LLC for facilitating gift and estate tax planning. *See, e.g.*, Miller, *supra* note 99, at 443 ("It may be preferable to eliminate default buy-out rights in a limited partnership statute rather than in a widely used LLC statute. Alternatively, a different entity without buy-out rights could be used by those seeking minority discounts for estate and gift tax purposes."); *id.* ("The creation of a special entity without default buy-out rights [provides] a vehicle for achieving tax goals, while placing investors on notice that special rules may apply. In this manner, the default buy-out rights of a diverse range of unsuspecting LLC investors will not be compromised."); Ribstein, *New Choice*,

VIII. CONCLUSION

Those who ignore history are doomed to repeat it. Years of grappling with conflicts between close corporation investors have revealed the perils of a business structure that lacks exit rights and that defaults to majority rule. Similarly, the frequency of such conflicts has underscored that business organization statutes often need to focus more on dissension-related issues.

Unfortunately, these lessons from close corporation history appear to have gone unlearned. LLC statutes usually share the "no exit" and majority rule features of the close corporation, and courts are apt to provide business-judgment-rule deference in LLC disputes. In addition, as is typical in many small business environments, LLC members are unlikely to engage in adequate planning for dissension. Taken together, these circumstances create a dangerous situation for minority investors when dissension arises between the owners. Nevertheless, most LLC statutes offer no default protection to minority investors when their financial and participatory interests are threatened by abusive majority conduct.

In short, the "seeds" of oppression in the close corporation are also present in the LLC setting. As a result, the LLC seems destined to repeat the oppression experience of the close corporation. Without legitimate judicial scrutiny of majority member conduct, LLC minority owners will be worse off than many of their close corporation brethren. Just as courts developed the oppression doctrine to protect minority shareholders in close corporations, so too should courts extend the oppression doctrine to safeguard minority members in LLCs. Learning from close corporation history, in other words, is important to the LLC's future.

supra note 7, at 339 ("[P]erhaps the limited partnership should be selected as the type of business association that provides the most suitable default rules for the family firm. . . . [L]egislators should amend limited partnership statutes to restrict member exit in order to ensure liquidity discounts for the members under the above tax provisions.")