PLANNING PROBLEMS IN THE LIMITED LIABILITY COMPANY

DENNIS S. KARJALA*

One of the more important developments in corporation law in this century has been the steady legislative and judicial recognition that rigid statutory norms concerning internal divisions of power in closely held incorporated enterprises serve little social purpose. Moreover, such rigidity often results in the frustration of reasonable expectations when courts refuse to enforce bargained-for agreements that violate the statutory norms. 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. The primary jurisprudential problem is no longer the enforcement of bargained-for divisions of power (assuming compliance with the requisite statutory formality), but rather the allocation of rights and duties when the parties have failed to take advantage of the planning opportunities available under the modern corporation statutes.[1]

The limited liability company statutes that have appeared so suddenly raise similar jurisprudential problems.[2] While the various statutes show a good deal of individuality[3]—a potentially undesirable retrogression in business association law from essentially national statutory standards for

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* Professor of Law, Arizona State University.

1. In earlier studies I have analyzed the planning problems for close corporations under the modern corporation statutes and the extent to which those problems are aggravated or alleviated by special close corporation legislation. Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L.J. 663 (1989) [hereinafter Karjala, *Analysis of Close Corporation Legislation*]; Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207 (1980) [hereinafter Karjala, *A Second Look*].

2. As of the time this Article was written, 47 states had adopted limited liability company legislation. In addition, the three states without LLC statutes, Hawaii, Massachusetts, and Vermont, all had LLC legislation pending in their legislatures. 2 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES app. D (1992 & Supp.).

3. For the purposes of this Article, I have considered just seven versions: the Uniform Limited Liability Company Act and the limited liability company legislation from Arizona, California, Colorado, Delaware, Idaho, and Oregon. I chose these statutes to provide a sample of the kinds of variations that are occurring, and I do not suggest that they are entirely representative of existing legislation. For a more systematic comparison, see Patrick J.S. Inouye, Note, *A Comparative Look at Oregon's Limited Liability Company Act*, 73 OR. L. REV. 133, 133 (1994) (examining thirteen statutes, including the Uniform Act).

corporations and partnerships[4]—they all allow the freedom of contract in matters of internal governance that has always characterized partnership law. Consequently, participants in these enterprises, together with their attorneys, can allocate the economic and political rights and duties among themselves in essentially any manner they choose.

This Article analyzes the positions of participants in limited liability companies who do not take advantage of the internal governance freedoms offered by the statute to plan for the kinds of breakdowns that occur in business relationships. It also considers the position of parties to these ventures who have agreed to a given power structure that, with the passage of time, becomes unsatisfactory to them. Part I briefly discusses the development of the limited liability company form and its roots in the liberalized provisions of modern corporation and partnership law. In Part II, the Article examines a variety of fact situations derived from partnership and close corporation case law as examples of the kinds of disputes that arise among the participants in closely held enterprises. The discussion focuses on planning issues facing closely held enterprises under limited liability company statutes, including the mode of operation and internal division of authority, potential liability to third parties, the rights of new entrants to the business, withdrawal rights of participants, and members' fiduciary duties. Within the context of each situation, it considers various possibilities or degrees of planning, in the form of an "Operating Agreement,"[5] that the parties have undertaken and asks how particular disputes will get resolved under the limited liability company statutes.

The Article concludes that it will be a mistake, in general, for parties to rely on the "default settings" of the controlling limited liability company statute. Such reliance can result in unpleasant surprises for which the parties would not have bargained had they considered the possibility of such occurrences at the time of formation. Because of the importance of

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4. The special close corporation statutes introduced a similar trend toward statutory balkanization. *See* Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1, at 700-02; Karjala, *A Second Look*, *supra* note 1, at 1264-67. It may be, however, that the continued trend toward liberality in the general corporation statutes has eliminated the need for attorneys to rely on the special legislation. For example, the drafters of the Model Business Corporation Act, who in 1984 proposed a Model Statutory Close Corporation Supplement for states wishing to distinguish between ordinary and "close" corporations, reverted to the idea of a single, flexible general corporation law in 1992. *See* ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS, CASES AND MATERIALS 465-66 (5th ed. 1994).

5. The Delaware equivalent to the operating agreement is called a "limited liability company agreement." DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1994).

individually bargained-for governance forms, the participation of a skilled attorney at the formation stage is as important in the limited liability company context as in the close corporation context.

I. THE DEVELOPMENT OF LIMITED LIABILITY COMPANY STATUTES

The standard model of the corporation has always called for managerial supervision by a shareholder-elected board of directors, whose policies are implemented by a group of appointed officers. When courts applied these general corporation law principles as rigid "statutory norms" to closely held incorporated enterprises, academic commentators began to call for special close corporation legislation, and eventually a number of state legislatures responded.[6] 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.[7]

In contrast to the traditional corporation structure, the standard partnership model envisions an association of active partners, each of whom has equal managerial authority to carry out ordinary business activities. Nearly all internal partnership matters, however, are subject to variation in the partnership agreement, and there is nothing that prohibits a partnership from operating through a board of directors or executive committee if the members so choose.

Consequently, business associates who negotiate their internal relationships can today effect the result of their advance planning with either the partnership or the corporate form. Thus, for planners, the choice of form is determined by a balance of limited liability and tax considerations. The difficult business-association-law questions arise when relationships among the parties break down in a manner for which the parties did not plan. The default positions of the corporate and partnership forms are very different, and rigid application, particularly of the corporate default provisions, can

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6. *See* Karjala, *A Second Look*, *supra* note 1, at 1207 n.1; Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1, at 665-68. One of the first academic articles to call for legislative recognition of the close corporation was Joseph L. Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1928).

7. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 7.32 (1993) [hereinafter RMBCA] (permitting contractual division of power in unanimously approved article provisions or in unanimous written shareholder agreements); DEL. CODE ANN. tit. 8, § 141(a) (1991) (requiring management by a board of directors except as otherwise provided in the articles).

result in hardship or even injustice.[8]

The limited liability company seems to be a mixture of the two traditional forms of business organization, and a somewhat different mixture from one state to another. As a jurisprudential policy matter, therefore, we might ask whether a new form was really necessary. From a business organization point of view, the answer is, "Clearly not!" The limited liability company form provides no additional internal structural freedom not already available under the modern corporation and partnership statutes. Furthermore, a new statute always brings interpretation uncertainties that may take a long time for the courts to iron out,[9] and this process gets even longer when, as is the case with limited liability company statutes, there are important statutory variations from state to state. Widespread use of these statutes may also undercut the value of the decades-long national jurisprudence that has developed under the general corporation and partnership statutes.[10]

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8. *See generally* Karjala, *A Second Look*, *supra* note 1; Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1. The partnership default provisions cause problems primarily when the planning failure is coupled with an express agreement not to terminate the partnership or to continue the partnership for a particular period of time. Absent such an agreement, partners are free to cause dissolution at any time without penalty, which gives them a remedy if they feel oppressed by those in control.

9. Business organization statutes in particular jurisdictions are only infrequently the subject of judicial interpretation, and not even the general Delaware Corporation Law, by far the most richly interpreted corporation statute, has a completely developed jurisprudence. *See* Karjala, *A Second Look*, *supra* note 1, at 1265 & n.230 (citing provisions of the Delaware Corporation Law that have not yet been interpreted by the courts).

10. After the liberalization of the general corporation laws to allow freedom of contract in internal matters, one of the strongest arguments against the adoption of special close corporation legislation was the resulting fractionation of what had become a national corporation law. Overall statutory similarity allows courts to rely on decisions from other jurisdictions in deciding cases of first impression in their own states. Karjala, *A Second Look*, *supra* note 1, at 1265-67; Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1, at 700-02.

Of course, similarities between a state's limited liability company statute and either its general corporation statute or its partnership statute may provide courts with an interpretative head start in particular cases. The problem, however, is whether the court will apply *appropriately* the corporation or partnership model or will simply take its cue from the statute itself, without adjustment for the reasonable expectations of the parties. Some courts have shown rigidity in interpreting the special close corporation statutes, to the detriment of the minority shareholders the statutes were designed to help. *E.g.*, Blount v. Taft, 246 S.E.2d 763 (1978) (allowing the majority shareholders to make a technical end run around a statutorily authorized shareholder agreement); Sundberg v. Lampert Lumber Co., 390 N.W.2d 352, 356 (Minn. Ct. App. 1986) (denying minority shareholder participation in a buy-back of shares from the majority family, notwithstanding the absence of a public market for the shares, because the minority-shareholder-favorable judicial dissolution provisions defined "close corporation" in a way that excluded the company in question). Similarly, rigidity in analogizing the limited liability company statutes to either the corporate or partnership model will just as surely result in injustice in some cases.

It seems that the only reason we have invited these difficulties is the Treasury Department's obtuse notion that the four-factor analysis for taxation as an "association" will be applied in a realistic manner only to organizations that do not call themselves "corporations."[11] Thus, "limited partnerships" and now also "limited liability companies" will not be taxed as associations if they lack two of the following four characteristics: continuity of life, centralization of management, limited liability, and free transferability.[12] Under the modern corporation statutes, two or more of these characteristics can be, and often are, eliminated in incorporated enterprises as well.[13] Nevertheless, if the participants continue to label themselves a "corporation" by organizing under a well-understood general corporation law, they will be taxed as an association. Now, by changing the label to "limited liability company" but otherwise organizing as they are free to do under the corporation statute, they magically change their tax status. Myopic fixation on labels by federal bureaucrats has thus driven an entire movement to a new business organization form, and all of the jurisprudential uncertainties and difficulties that come with it.[14]

II. ANALYSIS OF LIMITED LIABILITY COMPANY DEFAULT SETTINGS AND ASSOCIATED PLANNING PROBLEMS

Despite its overall jurisprudential drawbacks, the limited liability company is here. Careful planning for the types of breakdowns in relationships that typically occur in closely held business enterprises can

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11. *See* David C. Culpepper, *Tax Aspects of Limited Liability Companies*, 73 OR. L. REV. 5, 6 (1993). On the absence of a normative basis for their federal tax classification system, see Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 451-56 (1992).

12. Treas. Reg. § 301.7701-2 (as amended in 1993); Culpepper, *supra* note 11, at 6.

13. The parties can provide for dissolution at will or upon certain permitted withdrawals, for example, as well as for share transfer restrictions and elimination of the board of directors. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(a), 275 (1991); *id.* § 151 (1991 & Supp. 1994).

14. Another example illustrating the downside of our brand of federalism resulted from the overreaching of lawyers for the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC) in their efforts to recover assets for failed banks and savings and loan associations. Law and accounting firms seeking to protect themselves from the huge potential liabilities that can result from these heavy-handed actions have persuaded many state legislatures to adopt the "limited liability partnership" form, under which partners are no longer liable for the professional misconduct of the other partners. *E.g.*, ARIZ. REV. STAT. ANN. § 29-215(B) (Supp. 1994). It would be an interesting next step to see federal legislative preemption with respect to alleged misconduct in matters subject to RTC or FDIC jurisdiction. Then the result of this state-federal chess game will be that only the ordinary clients will be checkmated when they are defrauded by a judgment-proof member of the firm, a fundamental change in our notion of professional responsibility.

obviate later legal problems for limited liability companies in the same way that planning can now be effective through enforceable contracts in the partnership and corporation settings. The question for consideration is how courts and lawyers should address these issues when the parties have not provided a clear contractual resolution to their eventual dispute or when their contractual resolution works a long-term unfairness to members outside of the company's control group. Among the issues that should be considered are: the mode of operation and internal division of authority; the relationship between the mode of operation and potential liability to third parties; the rights of new entrants to the enterprise; oppression of inactive members and their successors; and fiduciary duties of members toward each other.

A. Mode of Operation and Division of Power

Most limited liability company statutes delegate internal management issues to the operating agreement adopted by the parties.[15] The statutory management provisions come into play only where the parties have not agreed.[16] In fact, it will be the rare case in which the default management provisions govern exclusively, because the parties will usually have agreed on *something*, if only implicitly. Moreover, important elements of their agreement will often be gleaned from how the parties actually operated and interacted with one another before the dispute arose.[17] Nevertheless, a brief look at the default positions under several statutes helps set the stage for situations in which the parties attempt variations on the statutory theme.

Some limited liability company statutes follow the partnership model and provide for governance in the ordinary course of business by the members on a one-person, one-vote and majority rule basis.[18] Others follow the

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15. *See infra* notes 24-25 and accompanying text. The limited liability company operating agreement is a very close analog of the partnership agreement in the partnership setting. *See generally* REVISED UNIF. PARTNERSHIP ACT §§ 101(5), 103 (1993) [hereinafter RUPA].

16. UNIF. LTD. LIAB. CO. ACT § 103(a) (1995) [hereinafter ULLCA] ("To the extent the operating agreement does not otherwise provide, this [Act] governs relations among the members, managers, and company.").

17. For example, in Katcher v. Ohsman, 97 A.2d 180 (N.J. Super. Ct. Ch. Div. 1953), plaintiff asserted that he had come into the business as a one-third shareholder with the oral assurance that he would have a veto power. *Id.* at 182. For 14 years, all business was conducted only upon unanimous approval of the three participants. *Id.* When the other two then tried to remove him as both officer and director by majority vote, the court accepted plaintiff's claims concerning the earlier oral agreement. *Id.* at 183.

18. *See, e.g.*, ULLCA § 405 (1995); ARIZ. REV. STAT. ANN. § 29-681 (Supp. 1994); IDAHO CODE § 53-623(1) (1994); OR. REV. STAT. §§ 63.130, 63.150(2) (Supp. 1994). Colorado does not expressly

corporate law model more closely and provide for voting in accordance with profit interests[19] or capital contributions.[20] Not all can be "right" in matching their default positions to the expectations of people who organize limited liability companies without negotiating the allocation of rights and duties and making explicit variations from their state's default mode.[21]

Consider, for example, the simple problem of two persons, A and B, who form a limited liability company.[22] A contributes the initial capital and B is deemed the active party managing the business. A and B orally agree that they will have an equal say in the business and that B will earn her "equal partner" status after two years. The implicit assumption is that B's initial salary is below market to account for B's capital contribution. If a dispute arises within the two-year period and A tries to fire B, B may be out of luck in states like California or Delaware that require deviations

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limit residual managerial power to the ordinary course of business. COLO. REV. STAT. ANN. § 7-80-401(2) (West Supp. 1994) (reserving management of the company's "business and affairs" to the members absent an article provision vesting managerial power in managers). Minority interests adverse to the majority in Colorado limited liability companies may find themselves frozen out of operations or employment, and they may have no realistic avenue of escape if the operating agreement prohibits resignation. Section 7-80-602 allows resignation at any time but provides for damages if resignation breaches the operating agreement. *Id.* § 7-80-602.

19 *E.g.*, CAL. CORP. CODE § 17103(a)(1) (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1994). In both states, these provisions are subject to variation only through an article provision or a *written* operating agreement. CAL. CORP. CODE § 17005(b); DEL. CODE ANN. tit. 6, § 18-101(6) (defining a "limited liability company agreement" to be a written agreement). This may cause some surprises for people who actually want the partnership model but, as often happens, fail to specify their choice with sufficient formality.

Like Colorado, *see supra* note 18, California does not require unanimous consent for matters outside the ordinary course of business. CAL. CORP. CODE § 17103(a)(2) (requiring a unanimous vote only for decisions to continue the business after dissolution, to approve transfers of membership interests and admissions of the assignee as a member, and to amend the articles or the operating agreement); *id.* § 17103(a)(3) (setting a majority vote as sufficient in all other matters). Delaware's default position, too, makes a greater than 50% interest controlling on all matters. DEL. CODE ANN. tit. 6, § 18-402. In California or Delaware limited liability companies, therefore, a minority interest that has ceded the statutory withdrawal right in the operating agreement may be vulnerable to freezeouts from employment and other activity in the company.

20. Inouye, *supra* note 3, at 138 (citing statutes from Florida, Nevada, Virginia, and Wyoming).

21. Parties in one state may choose to organize under the limited liability company statute of another, much as many corporations, both large and small, from many states now do under Delaware law. It will take a long time, however, before lawyers understand limited liability company statutes well enough to know which ones work best under which circumstances. Even more time will pass before a single state statute is recognized as so superior to the others that it becomes the "Delaware" of limited liability company statutes. Moreover, there may be practical, and even theoretical, barriers to out-of-state formation. *See* Ribstein, *supra* note 11, at 474 n.258.

22. This example is based on a problem presented in one of the popular corporations casebooks. HAMILTON, *supra* note 4, at 365.

from the default voting provisions (based on profit interests) to be in writing.[23] Moreover, even if B successfully resists A's termination efforts, B will find herself without power to raise her salary to market value after she has worked for two years to earn her capital contribution.

The statutes tend to permit major, if not total, variation from the statutory default provision through member-adopted operating agreements, although the statutes distinguish themselves into those that do[24] and those that do not[25] require operating agreements to be in writing. For matters that need not be in writing, even initially vague agreements may take more concrete form by inference from actual operations, and this may be the single most important feature of these statutes for participants seeking, for example, to claim veto powers (i.e., that no nonunanimous actions will be taken) or to maintain employment positions. On the other hand, A, in the example considered above, is in a difficult position if he has ceded managerial authority to B but feels that B's policies are running the company into the ground. A could force liquidation, assuming it is a legally viable choice for A (i.e., not explicitly or implicitly violative of the operating agreement), but liquidation can wipe out any going-concern value of the company and maybe its remaining assets in the process. Still, the requirement that the operating agreement can be amended only by unanimous consent[26] means that A is stuck with leaving B in charge unless he can get a court to intervene.

Things get even murkier if the statute requires something to be in writing

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23. *See supra* note 19.

24. DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1994).

25. ULLCA § 103(a) (1995); ARIZ. REV. STAT. ANN. § 601(11) (Supp. 1994); CAL. CORP. CODE § 17001(ab) (West Supp. 1995); COLO. REV. STAT. ANN. § 102(11) (West Supp. 1994); IDAHO CODE § 53-601(11) (1994); OR. REV. STAT. ANN. § 63.001(18) (Supp. 1994). California requires an article provision or a written operating agreement to vary the default provisions on amending the operating agreement, voting, meetings, appointment and removal of managers and officers, and indemnification. CAL. CORP. CODE § 17005(b). Colorado requires a written operating agreement to vary the statutory requirement for unanimity for admission to membership or for participation of transferees of interests in the management, to vary the statutory dissolution requirements, or to vary the other statutory requirements for a writing. COLO. REV. STAT. ANN. §§ 7-80-102(11) & 108(3).

26. *See, e.g.*, ULLCA § 404(c)(1) (1995); ARIZ. REV. STAT. ANN. § 29-681(C)(1) (Supp. 1994); CAL. CORP. CODE § 17103(a)(2)(C) (West Supp. 1995); IDAHO CODE § 53-623(2) (1994). Some of the statutes, in their default position, may permit amendment of operating agreements by simple majority vote. *See, e.g.*, OR. REV. STAT. ANN. § 63.150(3)(c) (Supp. 1994). Even this would not help A in our example, however, because A's vote does not constitute a majority. Of course, power to amend by majority vote coupled with retention by A of majority voting power (e.g., until B earns her full capital contribution) shifts the balance of power back to A and, in practice, nullifies any protection for continued employment that B can expect from an operating agreement.

and the parties agree only orally.[27] Some courts undoubtedly will enforce such oral agreements between the parties, at least as long as third-party rights are not involved, in the manner of the progressive close corporation cases.[28] Other courts, however, will reason that a statutorily prescribed method for accomplishing a particular result invalidates nonstatutory means of reaching the same result.[29] Consequently, it will be largely fortuitous if the default statutory provisions on allocation of control in the limited liability company actually match the expectations of the parties in a particular case. Active participation of counsel at the formation stage seems imperative.[30]

B. Mode of Operation and Third-Party Liability

Probably the major reason for the sudden development of limited liability company statutes is the possibility of combining partnership flow-through taxation with limited liability.[31] Although limited liability companies involve more formation formalities than partnerships, such as the filing of articles,[32] many people will wish to operate their limited liability companies with the informality of a partnership. They should realize, however, that excessive informality, such as casual commingling of assets, may jeopardize the very limited liability they seek in adopting the limited liability company form.

Some limited liability company statutes deal expressly with the "piercing the veil" or "alter ego" problem. California applies the corporate law rules

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27. Operating agreements in Delaware must be in writing. DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1994).

28. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577 (1964) (upholding a nonunanimous agreement among controlling members of close corporation that impinged on traditional board powers but affected no third-party rights).

29 *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1992) (en banc) (refusing special relief for minority shareholders in closely held enterprise that did not meet the statutory definition of "close corporation"); *see also* Karjala, *A Second Look*, *supra* note 1, at 1254-55.

30 Allocating managerial control in the limited liability company context may be even more complex than for traditional closely held corporations, because the parties will not be able to rely on traditional concepts like the board of directors, common stock, preferred stock, share classifications, and supermajority quorum and voting requirements. If the parties desire a more nearly corporate, as opposed to partnership, structure, the attorney drafting the operating agreement will essentially have to define all of these concepts anew.

31. *See generally* ULLCA prefatory note (1995) ("The allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms—properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.").

32. ULLCA § 202(a) (1995).

for piercing the corporate veil to limited liability companies.[33] Colorado also adopts the corporate law jurisprudence, with the additional proviso that failure to follow formalities is not a ground for imposing personal liability.[34] The Uniform Limited Liability Company Act provides simply that failure to observe the usual corporate formalities is not a ground for imposing personal liability.[35] The Arizona, Delaware, Idaho, and Oregon statutes do not expressly adopt the corporate law rules for piercing.[36] For all states, however, the policy reasons for piercing the corporate veil when justice requires apply with equal force to limited liability companies. Consequently, we may assume that the courts will in fact pierce the "limited liability company veil" even in states whose statutes do not explicitly adopt the corporate law rules.

This creates a planning problem: clients must be made to understand the need to maintain a distinction between themselves and the company. If the company alone is to be liable for its debts, it must be given some independent economic existence that is respected by the parties. The formal structure of corporations, while not always followed in closely held enterprises, can serve as a useful reminder that the corporate assets, for example, belong to the corporation and not to the individual shareholders.[37] Conversely, elimination of formal structural differences between the members of limited liability companies and the company itself can blur or even eliminate in the minds of the human participants the notion that the

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33. CAL. CORP. CODE 17101(b) (West Supp. 1995). The statute further states that failure to hold meetings or to observe the formalities associated with meetings is not a factor in piercing where the constituent instruments do not expressly require the holding of meetings. *Id.* This purported exception is unfortunate, because it invites a negative implication that the failure to observe these formalities *is* a factor if the operating agreement does require meetings. In the corporation setting, the failure to observe internal governance formalities is rarely the sole basis for piercing the limited-liability veil. *See* DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 686 n.14 (4th Cir. 1976); *cf.* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1067-68 (1991) (finding that failure to follow formalities is not as good a predictor of piercing determinations as a number of other factors).

34. COLO. REV. STAT. ANN. § 7-80-107 (West Supp. 1994).

35. ULLCA § 303(b) (1995).

36. However, Arizona and Oregon, along with Colorado, do adopt various versions of the corporate law rule for preincorporation liability. ARIZ. REV. STAT. ANN. § 29-652 (Supp. 1994) (liability for "persons who assume to act as a limited liability company without authority to do so"); COLO. REV. STAT. ANN. § 7-80-105 (West Supp. 1994) (same); OR. REV. STAT. § 63.054 (Supp. 1994) (liability for "persons purporting to act as or on behalf of a limited liability company" with knowledge of its nonexistence).

37. *See* Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1, at 678-80, 699 (discussing formal structures in closely held corporations).

company is a separate legal entity.

C. *New Entrants in the Company*

It is common for the participants in closely held enterprises to invite new members to join after formation, often pursuant to oral (and vague) arrangements.[38] In contrast to the formation stage, attorneys often are not consulted when the deal is struck. In the partnership setting, admission of a new partner normally requires unanimous consent of the partners,[39] but no particular formality is required for the consents. The corporate setting will usually involve some explicit negotiation for acquisition of shares by the new entrant, either from the corporation or from a departing shareholder, but often the deal is made without any further changes in the constituent instruments. When disputes arise concerning the nature and enforceability of these transactions, perhaps many years later, courts may have to determine the reasonable expectations of the parties using little more than evidence of actual operations to guide them as to the actual terms of the deal.[40]

The limited liability company statutes tend to treat the question of new entrants in some detail. The default position is typically unanimous consent for admission, whether the new interest is issued by the company or acquired from an existing member.[41] The situation in these cases is the same as the default position in the partnership, and if unanimous consent is expressed the admission will be effective and enforceable, to the extent the court can actually decipher the agreement. California and Delaware require, however, in addition to unanimous consent, that the new entrant become a party to the operating agreement or that her admission be reflected on the company records.[42] We can be certain that formal

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38. *See, e.g.*, B & B Equip. Co. v. Bowen, 581 S.W.2d 80 (Mo. Ct. App. 1979) (coupling an employment agreement with a stock purchase agreement, so that breach of the former was a ground for rescission of the latter); Katcher v. Ohsman, 97 A.2d 180, 183-84 (N.J. Super. Ct. Ch. Div. 1953) (treating an agreement to take action only by unanimous consent as an implied bylaw).

39. UNIF. PARTNERSHIP ACT § 18(g) (1914) [hereinafter UPA]; RUPA § 401(i) (1993).

40. *See* Karjala, *A Second Look*, *supra* note 1, at 1233-37 (discussing new entrants in close corporations).

41. *E.g.*, ULLCA §§ 404(c)(7), 503(a) (1995); ARIZ. REV. STAT. ANN. § 731(B) (Supp. 1994); COLO. REV. STAT. ANN. §§ 7-80-701 to 702(1) (West Supp. 1994); OR. REV. STAT. § 63.245(2) (Supp. 1994); *see also* IDAHO CODE § 53-638(1) to 640(1) (1994) (requiring unanimous consent unless otherwise provided in the operating agreement).

42. *See* CAL. CORP. CODE § 17100(a) (West Supp. 1995) (acquisition from the company); *id.* § 17303(a) (acquisition from a member). Both California provisions require that the new entrant become a party to the operating agreement. *See also* DEL. CODE ANN. tit. 6, § 18-301(b) (Supp. 1994)

accession to the operating agreement and reflection on the company records will not always be followed. When a dispute later arises, one side or the other will point to the missing formal action as a basis for denying the new entrant's membership in the company.

D. Oppression of Inactive Members and Their Successors

A major problem for closely held businesses that involve both active and inactive participants is that individual participants' goals and needs may change over the life of the business. Family businesses pass on to the next generation, often with shifts of control that lead to a falling out among the participants.[43] Divorce can upset the original agreement concerning salary arrangements for the active party.[44] The absence of dividend payments to minority members while the controlling parties are receiving hefty salaries and benefits begins to rankle.[45] The financing partner who fails to negotiate a cap on his required contributions but has otherwise ceded control to the active partner becomes uneasy as costs rise beyond expectations.[46] The basic jurisprudential problem in these and similar situations is defining the circumstances in which, and the extent to which, parties in these predicaments are entitled to judicial relief.

Partnership law addresses the problem by giving partners the power to withdraw at any time, coupled with a right to a payout of the value of their interests.[47] Of course, a withdrawing partner may be liable for damages if she withdraws in contravention of the partnership agreement or prior to the end of the agreed term or project,[48] and this can be a strong disincentive to the exercise of the power.[49] Nevertheless, whatever penalty arises from wrongful withdrawal is the result of express bargaining among the participants, which reduces the flavor of unfairness in many cases.

Traditional corporation law provides no power of withdrawal for outside,

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(acquisition from the company); *id.* § 704(1) (acquisition from a member). Both Delaware provisions require that the new entrant's admission be reflected on the records of the company.

43. *See, e.g.*, Brenner v. Berkowitz, 634 A.2d 1019 (N.J. 1993) (falling out between two sisters after the husband of one took full control of the business upon the death of the father).

44. *See, e.g.*, Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974).

45. *See, e.g.*, Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947).

46. Collins v. Lewis, 283 S.W.2d 258 (Tex. Civ. App. 1955).

47. UPA §§ 31(1)(b), 31(2), 42 (1914); RUPA §§ 601(1), 701 (1993). The 1914 UPA speaks of events of "dissolution," while the 1993 statute's notion of withdrawal from the enterprise is referred to as "dissociation." The distinctions are largely unimportant for purposes of the present discussion, so I try to use the term "withdrawal" to include the relevant events under both versions of the UPA.

48. UPA § 38(2)(a)(II) (1914); RUPA § 701(c) (1993).

49. *See* Karjala, *A Second Look*, *supra* note 1, at 1229 n.102.

noncontrolling shareholders, with the result that substantial investments can be tied up indefinitely with minimal or even no return.[50] Rights of withdrawal can, of course, result from negotiations and appropriate placement in the constituent instruments or shareholder agreement, but the 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. The law's response has been the creation of a mechanism for judicial dissolution in a proceeding initiated by a shareholder where those in control have acted in an "oppressive" manner.[51] "Oppression" is interpreted in terms of the reasonable expectations of the shareholders.[52]

The limited liability company statutes address this problem from both ends, sometimes, perhaps, allowing justice to fall through the crack in the middle. First, their default position follows the partnership model by providing an absolute right of withdrawal, which leads to dissolution and winding up of the business unless the operating agreement provides otherwise or the remaining members consent unanimously to its continuation.[53] Some limited liability company statutes continue the partnership model by allowing even withdrawals that are in breach of a provision of the operating agreement but holding the withdrawing member liable for damages.[54] Other states allow the operating agreement to remove the right of withdrawal completely (placing noncontrol members of the company in the same position as the traditional corporate minority shareholder).[55]

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50. This problem, referred to as minority shareholder oppression, has a voluminous literature. *See, e.g.*, Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699 (1993).

51. RMBCA § 14.30(2)(iii) (1993).

52. *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1176-77, 1179 (1984); *see* Karjala, *Analysis of Close Corporation Legislation*, *supra* note 1, at 674-77.

53. *See, e.g.*, ULLCA §§ 602(a), 801(3) (1995); ARIZ. REV. STAT. ANN. §§ 29-734, 29-781(A) (Supp. 1994); CAL. CORP. CODE §§ 17252(a) (West Supp. 1995) (requiring six months' written notice before withdrawal); *id.* § 17350(d); COLO. REV. STAT. ANN. §§ 7-80-602, 7-80-801(1)(c) (West Supp. 1994); DEL. CODE ANN. tit. 6, § 18-603 (Supp. 1994) (requiring six months' written notice before withdrawal); *id.* § 18-801(4); IDAHO CODE § 53-641(3) (Supp. 1994) (requiring 30 days' written notice before withdrawal); *id.* § 53-642(3); OR. REV. STAT. § 63.205(1)(b) (Supp. 1994) (requiring six months' written notice before withdrawal); *id.* § 63.621(4) (providing that right of continuation must be in a written operating agreement).

54. ULLCA § 602(c) (1995); ARIZ. REV. STAT. ANN. § 29-734 (Supp. 1994); COLO. REV. STAT. ANN. § 7-80-602 (West Supp. 1994).

55. CAL. CORP. CODE § 17252(a) (West Supp. 1995) (operating agreement may deny withdrawal right or specify remedies for wrongful withdrawal); DEL. CODE ANN. tit. 6, § 18-603 (Supp. 1994) (operating agreement may provide that a member may not resign prior to winding up); IDAHO CODE

The limited liability company statutes will thus raise few problems of oppression for noncontrol members of the company, or their successors, to the extent the operating agreement does not limit or deny withdrawal rights. An unhappy member can simply withdraw and be paid the value of her interest.[56] The problems will arise when the operating agreement does limit or deny withdrawal rights. Given the liquidity difficulties that an absolute right of withdrawal can generate,[57] most attorneys will probably advise their clients to include withdrawal rights limitations in the operating agreement.[58] This pattern may raise the same issues over which so much

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§ 53-641(3) (1994) (operating agreement may deny power to withdraw; moreover, if a member has power to withdraw, any withdrawal in breach of the operating agreement gives rise to damages); OR. REV. STAT. § 63-205 (Supp. 1994) (articles or operating agreement may deny power of voluntary withdrawal; moreover, any power to withdraw exercised in breach of the articles or the operating agreement gives rise to damages).

56. Such freedom of withdrawal does raise, however, the problem of premature termination of the company at the behest of a minority member.

57. *See, e.g.*, Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 69 (1982).

58. Some statutes require that limited liability companies have two or more members, which can also affect the analysis of withdrawal rights. *See, e.g.*, ARIZ. REV. STAT. ANN. § 29-632(A)(3) (Supp. 1994) (requiring a statement in the articles that there will be two or more members upon formation); CAL. CORP. CODE §§ 17001(t), 17050(b) (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-101(5) (Supp. 1994); OR. REV. STAT. § 63.001(12) (Supp. 1994). It is not clear how this requirement affects a power to continue the business upon the death or withdrawal of a member from a two-member company. These statutes provide that death, withdrawal, etc., cause a dissolution "except as otherwise provided in the operating agreement," which implies power to continue the business if the operating agreement so provides. What is unclear is whether any such continuation of the business by the single remaining member is as a sole proprietorship (with unlimited liability) or as a limited liability company. The two-member requirement implies the former, which means the loss of limited liability. The Oregon statute reinforces this interpretation by providing, in addition, for continuation of the business upon the vote of specified percentages in the operating agreement if there are at least two remaining members. OR. REV. STAT. § 63.621(4). On the other hand, some statutes expressly provide that a limited liability company continues to exist until cancellation of its certificate. CAL. CORP. CODE § 17356(3); DEL. CODE ANN. tit. 6, § 18-201(b). This language implies the ongoing existence of the limited liability company if the business is continued pursuant to the operating agreement. Such an interpretation leaves open, however, just what the two-member requirement means in these states. Arizona poses yet different interpretation problems, because its statute only requires a statement in the articles that there are two or more members at the time of formation. ARIZ. REV. STAT. ANN. § 29-632(A). Perhaps Arizona does not even have an ongoing two-member requirement.

Some limited liability company statutes have provisions analogous to Model Business Corporation Act § 139 (1969) or RMBCA § 2.04 (1993) covering liability for "preincorporation transactions." *E.g.*, ARIZ. REV. STAT. ANN. § 29-652; OR. REV. STAT. § 63.054. A single remaining member exercising a power to continue the business might also be inviting liability under these provisions, on the ground that she is acting on behalf of a nonexistent limited liability company (nonexistent because it no longer has two members).

ink has been spilled in the close corporation minority shareholder oppression debate, complicated by the absence in many LLC statutes of fair and reasonable provisions for judicial dissolution.

We might consider a few examples based on corporation case law. A famous case is *In re Radom & Neidorff, Inc.*,[59] in which two equal shareholders operated a very profitable music publishing business for many years. The business generated good earnings on essentially no fixed assets, which permits the conclusion that its success was based largely on the personal goodwill built up over the years by its two active participants. Upon Neidorff's death, his shares devolved on his wife, who happened to be the sister of the other shareholder, Radom. Brother and sister were on very bad terms with one another, and Radom sought judicial assistance in the form of a dissolution order.

It is clear that neither of the extreme remedies—immediate dissolution or permanent sharing by Mrs. Neidorff in future profits—is equitable. Immediate dissolution would allow Radom to make off with all of the company's current goodwill, half of which (presumably) was built up by Neidorff and rightfully belongs to Mrs. Neidorff. On the other hand, the continued goodwill over the long term will be increasingly the result of Radom's efforts, so Mrs. Neidorff's claim to share in the profits should properly attenuate with time. The best solution is a buyout of Mrs. Neidorff's interest at a price that takes into consideration the value of the company's goodwill at the time of Neidorff's death.

While the corporate statute, as interpreted by the New York Court of Appeals, led to a resolution overly favorable to Mrs. Neidorff,[60] the limited liability company statutes would have led automatically to the solution favoring Radom.[61] Because the limited liability default settings mirror the withdrawal provisions of partnership law, Neidorff's death would have caused dissolution of the company and a sale of its assets. There is no reason to think that anyone other than Radom would have bid on the goodwill, because it was personal to him, so the (minimal) existing assets would simply have been divided and he could have gone his separate way. Mrs. Neidorff would have received nothing for the value of Neidorff's share of the goodwill. Consequently, it is as imperative in the limited liability company context as in the corporate context for the parties to

59. 119 N.E.2d 563 (N.Y. 1954).

60. The New York Court of Appeals affirmed the dismissal of the dissolution petition and upheld Mrs. Neidorff's right to share in the continuing profits of the firm. *Id.* at 565.

61. *See supra* notes 53-55 and accompanying text.

negotiate a buyout provision, before the events triggering dissolution occur, that insures fair treatment of both the departing member and those who continue active in the business.

Another famous corporate law case suitable for testing the operation of limited liability company statutes is *Kruger v. Gerth*,[62] in which the New York Court of Appeals denied the dissolution demand of a minority shareholder who had inherited forty-six percent of a company with a net worth of $100,000. The minority shareholder complained that the company perpetually showed negligible earnings after payment of the salary (and bonus) of the majority shareholder. The result was that the majority shareholder could make permanent use of the minority shareholder's $46,000 investment in the company to generate a return payable solely to himself.

Had this been a limited liability company operating under the statutory default settings, death of the original minority shareholder would have triggered dissolution and eliminated the problem. If, however, the original parties had agreed that death would not trigger a dissolution and that the remaining party could continue the business on death, the *Kruger* plaintiff, the minority member's successor, may not even be a member of the company, an even worse outcome than under today's corporate law.[63] Even under a statute that permits withdrawal in breach of the operating agreement,[64] the successor who is not a member could not force a buyback of her interest by withdrawing, because there is no membership from which to withdraw. Moreover, as a nonmember, the successor may

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62. 210 N.E.2d 355 (N.Y. 1965).

63. Admission of an assignee to membership requires unanimous consent of the other members. *See supra* notes 41-42 and accompanying text. Under the default positions, assignees of interests in limited liability companies who are not admitted to membership simply receive whatever distributions their assignor would have been entitled to receive and have no right to participate in management. ULLCA § 502 (1995); ARIZ. REV. STAT. ANN. § 29-732(A) (Supp. 1994); CAL. CORP. CODE § 17301(a)(2)-(3) (West Supp. 1995); COLO. REV. STAT. ANN. § 7-80-702(1) (West Supp. 1994); DEL. CODE ANN. tit. 6, § 18-702(a), (b)(1) (Supp. 1994); IDAHO CODE § 53-636(b)-(c) (1994); OR. REV. STAT. § 63.249(2)-(3) (Supp. 1994). Some statutes expressly give the representative of a deceased member only the rights of an assignee. COLO. REV. STAT. ANN. § 7-80-704; IDAHO CODE § 53-639. The ULLCA and the Arizona statute have no express reference to the rights of a deceased member's representative, which presumably leaves representatives in the position of an assignee as well. California, Delaware, and Oregon give the deceased member's representative all the rights of a member for the purpose of settling the member's estate. CAL. CORP. CODE § 17304(a); DEL. CODE ANN. tit. 6, § 18-705; OR. REV. STAT. § 63.265. In these states, the deceased member's representative would have standing to petition for dissolution as a member, for example, but that power would (presumably) not pass on to the successor to the decedent's interest in the company.

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

lack technical standing to seek judicial dissolution.[65]

As discussed above, the judicial dissolution provisions in the corporation setting have become the primary weapon for the oppressed minority shareholder to obtain a return of her investment.[66] The default position of the limited liability company statutes normally permits relatively free withdrawal by members.[67] Therefore, minority or inactive member oppression should not be a significant problem for companies operating in the statutory default setting. Possibly because the drafters of these statutes viewed the limited liability company primarily as a partnership (with partnership law's nonwaivable power to force dissolution), the judicial dissolution provisions in some of the statutes are more stringent than the modern corporation statutes and appear to leave less to the discretion of the court.[68] The drafters of these limited liability company statutes seem to have forgotten that they allow absolute denial of withdrawal rights in the operating agreement. In these circumstances, not just successors of members but even members themselves may find courts unwilling to come to their assistance because of the limited circumstances in which the statutes authorize the dissolution remedy.

For example, in Arizona, Delaware, and Oregon, a court may order dissolution in an action by a member if it is established that it is "not reasonably practicable to carry on the business" according to the articles or an operating agreement.[69] Yet it is often possible to carry on the business while freezing a minority interest out of any return. Colorado has no provision for judicial dissolution on application by a member under any circumstances. Idaho provides for judicial dissolution on application by a member when the acts of those in control are "illegal, oppressive or fraudulent *and* . . . irreparable injury" is being threatened to or suffered by

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65. The statutes seem generally to permit judicial dissolution upon the petition of a "member." *See, e.g.*, ULLCA § 801(5) (1995); ARIZ. REV. STAT. ANN. § 29-785(A) (Supp. 1994); CAL. CORP. CODE § 17351 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-802(a) (Supp. 1994); IDAHO CODE § 53-643 (1994); OR. REV. STAT. § 63.661(2) (Supp. 1994). Colorado has no provision for judicial dissolution, even upon petition, by a member. COLO. REV. STAT. ANN. § 7-80-808 (West Supp. 1994) (permitting judicial dissolution and liquidation in actions by the attorney general, a creditor, or the company itself).

66. *See supra* notes 51-52 and accompanying text.

67. *See supra* notes 53-55 and accompanying text.

68. *Compare* DEL. CODE ANN. tit. 6, § 18-802 (Supp. 1994) (allowing a court to order dissolution of a limited liability company where it is "not reasonably practicable to carry on the business") *with* RMBCA § 14.30 (1993) (providing various grounds for judicial dissolution of a corporation, including oppression and deadlock).

69. ARIZ. REV. STAT. ANN. § 29-785 (Supp. 1994); DEL. CODE ANN. tit. 6, § 18-802 (Supp. 1994); OR. REV. STAT. § 63.661(2) (Supp. 1994).

the company.[70] Idaho's conjunctive requirement for irreparable injury severely narrows the modern corporate grounds for judicial dissolution. Of the statutes I have considered, only the Uniform Limited Liability Company Act follows the modern, liberal corporate model permitting judicial dissolution when those in control act in an "illegal, oppressive, fraudulent or unfairly prejudicial" manner toward the petitioning member.[71] California, perhaps, comes close by permitting judicial dissolution in an action by a member when dissolution is "reasonably necessary for the protection of the rights or interests of the complaining members" or when those in control have "knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority."[72]

Even if we assume that the operation of the company in *Kruger v. Gerth* would today be fairly labelled "oppressive" under the modern corporation statutes, a minority member of a limited liability company in similar circumstances who has ceded withdrawal rights could expect no judicial assistance in Arizona, Colorado, Delaware, Idaho, or Oregon.[73] The problem is not that the business cannot practicably be carried out under the operating agreement. It is rather that the operating agreement is inequitably benefiting only one of the members, essentially in perpetuity, and it is unfair to allow the situation to continue indefinitely. In other words, the limited liability company statutes in these states allow no leeway to members who make a bad initial deal, or to their successors. Even in California, relief would not depend on the finding of "oppression," a term with which courts have familiarity from the corporate context, but rather on an interpretation of the entirely new phrase "reasonably necessary for the protection of the rights or interests of the complaining members."[74]

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70. IDAHO CODE § 53-643(2) (1994) (emphasis added).

71. ULLCA § 801(5)(v) (1995). The Uniform Act also permits dissolution in an action by a member for unreasonable frustration of economic purpose (which might cover the *Kruger v. Gerth* situation discussed in the text accompanying *supra* note 62, assuming that the decedent member's successor has standing to bring the action), if it is not reasonably practicable to carry on the business with a particular member or in conformance with the operating agreement, or a dissociated member's interest has not been duly purchased when required. *Id.* § 801(5)(i)-(iv).

72. CAL. CORP. CODE § 17351(2), (5) (West Supp. 1995). California also permits the action if it is impracticable to carry on the business in conformance with the operating agreement, when the business has been abandoned, or when the management is deadlocked or subject to internal dissension. *Id.* § 17351(1), (3), (4).

73. *See supra* notes 69-70 and accompanying text.

74. CAL. CORP. CODE § 17351(2) (West Supp. 1995). What the majority shareholder in *Kruger* knowingly countenanced was clearly "persistent" and perhaps even "pervasive," but it is difficult to label as "fraud, mismanagement, or abuse of authority." *See id.* § 17351(5). Note that a California court

Only the Uniform Limited Liability Company Act, among the statutes considered here, clearly gets to the "right" result—allowing judicial dissolution notwithstanding that the parties have agreed to give up their right to withdraw at will—on the facts of *Kruger* (and then only on the assumption that the decedent member's successor has standing).

Minority interests can be particularly vulnerable in states like California and Delaware, which require operating agreements to be in writing and which permit in their default positions all business decisions to be made by majority vote.[75] Consider the holder of a minority interest in such a limited liability company who has ceded, in the operating agreement, his statutory withdrawal right but is brought into the business under an oral promise of continued employment. Technically, the oral promise cannot be part of the operating agreement. Thus, there is no breach or amendment of the operating agreement if the majority interest later terminates the minority member's employment. Judicial dissolution is available in Delaware only if it is impracticable to carry on the business under the operating agreement, which is not the case on these facts. In California, judicial assistance will be available if the court determines that dissolution is "reasonably necessary for the protection of the rights and interests" of the minority party. Whether that is the case on these facts depends on whether the minority party has a "right" to or "interest" in employment, notwithstanding that this right or interest is not guaranteed by the operating agreement.

There is a fairly clear lesson here: parties who form limited liability companies and who seek to protect their investments against loss due to premature termination by denying in the operating agreement the statutory default right of free withdrawal should at the same time make explicit provision for withdrawal at *some* time or under *some* conditions before ceding operational control to a subset of their group. This will not be an easy drafting job, nor can we expect that the parties who draft limited withdrawal rights will envision accurately all of the circumstances that will actually develop over time. The best general solution would be to amend the limited liability company statutes to follow the Uniform Limited Liability Company Act's provisions on judicial dissolution (probably with

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could read the "fraud, mismanagement, or abuse of authority" language as a narrowing of the corporate law "oppression" ground for judicial dissolution. If it did so, then even if the decedent member's successor has standing to bring the action, the court could also conclude that so long as the operating agreement is not breached, no rights or interests of the complainant are in need of protection, and thereby deny judicial dissolution under either subsection (2) or subsection (5).

75. *See supra* note 19.

some express provision for operation-of-law successors in interest who are not "members").

E. Fiduciary Duties in General

Partners have both a specific duty to account for profits earned from any use of partnership property[76] and a vaguer, more general duty of loyalty.[77] In the corporation setting, directors must sanitize self-dealing transactions either by securing the approval of the independent shareholders or directors or by proving the fairness of the transaction.[78] In addition, a growing body of case law for close corporations establishes a general majority shareholder fiduciary duty to treat the other shareholders fairly.[79] Such a duty also has been applied by at least some courts to minority shareholders.[80]

It is, of course, too early to predict what kinds of common law fiduciary duty principles the courts will develop for limited liability companies. The statutorily prescribed duties, however, exhibit a broad dispersion. In California, members of limited liability companies owe each other the same duties as partners.[81] Idaho also adopts the partnership principle by requiring, except as otherwise provided in the operating agreement or with the consent of a majority of the disinterested members, an accounting for transactions connected with the conduct of the company or any use of its property.[82] The Uniform Limited Liability Company Act imposes a similar

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76. UPA § 21 (1914); RUPA § 404(b)(1) (1993).

77. *See* Meinhard v. Salmon, 164 N.E. 545 (1928) ("Not honesty alone, but the punctilio of an honor the most sensitive, is . . . the standard of behavior."). The latest version of the UPA attempts to restrict the duty of loyalty to its statutory provisions. RUPA § 404(a) (1993).

78. RMBCA §§ 8.60-8.63 (1993).

79. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975) (noting that members in close corporations owe each other a duty of good faith more stringent than the standard of fiduciary duty between corporate directors and shareholders). Courts have generally followed *Donahue* in requiring control groups in closely held corporations to allow minority shareholder participation in stock redemption transactions. *See* HAMILTON, *supra* note 4, at 436-38. Other courts have extended the *Donahue* principle to assist shareholders seeking to maintain a previously agreed balance of voting power. Cressy v. Shannon Continental Corp., 378 N.E.2d 941, 945-46 (Ind. Ct. App. 1978); Hallahan v. Haltom Corp., 385 N.E.2d 1033, 1034 (Mass. App. Ct. 1979).

80. *E.g.*, Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 802-03 (Mass. App. Ct. 1981) (holding that a minority shareholder who possessed veto power had a duty not to refuse dividends where the result of refusal was possible investigation by the Internal Revenue Service).

81. CAL. CORP. CODE §§ 17150, 17153 (West Supp. 1995).

82. IDAHO CODE § 53-622(2) (1994). If the company is managed by managers, an Idaho member who is not a manager has no fiduciary duties when acting solely in the capacity of a member. *Id.* § 53-622(3). Idaho also imposes a duty of care, with liability limited to gross negligence or willful

duty of loyalty that is not subject to elimination in the operating agreement.[83] It also imposes duties to refrain from dealing with the company as an adverse party and to refrain from competing with the company,[84] and explicitly provides that there are no fiduciary duties other than those covered by the statute.[85] The Uniform Act also specifies that a member does not violate a duty merely because his conduct furthers his own interest.[86] Colorado and Oregon impose only a duty of care.[87] Delaware does not expressly incorporate any duties but provides that, with respect to whatever duties the law imposes, there is no liability to the extent of good faith reliance on the operating agreement and that the duties can be expanded or restricted by the operating agreement.[88] The Arizona statute makes no reference to duties of members at all. Again, the best way to test these provisions is by way of example.

In *Donahue v. Rodd Electrotype Co.*,[89] the controlling family used corporate assets to buy back shares from a family member at what we may assume was fair market value. The minority shareholder did not complain about the price or claim that the corporation had a better use for the money. Rather, she claimed that she should have been permitted to participate in the deal pro rata, because there was no other market for her shares. The court held for the plaintiff on the ground that the controlling family was using the corporate assets to create a market for the company's shares and that these assets should be used for the benefit of the shareholders generally and not simply those in control.[90]

In the corporate setting, control can be finely tuned through share ownership, so a buyout of only some of the shares can leave the same

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misconduct. *Id.* § 53-622(1).

83. ULLCA §§ 103(b)(2), 409(b)(1) (1995). The operating agreement may, however, identify "categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable," and specify the number of disinterested members who may ratify upon full disclosure. *Id.* § 103(2)(i)-(ii). The Uniform Act also imposes a duty of care, limiting liability to cases of grossly negligent, reckless, or willful conduct or knowing violations of law. *Id.* § 409(c).

84. *Id.* § 409(b)(2)-(3). On the other hand, a member is permitted to "lend money to and transact other business with the company." *Id.* § 409(f). In addition, all duties must be discharged consistently with the "obligation of good faith and fair dealing." *Id.* § 409(d).

85. *Id.* § 409(a).

86. *Id.* § 409(e).

87. COLO. REV. STAT. ANN. §§ 7-80-401(2), 7-80-406(1) (West Supp. 1994); OR. REV. STAT. §§ 63.130, 63.155 (Supp. 1994). These statutes require members to carry out their duties in good faith, using ordinary care and having the best interests of the company at heart.

88. DEL. CODE ANN. tit. 6, § 18-1101(c) (Supp. 1994).

89. 328 N.E.2d 505 (Mass. 1975).

90. *Id.* at 520.

parties (or their relatives) in control, as was the case in *Donahue*. The only result in the real world is that corporate assets flow into the pockets of some shareholders (related to those in control) but not others. The preferential buyout issue does not often arise in the partnership context, because most partners are active in the business and share equally in control. Similarly, we would not expect the issue to arise in the limited liability company context to the extent the company actually operates on the traditional partnership model: one-person, one-vote; relatively even distribution of profits; and relatively equal rights on dissolution. The limited liability company statutes, however, make it possible to issue ownership interests just like corporate shares,[91] and companies constructed in this manner may be indistinguishable from closely held corporations as a practical matter.

Suppose a limited liability company so constructed engages in a *Donahue*-type buyout from relatives of the controlling members. What relief, if any, will be available to complaining minority members? The California statute's broad reference to partnership fiduciary duties,[92] notwithstanding the absence of this transaction in the partnership setting, certainly would permit the court to adopt the *Donahue* rationale should it be so inclined. Similarly, the Uniform Limited Liability Company Act's prohibition on dealings adverse to the company,[93] coupled with the obligation of good faith and fair dealing,[94] may be a ground for court-ordered equal treatment. Idaho's requirement for an accounting[95] may also justify judicial intervention, unless the deal is approved by the disinterested members. Note, however, that if the Idaho limited liability company is managed by managers and the family member whose interest is the subject of the buyout is not a manager, the transaction literally falls outside the language of the statute.[96]

The complete absence of any affirmative statutory reference to fiduciary duties in the Arizona and Delaware statutes may leave the courts freer to develop traditional fiduciary duty principles following either the partnership or corporation law models, whichever is most appropriate to the case at

91. *See, e.g.*, ULLCA § 502(c) (1995).

92. CAL. CORP. CODE § 17153 (West Supp. 1995); *see supra* note 81 and accompanying text.

93. ULLCA § 409(b)(2) (1995); *see supra* notes 83-86 and accompanying text.

94. ULLCA § 409(d) (1995).

95. IDAHO CODE § 53-622(2) (1994).

96. *Id.* § 53-622(3) (providing that such a member has no duties to the company or the other members "solely by reason of acting" in his capacity as a member).

hand. The express inclusion of duty-of-care provisions in Colorado and Oregon, however, may incline the court to believe that it is restricted in developing common law duties. Even with respect to garden-variety self-dealing transactions, the courts in many states may have to reinvent the traditional rules requiring disinterested member approval and the allocation of the burden of proof.

III. CONCLUSION

The limited liability company should under no circumstances be treated as a "one size fits all" form of business organization. Even the small sample of limited liability company statutes considered in this study shows wide variety in many crucial provisions. Moreover, within any given jurisdiction it is unlikely that the default provisions on allocation of internal control, admission of new members, withdrawal rights and judicial dissolution, and fiduciary duty will match those desired or expected by particular people electing to do business in this new form. To the extent the parties can foresee future sources of friction, careful drafting of the operating agreement can provide an a priori resolution to the problem. Many small businesses, however, will elect not to assume the expense of negotiating, and hiring an attorney to draft, a carefully worded operating agreement. In addition, over 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. The extent to which courts will be willing and able to "do justice" in these situations is likely to be hampered in many jurisdictions by inadequate provisions for judicial dissolution at the instance of an "oppressed" member or member's successor and by undeveloped concepts of fiduciary duty in the limited liability company context. In short, careful planning is imperative, but it may not be enough.

As a business organization form, the limited liability company provides nothing (besides uncertainty) not already available under the partnership and corporation statutes. The only benefit seems to be pass-through taxation for small corporations without the limitations applicable to S corporations. If the federal and state governments could communicate with one another, they surely could have achieved this result without the difficulties and uncertainties of an entirely new form of business organization.