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## **Eat Your Vegetables (Or at Least Understand Why You Should): Can Better Warning and Education of Prospective Minority Owners Reduce Oppression in Closely Held Businesses?**

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## ARTICLES

### EAT YOUR VEGETABLES (OR AT LEAST UNDERSTAND WHY YOU SHOULD): CAN BETTER WARNING AND EDUCATION OF PROSPECTIVE MINORITY OWNERS REDUCE OPPRESSION IN CLOSELY HELD BUSINESSES?

*Michael K. Molitor\**

#### INTRODUCTION

Imagine this common scenario: A, B, and C are three family members or friends who visit a lawyer for help starting a business. A, B, and C tell the lawyer that they only need help in selecting an organizational form (“We’ve heard that LLCs are popular”), drafting charter documents, and making any necessary governmental filings. Their goal is to keep legal fees low, preserving funds for more useful ends like purchasing equipment. The lawyer advises A, B, and C that their three main choices are the partnership, the corporation (preferably an “S” corporation), or a limited liability company (LLC). After learning that the partnership form imposes unlimited personal liability on the partners<sup>1</sup> – whereas both the corporate and LLC forms generally insulate the owners from the debts of the business<sup>2</sup> – the parties instruct the lawyer to form a corporation (or an LLC) in which they will each own one-third of the equity and serve as directors of the corporation (or managers of the LLC).

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1. See *infra* notes 21-22 and accompanying text. However, partnerships may be organized as limited liability partnerships (LLPs), which may eliminate the partners’ personal liability for some or all of the LLP’s debts. See *infra* notes 42-48 and accompanying text.

2. See *infra* notes 23-24, 32 and accompanying text.

Although each owner expects to be employed by the business and earn a salary, none bothers to have the lawyer draft an employment agreement for him, if indeed this issue even crossed his mind.<sup>3</sup> Instead, each owner has a vague belief that his status as an equal owner and a director or manager will be sufficient. Moreover, since A, B, and C are family members or friends, none of them foresees or seriously expects any major conflicts in the future. Again, wishing to keep legal expenses low, they tell the lawyer to draft a “standard” set of articles of incorpora-

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3. A related issue is that the attorney usually represents the *business*, not the individual owners. See MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (amended 2003) (“A lawyer employed or retained by an organization represents the organization.”). Important planning devices to protect the interests of minority owners could present a conflict between the business's interests and the owners' interests if there are multiple owners. For example, in negotiating a buy-sell agreement that would obligate the business to repurchase an owner's equity interest upon certain events such as the termination of that owner's employment, the business's desires as to what events will “trigger” its obligations and what the purchase price and payment terms will be could materially diverge from the owner's desires, presenting a conflict of interest that makes dual representation of the business and that owner impermissible. See *id.* R. 1.7, 1.13(e). As such, the business lawyer should make sure that the prospective owners of the business clearly understand that the lawyer does not represent them. One commentator suggests that to “further clarify the representation of the client, the attorney preparing any document relating to the entity should consider including a provision that indicates that the attorney is preparing the document and that each party should confer with independent counsel.” William A. Shaheen, Jr., *Business Planning and Financing*, in ADVISING CLOSELY HELD BUSINESSES IN MICHIGAN § 1.2, at 1-3 to 1-4 (Jeffrey S. Ammon et al. eds., 2000 & Supp. 2004); see also MODEL RULES OF PROF'L CONDUCT R. 1.13(d) (amended 2003) (“In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.”).

The notion that an attorney represents an intangible entity presents the additional problem of determining which people “speak” for the entity. See Geoffrey C. Hazard, Jr., *Ethical Dilemmas of Corporate Counsel*, 46 EMORY L. J. 1011, 1014 (1997) (“Put more colloquially, the problem for an attorney dealing with a corporate official is: ‘Who is this guy anyway?’”). See generally Darian M. Ibrahim, *Solving the Everyday Problem of Client Identity in the Context of Closely Held Businesses*, 56 ALA. L. REV. 181 (2004); Ralph Jonas, *Who is the Client?: The Corporate Lawyer's Dilemma*, 39 HASTINGS L.J. 617 (1988); Thomas D. Morgan, *The Client(s) of a Corporate Lawyer*, 33 CAP. U. L. REV. 17 (2004); William H. Simon, *Whom (or What) Does the Organization's Lawyer Represent?: An Anatomy of Intraclient Conflict*, 91 CAL. L. REV. 57 (2003).

tion<sup>4</sup> and bylaws<sup>5</sup> (in the case of a corporation), addressing typical matters like the election of directors, board and shareholder meetings, and indemnification provisions; or to draft a “standard” set of articles of organization<sup>6</sup> and operating agreement<sup>7</sup> (in the case of an LLC), addressing similar matters.

After a few lean years, the business becomes very successful, enabling A, B, and C to receive substantial salaries and dividends. Later, however, personal and business conflicts align A and B against C and, in their capacities as a majority of the directors of the corporation or a majority of the managers (or members) of the LLC, A and B decide to fire C. Although a new employee is needed to replace the work formerly done by C, a replacement can be found for a much smaller salary than C had been receiving. Not coincidentally, this frees up a lot of cash flow, which A and B then use to increase their salaries. In turn, the increased salaries paid to A and B reduce the funds available to pay dividends to all three owners. In fact, A and B, who are now earning very generous salaries, decide that the business should stop paying dividends altogether.

C now finds himself in the unenviable position of being a “frozen out” minority owner who has not done any advance planning to protect himself. Although he owns one-third of the business, that interest is essentially worthless as long as A and B remain in control. C’s primary reason for starting the business – to create a job for himself – has evaporated. With dividends discontinued, he receives no return on his investment. Cementing C’s dilemma is the fact that there is no market in which to resell his ownership interest. Moreover, even if C could find a buyer, that buyer would likely demand steep discounts to reflect the fact that C is a minority owner with no control over the business and that C’s interest is not liquid.

This idealized (and very simplified) story is not new; courts, legislatures, and academics have been grappling with similar scenarios for decades,<sup>8</sup> often clumsily. To date, two primary avenues of relief have

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4. See MODEL BUS. CORP. ACT § 2.02 (1984) (listing the requirements for articles of incorporation).

5. See *id.* at § 2.06 (describing the nature of provisions included in bylaws).

6. See UNIF. LTD. LIAB. CO. ACT § 201 (2006) (listing the requirements for articles of organization).

7. See *id.* § 110 (listing restrictions for operating agreements and the effect of operating agreements).

8. See, e.g., F. HODGE O’NEAL & ROBERT B. THOMPSON, 1 O’NEAL’S OPPRESSION

been developed for a corporate shareholder in C's situation. First, he may sue A and B, claiming that their actions have breached the fiduciary duties that shareholders in a closely held corporation owe to one another. This cause of action gained widespread support after the seminal Massachusetts decision of *Donahue v. Rodd Electrotype Company of New England, Inc.*,<sup>9</sup> but is not followed everywhere.<sup>10</sup> Alternatively, some state statutes permit C to sue to have the corporation involuntarily dissolved (or, if possible, to receive other relief) if A and B have acted in an "oppressive" manner.<sup>11</sup> If C is an LLC member, the law is murkier, but appears to be evolving in a similar direction, as the LLC structure presents similar dangers to the minority owner who does not engage in advance planning.<sup>12</sup>

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OF MINORITY SHAREHOLDERS: PROTECTING MINORITY RIGHTS IN SQUEEZE-OUTS AND OTHER INTRACORPORATE CONFLICTS § 2.02 (2d ed. 1975); Douglas K. Moll, *Minority Oppression & The Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 883 (2005) ("For decades, the law has struggled with the plight of the close corporation minority investor."); Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1338 ("Since the 1940s, commentators have made a concerted effort to clearly delineate the 'distinctive needs' of close corporations and to convince courts and legislatures to change the law to accommodate those needs.") (citations omitted); see also *Miner v. Belle Isle Ice Co.*, 53 N.W. 218 (Mich. 1892) (granting dissolution of corporation where controlling shareholder paid himself an excessive salary and entered into contracts with the corporation that were very favorable to himself).

9. See 328 N.E.2d 505, 520-21 (Mass. 1975) (holding that stockholders in closely held corporations owe fiduciary duties to the other stockholders).

10. One commentator, by carefully examining case law in each state, convincingly demonstrates that *Donahue* has not actually received widespread support even though it is regularly referred to as a "majority" rule. Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 398-401 (2004). However, this conclusion is based in part on the assumption that cases decided under involuntary dissolution statutes should be considered *neither* "majority" nor "minority" decisions. *Id.* at 389-90. As discussed below, a statutory cause of action for involuntary dissolution may be an alternative to a minority shareholder pursuing a claim based on *Donahue's* fiduciary-duty analysis. See *infra* notes 194-212 and accompanying text. As such, it should not be inferred that a majority of states do not provide oppressed shareholders with *any* avenues of relief.

11. See, e.g., MODEL BUS. CORP. ACT § 14.30(a)(2)(ii) (1984) (amended 2006) (court may dissolve a corporation if it is established that the "directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive or fraudulent"); see also statutes cited in note 195 *infra*.

12. See, e.g., Moll, *supra* note 8, at 883; Sandra K. Miller, *The Role of the Court in*

Some will point out that C easily could have protected his interests when the business was formed. For instance, he could have insisted on an employment agreement that would allow his termination only for “cause” or a buy-sell agreement that would obligate the business to repurchase his equity interest upon certain events, such as losing his job. Alternatively, he could have insisted that certain actions, such as the firing of an owner-employee, only be taken by unanimous approval. But this will come as little consolation to C – when the business was started, C may not have realized that these protections were needed,<sup>13</sup> may not have believed that the expense involved in negotiating and drafting such documents was justified, or may have been intimidated by the seeming complexity and expense of adequate planning.

This Article argues that the remedies currently available to C, as well as other approaches that have been suggested by commentators, have serious shortcomings and are in need of reconsideration. Suing the majority owners under a fiduciary-duty claim or bringing an involuntary dissolution claim are avenues that are fraught with uncertainty for all parties involved, not to mention the enormous expense, time commitment, and inefficiencies that litigation entails. Alternatively, the “contractarian” school of thought, which generally posits that business owners should be free to structure their business relations as they see fit with minimal interference from the state, is reflected in many state statutes for close corporations and arguably does not go far enough to protect minority owners.<sup>14</sup> Rather, the contractarian view only works for

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*Balancing Contractual Freedom With the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1612 (2004).

13. See Moll, *supra* note 8, at 912 (“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. 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.”) (footnotes omitted); see also Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 115 (1995) (“Shareholders in close corporations tend to begin a venture with strong positive feelings toward each other, thereby making them less prone to create complex contractual exits.”).

14. Although the term “contractarian” is used in different contexts, for purposes of this Article it refers to the belief that laws should allow business owners to be completely, or at least largely, free to decide the terms of their relationship with minimal interference from the state through “mandatory” statutory provisions. See Mark J. Loewenstein, *A New Direction For State Corporate Codes*, 68 U. COLO. L. REV. 453, 459-60 (1997) (“Contractarian philosophy [holds] that no mandatory terms are justi-

sophisticated parties who have the foresight to contract in anticipation of future disputes; many small business owners simply do not “order” their affairs adequately (or at all) when starting businesses.<sup>15</sup> Thus, the long-standing problem of minority owner oppression in the small business context still awaits a solution.

Granted, no contract, no matter how well thought-out, can anticipate and address each and every future dispute that may arise in a small business. This Article argues, however, that small business owners should be *required to learn about* ways to protect their interests when it really matters – before forming the business.<sup>16</sup> While normally this is a function that attorneys should perform, the sad fact is that this does not appear to be happening with an acceptable frequency, as demonstrated by the never-ending litigation involving minority owner abuse. To that end, this Article suggests that statutes governing both corporations and LLCs should require all owners to read several warnings about the dangers of a lack of advance planning before starting a business, or before purchasing an equity interest in an existing closely held business. Moreover, to lessen the expense involved in negotiating and drafting planning protections, this Article suggests that “form” agreements and provisions protecting minority interests should be widely available, either as freely available standard “template” agreements or – as we gather more information about the choices actually made by participants in closely held businesses – default provisions in statutes. Further, this Article suggests ways in which the bar can better educate prospective business owners, not to mention lawyers and other professionals, about the perils of being a minority owner and the benefits of planning.

Finally, this Article recommends that states should begin compiling statistical information about the actual choices made by owners of various types of closely held businesses and make this information available to prospective owners to guide them in their own decision making, or as data to use in drafting a set of “form” documents or “default” provisions

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fiable; it trumpets the value of giving the participants in the corporate enterprise – managers, shareholders, creditors, employees – the maximum freedom to fashion their relations in the way they choose. In brief, this philosophy holds that the state is ill-situated to mandate the terms of corporate governance, especially in comparison with the parties who risk their capital or livelihoods on the terms.”).

15. See Moll, *supra* note 8, at 952-54.

16. The situation for owners who do not purchase their interest in a closely held business, such as those who inherit, is somewhat different. See *infra* note 411 and accompanying text.

in statutes. One of the major debates in the literature on closely held businesses is over the extent to which minority owners do – or can be expected to – contract to protect their interests. The collection of such information will allow us to answer that question with data, rather than anecdotally.

Part I of this Article reviews the current landscape of available business forms and details the many ways in which the majority owners of a business can take advantage of the minority owners. Part I also reviews the many ways in which the minority owner could have protected himself – if he had the foresight to do so. Part II then reviews the main statutory and judicial responses to the problem of minority owner oppression and discusses their inadequacy. After discussing some other suggestions that have been posited, Part III then presents some hopefully workable solutions.

### I. A CLOSER LOOK AT MINORITY OWNER “OPPRESSION”

The topic of “oppression” of minority business owners (particularly in corporations),<sup>17</sup> as well as the ways in which the astute prospective

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17. See, e.g., F. HODGE O’NEAL & ROBERT B. THOMPSON, 1 O’NEAL AND THOMPSON’S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 3:6 (Rev. 2d. ed. 2005); see generally Edwin J. Bradley, *An Analysis of the Model Close Corporation Act and a Proposed Legislative Strategy*, 10 J. CORP. L. 817 (1985); Krishnan S. Chittur, *Resolving Close Corporation Conflicts: A Fresh Approach*, 10 HARV. J. L. & PUB. POL’Y 129 (1987); Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25 (1986); 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 (1977); Daniel S. Kleinberger, *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 WM. MITCHELL L. REV. 1143 (1990); Moll, *supra* note 8; Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989 (2001) [hereinafter Moll, *Reasonable Expectations*]; Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749 (2000) [hereinafter Moll, *Perspective*]; Douglas K. Moll, *Shareholder Oppression & Dividend Policy in the Close Corporation*, 60 WASH. & LEE L. REV. 841 (2003) [hereinafter Moll, *Dividend Policy*]; Douglas K. Moll, *Shareholder Oppression and “Fair Value”: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L. J. 293 (2004) [hereinafter Moll, *Fair Value*]; Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717 (2002) [hereinafter Moll, *Close Corporation Disputes*]; Charles W. Murdock, *The Evolution of Effective*



minority owner of a business can protect himself from such abuse (or at least have an “exit” if abuse occurs) has already been extensively treated elsewhere.<sup>18</sup> The following discussion, therefore, does not reiterate that comprehensive discussion of these topics. However, it first would be helpful to predict which business forms will be with us in the foreseeable future. After all, the 1990s and later years have witnessed a major expansion of the choices of forms in which to operate a business. At the same time, old forms that were thought to have become obsolete have made a surprising “comeback.” The situation has become so complicated that some commentators have even suggested eliminating some of the available business forms.<sup>19</sup>

A. The Spread of New and Modified Forms of Business Organization

Traditionally, the primary choices for operating a for-profit business in the United States were the corporation, the general partnership and, to a lesser degree, the limited partnership. Generally speaking, the attributes of each form (and thus the task of choosing between them) were relatively simple. One of the main benefits of the partnership is its “flow-through” tax treatment. In other words, the partnership itself is not a tax-paying entity. Instead, its various tax attributes are passed through to the partners; if the partnership earns income, then each partner must report his proportionate share of that income on his income tax return, but the partnership itself does not pay taxes.<sup>20</sup> The main disad-

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*Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425 (1990); F. Hodge O’Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978); 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 (1992); Robert B. Thompson, *Corporate Dissolution and Shareholders’ Reasonable Expectations*, 66 WASH. U. L. Q. 193 (1988) [hereinafter Thompson, *Corporate Dissolution*]; Robert B. Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 699 (1993) [hereinafter Thompson, *Cause of Action*]; Steven Stern, Comment, *Proposals to Help the Minority Stockholder Receive Fairer Dividend Treatment from the Closely Held Corporation*, 56 NW. U. L. REV. 503 (1961).

18. See, e.g., Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 Yale L.J. 119, 142-44 (2003) (discussing options for minority shareholders suffering from oppression); see also articles cited *supra* note 17.

19. See *infra* notes 55-63 and accompanying text.

20. I.R.C. § 701 (2008).

vantage of the partnership form is that partners are personally liable, jointly and severally, for the partnership's liabilities, even those caused by another partner.<sup>21</sup> Thus, if the business's liabilities exceed its ability to pay, the partners' personal assets could be at risk of unlimited liability.<sup>22</sup>

In contrast, the corporation offers precisely the opposite characteristics. The main benefit of the corporate form is the liability protection it provides for the corporation's shareholders.<sup>23</sup> If the business's liabilities exceed its ability to pay, the shareholders' personal assets will not be at risk of unlimited liability (at least outside of a "piercing the corporate veil" claim<sup>24</sup>). The worst that likely would happen to a shareholder is that his stock in the corporation would become worthless if, for example, the corporation went bankrupt. The main disadvantage of the corporate form, however, is that the corporation pays income taxes. If the corporation pays any dividends to its shareholders, each shareholder is taxed on the amount that he receives.<sup>25</sup> Thus, the corporate form involves a "double layer" of taxation.<sup>26</sup> The Internal Revenue Code allows corporations to avoid this double taxation if they comply with the many requirements of Subchapter S of the Internal Revenue Code.<sup>27</sup> For

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21. See, e.g., UNIF. P'SHIP ACT § 306(a) (1997); see also *id.* § 15 (1914) (stating partners are jointly and severally liable for a partner's wrongful act, and jointly liable for all other obligations of the partnership).

22. Under the Revised Uniform Partnership Act's "exhaustion rule," a judgment creditor of a partner may not recover a judgment based on a claim against the partnership from a partner's personal assets unless the partnership's assets are insufficient to pay the claim, or other exceptions apply. *Id.* § 307(d) (1997).

23. See, e.g., MODEL BUS. CORP. ACT § 6.22(b) (1984); FRANKLIN A. GEVURTZ, CORPORATION LAW 7 (2000) ("[S]tockholders have no liability for the corporation's debts simply by virtue of being stockholders. Hence, all they stand to lose by virtue of being stockholders if the corporation goes under is whatever they paid to purchase their stock.") (footnote omitted).

24. In the typical veil-piercing case, an unpaid corporate creditor seeks to hold one or more of the shareholders liable for the claim. There literally are thousands of reported veil-piercing decisions. See, e.g., Robert B. Thompson, *Piercing the Corporate Veil Within Corporate Groups: Corporate Shareholders as Mere Investors*, 13 CONN. J. INT'L L. 379 (1999); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

25. I.R.C. § 61(a)(7) (2008) (including dividends in "gross income").

26. Moll, *Reasonable Expectations*, *supra* note 17, at 998 n.37 (stating that "[corporations are subject to] double taxation – once as business income at the corporate level, and once as personal income at the shareholder level.>").

27. I.R.C. § 1366 (2008); see also JOHN R. MARQUIS ET AL., *Overview of Tax*

the most part, an “S” corporation gets the best of both worlds: limited liability and flow-through tax treatment. The problem, however, is that not all corporations can qualify to be “S” corporations.<sup>28</sup>

Thus, the choices were pretty clear. The partnership traditionally was much more “flexible” in terms of allowing partners to structure their internal relationship as they saw fit, at least outside some limited areas.<sup>29</sup> With the corporation, however, most statutory rules applied even if the parties did not desire them, although over time there was a movement to allow shareholders, at least in closely held corporations, to modify the statutory rules to some degree.<sup>30</sup> As a result, with the exception of some relatively exotic business forms such as the business trust or the cooperative, the task of the business lawyer in advising his or her client as to which form of business organization to choose wasn’t terribly difficult or complicated.<sup>31</sup>

*The Rise of the LLC.* Enter the LLC, a business form that protects its owners (the “members”) from personal liability for the LLC’s obligations while simultaneously providing flow-through tax treatment, making it the best of both worlds.<sup>32</sup> In addition, the LLC provides the mem-

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*Issues, in* ADVISING CLOSELY HELD BUSINESSES IN MICHIGAN, *supra* note 3, § 9.46, at 9-33 (“S corporations . . . are generally not separate taxpaying entities. . . . All of the S corporation income (or loss), regardless of whether it is distributed to the shareholders, passes through to the shareholders and is included in the shareholders’ personal income.”).

28. A limited partnership retains flow-through tax treatment, but in most situations imposes personal liability for the liabilities of the limited partnership only on the general partner(s), not the limited partner(s). *See* UNIF. LTD. P’SHP ACT § 303(a) (1976) (amended 1985).

29. *See, e.g.*, UNIF. P’SHP ACT § 18 (1914) (“The rights and duties of the partners in relation to the partnership shall be determined, *subject to any agreement between them*, by the following rules . . . .”) (emphasis added). The Revised Uniform Partnership Act is more explicit, providing that “relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent the partnership agreement does not otherwise provide, this [Act] governs . . . .” UNIF. P’SHP ACT § 103(a) (1997). However, the Revised Uniform Partnership Act does contain a relatively short list of rules that may not be modified (or at least not greatly modified) by the partnership agreement. *Id.* § 103(b).

30. *See infra* notes 231-50 and accompanying text.

31. Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023, 1023 (2003) (“The world once was a simpler place in to which to form a business. One could choose between the corporation and [the] partnership.”).

32. *See, e.g.*, JAMES R. CAMBRIDGE & GEORGE J. CHRISTOPOULOS, MICHIGAN

bers with a great deal of contractual freedom in setting the firm's governance rules.<sup>33</sup> Today, every state has an LLC statute<sup>34</sup> and the LLC is viewed by many as the "entity of choice" for small businesses.<sup>35</sup>

Given these attractive characteristics, one would think that the LLC would have caught on like wildfire in the United States after Wyoming became the first state to adopt an LLC statute in 1977.<sup>36</sup> In reality,

LIMITED LIABILITY COMPANIES § 9.1, at 9-2 (1998 & Supp. 2006) ("The principal tax motivation for forming an LLC is to obtain the favorable pass-through tax treatment that results from the LLC being classified as a partnership for federal income tax purposes. . . . [T]he use of an S corporation is subject to many restrictions that do not apply to LLCs.").

33. See, e.g., DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."); UNIF. LTD. LIAB. CO. ACT § 103 cmt. (1996) ("[T]he only matters an operating agreement may not control are specified in [Section 103(b)]. . . . [E]very section of this Act is simply a default rule, regardless of whether the language of the section appears to be otherwise mandatory."); Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 353 (2003) (in creating the LLC, legislators "sought a business entity that, through private contracting among participants, would . . . reduce legal strife internally among investors, and deter judicial intermeddling") (footnote omitted).

34. For a list of citations to each state's LLC statute, see Nicholas L. Georgakoloulos, *Contract-Centered Veil Piercing*, 13 STAN. J.L. BUS. & FIN. 121, 126 n.18 (2007).

35. See, e.g., LARRY E. RIBSTEIN & ROBERT R. KEATINGE, 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1.1, at 1-1 (2d ed. 2004) (the LLC is "the preferred choice for many businesses"); Thomas E. Rutledge, *The Alphabet Soup of Unincorporated Business Law: What is Happening With LLCs, LPs, LLPs, GPs, LLLPs, & BTs and Dealing with RUPA, Re-RUPA, (Re)ULLCA, UNETA, MITA, & META*, ALI-ABA Video Law Review, VML0202 ALI-ABA 1, at \*7 (Feb. 2, 2006) ("Today, most choice of entity analysis begins with a presumption that the LLC will be the most viable option, and only in relatively narrow fact situations will that presumption not carry through to the final analysis.").

36. Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 547 (codified as amended at WYO. STAT. ANN. §§ 17-15-101 to -144 (Michie 2007)). Writing in 1996, the National Conference of Commissioners on Uniform State Laws summarized the history of LLCs:

Borrowing from abroad, Wyoming initiated a national movement in 1977 by enacting this country's first limited liability company act. The movement started slowly as the [IRS] took more than ten years to announce finally that a Wyoming limited liability company would be taxed like a partnership. Since that time, every State has adopted or is considering its own distinct limited liability company act, many of which have already been amended one or more times.

UNIF. LTD. LIAB. CO. ACT, prefatory note (1996).

however, it took a long time for the LLC idea to gain popularity, due to uncertainty between 1980, when the IRS published proposed regulations that would have treated LLCs as corporations for tax purposes,<sup>37</sup> and 1996, when the IRS promulgated its “check-the-box” regulations.<sup>38</sup> These regulations basically allow any unincorporated entity, including an LLC, to receive flow-through tax treatment unless it chooses to be taxed as a corporation or it is treated as a corporation under another section of the Internal Revenue Code (such as publicly traded limited partnerships<sup>39</sup>). The check-the-box regulations rendered obsolete a number of provisions in state statutes that had been designed to conform to interim IRS regulations and to ensure that an LLC was denied at least two of the “usual” four corporate characteristics.<sup>40</sup> Nonetheless, LLC statutes continue to exhibit a great degree of variation from state to state.<sup>41</sup>

*Limited Liability in Partnerships (the LLP).* Aside from the LLC, a somewhat concurrent movement resulted in another “best of both worlds” entity: the limited liability partnership, or LLP. In 1991, Texas enacted the first state LLP statute<sup>42</sup> in response to a perceived crisis of

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37. See 45 Fed. Reg. 75,709, 75,710 (1980). Three years later, the IRS withdrew these proposed regulations. RIBSTEIN & KEATINGE, *supra* note 35, § 1.2, at 1-6.

38. 26 C.F.R. §§ 301.7701-1 to .7703 (1996). These regulations became effective on January 1, 1997. As one commentator explains, the check-the-box regulations were a result of the fact that the prior “mandatory tax classification scheme became an administrative nightmare.” Miller, *supra* note 33, at 360.

39. See I.R.C. § 7704(a) (2008) (treating most publicly traded partnerships as corporations); see also CAMBRIDGE & CHRISTOPOULOS, *supra* note 32, § 9.3, at 9-3 to 9-4 (“Generally, an LLC is permitted to simply elect whether it will be treated as a partnership or as an association taxed as a corporation.”).

40. A former Treasury regulation, 26 C.F.R. § 301.7701-2(a)(1) (1996), listed six characteristics that were used to determine whether an unincorporated entity should be taxed as a corporation: (1) associates, (2) an objective to carry on business and divide the gains therefrom (i.e., a profit motive), (3) continuity of life, (4) centralized management, (5) limited liability for owners, and (6) free transferability of interests. However, since the first two factors were common to all businesses, only the last four factors really mattered. In essence, the regulations provided that an entity would be taxed as a partnership *unless* it had three or more of the four “corporate” characteristics. In other words, state law had to *deny* the entity at least two of the four corporate characteristics for the entity to be taxed as a partnership.

41. See *infra* note 148 and accompanying text.

42. See 1991 Tex. Gen. Laws 901, § 84. The current statute is TEX. BUS. ORGS. CODE ANN. §§ 152.801-805 (Vernon 2006). Section 152.801 provides a “full shield”

liability in many accounting and law partnerships.<sup>43</sup> Today, every state recognizes some form of LLP,<sup>44</sup> either a “full shield” LLP (in which partners generally are not personally liable for any of the partnership’s liabilities except those they personally caused) or a “partial shield” LLP (in which partners are generally not personally liable for the wrongful acts of other partners or employees, but remain personally liable for other liabilities of the partnership<sup>45</sup>). Approximately seventeen<sup>46</sup> of the

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by providing that LLP partners are not personally liable for the debts and obligations of the LLP. However, a partner in a Texas LLP will be personally liable for his own conduct. He will also be personally liable for conduct by another partner or a representative of the partnership, but only if (1) he was “supervising or directing the other partner or representative” when the conduct occurred, (2) he was “directly involved” in the conduct, or (3) he had notice or knowledge of the conduct “at the time of the occurrence and then failed to take reasonable action to prevent or cure” it.

43. LLP statutes were the product of a lobbying effort by large accounting firms to limit their partners’ personal liability exposure to claims of malpractice by other partners, particularly in light of an increase of securities law violation claims against accounting firms. *See generally* William H. Clark, *Rationalizing Entity Laws*, 58 BUS. LAW. 1005, 1006 (2003); Rutledge, *supra* note 35, at \*8.

44. *See* UNIF. LTD. LIAB. CO. ACT, prefatory note (2006) (“[E]very state has some form of LLP legislation . . . . In full-shield jurisdictions, LLPs and member-managed LLCs offer entrepreneurs very similar attributes and, in the case of professional service organizations, LLPs may dominate the field.”).

45. “It is difficult to conceive of many situations where a business lawyer would recommend that the client choose the ‘half-a-loaf’ protection that the [Michigan partial-shield] LLP provides when the client can have the whole loaf with an LLC.” CAMBRIDGE & CHRISTOPOULOS, *supra* note 32, § 2.1, at 2-3. The Michigan “half-a-loaf” LLP statute only shields a partner of an LLP from liabilities of the partnership “arising from negligence, wrongful acts, omissions, misconduct, or malpractice committed . . . by another partner or an employee, agent, or representative of the partnership.” However, the statute does not shield a partner from liability “for the partner’s own negligence, wrongful acts, omissions, misconduct, or malpractice or that of any person under the partner’s direct supervision and control.” MICH. COMP. LAWS. ANN. § 449.46 (2006) (emphasis added).

46. No attempt is made in this Article to determine how many states have full shields and how many have partial shields. However, commentators have observed:

The principal effect of a partnership becoming [an LLP] is that partners obtain some form of limited liability. . . . Most states provide that LLP partners are relieved from personal liability only for partnership debts and obligations created by the negligence or other misconduct of other partners and partnership employees and agents (partial liability shield). A few LLP states provide that partners are relieved from personal liability for all partnership debts and obligations regardless of how created.

state LLP statutes provide for a “full shield,” as does the 1997 version of the Uniform Partnership Act (RUPA).<sup>47</sup> Because in most other respects an LLP is the same as a general partnership,<sup>48</sup> it receives the same flow-through tax treatment.<sup>49</sup> In fact, one advantage of the LLP over the LLC is that it comes with a “built-in” body of case law developed over decades in the general partnership context.<sup>50</sup>

*(More) Limited Liability in Limited Partnerships (the LLLP).* Usually, a general partner of a limited partnership is liable for the limited partnership’s debts, but a limited partner is not, unless he or she participates in the control of the business; even then, the limited partner will be liable only to those persons who reasonably believed that the limited partner was a general partner.<sup>51</sup> Recently, however, many statutes were amended to provide that *general* partners can avoid liability for the limited partnership’s obligations if the limited partnership elects limited liability limited partnership (LLLP) status.<sup>52</sup> Nearly twenty states have adopted LLLP statutes.<sup>53</sup>

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All states expressly or impliedly preserve partner liability for the personal misconduct of the partner.

CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW § 15.02(1) (footnotes and citations omitted). The table to this chapter indicates that 17 states had “full shield” LLP laws. It was current as of 2007. *See id.* tbl.15.

47. UNIF. P’SHP ACT § 306(c) (1997).

48. LLP status requires a filing with the state, unlike a general partnership. *See, e.g., id.* § 1001(c) (after required partner approval, a partnership may become an LLP by filing a “statement of qualification”). In nearly all other respects, LLPs are just general partnerships. *See* BISHOP & KLEINBERGER, *supra* note 46, § 15.02(1). However, some states also impose insurance requirements for LLP status. *See, e.g.,* TEX. BUS. ORGS. CODE ANN. § 152.804 (Vernon 2006).

49. In 1992, shortly after the Texas statute was enacted, the IRS confirmed that LLPs would receive flow-through tax treatment. Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992).

50. Robert R. Keatinge et al., *Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization*, 51 BUS. LAW. 147, 149 (1995).

51. *See* UNIF. LTD. P’SHP ACT § 303(a) (1976) (amended 1985). However, the Uniform Limited Partnership Act was amended in 2001 to provide that limited partners are not personally liable for the obligations of the limited partnership solely because they are limited partners, even if they participate in the “management and control of the limited partnership.” UNIF. LTD. P’SHP ACT § 303 (2001).

52. Section 404(c) of the 2001 version of the Uniform Limited Partnership Act provides that an obligation of an LLLP is solely the obligation of the LLLP, and that

The LLC, the LLP, and the LLLP expanded business owners' choices of business forms that provide both limited liability for the owners from the entity's obligations and flow-through taxation. In just a few decades, business organization law has gone from a "sleepy" state of having only a handful of form choices to having many more. As one commentator observed, "the options facing the business lawyer [have] become extremely varied, to the point of almost being bewildering."<sup>54</sup> The question became: have we gone overboard?

*The Entity Rationalization Movement.* Due to the recent invention of certain business forms (such as the LLC), the modification of existing forms (such as the morphing of the general partnership into the LLP), and the reemergence of business forms that had, until recently, almost been given up for dead (such as the limited partnership), some commentators proposed simplifying our business organizations laws.<sup>55</sup> Proposals have included consolidating some of the currently existing forms, or instead creating a new form of business organization that would replace some of the currently existing forms.<sup>56</sup> As for the former approach, one commentator observed:

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general partners are not personally liable for such obligations "solely by reason of being or acting as a general partner." *Id.* § 404(c). Of course, without LLLP status, the general partners of a limited partnership are usually personally liable, jointly and severally, for the limited partnership's debts. *Id.* § 404(a).

53. See, e.g., 805 ILL. COMP. STAT. ANN. § 215/201(a)(4) (West Supp. 2008); NEV. REV. STAT. ANN. § 88.606 (Supp. 2007); TEX. BUS. ORGS. CODE ANN. §§ 1.002(50), 5.055(b) (Vernon Supp. 2007). Also adopted in the following states: Arkansas, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kentucky, Maine, Maryland, Minnesota, Montana, North Carolina, South Dakota, and Virginia.

54. Clark, *supra* note 43, at 1006-07 (footnotes omitted); see also Thomas F. Blackwell, *The Revolution is Here: The Promise of a Unified Business Entity Code*, 24 IOWA J. CORP. L. 333, 336-37 (1999) ("[C]hoice of entity has now become a complex endeavor likely to mystify a prospective business owner or an attorney who has not been regularly and recently involved with choice of entity issues.").

55. See generally Ribstein, *supra* note 31, at 1023-24 ("Lawyers and legislatures have started thinking that it is time to clean up the mess created by the proliferation of [business] forms. Specifically, they think business forms can be 'rationalized' by using common provisions to solve common problems.") (footnotes omitted).

56. See, e.g., Dale A. Oesterle & Wayne M. Gazur, *What's in a Name? An Argument for a Small Business "Limited Liability Entity" Statute (With Three Sets of Default Rules)*, 32 WAKE FOREST L. REV. 101 (1997) (discussed *infra* notes 360-74); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1 (1996) (suggesting the creation of a "standard business organ-



With the advent of full shield LLPs for both general partnerships and limited partnerships, potential movement toward simplification that was previously not possible is at least now conceivable . . . . Any governance structure that can be achieved in either a limited partnership or an LLC can also be achieved in a full shield LLP. The result may be the possible return to full shield [LLPs] as the sole necessary alternative to corporations.<sup>57</sup>

This appeared in a 2003 issue of *The Business Lawyer* which, along with the following issue, reprinted several papers that were presented at a November 2002 symposium entitled *Entity Rationalization: What Can or Should Be Done About the Proliferation of Business Organizations?*<sup>58</sup> Reading these articles written by prominent practitioners and academics, reveals a sense that there truly was a movement afoot that, if carried to its logical conclusion, would have reduced the confusing array of business entity choices currently perplexing attorneys.

In May 2006, however, whatever momentum that may have started toward the goal of eliminating one or more current business forms and/or creating new business forms was dealt a serious blow when the Study Committee on an Omnibus Business Organizations Code issued a preliminary report.<sup>59</sup> The committee, a joint project of the National

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ization” to replace all business organization forms other than the “traditional” corporation); Loewenstein, *supra* note 14, at 456, 471-72 (arguing that current trends should result in two different business forms: the corporation with “traditional mandatory provisions” and “a flexible, limited liability entity – without mandatory provisions”).

57. Clark, *supra* note 43, at 1018.

58. Richard A. Booth, *Entity Rationalization: What Can or Should Be Done About the Proliferation of Business Organizations?*, 58 BUS. LAW. 1003, 1003 (2003).

59. Another serious impediment to the rationalization movement is that the transition from a pre-rationalization world to a post-rationalization world would be extremely difficult, if not impossible. If, for example, LLCs are eliminated because they are viewed as superfluous in light of the LLP form, would all currently existing LLCs be required to convert into LLPs or something else? If so, when? Even worse, if rationalization replaced all of the currently existing forms with new forms, then thousands of firms now in existence would need to convert into a new form. This problem would be exacerbated by the fact that revisions to the fifty states’ respective laws would certainly not proceed at the same pace. See Ribstein, *supra* note 31, at 1039 (“Transition problems may, in fact, be the most convincing argument against rationalization.”). Yet another drawback was the concern that the creation of any new type of business entity would necessarily involve a great deal of uncertainty as to what to do with existing principles of law. As Professor Blackwell asked, “Will businesses want to utilize a new entity form if there is uncertainty whether courts . . . would treat it as a corporation, a

Conference of Commissioners on Uniform State Laws and the American Bar Association, had been formed in 2002 to determine whether an integrated business organizations statute that includes corporations and unincorporated entities was feasible.<sup>60</sup> Specifically, one issue studied by the committee was “[w]hether the number of business entity forms should be reduced, e.g., one corporate form, [and] one non-corporate form, . . . or alternatively, one form for closely-held businesses and one form for publicly-traded businesses.”<sup>61</sup> The committee concluded that a drafting project should be undertaken which would include various model and uniform business organizations statutes.<sup>62</sup>

As to “whether the number of business entity forms should be reduced,” the committee wrote:

The consensus (but not unanimous) position on this issue was that any attempt to do so would be impractical and would make the proposed Omnibus Code unenactable. One member [suggested] . . . that because of the popularity of limited liability companies, there

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partnership, or something else entirely? Could an attorney ethically recommend such a course of action?” Blackwell, *supra* note 54, at 339.

60. REPORT OF STUDY COMMITTEE ON AN OMNIBUS BUSINESS ORGANIZATIONS CODE 1 (May 3, 2006), *available at* [http://www.icaa.org/downloads/BOS/EntityLaw/Omnibus\\_CommitteeReport\\_050306.pdf](http://www.icaa.org/downloads/BOS/EntityLaw/Omnibus_CommitteeReport_050306.pdf) [hereinafter OMNIBUS BUSINESS ORGANIZATIONS CODE].

61. *Id.*

62. In February 2007, the Study Committee released a discussion draft of its Omnibus Business Organizations Code, which essentially provides the provisions that would be common to all business organizations (and thus contained in the “hub” of a “hub and spoke” approach), such as the mechanics of filing documents with the secretary of state, registered agents and registered offices, qualification of foreign entities, etc. See NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAW & AM. BAR ASS’N, OMNIBUS BUSINESS ORGANIZATIONS CODE DISCUSSION DRAFT (Feb. 26, 2007), *available at* [http://www.law.upenn.edu/bll/archives/ulc/oboc/2007marchmeeting\\_draft.htm](http://www.law.upenn.edu/bll/archives/ulc/oboc/2007marchmeeting_draft.htm). The draft for the Study Committee’s February 2008 meeting indicates that the code will eventually also include “spokes” relating specifically to business corporations, nonprofit corporations, general partnerships, limited partnerships, LLCs, cooperative limited associations, nonprofit associations, and business trusts. However, these would not be *new* provisions; instead, the act “would ultimately constitute a ‘hub’ linked to entity-specific articles as ‘spokes’, with each spoke incorporating those provisions of the respective ABA model acts or NCCUSL uniform acts which are not common provisions dealt with in the hub.” NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAW & AM. BAR ASS’N, OMNIBUS BUSINESS ORGANIZATIONS CODE DISCUSSION DRAFT (Nov. 5, 2007), *available at* [http://www.law.upenn.edu/bll/archives/ulc/oboc/2008feb\\_meetingdraft.htm](http://www.law.upenn.edu/bll/archives/ulc/oboc/2008feb_meetingdraft.htm).

was really no longer a need for limited partnerships. Most members of the Study Committee rejected this position for two reasons: (1) over 50,000 new limited partnerships have been formed in each of the three most recent years for which filing statistics are available (2002-2004); and (2) there are at least 850,000 existing active limited partnerships which need a governing statutory framework . . . .

A related question . . . was whether the Omnibus Code should create any new types of entities. The answer to this was “no.” If a new type of entity is invented in the future and gains tractions [sic] in the states, however, the Committee was open to the possibility that it might be brought into the Omnibus Code; but no one thought this was likely to occur in the foreseeable future. Practitioners are currently overwhelmed by the proliferations of existing types of entities, all the different statutes that govern them, and the differences, and in many cases inconsistencies between similar concepts, in all these statutes.<sup>63</sup>

Assuming this accurately predicts the near future, it looks like we will continue to live in a world with general partnerships, LLPs (both partial shield and full shield), LLCs (both member-managed and manager-managed), corporations (both “C” corporations and “S” corporations), LPs, LLLPs, and all of the other currently available forms. While some of the other goals of the rationalization movement<sup>64</sup> such as the promulgation of “hub and spoke” statutes<sup>65</sup> may come to pass, it is doubtful that any of the current business forms will be eliminated any time soon.<sup>66</sup> It also appears that few people have any appetite for new business forms.

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63. OMNIBUS BUSINESS ORGANIZATIONS CODE, *supra* note 60, at 6-7.

64. To be fair, the aims of the rationalization movement were more varied. The overall goal of the movement seems to be the elimination of unnecessary differences between different business entity statutes. One aim would have been to examine similar provisions in different statutes and determine if the differences in wording between the two sections represent “real” differences or merely are a result of the fact that the statutes were written by different legislatures at different times. If there are not “real” differences, then the differing language should be harmonized, one statute could incorporate provisions of the other by reference, or the rule could be contained in a separate section that applies to both corporations and LLCs, such as in the “hub” of a “hub and spoke” approach. *See* Clark, *supra* note 43, at 1020. Not all the papers in *The Business Lawyer* symposium were pro-rationalization, however. Ribstein, for one, wrote: “[E]ven if rationalization might otherwise be a good idea, transition to a rationalized world will lead to more, rather than less, complication, as myriad rationalized statutes are added to the mix both across states and within states during the transition

*Conclusion: Corporations and LLCs Are Likely “Settings” of Abuse.* This brings us to the present question: in which of the many currently existing business forms is abuse of minority owners by majority owners likely to occur? On which business forms should this discussion focus? This Article will focus on corporations and LLCs, and will exclude general partnerships (whether “regular” or LLP) and limited partnerships (whether “regular” or LLLP).

This Article disregards limited partnerships because limited partners often are passive or “sophisticated” investors who are not likely to work at the business, but who can be expected to contract to protect their rights before committing capital to the enterprise.<sup>67</sup> The reason for excluding partnerships (including LLPs) from this discussion, on the other hand, is not because partners can be expected to be “sophisticated,” but rather because partnership law generally provides important protections to owners that corporate and LLC laws do not. For example, to return to the hypothetical situation outlined in the Introduction to this Article, if A, B, and C had not formed a corporation or an LLC, but had simply started a business without consulting a lawyer or making any state filings, they would have formed a partnership.<sup>68</sup> Moreover, because they likely did not agree on many (if any) of the details of their relation-

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period. . . . The time for uniform laws on entity rationalization has not, and probably should never, come.” Ribstein, *supra* note 31, at 1042.

65. See *supra* notes 62, 64.

66. However, the ABA’s web site explains that the mission of the Entity Rationalization Committee includes “working to analyze the substantive differences among entity forms, and to develop a scheme to integrate existing entity laws into a comprehensive code that reduces the number of entity forms . . . .” AM. BAR ASS’N, ENTITY RATIONALIZATION, <http://www.abanet.org/dch/committee.cfm?com=CL980000> (last visited Mar. 11, 2009).

67. Granted, due to the recent statutory changes discussed above, see *supra* notes 51-53 and accompanying text, a limited partner in a limited partnership or an LLLP need not be “passive.” It is also true that a limited partner may not be “sophisticated.” Historically, however, the limited partnership form was used for somewhat “specialized” transactions involving a general partner who would run the business and passive (and wealthy) limited partners who contributed the capital. See, e.g., Rutledge, *supra* note 35, at \*3 (“Occasionally we would encounter a limited partnership, typically in one of its traditional applications for real estate or other financing in which the investors were expected and expecting to take a passive role . . .”).

68. See UNIF. P’SHP ACT § 202(a) (1997). No state filings are required to form a partnership.

ship, the partnership statute would provide a comprehensive set of “default” rules.<sup>69</sup>

Importantly, these default rules are protective of C, even if he has not done any advance planning. For example, although he has no default right to be paid a salary,<sup>70</sup> C could force the partnership to “buy him out” simply by dissociating (withdrawing) from the partnership.<sup>71</sup> Thus, in a partnership, C has important exit rights that he would not have in a corporation or an LLC unless he had previously contracted for them.<sup>72</sup> Furthermore, while C could have been removed from decision-making positions in an LLC or a corporation,<sup>73</sup> each partner in a partnership has equal management rights with respect to the partnership, unless otherwise agreed.<sup>74</sup> While the usual rule in a partnership is majority rule, actions that are outside the ordinary course of business require unanimous consent, unless otherwise agreed.<sup>75</sup> Partners are also entitled to more access to information about the business than are shareholders.<sup>76</sup> Further, long-standing case law holds that partners owe fiduciary duties to one another,<sup>77</sup> which could be used to challenge abusive majority

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69. *See id.* § 103(a) (“[R]elations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent that the partnership agreement does not otherwise provide, this [Act] governs relations among the partners and between the partners and the partnership.”).

70. *Id.* § 401(h).

71. Upon a partner’s dissociation, the partnership will either be dissolved or continue without the dissociated partner. If A, B, and C have formed an “at will” partnership (as opposed to a partnership for a term or an undertaking), C’s dissociation will cause the partnership to be dissolved, unless otherwise agreed. *Id.* § 801(1). Upon dissolution, the partnership would enter into a period of winding up during which it would complete unfinished business, pay creditors, and (funds permitting) distribute any remaining funds to the partners according to their interests. *See id.* §§ 802, 807. Generally, if the partners had instead formed a partnership for a term or an undertaking, C could still dissociate at any time (albeit “wrongfully”) and require the partnership to “buy out” his interest. *See id.* §§ 701(a), 701(b), 602(b); *see also* UNIF. P’SHP ACT § 31(1)(b) (1914).

72. *See infra* notes 99-105 and accompanying text.

73. A and B, in their capacities as directors, could remove C from officer positions and, in their capacities as shareholders, could remove C from the board of directors. *See* MODEL BUS. CORP. ACT §§ 8.01, 8.08 (1984).

74. *See, e.g.*, UNIF. P’SHP ACT § 401(f) (1997).

75. *Id.* § 401(j).

76. *Compare* UNIF. P’SHP ACT §§ 403(b), 103(b)(2) (1997) *with* MODEL BUS. CORP. ACT §§ 16.02(b), (c), 16.20 (1984).

77. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty

tactics. Although C could have unwittingly bargained away some of these protections, this is unlikely. Thus, partnership law itself is ordinarily sufficient to protect C from the more egregious of A and B's actions, or at least give him an "exit" out of an abusive partnership relationship.<sup>78</sup>

*B. How Can I Oppress You? Let Me Count the Ways*

*What is a "Closely Held" Business?* Before cataloging the ways in which a majority<sup>79</sup> faction in a closely held business can abuse a minority owner, it may be helpful to define the terms "close" or "closely held."<sup>80</sup> One well-known definition is found in *Donahue v. Rodd*

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of finest loyalty. . . . A [partner] is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *But see* Siegel, *supra* note 10, at 442 (*Meinhard* has "little specific content"); UNIF. P'SHIP ACT § 404 (1997) (the "only fiduciary" duties of partners are the duty of loyalty and the duty of care, both as delineated in that section). Some states have imposed partner-like duties on shareholders in closely held corporations. *See infra* notes 180-93 and accompanying text.

78. In addition, C is protected from having his interest in the partnership diluted by the addition of new partners, because unanimous partner consent is needed to admit new partners (absent a contrary agreement). UNIF. P'SHIP ACT § 401(i) (1997). In contrast, shareholders and LLCs members do not usually have preemptive rights. *See infra* notes 136-37, 170 and accompanying text.

79. Two other important terms are used often in this Article: "minority" and "majority." These terms obviously refer to the relative percentages of voting equity that the various owners (or groups thereof) have in the business. To take a simple example, if A and B are the two shareholders of a corporation that has only one class of voting stock, and A owns 51% of the outstanding stock and B owns 49%, then obviously A is the majority shareholder and B is the minority shareholder. Under traditional plurality (also known as "straight") voting, the holder (or holders, if they are acting in concert) of a majority of the outstanding shares of voting stock can elect all the directors. *See, e.g.*, MODEL BUS. CORP. ACT § 7.28(a) (1984); GEVURTZ, *supra* note 23, at 482. Because A can elect all the directors, and the board normally makes the important business decisions for the corporation, A has "control" of the corporation. Thus, commentators often refer to the "majority" as the shareholder(s) who can "control the operations of the firm." Moll, *supra* note 8, at 883-84 n.1.

80. Although the terms are used interchangeably in this Article, there is a distinction between a "close" corporation and a "closely held" corporation. The former is a corporation with a small number of shareholders *and* that qualifies under portions of the relevant corporation statute designed for "close" corporations and discussed below at notes 199-219 and accompanying text. "Closely held" corporations, on the other hand, also have few shareholders, "but the corporation either has not elected special status under its respective statute's close corporation provisions, does not qualify under

*Electrotype Company of New England, Inc.*,<sup>81</sup> where the court wrote that a close corporation is “typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.”<sup>82</sup> Although there does not appear to be any accepted level at which a corporation’s shareholders become too numerous for the corporation to be considered a “close” corporation, as a practical matter the characteristic that most if not all of the shareholders are active in management of the corporation will limit this number to probably fewer than ten.<sup>83</sup> In any event, the close corporation shareholder is obviously in a very different situation than the shareholder in a publicly traded corporation, who in most cases will simply be an investor who neither

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its respective statute, or its statute does not provide for this separate category of corporations.” Siegel, *supra* note 10, at 378 n.2.

81. 328 N.E.2d 505 (Mass. 1975).

82. *Id.* at 511; *see also* MELVIN A. EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 325 (9th unabr. ed. 2005) (“Close corporations have only a small number of shareholders, and are often characterized by owner-management and restrictions on the transferability of ownership interests. In important respects, close corporations resemble partnerships . . . .”); AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.06 (1992) (defining a closely held corporation as “a corporation the equity securities . . . of which are owned by a small number of persons, and for which securities no active trading market exists”); Robert W. Hillman, *The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering with Closely-Held Business Associations*, 2005 U. ILL. L. Rev. 171, 179 (“participants’ investments in [closely held businesses] often are substantial, nondiversified and illiquid. . . . Moreover, these owners may invest their energy as well as their money, and a quick glance at a balance sheet assessing capital contributions provides only a small measure of what they have actually invested in their firms.”); Kleinberger, *supra* note 17, at 1148 (“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. The corporation typically is an important (and often principal) source of income for each shareholder. Payout is frequently in the form of salary rather than dividends.”) (footnotes omitted). As Professor Thompson observed, closely held corporations have the following characteristics:

(i) participants usually expect to be actively involved in the management and operation of the enterprise; (ii) the lack of a market for shares . . . means that a minority shareholder has no satisfactory way to leave the enterprise; and (iii) when dissension occurs within the enterprise, the norms [of corporate law] of centralized control and majority rule . . . may be used by those in control of the corporation to undermine the expectations of minority participants.

Thompson, *Cause of Action*, *supra* note 17, at 717 (footnotes omitted).

83. Some statutes, however, allow corporations with greater numbers of shareholders to elect to be considered a statutory “close” corporation. *See infra* note 237.

works for the corporation nor is involved in its management, and may only hold the corporation's stock for a short period of time. The close corporation shareholder, on the other hand, has a much more "intimate" relationship with the corporation and the other shareholders.<sup>84</sup> If the shareholders of a close corporation do not get along, serious problems are likely to arise.

*What Can Go Wrong For the Minority Owner of a Closely Held Business?* The following section describes some of the more "popular" techniques for taking advantage of a minority shareholder in a close corporation. Because this is a topic that has received much scholarly attention, the following discussion is only a brief summary.<sup>85</sup> Also, given the long history of the corporation compared to the relative upstart LLC, most of the reported decisions concern corporations instead of LLCs.<sup>86</sup> However, commentators have argued that the possibility for minority abuse is just as likely in the LLC.<sup>87</sup>

*Loss of Employment.* Perhaps the most serious blow that can be dealt to a minority owner in a closely held business is being fired from, or otherwise denied, employment. While it is true, of course, that there are many different types of investors in closely held businesses, a major reason why a minority shareholder became a shareholder may have been

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84. Thompson, *Cause of Action*, *supra* note 17, at 702.

85. See *supra* note 17 for a sampling of the articles that have been written on this topic. For a more thorough discussion of common tactics of minority abuse, see O'NEAL & THOMPSON, *supra* note 17, at 3-1 to 3-198.

86. See Miller, *supra* note 33, at 389 (LLC oppression case law is "still in its infancy.").

87. O'NEAL & THOMPSON, *supra* note 17, § 6:1, at 6-2 (LLC is "a newer form of business that . . . promises to raise many traditional squeeze-out issues."); Moll, *supra* note 8, at 956 ("[T]he '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 shareholder vulnerable in the close corporation for decades – exists in the LLC.") (footnote omitted); James R. Cambridge, *Minority Member Oppression*, XXVI MICH. BUS. L.J. 11, 11 (Spring 2007) ("The oppression of a minority owner can occur in any business organization – a corporation, partnership or limited liability company . . ."). The trend among state LLC statutes appears to be in favor of the rule that LLC members may not freely withdraw and expect to receive a pay-out unless otherwise provided in the operating agreement. See 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, 426-33 (2001).



to create a job for himself. Often, a salary is the way a minority owner extracts most of his “return” from his investment in the company,<sup>88</sup> especially given that the corporation receives a deduction for salaries paid to employees, but not for dividends paid to shareholders.<sup>89</sup> But unless the minority shareholder has an employment agreement, the majority may easily fire him with few obstacles. First, the “at will” rule prevails in United States employment law, meaning that an employer may freely fire an employee for any reason or no reason, outside a few limitations such as anti-discrimination statutes.<sup>90</sup> Second, the entity that makes employment decisions in the corporation is usually the board of directors, at least insofar as officers or other management-level employees are concerned.<sup>91</sup> Third, a majority shareholder in a corporation will, in the absence of a shareholder voting agreement, control the board of directors.<sup>92</sup>

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88. As O’Neal and Thompson put it:

A person acquiring a substantial interest in a closely held business often invests a large percentage of personal resources to acquire that interest. Typically such an investor enters the enterprise expecting to participate actively in the entity’s affairs as a key employee and perhaps as a manager, for example as a director and principal officer of a corporation. The investor may give up employment with accumulated seniority and security features to work full time for the new business. Often the participant may have no income other than the salary from the business. Close corporations usually do not pay dividends or pay only small and infrequent dividends so that a shareholder excluded from employment is effectively denied anything more than a token return on the investment even though that investment may be substantial.

O’NEAL & THOMPSON, *supra* note 17, § 3:6 at 3-37 to 3-38 (footnotes omitted); *see also* Moll, *Fair Value*, *supra* note 17, at 340 (“For many close corporation investors, the desire for employment . . . is the principal enticement motivating their decision to commit capital to a venture.”); Thompson, *Cause of Action*, *supra* note 17, at 702 (shareholders in close corporations “usually expect employment and a meaningful role in management . . .”).

89. I.R.C. § 162(a)(1) (2008). Thus, a “C” corporation may lessen its tax liability by paying large salaries to its shareholders-employees. *See also* GEVURTZ, *supra* note 23, at 451 (describing reasons for the “extraordinarily common practice of closely held corporations distributing the bulk, if not all, of their income to their owners through salaries rather than dividends”).

90. GEVURTZ, *supra* note 23, at 460. *See generally* Margaret H. Paget, *Exceptions to the At-Will Employment Doctrine and Its Applicability to Minority Shareholders*, 88 MASS. L. REV. 41, 41 (2003).

91. *See, e.g.*, MODEL BUS. CORP. ACT § 8.40(b) (1984) (amended 2000).

92. As discussed in note 79 *supra*, the holder(s) of a majority of the voting stock in a corporation will be able to elect the entire board of directors. Even if cumulative voting is used, it is likely that the majority shareholder(s) will be able to elect a majority of the directors. For a discussion of cumulative voting, *see infra* note 128.

*Withholding Dividends.* Another common “squeeze-out” technique or method of “oppression” is to withhold dividends, particularly if this is coupled with a denial of employment to the minority. As with employment decisions, dividend decisions rest with the board of directors,<sup>93</sup> and the majority shareholder(s) will be in control of the board. The minority shareholder now finds that, although he is still one of the owners of the business and may in fact own a sizable percentage of the corporation’s stock, he is no longer receiving any return from that ownership: no salary, no dividends and, due to the lack of a market, little or no ability to realize a gain on the resale of his stock.

*Self-Dealing Transactions.* Given that it controls the board of directors and that the board is the ultimate decision-making authority in the corporation,<sup>94</sup> the majority is in a position to engage in a number of “sweetheart” deals with itself. For example, the majority could cause the board to increase the salary or salaries of the member(s) of the majority group (which could easily be done, given that the corporation would no longer be using cash to pay a salary to the minority shareholder or dividends to any shareholders). Family members could be hired at overly generous salaries.<sup>95</sup> Corporate assets could be sold to the majority for less than their fair market values.<sup>96</sup> The corporation could buy or lease assets from the majority for exorbitant prices or redeem stock from majority shareholders but deny that opportunity to the minority.<sup>97</sup> The list goes on.<sup>98</sup>

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93. See, e.g., MODEL BUS. CORP. ACT § 6.40(a) (1984) (amended 1987)

94. See, e.g., *id.* § 8.01(b) (1984) (amended 2005).

95. See O’NEAL & THOMPSON, *supra* note 17, at 3-55, and 3-140 to 3-141.

96. See *id.* at 3-122.

97. See, e.g., *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975).

98. The self-dealing transactions described in this paragraph would involve not just indirect harm to the minority shareholder, but direct harm to the corporation. Thus, the minority shareholder could bring a derivative action on behalf of the corporation against the wrongdoer(s). However, derivative actions involve, to say the least, procedural “hurdles” not involved in ordinary litigation. For this reason, a major issue in litigation involving close corporations is whether the action must be brought as a derivative action (in which event any judgment would be recovered by the corporation) or whether it may instead be brought as a director action. The ALI *Principles of Corporate Governance* provide that most close-corporation disputes may be brought as direct actions if they do not “(i) unfairly expose the corporation or the defendants to a multi-

*Force-Outs.* Another possibility is to eliminate the minority's ownership interest. For example, the majority owners could form a new company of which they are the sole owners, and merge the existing company into the new company in a "cash out" merger, thus eliminating the minority's equity position. A similar tactic would be to sell the assets of the existing company to the new company, and then dissolve the existing company.

C. Why is Combating Minority Owner Oppression Difficult?

Let's assume the worst: A and B take some of the "oppressive" actions discussed above against C. Although C did not engage in any advance planning, is it really that difficult for C to combat A and B's conduct under "traditional" corporate law rules? Unfortunately, it is.

*Minority Shareholders Usually Lack "Exit Rights."* Witnessing the breakdown of relations with A and B, C reasonably may conclude that the most viable option is to "walk away," perhaps start a new business with a pay-out from the corporation in exchange for surrendering his stock. After all, even if C goes to the trouble and expense of suing A and B – and is lucky enough to obtain some form of judicial relief – it seems likely that A and B will engage in other forms of abusive conduct in the future. At best, the "atmosphere" at the office will likely be quite cold. The problem, however, is that no pay-out is forthcoming.

Absent a contractual obligation or a provision in its articles of incorporation or bylaws, a corporation has no obligation to repurchase a shareholder's stock.<sup>99</sup> For a shareholder in a publicly traded corporation (or at least one with a relatively liquid and orderly market), this does not present much of a problem: when the shareholder wants to sell his

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plicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons." AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(d) (1992). In addition, interested-director transactions that were not approved by disinterested directors or disinterested shareholders often must meet a "fairness" test. *See, e.g.*, MODEL BUS. CORP. ACT § 8.61(b) (1984) (amended 2005).

99. *See, e.g.*, Miller, *supra* note 87, at 421 ("[T]he corporate shareholder of a private company is very much locked into his or her investment absent a buy-sell agreement . . . .") (footnotes omitted). Of course, absent a contractual restriction, a shareholder may freely resell his shares to a third party.

stock, a simple telephone call to one's broker or a few clicks of a computer mouse and the stock will quickly be sold. For the minority shareholder in the closely held corporation, however, this option is by definition unavailable, meaning that finding a buyer could be a difficult process.<sup>100</sup> Moreover, once a buyer is found, he is not likely to be willing to pay the full "intrinsic" value of the stock, particularly if the reason the minority shareholder is seeking to sell his stock is internal dissension.<sup>101</sup> The buyer is likely to reduce his offering price to reflect the fact that the stock represents a minority position in a firm controlled by a majority group, and that the stock is not liquid.<sup>102</sup> Coupled with the fact that corporations may have perpetual life,<sup>103</sup> this difficulty in finding a buyer means that a minority shareholder is often "locked in" to his investment; the minority shareholder "who has fallen out with the majority faces the prospect of the majority having indefinite use of any capital he or she

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100. See, e.g., Chittur, *supra* note 17, at 135 ("The minority in the close corporation . . . is left without systemic protection. This arrangement is the equivalent of a political system that does not permit minorities to emigrate."); Haynsworth, *supra* note 17, at 29 ("The illiquidity of close corporation stock is not only a major cause of intra-shareholder dissension, but it also contributes to the difficulty of remedying dissension once it occurs.") (footnote omitted); Hetherington & Dooley, *supra* note 17, at 6 ("No other form of business organization subjects an owner to the dual hazards of complete loss of liquidity and an indefinite exclusion for sharing in [profits].").

101. See Kleinberger, *supra* note 17, at 1148 ("As a business matter, who would want to buy a [minority position in a] company when the seller is leaving because 'things turned sour'?"); Utset, *supra* note 8, at 1342 ("A minority shareholder selling for a legitimate reason may find it difficult to convince a buyer that his attempt to exit is not due to a problem with the business or with the majority shareholder.").

102. Utset, *supra* note 8, at 1342 ("Valuing close corporation shares is made difficult by the non-existence of a liquid market or other objective valuation mechanisms.").

103. As discussed above, see *supra* note 71 and accompanying text, a partner often may trigger the dissolution of the partnership by dissociating by express will. Once a partnership goes into dissolution, pays its creditors, and otherwise completes its winding up process, any left-over funds will be distributed to the partners. UNIF. P'SHIP ACT § 807(b) (1997). The dissolution of a corporation is not so easily (or single-handedly) achieved; under most corporate statutes, it requires a shareholder vote, and obviously the holders of a minority of the outstanding voting stock of the corporation will not be able to force a dissolution over the objections of the majority shareholder(s). See, e.g., MODEL BUS. CORP. ACT §§ 14.02(e), 7.25(c) (1984). Another type of dissolution is sometimes called "involuntary" dissolution; as discussed below, see *infra* notes 194-97 and accompanying text, many statutes allow shareholders to petition the court for dissolution of the corporation upon a showing of grounds such as deadlock or "oppression."

has contributed to the enterprise with no immediate return.”<sup>104</sup> As a result, “[m]ore than any other characteristic, this ‘no exit’ phenomenon has pushed the law into developing special rules for shareholders in close corporations.”<sup>105</sup>

*Majority Control and the Business Judgment Rule.* In most states in the mid-twentieth century, the minority shareholder was confronted with the following dilemma: while the corporate statute assumed majority control and limited shareholder involvement in corporate decisions, courts often invalidated attempts by shareholders to “contract around” these statutory norms.<sup>106</sup> Instead, the law offered shareholders protection in the form of fiduciary duties imposed on directors.<sup>107</sup> However, the “effectiveness of this fiduciary norm in protecting minority shareholders was limited by the liberal judicial use of the business judgment rule, a doctrine which embodies a broad judicial deference to the corporation’s board of directors to determine business policy and to conduct corporate affairs.”<sup>108</sup>

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104. Thompson, *Corporate Dissolution*, *supra* note 17, at 197.

105. Kleinberger, *supra* note 17, at 1149.

106. *See infra* notes 213-16 and accompanying text.

107. At the risk of vastly oversimplifying a complex topic, directors (as well as officers) owe two primary duties to the corporation and, depending on who one asks, perhaps to the shareholders as well: a duty of care and a duty of loyalty. *See generally* GEVURTZ, *supra* note 23, at 273-437. These duties, coupled with the ability to enforce them through the mechanism of the shareholder derivative action (*see supra* note 98), will protect the minority shareholder to some degree. In addition, other “general” corporate law rules will protect the minority shareholder, such as the prohibition on non-pro rata dividends or other distributions. *See, e.g.*, MODEL BUS. CORP. ACT § 6.01(a) (1984) (amended 2003). For a forceful argument that existing legal rules and non-legal constraints are largely sufficient to protect minority shareholders in close corporations with high investments in “match specific” assets (i.e., assets that are more valuable to the company’s insiders than to third parties, such as the intellectual property rights to a new invention that is still being developed) from opportunistic behavior by the majority shareholders, see Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 915 (1998-99).

108. Thompson, *Corporate Dissolution*, *supra* note 17, at 195 (footnotes omitted); *see also* Kleinberger, *supra* note 17, at 1152 (“[T]raditional corporate law doctrine facilitates the oppression of minority shareholders. In traditional theory, ultimate authority resides with the board of directors, and the business judgment rule makes it very difficult for a disgruntled shareholder to challenge the board’s decision.”).

While a detailed discussion of the business judgment rule is outside the scope of this Article, it may be summarized as a judicial “hands off” philosophy; courts will not interfere with *business decisions* made by directors unless the person challenging the action can show some reason not to “trust” the board, such as fraud, illegality, or a conflict of interest, or that the directors were not reasonably informed when they reached their decision.<sup>109</sup> Absent these facts, the board’s decision will stand, and the directors will not be liable for whatever damages the corporation suffered as a result of the decision.<sup>110</sup> One premise of the business judgment rule is that business decisions always involve a degree of uncertainty, and that courts should not punish directors for poor decisions that were made in good faith. If the rule were otherwise, few people would serve as directors for fear of exposing themselves to enormous liability, even if insurance and indemnification were available.<sup>111</sup> This would leave many corporations without competent minds to guide them. On the other hand, the business judgment rule does not give the majority shareholders (in their capacities as directors) *carte blanche* to do anything: “the business judgment rule . . . is not a license for boards to exercise unlimited discretion; boards are given great leeway, but they must not commit fraud or grossly abuse their discretion.”<sup>112</sup>

The problem for a minority shareholder in a closely held corporation is that most decisions that may adversely affect him, such as the termination of his employment and dividends, are *director decisions*.<sup>113</sup> Thus, the business judgment rule would shield these decisions from judicial inquiry unless the plaintiff could show that they were tainted by a conflict of interest or other ground for overcoming the business judgment rule. While it may be easy to show that some director decisions were the products of a conflict of interest (e.g., where the majority increases its own salaries), it may be difficult to do so with other decisions

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109. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (business judgment rule is a presumption that the directors made a decision “on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company”). See generally DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 1998 & Supps).

110. *Aronson*, 473 A.2d at 812.

111. Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. 39, 58-59 (2008).

112. Siegel, *supra* note 10, at 452 (footnote omitted).

113. See GEVURTZ, *supra* note 23, at 452.

(e.g., the decision to terminate the plaintiff's employment). If the plaintiff cannot overcome the business judgment rule, he will lose the case.<sup>114</sup>

The "no exit" situation, coupled with the business judgment rule, means that traditional corporate law makes it difficult for an abused minority shareholder who has not engaged in adequate planning to combat the situation effectively. Partly as a result, the law has developed some avenues by which the minority shareholder may attempt to obtain some relief. Before turning to those developments (and their shortcomings), however, we will briefly review some of the planning that could have protected the minority shareholder.

*D. How the Minority Could Have Protected Itself in Advance*

*1. In the Corporation*

*Employment Agreements.* As discussed above,<sup>115</sup> many shareholders in close corporations depend on a salary to earn a return on their investment, yet may be easily fired due to the usual "at will" employment rule. Thus, the minority shareholder who is an employee would be well advised to limit the corporation's ability to terminate his employment. The usual way of doing this is through an employment agreement with the corporation, providing that the employee will be employed for a specified period of time and that this employment may not be earlier

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114. See generally *id.* at 452-53 (discussing the difficulties that the business judgment rule presents for the minority shareholder complaining that his employment was terminated and/or that dividends were improperly withheld). For an argument that it is inappropriate to apply the business judgment rule in the context of disputes between shareholders of close corporations, see Chittur, *supra* note 17, at 156-61. See also Moll, *Dividend Policy*, *supra* note 17, at 863 (The "business judgment rule is an uneasy fit in the close corporation context, and its minimal inquiry into the propriety of the majority's decision is inconsistent with the thrust of the shareholder oppression doctrine."). In *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000), the court observed:

[M]any of Hill's alleged "oppressive" acts, including the . . . termination of employment, and the cessation of benefits, are classic examples of acts typically shielded from judicial scrutiny under the business judgment rule. Generally, employees who are adversely affected by such officer and director decisions may not claim oppression . . . even if they are also shareholders of the corporation. Certain actions by a director, however, receive much different treatment when the corporation only has a few shareholders, including that director.

*Id.* at 467 (footnote omitted).

115. See *supra* notes 88-92 and accompanying text.

terminated without some defined “cause.”<sup>116</sup> Although an employment agreement will not prevent termination altogether, a firing without a listed “cause” would constitute a breach of contract. Damages (typically lost wages, subject to an obligation to mitigate damages by searching for other employment) would be easy to determine.<sup>117</sup>

*Buy-Sell Agreements.* Because close corporation shareholders lack an easy “exit”, it is critical to have a buy-sell agreement that obligates the corporation or the other shareholders to buy the minority’s stock in certain events, such as when the minority’s employment is terminated. Although negotiating and drafting a buy-sell agreement is not a simple process because it must address important and thorny issues (such as how the price of the stock will be determined and how and when the price will be paid<sup>118</sup>), the minority shareholder’s failure to have a buy-

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116. Stewart J. Schwab and Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For*, 63 WASH. & LEE L. REV. 231, 248-49 (2006). Even with an employment agreement that limits the “at will” status of the employee, incomplete planning can still result in unfortunate results. In *Franchino v. Franchino*, 687 N.W.2d 620 (Mich. Ct. App. 2004), the plaintiff’s employment agreement provided that he could be terminated only by unanimous consent of the directors. Because the plaintiff and the defendant (his father) were the only two directors, the plaintiff probably thought that his job was safe – obviously he would not vote for his own termination. However, in 2001, after many disputes, the defendant (who owned 69% of the stock) removed the plaintiff from the board and then, as the sole director, “unanimously” terminated the plaintiff’s employment. *Id.* at 623. The plaintiff sued for “oppression” statute but was not successful because the Michigan statute provided at the time that oppression meant “a continuing course of conduct or a significant action or series of actions that substantially interferes with the interests of the shareholder *as a shareholder*.” MICH. COMP. LAWS ANN. § 450.1489(3) (2006) (emphasis added). Although the plaintiff argued that his firing constituted oppression of his rights as a shareholder because most of his return on his stock was paid in the form of his salary rather than dividends, the court disagreed because shareholder rights only include “voting at shareholder’s meetings, electing directors, adopting bylaws, amending charters, examining the corporate books, and receiving corporate dividends.” 687 N.W.2d at 628.

117. ROBERT S. THOMPSON ET AL., REMEDIES: DAMAGES, EQUITY AND RESTITUTION 1049 (3d ed. 2002).

118. For some important drafting considerations for buy-sell agreements, see Julius H. Giarmarco, *Succession Planning*, in ADVISING CLOSELY HELD BUSINESSES IN MICHIGAN, *supra* note 3, §§ 7.2 – 7.13 (2000 & Supp. 2006).



sell agreement in place will leave him without a viable exit if things turn sour.<sup>119</sup>

*Dissolution Provisions.* Another option is to include a provision in the company's articles of incorporation stating that the company will be dissolved if any of the founding shareholders (or some other designated group) ceases to be employed by the corporation, either for any reason or if a founding shareholder is discharged from employment without cause.

*Voting and Governance Agreements.* Shareholders may agree how they will vote their stock in the future.<sup>120</sup> Thus, A, B, and C could have entered into a voting agreement that specifies that they would vote their shares such that A, B, and C – and no other persons – are elected to the board. This would guarantee C a spot on the board (albeit a minority one); if the agreement were breached, he could sue for specific performance.<sup>121</sup> A limitation on the efficacy of a shareholder voting agreement, however, is the fact that the role of shareholders in corporate governance is usually limited to voting on the election or removal of directors and certain “organic” changes, such as mergers, significant asset sales, and amendments to the articles of incorporation. The decisions that are more important for C, such as the selection and compensation of officers and the declaration of dividends, are board decisions. May A, B, and C, in their capacities as *directors*, agree in advance on certain matters that would normally be considered board decisions? For a long time, the answer was “no.”<sup>122</sup>

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119. This is not really a problem for a partner because the partnership statute gives him a “built-in” buy-sell agreement in the form of his ability to trigger dissolution of the partnership. See *supra* note 71 and accompanying text. This power may give the partner bargaining leverage to negotiate favorable exit terms.

120. See, e.g., MODEL BUS. CORP. ACT § 7.31 (1984); Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441, 444 (Del. 1947); see also MODEL BUS. CORP. ACT § 7.30 (1984) (voting trusts).

121. See, e.g., MODEL BUS. CORP. ACT § 7.31(b) (1984).

122. For example, in *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934), three shareholders entered into an agreement that specified they would use their best efforts to ensure that each was appointed to a specified officer position and paid a specified salary. The court ruled that “contracts whereby limitations are placed on the power of directors to manage the business of the corporation by the selection of agents at defined salaries,” are unenforceable. *Id.* at 236.

Many states' statutes, however, now permit such an agreement, provided certain safeguards are observed. For example, Section 7.32 of the Model Business Corporation Act (the "MBCA") essentially allows the parties to structure corporate governance rules as they see fit. One of the unusual things that could be accomplished with a Section 7.32 agreement is that it may establish "who shall be the directors or officers . . . or their terms of office or manner of selection or removal."<sup>123</sup> In other words, decisions that traditionally were off-limits to advance agreement among the directors, such as the identities of the officers and their salaries, can be addressed in a Section 7.32 agreement. Although a Section 7.32 agreement must be in writing and approved by all of the shareholders,<sup>124</sup> these are not difficult hurdles in a closely held corporation.<sup>125</sup>

*Cumulative Voting.* The holder of a majority of the outstanding voting stock of a corporation usually has the ability to elect all of the directors.<sup>126</sup> Although cumulative voting will not give a minority shareholder the power to elect a majority of the board,<sup>127</sup> it may be an important device to ensure that the minority – assuming that he owns enough

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123. MODEL BUS. CORP. ACT § 7.32(a)(3) (1984) (added 1990).

124. *Id.* § 7.32(b)(1).

125. Statutes validating such agreements sometimes take a curious approach. Rather than specifically providing that the agreement *is* enforceable, a statute may provide that the agreement will *not* be viewed as *unenforceable because of* certain arguments. For example, a Delaware statute provides that that no stockholders' agreement or charter provision "shall be invalid on the ground that it is an attempt . . . to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners." DEL. CODE ANN. tit. 8, § 354 (2006). This language may have been chosen simply to reject "an early line of cases . . . that more often than not invalidated shareholders' agreements on the grounds captured today in the statute." JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 14.02, at 386 (2d ed. 2003). However, it still "invite[s] the resourceful lawyer to identify a basis not already negated in the statute as the missile to sink the shareholders' agreement." *Id.* The MBCA, on the other hand, specifies that such an agreement "is effective." MODEL BUS. CORP. ACT § 7.32(a) (1984) (added 1990).

126. *See supra* note 79.

127. Thus, the minority should negotiate for a veto power over some board decisions, such as by including unanimous or supermajority approval requirements for certain actions in the corporation's articles of incorporation or bylaws, as discussed below *infra* notes 132-34 and accompanying text.

shares<sup>128</sup> – can elect at least one director (probably himself) to the board and have the resulting access to information about the corporation.<sup>129</sup> In order for cumulative voting to apply, most state statutes require that it be specified in the corporation's articles of incorporation.<sup>130</sup> Another way to ensure that the minority director could elect someone to the board would be to create separate classes of stock that are identical in all respects except that each class is entitled to elect a designated number of persons to the board, to the exclusion of the other classes.<sup>131</sup>

*Supermajority Voting Requirements.* Yet another alternative for C is to have a “veto” over certain corporation decisions. Statutes typically provide that a corporation's articles of incorporation may increase the usual majority voting or quorum requirements necessary for shareholders to approve an action.<sup>132</sup> The same may often be done with director decisions.<sup>133</sup> Thus, the corporation's charter documents could provide that certain actions, such as a merger or asset sale, the approval of officer compensation, the issuance of additional shares of stock, or the removal of an officer or director,<sup>134</sup> can only be taken by unanimous director or shareholder consent or at least some percentage of the directors or shares that will necessitate C's approval.

*Preemptive Rights.* From a “control” perspective (other than cumulative voting), it may not matter a great deal whether C owns 49% of the

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128. One formula used for cumulative voting is  $S / (D+1) + "1" = X$ , where S is the number of shares that will be voted at the shareholders' meeting, D is the number of director positions to be elected at that meeting, “1” means to round up to the next nearest whole number, and X is the number of shares a shareholder needs to own to ensure that he will be able to elect one person of his choosing to the board. In cumulative voting, a shareholder has a number of votes equal to the number of shares that he owns multiplied by the number of director positions. See generally MODEL BUS. CORP. ACT § 7.28(c) (1984).

129. Although shareholders do have limited rights to inspect corporate books and records and receive other corporate information, directors have a much greater right to do so. See GEVURTZ, *supra* note 23, at 194.

130. See, e.g., MODEL BUS. CORP. ACT §§ 7.28(a), (b) (1984).

131. See generally GEVURTZ, *supra* note 23, at 496-98.

132. See, e.g., MODEL BUS. CORP. ACT §§ 7.28(a) (1984); see also *id.* § 7.27(a) (1984).

133. See, e.g., *id.* § 8.24(c).

134. As for the removal of directors, C would also be well-advised to make sure that the articles of incorporation require “cause” to remove a director. See *id.* § 8.08.

outstanding stock or 1%; regardless, as a minority shareholder he is in no position to control the corporation, absent the various contractual and charter devices now under consideration. From an economic perspective, however, C's percentage ownership does matter when dividends are paid or the corporation is sold.<sup>135</sup> As such, C should take steps to ensure that he retains his one-third ownership percentage in the company. C may either prevent the corporation from issuing additional stock and thus diluting C's percentage (which may be done with a supermajority provision, as discussed above), or insist on preemptive rights, i.e., the right of first refusal to purchase additional shares of the corporation's stock if the corporation issues shares.<sup>136</sup> In most states, shareholders do not have preemptive rights unless the articles of incorporation provide for them.<sup>137</sup> Although preemptive rights would allow C to maintain his one-third interest, they will be of little use if C does not have the funds with which to buy additional shares.

*Arbitration Agreements.* Another option is to have an agreement that would refer certain disputes to arbitration. Important terms of the agreement include what types of disputes could be arbitrated and how the arbitrator(s) are selected. Although arbitration can be quicker and less expensive than litigation<sup>138</sup> and allows the parties to choose arbitrators that have expertise in a given area,<sup>139</sup> arbitrators seem to have a tendency to render compromise decisions that are not fully satisfactory to either party.<sup>140</sup> Also, arbitration "seems to work best as a technique to

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135. Dividends are paid in proportion to the amount of stock owned by the shareholders. Obviously, a shareholder who owns 49% of the outstanding common stock would receive 49% of the total dividends paid on the common stock. *See id.* § 1.40(6) (defining "distribution" as "a direct or indirect transfer of money or other property . . . by a corporation to or for the benefit of its shareholders in respect of any of its shares").

136. Even if C has no preemptive rights or ability to "block" a stock issuance, he may – in theory at least – be protected by the fact that statutes require a corporation's board of directors to determine whether the consideration received by the corporation in exchange for stock is adequate. *See, e.g.,* MODEL BUS. CORP. ACT § 6.21(c). Thus, although C's voting power would be diluted, if the corporation were issuing additional shares for adequate consideration, C would have a "smaller piece of a bigger pie."

137. *See, e.g., id.* § 6.30(a); *see also* GEVURTZ, *supra* note 23, at 136.

138. COX & HAZEN, *supra* note 125, § 14.13, at 410.

139. Elizabeth J. Champnoi, *Arbitration: What You Absolutely Must Know*, in REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES 543, 547 (2007).

140. *Id.* at 549.

resolve disputes involving essentially factual issues” and is “less successful when used in an attempt to resolve deep-seated management policy disputes.”<sup>141</sup> In other words, arbitration may be practical if it is used infrequently and only to decide a limited range of issues. But if the parties are so antagonistic to one another that arbitration must be used frequently, or if arbitration is used to decide fundamental issues concerning the company, the business likely won’t survive without a change in ownership. Arbitration is no way to run a business for extended periods.<sup>142</sup>

*Provisional Directors.* Many states allow shareholders in certain situations to petition the court to appoint a provisional director, i.e., a neutral third party appointed to the board, usually for a limited time.<sup>143</sup> Even without a statute, it may be possible to incorporate such a right in the corporation’s charter documents.<sup>144</sup> However, a provisional director likely will be effective only where there is a deadlock (as opposed to shareholder oppression) and the vote of the provisional director would break the deadlock. As such, this most likely will not be as valuable an option for a minority shareholder as for an “equal” shareholder. Also, like arbitration, if the “dissension among the shareholders is protracted and deep seated,” the use of a provisional director likely will not be an effective way to resolve disputes.<sup>145</sup>

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141. Haynsworth, *supra* note 17, at 29; *see also* COX & HAZEN, *supra* note 125, § 14.13 at 410 (“Most objections to arbitration of intracorporate disputes are based on the supposed unfitness of the arbitral process for formulating corporate policy and making managerial decisions.”).

142. For a discussion of legal arguments that may be raised against (and for) the enforceability of agreements to arbitrate corporate disputes (i.e., decisions normally made by shareholders or directors), *see* GEVURTZ, *supra* note 23, at 511-13; 9A FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 4724 (Supp. Sept. 2006). For a brief discussion of the alternative of mediation, *see* Susanna M. Kim, *The Provisional Director Remedy for Corporate Deadlock: A Proposed Model Statute*, 60 WASH. & LEE L. REV. 111, 129-31 (2003).

143. Kim, *supra* note 142, at 114 (“[O]ver twenty states have adopted statutes that specifically empower courts to appoint provisional directors in cases of corporate deadlock, and courts in all states have the equitable power to order the designation of an additional director in lieu of dissolution.”) (footnotes omitted). Closely related to the idea of a provisional director are the ideas of “custodians” and “temporary receivers.” *See id.* at 125-27.

144. O’NEAL & THOMPSON, *supra* note 17, § 7:23.

145. Haynsworth, *supra* note 17, at 27-28; *see also* Thompson, *Corporate Dissolution*, *supra* note 17, at 229.

*Transfer Restrictions.* Finally, no discussion of protections that a minority shareholder should consider would be complete without a mention of share transfer restrictions. A shareholder may freely transfer any or all of his shares to a third party unless he has contractually agreed not to do so or has granted a right of first refusal in the event of a contemplated transfer.<sup>146</sup> Given the intimate relationship of shareholders in a close corporation – many of whom will also be directors, officers, and employees of the company – it may be important to control the persons to whom shareholders may transfer their shares. An otherwise harmonious relationship could be strained by the entrance of a new shareholder. Fortunately, most states uphold the validity of such agreements, provided that they are set forth in the articles or bylaws of the company, or in a written agreement between the shareholders and the corporation, and are for a “reasonable” purpose.<sup>147</sup>

## 2. *In the Limited Liability Company*

Three factors make the following discussion fairly general. First, unlike corporation statutes, the LLC statutes of the various states are very diverse and so far no popular model or template seems to have emerged.<sup>148</sup> For this reason, the following discussion will consider the laws of the states of California, Delaware, and New York, as well as the Revised Uniform Limited Liability Company Act (Re-ULLCA).<sup>149</sup> Second, many LLC statutes allow parties a great degree of contractual freedom and contemplate that the LLC will have an operating agree-

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146. *See supra* note 99.

147. *See, e.g.*, MODEL BUS. CORP. ACT. § 6.27(c) (1984) (share transfer restrictions authorized (1) to maintain the corporation’s status when the status depends on the number or identity of shareholders, such as “S” corporation status, (2) to preserve securities law exemptions, or (3) for any other “reasonable purpose”).

148. *See, e.g.*, Miller, *supra* note 33, at 354-55 (“The now famous ‘Check-the-Box’ Regulations heralded substantial revision of state LLC statutes, which are now quite varied across the country.”).

149. Re-ULLCA was approved by the National Conference of Commissioners on Uniform State Laws in July 2006. For a discussion of the differences between Re-ULLCA and the 1996 Uniform Limited Liability Company Act, see Daniel S. Kleinberger & Carter G. Bishop, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515 (2007).

ment.<sup>150</sup> In other words, an LLC is, to a large degree, whatever its operating agreement says it is. Third, there are two basic types of management structures in LLCs: (1) member-managed LLCs, where each member has a right to participate in business decisions,<sup>151</sup> and (2) manager-managed LLCs, where most business decisions are made by the manager(s).<sup>152</sup> The differences between these types of LLCs can be significant. With those caveats in mind, a few words about how a minority LLC member may protect himself are in order.

*Employment Agreements.* There is no reason to think that a minority LLC member would be less interested in employment than would a minority shareholder. However, even in a member-managed LLC, a member is not entitled to remuneration for services rendered unless the operating agreement so provides.<sup>153</sup> Thus, the minority LLC member should obtain an employment agreement to document the terms and conditions of employment, and to establish a measure of damages if the LLC terminates his employment.

*Operating Agreement Provisions.* LLC members are largely free to determine the LLC's governance rules through operating agreement provisions.<sup>154</sup> The extent to which the minority owner needs to protect himself will depend on whether the relevant LLC statute provides him with favorable default rules.

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150. See *supra* note 33 and accompanying text. The two LLC charter documents are the articles of organization and the operating agreement, which are somewhat akin to the articles of incorporation and bylaws of a corporation, respectively. Most statutes require very little information to be included in the articles of organization, leaving the operating agreement to contain most of the LLC's governance rules. Cf. Kleinberger & Bishop, *supra* note 149, at 520-21. One recent empirical study suggests that "form" LLC operating agreements are common. See *infra* notes 346-55 and accompanying text.

151. J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 IOWA J. CORP. L. 97, 107 (2000).

152. *Id.* at 108.

153. See, e.g., CAL. CORP. CODE § 17004(b) (West 2006); REV. UNIF. LTD. LIAB. CO. ACT § 407(f) (2006); see also *id.* § 407 cmt. Member compensation does not appear to be addressed in the Delaware statute. The New York statute addresses this issue indirectly, by providing that LLCs have the power to "elect or appoint managers, employees and agents . . . define their duties and fix their compensation." N.Y. LTD. LIAB. CO. LAW § 202(h) (McKinney 2007).

154. Kleinberger & Bishop, *supra* note 149, at 520-21.

“Exit Rights.” An LLC will rarely be publicly traded; if it were, then it would be taxable as a corporation<sup>155</sup> – a result that the owners probably were trying to avoid. Thus, a minority member will likely face the same practical difficulties in reselling his interest as would a minority shareholder in a closely held corporation.<sup>156</sup> Moreover, LLC statutes may not grant an LLC member the default ability to withdraw voluntarily from the business and receive a buy-out. Although early LLC statutes often provided that a member could easily dissolve the LLC,<sup>157</sup> following the check-the-box regulations, there has been a trend toward making LLCs more durable.<sup>158</sup> In other words, many LLC statutes do not provide members with a default right to withdraw from the LLC prior to its dissolution and receive a sum of money from the LLC in redemption of their interests.<sup>159</sup> If that is the case, the minority member would be well-advised to include such rights in the operating agreement.

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155. Sandra K. Miller, *The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference*, 87 NEB. L. REV. 125, 134 (2008). See I.R.C. § 7704 (2008) (taxing publicly traded partnerships as corporations).

156. See *supra* note 100.

157. Under the 1996 version of the Uniform Limited Liability Company Act, an LLC member could dissociate by express will from the LLC and receive the fair value of his interest in the LLC. See UNIF. LTD. LIAB. CO. ACT §§ 601(1), 701(a)(1) (1996).

158. Although Re-ULLCA provides an LLC member has a broad right to dissociate by express will from the LLC, upon dissociation a member is treated as a mere transferee of its transferable interest in the LLC. Essentially, this means that the dissociated member is *not* entitled to any buy-out of his interest in the LLC. See REV. UNIF. LTD. LIAB. CO. ACT § 603(a) (2006); see also *id.* § 603 cmt. (“[D]issociation does not entitle a person to any distribution. Like most *inter se* rules in this Act, this one is subject to the operating agreement.”).

159. None of the statutes under consideration here provide default exit rights. In Delaware, a member who resigns from the LLC is entitled to receive the “fair value” of his interest, unless the operating agreement (called a limited liability company agreement in Delaware) provides otherwise. DEL. CODE ANN., tit. 6, § 18-604 (2005). While at first this seems to provide the LLC member with a default exit right, a member may resign only as specified in the operating agreement. Further, unless the agreement provides otherwise, a member may not resign from the LLC before dissolution. *Id.* § 18-603. Thus, the Delaware LLC member is trapped in his investment until the LLC dissolves, unless the operating agreement provides otherwise. California and New York are similar. See CAL. CORP. CODE § 17252(a) (West 2006); N.Y. LTD. LIAB. CO. LAW §§ 606(a), 509 (McKinney 2007).



*Supermajority Vote Provisions.* Another issue to be addressed is the usual “majority-rule” principle in LLCs. In member-managed LLCs most decisions are made by a majority vote.<sup>160</sup> How one determines a “majority” is a point of departure for many state statutes: “about half of the LLC statutes default to members voting on a per capita (one vote per member) basis, while the other half default to members voting on a pro rata (by financial interest) basis.”<sup>161</sup> Either way, the minority member will not be able to determine the outcome of most voting, unless the decision requires a unanimous vote. Thus, he may be well-advised to ensure that the operating agreement will give him a veto over certain decisions, such as mergers or conflict-of-interest transactions.

In a manager-managed LLC, most decisions are made by the manager(s),<sup>162</sup> with the voting power of members usually reserved to electing managers and voting on certain “major” decisions such as mergers and asset sales.<sup>163</sup> Thus, the member of a manager-managed LLC has somewhat similar voting rights to a corporate shareholder.<sup>164</sup> The question, then, is who elects the managers? Usually, a majority of

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160. Moll, *supra* note 8, at 941-42.

161. *Id.*; see also CAL. CORP. CODE § 17103 (West 2006) (in absence of contrary provision in articles or operating agreement, LLC members vote in proportion to their interests in the profits of the LLC; matters other than the amendment of the articles or operating agreement are decided by “a majority in interest of the members”); *id.* § 17150 (West 2006); DEL. CODE ANN., tit. 6, § 18-402 (2005) (unless otherwise provided in LLC agreement, management of the LLC is “vested in its members in proportion to the then current percentage or other interest of members in the profits . . . the decision of members owning more than 50 percent . . . [being] controlling”); N.Y. LTD. LIAB. CO. LAW § 402 (McKinney 2007) (unless otherwise provided in the operating agreement, members vote in proportion to their respective shares of the current profits of the LLC; member decisions are made by a “majority in interest” or “at least a majority in interest”); REV. UNIF. LTD. LIAB. CO. ACT § 407(b) (2006) (unless otherwise provided in operating agreement, in member-managed LLC, each member has “equal rights in the management and conduct” of LLC business; decisions in the ordinary course of business are made by majority of the members, and decisions outside the ordinary course or involving an amendment to the operating agreement must be unanimous).

162. CAL. CORP. CODE §§ 17150, 17156 (West 2006); DEL. CODE ANN., tit. 6, §§ 18-402, 18-404 (2005); N.Y. LTD. LIAB. CO. LAW § 408 (McKinney 2007); REV. UNIF. LTD. LIAB. CO. ACT § 407(c) (2006).

163. REV. UNIF. LTD. LIAB. CO. ACT § 407(c) (2006).

164. Shareholders’ voting rights typically are limited to electing or removing directors and voting on major events such as mergers, large asset sales, and amendments to the articles. Allison D. Garrett, *The Corporation as a Sovereign*, 60 ME. L. REV. 129, 136 (2008).

the members elect the managers.<sup>165</sup> As such, the minority owner may want to consider operating agreement provisions that would allow him to elect at least some (albeit a minority) of the managers and prevent the removal of managers that he elected.

*Fiduciary Duties.* State LLC laws vary widely on the question of whether members owe one another or the LLC fiduciary duties and, if so, the extent to which those duties may be modified or waived by the operating agreement.<sup>166</sup> In states where the statute does not address this

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165. See, e.g., CAL. CORP. CODE § 17152(a) (West 2006) (“Election of managers to fill initial positions or vacancies shall be by the affirmative vote of a majority in interest of the members.”); N.Y. LTD. LIAB. CO. LAW §§ 413(a), 402 (McKinney 2007) (unless otherwise provided in operating agreement, managers elected annually by majority in interest of the members); REV. UNIF. LTD. LIAB. CO. ACT § 407(c)(5) (2006) (in a manager-managed LLC, a “manager may be chosen at any time by the consent of a majority of the members”). In Delaware, an LLC may be manager-managed only if its LLC agreement so provides. In that situation, the statute essentially leaves the manner of the election of the manager(s) to the agreement, providing only that the manager(s) “shall be chosen in the manner provided in the limited liability company agreement.” DEL. CODE ANN. tit. 6, § 18-402 (2005); see also *id.* § 18-101(10).

166. See generally Miller, *supra* note 12, at 1622-25 (discussing variations in statutes concerning the fiduciary duties of care and loyalty, if any, owed by LLC members and/or managers). The four statutes under consideration differ considerably. California and Re-ULLCA presume that members, at least in their capacities as managers, will owe fiduciary duties akin to partnership-based fiduciary duties. In California, the “fiduciary duties a manager owes to the [LLC] and to its members are those of a partner to a partnership and the other partners. . . .” CAL. CORP. CODE § 17153 (West 2006); see also *id.* § 17005(d) (fiduciary duties of manager may be modified only in a written operating agreement “with the informed consent of the members”); *id.* § 17150 (in a member-managed LLC, each member is “subject to all duties and obligations of managers . . .”).

Under Re-ULLCA, if the LLC is manager-managed, a non-manager owes no fiduciary duties to the LLC or other members solely by reason of being a member. UNIF. LTD. LIAB. CO. ACT § 409(g)(5) (2006). If the LLC is member-managed, however, things are more complex. First, under Section 409(a) members owe the LLC and the other members the fiduciary duties of care and loyalty. As for the duty of loyalty, Section 409(b) does not provide a complete definition, stating only that the duty of loyalty “includes” certain aspects. This is a change from the approach in RUPA and the 1996 ULLCA, both of which provided a purportedly complete definition. See UNIF. P’SHIP ACT § 404(b) (1997); UNIF. LTD. LIAB. CO. ACT § 409(b) (1996). According to commentators, the “cabin-in” approach of RUPA and the 1996 ULLCA “ignores the implicit fiduciary or fiduciary-like duty of members to avoid oppressing fellow members, . . . and puts inordinate pressure on the concept of ‘good faith and fair dealing.’” Kleinberger & Bishop, *supra* note 149, at 523 (footnotes omitted). Under

issue, courts might not impose fiduciary duties or might do so in unpredictable ways. As one author put it, the “growing movement away from the judicial implication of broad fiduciary duties makes it increasingly important for the minority LLC member to obtain express contractual protections and for the LLC statute itself to provide a variety of minimum statutory protections . . . .”<sup>167</sup> Of particular concern here is to include an operating agreement provision that allows one or more members to remove a manager or managers for breach of fiduciary duties (or in other specified circumstances). If state law doesn’t supply an acceptable definition, such fiduciary duties must be defined in the operating agreement.

“*Oppression*” Provisions. As discussed later,<sup>168</sup> an important protection for minority corporate shareholders are statutes that allow suits

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Re-ULLCA, the operating agreement generally may not eliminate the duties of loyalty or care or “any other [i.e., uncodified] fiduciary duty,” REV. UNIF. LTD. LIAB. CO. ACT § 110(c)(4) (2006). But it may restrict – or even eliminate – certain aspects of the duty of loyalty if “not manifestly unreasonable.” *Id.* § 110(d)(1). The operating agreement may also identify “specific types or categories of activities” that will not constitute loyalty violations.

New York’s statute imposes on managers a duty to act “in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances.” N.Y. LTD. LIAB. CO. LAW § 409(a) (McKinney 2007). It also implicitly recognizes that managers owe a duty of loyalty by including provisions concerning conflict-of-interest transactions. *See id.* § 411. Delaware’s LLC statute does not expressly impose any fiduciary duties. In addition, it ostensibly allows the LLC agreement to eliminate any fiduciary duties that may exist at common law. *See DEL. CODE ANN. tit. 6, § 18-1101(c)* (2005) (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to [an LLC] or to another member or manager . . . [such] duties may be expanded or restricted or eliminated by provisions in the [LLC] agreement; provided, that the [LLC] agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”). Re-ULLCA, however, “rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of ‘freedom of contract’ against the dangers that inescapably exist when some have power over the interests of others.” REV. UNIF. LTD. LIAB. CO. ACT § 110 cmt. (2006).

167. Miller, *supra* note 87, at 450. *But see infra* notes 257-75 and accompanying text. Writing a few years later, Professor Miller observed that courts are “leading the way toward balancing the interest in contractual freedom with the need to constrain opportunistic and deceptive conduct through the development of a minimum mandatory core of acceptable business conduct.” Miller, *supra* note 12, at 1613.

168. *See infra* notes 194-212 and accompanying text.

for dissolution of a corporation (or other forms of relief such as a forced buy-out of the complaining shareholder) if the directors or those in control of the corporation are guilty of “oppressive” behavior. While some states include such provisions in their LLC statutes,<sup>169</sup> a minority member of an LLC in a state without such protection may be well-advised to include such a provision in the operating agreement.

*Other Protections.* Obviously, the degree to which a minority member needs to negotiate for protections will depend on the relevant statute. A few other ideas that should be considered include preemptive rights,<sup>170</sup> dissenters’ rights in the event of certain business combinations involving the LLC,<sup>171</sup> and arbitration provisions.<sup>172</sup>

## II. JUDICIAL AND LEGISLATIVE RESPONSES

### A. In Close Corporations

*Fiduciary Duty Analysis and Oppression Statutes.* Although “[e]ach state has a unique regime for addressing minority shareholder oppression in closely held businesses,”<sup>173</sup> it can fairly be said that two primary causes of action have emerged in many states for the minority shareholder of a closely held corporation who is aggrieved by conduct of the majority.<sup>174</sup> The first avenue for relief, which was judicially created,

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169. See *infra* notes 276-78.

170. For example, Delaware law expressly provides that members do not have preemptive rights unless the limited liability company agreement so provides. DEL. CODE ANN. tit. 6, § 18-301(e) (2005).

171. The existence of dissenters’ rights softens the blow in a “squeeze out” merger; although the majority would have sufficient voting power to cause the LLC to be merged into another entity in a transaction in which the minority’s equity interest would be eliminated, at least the minority would be able to petition the court to determine the fair value of its interest in the LLC. Some LLC statutes provide dissenters’ rights in many business combinations. See, e.g., CAL. CORP. CODE § 17601 (West 2006); N.Y. LTD. LIAB. CO. LAW § 1002(e) (McKinney 2007). In a Delaware LLC, dissenters’ rights are available only if so provided in the LLC agreement or in the merger agreement. See DEL. CODE ANN. tit. 6, § 18-210 (2005).

172. See *supra* notes 138-42 and accompanying text.

173. John H. Matheson & R. Kevin Maler, *A Simple Statutory Solution to Minority Oppression in the Closely Held Business*, 91 MINN. L. REV. 657, 661 (2006) (noting that this is “a surprising state of affairs for such an important area of corporate law”).

174. *But see* Nixon v. Blackwell, 626 A.2d 1366, 1379 (Del. 1993) (rejecting “special, judicially-created rules to ‘protect’ minority stockholders of closely-held

was made famous by *Donahue v. Rodd Electrottype Company of New England, Inc.*,<sup>175</sup> where the court held that shareholders in a closely held corporation owe fiduciary duties to one another that are substantially similar to the fiduciary duties that partners owe one another.<sup>176</sup> The second avenue for relief, which is found in several state statutes,<sup>177</sup> is to sue for dissolution of their corporations (or other relief<sup>178</sup>) on the basis

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Delaware corporations”); *Riblet Products Corp. v. Nagy*, 683 A.2d 37, 39-40 (Del. 1996) (holding that although majority stockholders have fiduciary duties to minority stockholders *qua* stockholders, those duties are not implicated when the issue involves the rights of the minority stockholder *qua* employee under an employment contract.). *See generally* *Hunt v. Data Mgmt.*, 985 P.2d 730 (Kan. Ct. App. 1999) (following Delaware law). For a powerful argument that the Delaware approach is preferable to the Massachusetts approach, see Siegel, *supra* note 10. For the contrary argument, see Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099 (1999). For the argument that *Nixon* isn’t really very different from the Massachusetts approach, see GEVURTZ, *supra* note 23, at 456-58.

175. 328 N.E.2d 505 (Mass. 1975).

176. The narrow holding of *Donahue* was the “equal access rule,” i.e., that if the stock of a member of the “controlling group” of a closely held corporation is redeemed, “the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price.” *Id.* at 518. En route to this holding, however, the court observed that “the close corporation bears [a] striking resemblance to a partnership,” that “[c]ommentators and courts have noted that the close corporation is often little more than an ‘incorporated’ or ‘chartered’ partnership,” and that “[j]ust as in a partnership, the relationship among the stockholders must be one of trust, confidence and absolute loyalty . . . .” *Id.* at 512. As such, it is fair to say that *Donahue* essentially treated close corporations like partnerships in many ways, at least insofar as fiduciary duties are concerned.

It is easy to criticize *Donahue* for jumping to this conclusion; *partners* should be held to high fiduciary duties, but should *shareholders*? Partners, for one thing, have the ability to bind the partnership (and indirectly the partners) through a broad apparent authority power, something which shareholders – at least in their capacities as such – do not have. *See* UNIF. P’SHIP ACT § 301 (1997). Secondly, all partners are jointly and severally liable for all partnership obligations, *see id.* § 306, which is opposite the limited-liability norm for shareholders. As such, it seems much more important for partners to “behave” than shareholders; your partner can get you in a lot more trouble than can your fellow shareholder.

177. Dissolution of a corporation for oppression may also be available as a common-law remedy, even in states with an involuntary dissolution statute. *See, e.g.*, *Lewis v. Jones*, 483 N.Y.S.2d 868 (N.Y. App. Div. 1985).

178. As discussed below, some statutes expressly provide the court with other remedial options. *See infra* notes 300-11 and accompanying text. Even if the statute ostensibly provides that dissolution is the only possible remedy for oppression, courts

of “oppression.” Although these two avenues are technically distinct, “the varied state regimes have begun to converge over the past quarter century.”<sup>179</sup>

*Fiduciary Duty Analysis.* As noted above, the *Donahue* court imposed fiduciary duties on the shareholders of a closely held corporation.<sup>180</sup> This was a major break from the traditional view that shareholders, in their capacities as shareholders, owe no fiduciary duties to the corporation or to the other shareholders.<sup>181</sup> However, this does not mean that every adverse effect on a minority shareholder will give rise to a claim that the other shareholders breached their fiduciary duties. In *Wilkes v. Springside Nursing Home, Inc.*,<sup>182</sup> decided by the same court one year later, the court seems to have realized that a broad notion of fiduciary duties could hamper the efficient operation of the corporation, a concern initially raised in the concurring opinion in *Donahue*.<sup>183</sup>

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often have used their “inherent equity power as the basis for granting alternative remedies not mentioned in the statute.” Thompson, *Cause of Action*, *supra* note 17, at 721.

179. Matheson & Maler, *supra* note 173, at 665; *see also id.* at 687-89 (arguing that statutory and common-law approaches to minority shareholder oppression have become increasingly similar in terms of both the definition of oppression and the available remedies). One commentator observed that “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.” Moll, *Fair Value*, *supra* note 17, at 305; *see also* COX & HAZEN, *supra* note 125, § 14.12 at 404 (“It is . . . safe to say that over the past two decades there has been an extensive and significant melding of fiduciary standards to state involuntary dissolution statutes such that it is difficult to isolate the doctrine of fiduciary obligation in close corporations from involuntary dissolution.”); Thompson, *Cause of Action*, *supra* note 17, at 700 (“The standards used by some courts to determine a breach of fiduciary duty . . . are substantially the same as the standards used by other courts to define oppression as a ground for involuntary dissolution.”) (footnote omitted). One commentator, however, argues that “[a]lmost no oppression statute . . . can be fairly read as a codification of the majority [*Donahue*] rule.” Siegel, *supra* note 10, at 430. For one thing, only two state dissolution statutes provide that *Donahue*-like fiduciary duties are owed by *all* shareholders to one another; instead, most dissolution statutes apply to oppression by directors, officers, or those in “control” of the corporation, which would exclude minority shareholders. *See id.* at 430-31.

180. *Donahue*, 328 N.E.2d at 519.

181. *See* GEVURTZ, *supra* note 23, at 452. *But see id.* at 347 (discussing duties of controlling shareholders); COX & HAZEN, *supra* note 125, at 252-58 (same).

182. 353 N.E.2d 657 (Mass. 1976).

183. The concurring opinion in *Donahue* expressed concern that the notion of fiduciary duties could be taken too far: “I do not join in any implication . . . that the

In *Wilkes*, a minority shareholder had a falling out with the other three shareholders and found his employment terminated, with the result that he was earning no return on his investment.<sup>184</sup> However, because the court was concerned that applying *Donahue* in an “untempered” manner would “unduly hamper [the controlling group’s] effectiveness in managing the corporation in the best interests of all concerned,”<sup>185</sup> the court did not blindly grant relief to the plaintiff. Instead, it established a two-part test. First, when a minority shareholder brings suit for an alleged breach of fiduciary duty in a closely held corporation, the court must “carefully analyze” whether “the controlling group can demonstrate a legitimate business purpose for its action.”<sup>186</sup> If such a purpose is offered by the defendants, the plaintiff-shareholder must “demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest.”<sup>187</sup> If both parties make their required showings, the court must then “weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.”<sup>188</sup> Thus, the *Wilkes* court seemingly contemplated a lot of judicial involvement in settling disputes among shareholders. Not only must the court determine whether the defendants had a “legitimate business purpose” for their actions, but if the defendants had

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[equal access rule] applies to all operations of the corporation as they affect minority stockholders. That broader issue, which is apt to arise in connection with salaries and dividend policy, is not involved in this case. The analogy to partnerships may not be a complete one.” 328 N.E.2d at 521 (Wilkins, J., concurring).

184. See 353 N.E.2d at 659-61.

185. *Id.* at 663. The court also noted that the majority had “certain rights to what has been termed ‘selfish ownership’ in the corporation which should be balanced against the concept of their fiduciary obligation to the minority.” *Id.* (citation omitted).

186. *Id.*

187. *Id.*

188. *Id.* *Wilkes* could also be interpreted as adopting the “reasonable expectations” test (discussed *infra* notes 201-12) due to the following statement: “Wilkes was one of the four originators of the nursing home venture; and . . . [had] invested his capital and time for more than fifteen years with the *expectation* that he would continue to participate in corporate decisions.” *Id.* at 664 (emphasis added). Earlier, the court stated that “by terminating a minority stockholder’s employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder’s *purposes in entering on the corporate venture* and also deny him an equal return on his investment.” *Id.* at 662-63 (emphasis added); see also *Brodie v. Jordan*, 857 N.E.2d 1076, 1079 (Mass. 2006) (after reviewing examples of “freeze-outs,” court observed that “[w]hat these examples have in common is that . . . the majority frustrates the minority’s reasonable expectations of benefit from their ownership of shares.”).

such a purpose, the court must then decide whether it is practical or likely that the “less harmful alternative” offered by the plaintiff will achieve the purpose offered by the defendants.<sup>189</sup>

To be sure, *Wilkes* and *Donahue* are not the only cases that have applied fiduciary duty analysis, and its application can be much more nuanced than the above discussion indicates, particularly at the intersection between fiduciary duties and the at-will employment doctrine.<sup>190</sup> It is sufficient to recognize that fiduciary duty analysis is an important – albeit clumsy, uncertain, and inefficient – avenue for the abused minority shareholder who has not engaged in advance planning to fight back. *Donahue* is probably incorrectly described as the majority rule,<sup>191</sup> particularly in light of the fact that a majority of states have “oppression” statutes that to some degree render *Donahue*-based claims unnecessary.<sup>192</sup> But even *Donahue*’s strongest detractors acknowledge that it has been followed in many states.<sup>193</sup>

*Involuntary Dissolution.* The other main approach to remedying the abuse of minority shareholders is to allow dissolution of the corporation upon a showing that “the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent”<sup>194</sup> or similar phrases. At least thirty-seven states have such statutes.<sup>195</sup> If granted, an order of dissolution under such a

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189. *Wilkes*, 353 N.E.2d at 663.

190. *See, e.g., Merola v. Exergen Corp.*, 668 N.E.2d 351 (Mass. 1996), in which the court found that the majority shareholder did not breach its fiduciary duty to the plaintiff-minority shareholder by firing him without a legitimate business purpose. The plaintiff had started as an employee with the company before purchasing stock. Importantly, the plaintiff’s firing was in accordance with his employment agreement and he was adequately compensated when the corporation redeemed his stock. Essentially, the case clarifies that fiduciary duty analysis does not automatically protect interests, such as employment, that are not “traditional” shareholder interests.

191. *See supra* note 10.

192. *See infra* notes 194-212 and accompanying text.

193. *See Siegel, supra* note 10, at 416.

194. *See, e.g., MODEL BUS. CORP. ACT* § 14.30(a)(2)(ii) (1984) (amended 2006). Dissolution-for-oppression statutes date back to at least 1933 in Pennsylvania and Illinois. However, two of the more significant developments in this area, which greatly influenced other state statutes, were amendments to the California and New Jersey corporate statutes in the 1970’s. *See generally Matheson & Maler, supra* note 173, at 665-68.

195. *See, e.g., 805 ILL. COMP. STAT. ANN.* § 5/12.56(a)(3) (West 2004); *MICH. COMP. LAWS ANN.* § 450.1489 (2002 & Supp. 2008); *N.Y. BUS. CORP. LAW* § 1104-



statute usually is conditioned on allowing either the corporation or the other shareholders to forestall dissolution by purchasing the complaining shareholder's shares at "fair value."<sup>196</sup> Also, many statutes provide for relief other than dissolution.<sup>197</sup>

As one would guess, most of the litigation in this area focuses on whether "oppression" has occurred, particularly since that term often is not defined in the statute. Different courts have offered different definitions, with the "earlier interpretations of oppression speak[ing] in terms of wrongful conduct, violations of the duty of good faith and fair dealing, breaches of fiduciary duty, and the like."<sup>198</sup> One court defined "oppressive" as "conduct by corporate managers toward stockholders which departs from the standards of fair dealing and violates the principles of fair play on which persons who entrust their funds to a corporation are entitled to rely."<sup>199</sup> While this definition sounds eloquent, it isn't terribly helpful for the planning attorney or a trial court reviewing conduct after the fact. The subjective and vague nature of these standards can easily lead one to conclude they are "little more than the court's gut instinct."<sup>200</sup>

A more concrete approach to defining "oppression" is found in *In re Kemp & Beatley, Inc.*,<sup>201</sup> in which the New York Court of Appeals adopted the "reasonable expectations" test:

A court . . . must investigate what the majority shareholders knew, or should have known, to be the petitioner's expectations in entering

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a(1)(1) (McKinney 2003); TEX. BUS. CORP. ACT. ANN. art. 7.05(1)(c) (Vernon 2003).

196. Such a provision recognizes what often happens in the "real world"; one study found that where courts ordered involuntary dissolution, one group of shareholders almost always ended up buying out the other group of shareholders. See Hetherington & Dooley, *supra* note 17.

197. See *infra* note 308.

198. GEVURTZ, *supra* note 23, at 471 (citations omitted).

199. *Giannotti v. Hamway*, 387 S.E.2d 725, 730 (Va. 1990).

200. GEVURTZ, *supra* note 23, at 471; see also *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387, 393 (Or. 1973) (general definitions of oppression are of "little value for application in a specific case."). One commentator suggests that the vagueness of the term "oppression" could be reduced if statutes contain a (nonexclusive, of course) list of factors that are indicative of minority owner abuse or "squeeze-outs." See Miller, *supra* note 87, at 464 (listing several suggested factors).

201. 473 N.E.2d 1173 (N.Y. 1984).

the particular enterprise<sup>202</sup>. Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression.

Rather, oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner's decision to join the venture. . . . [M]uch will depend on the circumstances in the individual case.<sup>203</sup>

At least two state statutes have codified the reasonable expectations test.<sup>204</sup> For example, the Minnesota involuntary dissolution statute provides in part that:

In determining whether to order equitable relief, dissolution, or a buy-out, the court shall take into consideration the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair, and reasonable manner in the operation of the corporation and the *reasonable expectations of all shareholders as they exist at the inception and develop during the course of the shareholders' relationship with the corporation and with each other.*<sup>205</sup>

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202. In *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983), the court found that the reasonable expectations could evolve, rather than being frozen at the point where the shareholder initially became a shareholder.

203. *Kemp & Beatley*, 473 N.E.2d at 1179. The New York oppression statute required a court to determine whether dissolution is the "only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment" and is "reasonably necessary for the protection of the rights and interests of any substantial number of shareholders or of the petitioners." *See id.* at 1177 n.1. As a result, the court found that it must also determine whether "some remedy short of or other than dissolution constitutes a feasible means of satisfying both the petitioner's expectations and the rights and interests of any other substantial group of shareholders." *Id.* at 1180. Further, the defendants could demonstrate the "existence of an adequate, alternative remedy." *Id.* If the court orders dissolution, the order must be conditioned on allowing other shareholders to purchase the plaintiff's shares at fair value. This latter requirement, which presumably should satisfy both the plaintiff (who receives some cash for his shares, solving his "exit" problem) and the corporation and other defendants (who are allowed to continue the corporation's existence) is somewhat codified in Section 14.34(a) of the MBCA. MODEL BUS. CORP. ACT § 14.34(a) (1984) (added 1990 and amended 2006).

204. *See* MINN. STAT. ANN. § 302A.751, subd. 3a (West 2004); N.D. CENT. CODE § 10-19.1-115 (2005).

205. MINN. STAT. ANN. § 302A.751, subd. 3a (West 2004) (emphasis added). This

In addition, the fiduciary duty approach discussed above can be seen as also having adopted a “reasonable expectations” approach, with the result that the two different sources of remedies for abused minority shareholders (either common law or statutory) are quite similar in practice.<sup>206</sup>

Although not universally followed,<sup>207</sup> the reasonable expectations text is popular, having been adopted in approximately twenty states.<sup>208</sup> It also is an improvement over other definitions of oppression and, as delineated by *Kemp & Beatley*, gives the court several specific factors to consider. Its focus is on the effect on the minority, not whether there was a business justification for the majority’s actions: “Under this perspective, importantly, oppression can be found even though the conduct that frustrates the minority’s expectations does not entail a breach of fiduciary duty by the controlling shareholder.”<sup>209</sup> In other words, whether the defendants can show a “legitimate business purpose” for their actions (which is relevant under *Wilkes*<sup>210</sup>) may be irrelevant under the reasonable expectations approach.<sup>211</sup> The reasonable expectations ap-

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statute further provides that “any written agreements, including employment agreements and buy-sell agreements, between or among shareholders or between or among one or more shareholders and the corporation are presumed to reflect the parties’ reasonable expectations concerning matters dealt with in the agreements.”

206. See *supra* note 188.

207. See, e.g., *Kiriakides v. Atlas Food Sys. & Servs., Inc.*, 541 S.E.2d 257 (S.C. 2001) (rejecting use of reasonable expectations as the sole test for oppression under the South Carolina statute); see also *Scott v. Trans-System, Inc.*, 64 P.3d 1, 6 (Wash. 2006) (offering two alternative definitions of oppression, and observing that the reasonable expectations test “is most appropriate in situations where the complaining shareholder was one of the original participants in the venture”).

208. Matheson & Maler, *supra* note 173, at 664 (stating that twenty states use the reasonable expectations test, one state uses reasonable expectations “as a factor,” and twelve states use a “fiduciary duty approach that . . . could be employed to reach the same result as the reasonable expectations standard”) (footnotes omitted); see also O’NEAL & THOMPSON, *supra* note 17, § 7:15, at 7-105 to 7-106 (Supp. 2004); Moll, *Fair Value*, *supra* note 17, at 306 (reasonable expectations test is most popular approach to defining oppression); Thompson, *Corporate Dissolution*, *supra* note 17, at 208-10 (same).

209. Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 IOWA J. CORP. L. 371, 390 (2003).

210. See *supra* note 186 and accompanying text.

211. Typically, fiduciary-duty analysis and reasonable-expectations analysis will lead to the same conclusion. However, for an example of how the two approaches could lead to different results, see Art, *supra* note 209, at 396-98; see also Utset, *supra*

proach also provides the minority shareholder who had certain “expectations” about his relation to the corporation but did not document them in writing an escape hatch: a way to enforce unwritten agreements. As discussed further below, however, it suffers from several flaws.<sup>212</sup>

*The “Contractarian” School’s Effects on Corporate Law.* If fiduciary duty analysis and oppression statutes were attempts to rescue an abused minority shareholder – particularly one who had not engaged in any advance planning – a parallel development was making it more likely that planning would be upheld by the courts. A series of intellectual leaps was required.

Historically, corporate statutes made no distinction between publicly traded, or widely held, corporations and closely held corporations, despite the very real differences between these types of firms. Thus, statutory provisions like Section 8.01(b) of the MBCA<sup>213</sup> were interpreted as precluding shareholders from participating in business decisions affecting the corporation – even if all the shareholders entered into a written agreement giving them (in their capacities as shareholders) certain management rights.<sup>214</sup> A rule reserving managerial authority to the board, rather than the shareholders, is a sound rule even today, especially for publicly traded firms. However, the philosophy of statutory provisions such as Section 7.32 of the MBCA (which would allow the shareholders to eliminate the board of directors and fill that void themselves)<sup>215</sup> found no place in most early corporation statutes. In other words, one size *did* fit all – if the founders of a business felt that the requirements of corporate statutes were too restrictive, their only other real choice was to form a partnership; partnership law has always allowed the partners to create their “own law” through partnership agreements that dramatically depart from statutory default rules.<sup>216</sup>

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note 8, at 1399 (“Under the pure reasonable expectations approach, the majority shareholder’s justifications for firing the minority shareholder are not relevant to the [oppression] inquiry.”).

212. See *infra* notes 293-98 and accompanying text.

213. MODEL BUS. CORP. ACT § 8.01(b) (1984) (amended 2000) (“All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation shall be managed by or under the direction of, the board of directors . . .”).

214. See *infra* note 228.

215. MODEL BUS. CORP. ACT § 7.32 (1984) (added 1990).

216. Partnership law has long recognized the freedom of the partners to structure their relationships as they see fit, at least outside of a few narrowly defined circumstances. See, e.g., UNIF. P’SHIP ACT § 18 (1914) (“The rights and duties of partners in

Nonetheless, beginning in the late 1940s, court decisions and academic literature<sup>217</sup> paved the way for more widespread acceptance of the “contractarian” school of thought for closely held corporations. For example, in 1964, the Illinois Supreme Court noted that courts have permitted close corporations to deviate slightly from corporate norms, since there are no valid reasons to preclude parties in close corporations from entering into agreed-upon management agreements.<sup>218</sup>

Today, the premise that shareholders in a closely held corporation should be free to agree on arrangements that would violate certain “fundamental” rules of corporate governance is widely endorsed, reflected not just in judicial decisions<sup>219</sup> and academic commentary,<sup>220</sup> but in

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relation to the partnership shall be determined, *subject to any agreement between them* by the following rules . . . .”) (emphasis added); Hillman, *supra* note 82, at 171 (“Partnership law encourages private ordering through bargaining by providing a set of statutory default norms that, with only a few exceptions, yield to agreements negotiated by partners. Corporate law, in contrast, historically has provided a mandatory framework for firm structure which is highly resistant to shareholders’ attempts to define their relationships through bargaining.”).

217. See, e.g., Carlos D. Israels, *The Close Corporation and the Law*, 33 CORNELL L. Q. 488 (1948); George D. Hornstein, *Stockholders’ Agreements in Closely Held Corporations*, 59 YALE L. J. 1040, 1040 (1950) (“There is no reason why mature men should not be able to adapt the statutory form to the structure they want, so long as they do not endanger other stockholders, creditors, or the public, or violate a clearly mandatory provision of the corporation laws.”). For a discussion of the evolution of the law (and legal scholarship) toward the principle that participants in a closely held corporation should essentially be free to structure their relationship as they see fit, see Hillman, *supra* note 83. As Professor Hillman notes, not until 1936 did “a significant court decision actually mold[] corporate law to the special circumstances of a closely-held firm.” *Id.* at 174 (citing *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936)).

218. See *Galler v. Galler*, 203 N.E.2d 577, 584-85 (Ill. 1964) (citations omitted).

219. See, e.g., *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936) (enforcing agreement between the only two shareholders of two corporations that one shareholder would ensure that the other would remain as general manager of one of the corporations as long as he was “faithful, efficient and competent” and that he would receive one-fourth of the corporation’s net income, either as salary or as dividends). According to Professors Cox and Hazen, the “courts’ liberal approach toward agreements restricting director discretion can be traced to *Clark v. Dodge*.” COX & HAZEN, *supra* note 125, § 14.05 at 391. Two important factors that led the court to its holding, which departed from precedent, were that the shareholders agreement was unanimous, and that the agreement limited director discretion only in certain areas. *Id.* at 392; see also *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980) (upholding agreement unanimously entered into by shareholders of a Delaware corporation that provided that the corporation could conduct no business or activities without the minority shareholder’s consent); EISENBERG, *supra* note 82, at 336 (“In contrast [to partnership law], corporation law traditionally was not

many statutory provisions.<sup>221</sup> For example, Section 7.32 of the MBCA essentially allows shareholders – provided that every one of them agrees – to completely rewrite the corporate rule book, going so far as to allow the abolition of the board of directors, or agreements governing the corporation and its management.<sup>222</sup> Also, one could view LLC statutes, which usually give the parties great freedom to structure their relationships as they see fit,<sup>223</sup> as a continuation of this trend.

Although this approach is not without dangers (especially to unwitting minority shareholders<sup>224</sup> or those who simply write poor contracts), it reflects the view that the parties' desires are much more important than the particular business organization form they have selected. It also

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as attuned to contractualization, and in the corporate context there was often serious question whether such arrangements would be deemed valid. Today, however courts and legislatures have shown themselves increasingly ready to enforce contractual arrangements in close corporations. . . ."); COX & HAZEN, *supra* note 125, at 393 ("Today, it appears that any limits on the scope or validity of shareholders' agreements are imposed only when there is a clear conflict with the governing corporate statute and, more particularly, if there is any fraud in the agreement's execution or operation.") (citations omitted); Rock & Wachter, *supra* note 107, at 914 ("The evolution toward greater flexibility was long, and at times, hard fought, but it no longer is a central issue. Today, participants in the close corporation can largely tailor its terms to their purposes.").

220. See, e.g., Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1397 (1989); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 18-19 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 299 (1986).

221. E.g., 15 PA. CONS. STAT. ANN. § 1306 cmt. (purpose of Pennsylvania statute is "to provide the shareholders with the greatest possible latitude in regulating the internal affairs of their corporation").

222. See MODEL BUS. CORP. ACT § 7.32(a) (1984) (added 1990). Due to the unusual things that may be accomplished with a Section 7.32 agreement, the statute requires that every shareholder must consent to the agreement in order for it to be valid. *Id.* § 7.32(b)(1).

223. See *supra* note 33 and accompanying text.

224. As one commentator observed concerning LLCs, "the move to increasing contract rights has led to a concomitant ability among investors to *decrease* their fiduciary obligations." Siegel, *supra* note 10, at 466 (emphasis added). However, Professor Siegel believes it would be hypocritical to argue that shareholders are not likely to engage in advance planning, yet complain about statutes that allow fiduciary duties to be decreased. In other words, this argument "exposes that the real concern is not whether shareholders will expend the effort to protect themselves by contract but rather disagreement over the choices that shareholders make by contract." *Id.* at 469-70.

recognizes that the role of corporate law should be to provide default rules “while leaving managers free to customize their companies’ charters with legally enforceable rights and obligations.”<sup>225</sup>

*Special Statutes For “Close” Corporations.* In the early and middle twentieth century some began to believe that general corporation laws – designed primarily (or exclusively) to meet the needs of public corporations<sup>226</sup> – thwarted the ability of shareholders in closely held corporations to enter into agreements that would be permissible in the partnership context.<sup>227</sup> This was particularly so in the wake of several court decisions that refused to enforce shareholder agreements (sometimes agreed to by *all* of the shareholders) because they violated certain “statutory norms,” for example by impinging on the statutory authority of the board of directors to hire officers and set their salaries.<sup>228</sup> As Professor Thompson observed: “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.”<sup>229</sup> On the other hand, some courts did recognize the shareholders’ ability to modify traditional corporate law rules; the development of the law was not uniform in all states.<sup>230</sup>

Thus, recognizing the trend of increasing contractual freedom, but perhaps leery of allowing shareholders to go “too far,” some states subsequently adopted special provisions in their general corporation statutes for closely held corporations (or, more specifically, non-public corpora-

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225. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 780 (2006).

226. See Dennis S. Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L. J. 663, 668 (1989).

227. *Id.* at 667-69.

228. See, e.g., *Jackson v. Hooper*, 75 A. 568 (N.J. Eq. 1910) (refusing to enforce agreement between two 50% shareholders that business decisions would require the assent of each shareholder); *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 77 N.E.2d 633 (N.Y. 1948) (invalidating unanimous shareholders’ agreement that would have given certain management powers to specified shareholders); see also *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934) (refusing to enforce agreement between three shareholders that they would each use their best efforts to ensure that each of them was appointed to a specified officer position and paid a specified salary – decisions traditionally reserved to the corporation’s board of directors).

229. Thompson, *Corporate Dissolution*, *supra* note 17, at 195 (footnote omitted).

230. See *supra* notes 217-19 and accompanying text.

tions).<sup>231</sup> In 1955, North Carolina became one of the first states<sup>232</sup> to move in this direction when it adopted a statute that validated written agreements that had been unanimously approved by shareholders of non-public corporations, even if the agreement treated the corporation like a partnership or dictated decisions normally made by the corporation's board of directors.<sup>233</sup> In other words, unanimous shareholder agreements could result in corporate governance at odds with "normal" corporate governance.<sup>234</sup> This approach can now be found in the statutes

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231. Commentators had been calling for specialized close-corporation legislation since at least 1928. See Joseph L. Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273, 281-84 (1928).

232. But see O'Neal, *supra* note 17, at 873-74 (stating that N.Y. STOCK CORP. L. § 9, which allowed the corporation's bylaws to set quorum and voting requirements higher than the "normal" rules for both shareholder and director action, "was hailed at the time of enactment as being the first important legislative recognition of the special management problems of close corporations").

233. See *id.* at 874; Karjala, *supra* note 226, at 669 (describing the North Carolina statute as the "first, cautious step" in this direction). Another important development was Section 620(b) of the New York Business Corporation Law. When adopted in 1961, Section 620(b) provided that a provision in a corporation's certificate of incorporation "otherwise prohibited by law as improperly restrictive of the discretion or powers of the directors in their management of corporate affairs . . . shall nevertheless be valid" (1) if all of the shareholders (or incorporators, before the issuance of shares) approve the provision and (2) if shares are thereafter issued or transferred to persons who did not have knowledge of the provision, those persons consent to it in writing. N.Y. BUS. CORP. LAW § 620(b) (McKinney 1961). Section 620(b) thus "validate[d] shareholder agreements which otherwise could be invalid because the agreement restricts the board in managing the corporation – either in that the agreement commands certain board decisions or in that the agreement transfers management authority to someone other than the board." GEVURTZ, *supra* note 23, at 503. In addition, in 1962 South Carolina adopted provisions in its corporation law that "expressed a desire to permit shareholders in a close corporation to act in the corporation's internal affairs almost as freely as though they were in a partnership." O'Neal, *supra* note 17, at 874.

234. A related, but earlier, development was the recognition that one or more shareholders could enter into agreements among themselves as to how they would vote their shares in the future, even if such agreements were not entered into by all of the shareholders. Some early decisions invalidated such shareholder voting agreements on public policy grounds because they "interfered with a shareholder's duty to vote according to his or her independent judgment and in the best interest of the corporation." GEVURTZ, *supra* note 23, at 486 (citing *Halderman v. Halderman*, 197 S.W. 376 (Ky. 1917)). However, courts in the mid-20th century found shareholder voting agreements enforceable. *E.g.*, *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441 (Del. 1947).



of several states (albeit, in varying degrees),<sup>235</sup> as well as Section 7.32 of the MBCA.<sup>236</sup> While many of these statutes are applicable to any non-public corporation, the requirement of unanimous shareholder approval limits the usefulness of these statutes to corporations with small numbers of shareholders.<sup>237</sup>

Other states, the first “wave” being Delaware, Kansas, Maryland, and Pennsylvania,<sup>238</sup>) took a different approach,<sup>239</sup> adopting provisions

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235. See, e.g., MICH. COMP. LAWS ANN. § 450.1488 (2008); TEX. BUS. ORG. CODE ANN. § 21.101 (2007). For the current statute of North Carolina, the pioneer in this area, see N.C. GEN. STAT. § 55-7-31(b) (2008). The other states include: Alabama, Alaska, Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Iowa, Maine, Massachusetts, Mississippi, Montana, Nebraska, New Hampshire, Oregon, South Dakota, Utah, Virginia, Washington, West Virginia, and Wyoming.

236. MODEL BUS. CORP. ACT § 7.32 (1984) (added 1990).

237. This highlights the difficulty of actually defining a “close corporation” for purposes of these statutes – a “point of contention for decades.” Chittur, *supra* note 17, at 145. There are at least four approaches that states have taken: (1) self-selective (where a corporation can declare itself to be a close corporation in its charter), (2) permissive (where a corporation with certain characteristics is permitted to use the special statutory provisions for close corporations), (3) numerical restrictive (where a close corporation is defined by the number of shareholders), and (4) share transfer restrictive (where a close corporation is defined in terms of the restrictions on transfers of its stock). See *id.* at 145-46. Note, however, that a focus on the number of shareholders can sometimes produce inequitable results. For example, in *Sundberg v. Lampert Lumber Co.*, 390 N.W.2d 352, 354 (Minn. Ct. App. 1986), the court held that the corporation was not a “close corporation” within the meaning of Minnesota’s buyout statute, which applied to corporations with 35 or fewer shareholders. In that case, 70% of the corporation’s stock was owned by the members of one family and 10% of the stock was owned by the members of another family, but the rest was owned by 90 other shareholders.

238. See O’Neal, *supra* note 17, at 875-78. In 1978, Professor O’Neal noted that many statutes adopted since World War II, even if not designed specifically for close corporations, contained provisions that gave the participants in a close corporation more flexibility in structuring their affairs, such as permitting high quorum and voting requirements for shareholder and director actions and validating shareholder agreements that addressed decisions normally made by the board. See *id.* at 879. In addition, by then most state statutes made agreements to arbitrate future disputes enforceable, a departure from the common law. *Id.* For the current versions of the Delaware, Kansas, Maryland, and Pennsylvania statutes, see DEL. CODE ANN. tit. 8, §§ 341-56 (2002); KAN. STAT. ANN. §§ 17-7201 to 17-7216 (2006); MD. CODE ANN., CORPS. & ASS’NS §§ 4-201 *et seq.* (2008); 15 PA. CONS. STAT. ANN. §§ 2301 *et seq.* (West 1998).

239. This is not to suggest that states have only taken two statutory approaches to close corporation problems. Instead, “close corporation statutes vary widely not simply in the approach each takes toward meeting the unique needs of close corporations but

in their statutes that only apply to close corporations, as defined by the statute (which usually requires the corporation to “opt in”<sup>240</sup> to the statute). A subchapter of the Delaware statute, entitled “Close Corporations; Special Provisions,”<sup>241</sup> varies the provisions of the Delaware General Corporation Law (the “DGCL”): (1) only to the extent specified in the subchapter, and (2) only as to corporations that have followed a specified procedure to be governed by the subchapter.<sup>242</sup> Although Delaware is a much more popular state of incorporation for publicly traded corporations than for closely held corporations,<sup>243</sup> given Delaware’s prominence in the corporate law field,<sup>244</sup> this statute deserves discussion.

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also in the legislature’s perception of what areas of the close corporation merit special treatment.” COX & HAZEN, *supra* note 125, § 14.02, at 387. For the argument that such statutes provide very few benefits to shareholders, while also resulting in various harms, see Karjala, *supra* note 226, at 689-702.

240. See Karjala, *supra* note 226, at 691 (“Nearly all of the special close corporation legislation is enabling and elective; that is, it permits deviations from the traditional forms by those who elect to make use of it. These . . . statutes do nothing more for parties who know what they want and hire a competent lawyer to effect their desires in appropriate legal instruments than do flexible general corporation statutes.”) (footnote omitted). As a result of the opt-in requirement, “only a tiny fraction of newly formed corporations elect to become statutory close corporations.” EISENBERG, *supra* note 82, at 338 (citing 1 F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs § 1.20 (rev. 3d ed. 2004). “The result is that for practical purposes, statutory close corporation provisions are much ado about very little.” *Id.*; see also Rock & Wachter, *supra* note 107, at 929 (“[F]ew firms avail themselves of the opportunity to organize under such statutes. On the contrary, close corporations seem to stubbornly adhere to organizing under the general corporation codes.”); Michael E. Brown, *Comment and Note, Missouri Close Corporations: Proposals to Strengthen Protections for Minority Shareholders*, 68 UMKC L. REV. 145, 166 (1999) (“Currently, there are 3,573 active close corporations out of 116,528 corporations in the State of Missouri.”).

241. DEL. CODE ANN. tit. 8, §§ 341-56 (2002).

242. See *id.* §§ 342, 343.

243. See Timothy P. Glynn, *Delaware’s Vantagepoint: The Empire Strikes Back in the Post-Post-Enron Era*, 102 Nw. U.L. Rev. 91, 130 (2008) (noting that in contrast to its dominance amongst publicly traded corporations, Delaware captures only a small fraction of the closely held corporations).

244. See State of Delaware, The Official Website for the First State, Department of State: Division of Corporations, available at <http://www.corp.delaware.gov/about/agency.shtml> (“More than 50% of all publicly-traded companies in the United States including 63% of the Fortune 500 have chosen Delaware as their legal home.”) (last visited Feb. 2, 2009).

One important provision in the DCGL is Section 350, which validates written agreements among the holders of a majority of the outstanding voting stock even if they relate to the conduct of the corporation by limiting the powers of the board of directors.<sup>245</sup> Section 350 allows the shareholders (“stockholders” in Delaware) to agree in advance who will be the officers of the corporation and what their respective salaries will be, even though these determinations are ordinarily made by the directors.<sup>246</sup> Similarly, under DGCL Section 351, the corporation’s certificate of incorporation may provide for its business to be managed by the stockholders instead of the directors.<sup>247</sup> In fact, the corporation may eliminate the board altogether.<sup>248</sup> Even more permissive, Section 354 provides that the shareholders essentially can treat the corporation like a partnership, stating that no written agreement or charter provision will be considered invalid on the ground of treating the corporation like a partnership or the relations among or between the stockholders and the corporation in ways that are only appropriate for partners.<sup>249</sup>

Thus, under the DGCL, shareholders may change many fundamental rules of corporate governance. If the shareholders do not want a board of directors, they do not have to have one; if they want to limit the directors’ discretion to choose the officers, they may do so. The subchapter thus is a delight for those in the contractarian school of thought because it allows businesspeople to “write their own ticket.” However, with the exception of Section 353,<sup>250</sup> none of the substantive special provisions for close corporations provides any “default” rule. Instead, each provides the shareholders with an opportunity to change certain “fundamental” rules of corporation governance; the DGCL does not, however, actually require that they do so, or even that they consider doing so. In this sense, the Delaware statute may only be advantageous for

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245. See DEL. GEN. CORP. L. § 350 (2001).

246. See *id.*

247. See *id.* § 351.

248. Section 352(a) would allow any shareholder to petition the court for the appointment of a custodian when the shareholder-managers are deadlocked, resulting in the corporation suffering or being threatened with irreparable injury. See *id.* § 352(a).

249. See *id.* § 354.

250. Section 353 would allow the court, upon petition by certain parties, to appoint a “provisional director” (an impartial third party) when the directors are deadlocked “with the consequence that the business and affairs of the corporation can no longer be conducted to the advantage of the stockholders generally.” *Id.* § 353(a).

sophisticated parties, in that it does not suggest any provisions for the shareholders to consider. For example, a layperson may wonder what, exactly, would be an agreement that would treat the corporation as if it were a partnership. Even if the statute were more helpful in actually suggesting some of the *substantive* provisions, it gives no guidance on how to draft them.

### B. In Limited Liability Companies

Although commentators have recognized the potential for minority owner abuse in an LLC,<sup>251</sup> there are very few LLC oppression cases. One reason is that the LLC is relatively new. Additionally, “early LLC statutes adopted easy exit and shared power governance procedures,”<sup>252</sup> which made abuse of minority LLC members somewhat less likely.<sup>253</sup> They also allowed LLC members to address their expectations contractually in the operating agreement.<sup>254</sup>

Statutory responses to potential problems of abuse of minority LLC members are highly varied from state to state. Nonetheless, there are some indications that the development of LLC oppression law will proceed along the same lines as close corporations. Some states will use fiduciary duty analysis,<sup>255</sup> particularly if the LLC is member-managed, some states will adopt “oppression” statutes,<sup>256</sup> and some will do neither. Due to the unique nature of the LLC, though, this statement is probably an oversimplification.

*Judicial Responses.* Some cases have found that LLC members owe fiduciary duties to one another and/or the LLC in the same manner as partners (or close corporation shareholders). In *Anest v. Audino*,<sup>257</sup> for example, the court found that a member of a member-managed LLC owed fiduciary duties to another member, even though the first member owned only a minority interest.<sup>258</sup> The court found the role of a member

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251. See *supra* note 87 and accompanying text.

252. O’NEAL & THOMPSON, *supra* note 17, § 6.2 at 6-3.

253. See Moll, *supra* note 8, at 956.

254. See *id.* at 954.

255. See *supra* notes 180-93 and accompanying text.

256. See *supra* notes 194-212 and accompanying text.

257. 773 N.E.2d 202, 209 (Ill. Ct. App. 2002); see also Bishop of Victoria Co. Sole v. Corporate Bus. Park, LLC, 158 P.3d 1183, 1190 (Wash. Ct. App. 2007).

258. *Anest*, 773 N.E.2d at 209.

of a member-managed LLC to be essentially akin to that of a corporate director or officer.<sup>259</sup> Furthermore, a Rhode Island court found that the *members* in a *manager*-managed LLC owed partner-like fiduciary duties to both the LLC and to one another, due in part to the “paucity” of members in that LLC.<sup>260</sup> Thus, members could pursue an oppression claim based on “reasonable expectations.”

In *Credentials Plus, LLC v. Calderone*,<sup>261</sup> the plaintiff LLC sued a former member who had been the LLC’s sole operating officer, claiming that she had violated her fiduciary duties to the LLC by competing with it while still a member.<sup>262</sup> In determining what fiduciary duties, if any, LLC members owed to one another, the court broke new ground under Indiana law: “Because [LLCs] are relatively new business entities, courts are forced to grapple with financial and liability issues in terms of LLCs’ similarities to partnerships and corporations.”<sup>263</sup> Thus, due to the

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259. *Id.* at 210. The Illinois LLC statute at the time did not address fiduciary duties, but did state that members are liable for the debts of the LLC in the same circumstances as shareholders are liable for a corporation’s debts (i.e., veil-piercing situations), and that managers of an LLC are liable to the same extent as directors of corporation. *See id.* The court read these provisions as instructing it to look to corporate law to determine whether LLC members owe fiduciary duties to one another and eventually found that they did, analogizing the situation both to that of a closely held corporation and that of a director or officer’s duties to a corporation. *See id.* at 209-10; *see also* Dickens v. Alliance Analytical Labs., LLC, 111 P.3d 889, 891 (Wash. Ct. App. 2005) (in LLCs, a fiduciary duty “exists between the company, its members and its managers”).

260. *See* Marsh v. Billington Farms, LLC, 2006 WL 2555911 (R.I. Super. Aug. 31, 2006). In *Marsh*, the court held that the manager of the LLC owed the LLC and the other members a “fiduciary duty akin to the duty owed by directors to their corporation.” *Id.* at \*5. In addition, because the manager was also a member, the court found that he owed partner-like duties to the LLC and the other members, reasoning in a manner similar to the *Donahue* court decades earlier. As the court stated: “Due to the paucity of members, the active participation by the [plaintiffs], and the intimate relationship between the four [members], the members of the LLC assumed a heightened fiduciary duty not only to the LLC, but to each other – a duty of utmost care, loyalty, and good faith.” *Id.*; *see also* Sports Imaging of Arizona, LLC v. 1993 CKC Trust, 2008 WL 4448063 (Ariz. Ct. App. 2008) (trust that owned 15% of LLC and 99% of corporate co-manager of the LLC owed fiduciary duties to the LLC due to its significant control over the LLC).

261. 230 F. Supp. 2d 890 (N.D. Ind. 2002).

262. *See id.* at 896-97. The court also found that the defendant’s activities violated the operating agreement. *See id.* at 896-98.

263. *Id.* at 898.

LLC's "hybrid nature,"<sup>264</sup> the court applied fiduciary concepts from both partnership law (because LLCs have some characteristics in common with partnerships<sup>265</sup>) as well as close corporation law (the LLC in *Calderone*, had it been a corporation, would have met the definition of a close corporation under Indiana case law<sup>266</sup>). In 2006, an Indiana state court followed *Calderone*, holding that "common law fiduciary duties, similar to the ones imposed on partnerships and closely-held corporations, are applicable to Indiana LLCs."<sup>267</sup>

In *Anderson v. Wilder*,<sup>268</sup> a Tennessee decision, the defendants owned 530 ownership units in the LLC, or 53% of the total number of units.<sup>269</sup> The defendants expelled the plaintiffs from the LLC and repurchased the plaintiffs' membership interests at the price set forth in the operating agreement, which was \$150 per unit.<sup>270</sup> Less than a month later, however, the defendants resold these units (as well as a few of their other units) to a new investor for \$250 per unit.<sup>271</sup> Although their expulsion was expressly permitted by the operating agreement, the plaintiffs claimed that the defendants breached their fiduciary duties to them.<sup>272</sup> The *Anderson* court's decision distinguished a prior case, which had held that members in a Tennessee LLC owe fiduciary duties only to the LLC.<sup>273</sup> The *Anderson* court held that "a majority shareholder [sic] of an LLC stands in a fiduciary relationship to the minority.

264. *Id.*

265. *See id.* (citing, e.g., *Ruggio v. Vining*, 755 So. 2d 792, 795 n.2 (Fla. Dis. Ct. App. 2000)).

266. *See id.* at 899 (citing *G&N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227, 236 n.2 (Ind. 2001)).

267. *Purcell v. S. Hills Invs., LLC* 847 N.E.2d 991, 997 (Ind. Ct. App. 2006).

268. 2003 WL 22768666 (Tenn. Ct. App. 2003).

269. *Id.* at 1.

270. *Id.*

271. *Id.*

272. *Id.*

273. *McGee v. Best*, 106 S.W.3d 48, 64 (Tenn. Ct. App. 2002). The *McGee* court based its holding on a provision of the Tennessee LLC statute that described what duties members owe to the LLC, writing that the statute "defines the fiduciary duty of members of a member-managed LLC as one owing to the LLC, not to individual members. We cannot contravene the intent of the Legislature." *Id.* The *Anderson* court, however, apparently did not view the statute as providing an exclusive list of the fiduciary duties owed by LLC members. The *Anderson* court also observed that *McGee* was "in essence an employment dispute and did not involve an allegation of oppression by a majority shareholder group." *Anderson*, 2003 WL 22768666, at \*6 (Tenn. Ct. App. 2003).

. . . Such a holding does not conflict with the statute, and is in keeping with the statutory requirement that each LLC member discharge all of his or her duties in good faith.”<sup>274</sup> The court based this holding on the fact that Tennessee law imposes fiduciary duties on partners, as well as majority shareholders in closely held corporations, finding no reason to single out LLCs (or at least closely held LLCs) for different treatment.<sup>275</sup>

*Oppression/Dissolution Statutes.* At least eleven state statutes allow LLC members to sue for oppression,<sup>276</sup> much like shareholders can sue for oppression in corporations.<sup>277</sup> In addition, Minnesota and North Dakota use an “unfairly prejudicial” standard, coupled with references to the “reasonable expectations” of the LLC’s members.<sup>278</sup>

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274. *Anderson*, 2003 WL 22768666, at \*6 (citing *Nelson v. Martin*, 958 S.W.2d 643 (Tenn. 1997)).

275. *See id.* at \*5-6; *see also* *Holland v. Burke*, 2008 WL 4514664 (Mass. Super. Ct. 2008) (applying *Donahue*-based fiduciary duty analysis to claim by plaintiff that he was wrongfully removed from positions with LLC, as well as two corporations); *Perry Golf Course Development, LLC v. Housing Authority of City of Atlanta*, 670 S.E.2d 171, 178 (Ga. Ct. App. 2008) (members of LLC owed fiduciary duties to one another).

276. *See, e.g.*, 805 ILL. COMP. STAT. ANN. § 180/35-1(4)(E) (West 2008); MICH. COMP. LAWS ANN. § 450.4515(1) (2008); *see also* N.C. GEN. STAT. § 57C-6-02(2)(ii) (2008) (liquidation is permitted if “reasonably necessary for the protection of the rights or interests of the complaining member”). The Michigan LLC oppression statute is extremely similar to the Michigan corporate oppression statute. *See* MICH. COMP. LAWS ANN. § 450.1489(1) (2008). One commentator believes that courts will look to authority under the corporate statute for guidance in interpreting the LLC oppression provision. *See* Cambridge, *supra* note 87, at 12; *see also* CAL. CORPS. CODE § 17351(a)(5) (2008) (LLC member may bring an action for dissolution of the LLC if, among other things, “those in control of the company have been guilty of, or have knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority.”). The other states include: Hawaii, Idaho, Montana, South Carolina, South Dakota, Utah, Vermont, West Virginia, and Wisconsin.

277. *See supra* notes 194-212 and accompanying text.

278. Minnesota and North Dakota allow for involuntary dissolution if those in control of the LLC have acted in a “manner unfairly prejudicial toward one or more members in their capacities as members or governors of any limited liability company, or as managers or employees of a closely held limited liability company.” MINN. STAT. § 322B.833, subd. 1(2)(ii) (Supp. 2008); N.D. CENT. CODE § 10-32-119(1)(b)(2) (2008). The Minnesota statute also provides:

In determining whether to order relief . . . the court shall take into consideration the duty that all members in a closely held limited liability company owe one another to act in an honest, fair, and reasonable manner in the operation of the limited liability company and the reasonable expectations of all members as they exist at the inception

*C. Benefits of These Approaches*

To review, courts and legislatures have developed two methods to protect the abused minority shareholder (or LLC member) who did not engage in advance planning: fiduciary-duty analysis<sup>279</sup> and statutes that allow involuntary dissolution for oppression.<sup>280</sup> Meanwhile, developments in the contractarian school of thought as well as the enactment of special statutes for closely held corporations encouraged planning and assured its enforceability.<sup>281</sup> These developments are major intellectual achievements; a minority business owner is much better off today than his predecessors in previous generations. Before discussing some criticisms of these approaches, it is useful to review in more detail their benefits.

*Solves the “Exit Problem.”* As noted above, in a closely held business it is difficult to escape oppression by selling one’s ownership interest to a third party, due to the lack of a market for such interests and the fact that a buyer – if one is found – will demand steep minority and lack-of-marketability discounts.<sup>282</sup> As such, the minority owner whose employment is terminated likely will receive little return on his investment, and cannot demand that his interest be redeemed without a buy-sell agreement.<sup>283</sup> Fiduciary-duty analysis and involuntary dissolution statutes provide a remedy because the most common result in such cases is that the court will order the majority to “buy out” the complaining shareholder.<sup>284</sup> This effectively solves the “exit problem.”

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and develop during the course of the members’ relationship with the limited liability company and with each other.

MINN. STAT. § 322B.833, subd. 4. The North Dakota statute contains nearly identical language. N.D. CENT. CODE § 10-32-119(4). This reasonable expectation test is similar to what these states have included in the involuntary-dissolution provisions of their corporate statutes. See *supra* note 205 and accompanying text. For a discussion of the similarities between the term “oppressive” and the phrase “unfairly prejudicial” in these statutes, see *Roemmich v. Eagle Eye Dev., LLC*, 2006 WL 2433410, at \*37-39 (D. N.D. 2006).

279. See *supra* notes 180-93 and accompanying text.

280. See *supra* notes 194-212 and accompanying text.

281. See *supra* notes 226-50 and accompanying text.

282. See *supra* notes 99-105 and accompanying text.

283. See *supra* note 99 and accompanying text.

284. Moll, *Fair Value*, *supra* note 17, at 308-10.



*Solves the "No Written Contract" Problem.* Many of the reported decisions involving minority shareholder oppression feature a plaintiff-shareholder who did not memorialize any understandings that he had with the majority faction.<sup>285</sup> There are many reasons for this failure, especially the desire to avoid attorney fees and the "trusting," optimistic and unsophisticated nature of many small business owners.<sup>286</sup> The reasonable expectations test, however, does not require any of the minority's expectations to be in writing, so long as he can show (among other things) that the majority faction knew, or should have known, of these expectations.<sup>287</sup> Similarly, fiduciary-duty analysis does not demand any written documentation, which may be particularly important where the matter at issue is one that the parties could not have foreseen when the business was formed.

*Discourages Oppressive Behavior by the Majority.* If the majority faction knows that the minority has effective legal remedies, it may decline to pursue its planned oppressive activities, or it may come to the bargaining table before doing so. Even if the oppressive conduct occurs, the minority shareholder will likely have better settlement leverage in litigation.

*Allows the Parties to Customize Their Relationships.* The contractarian movement and the development of special statutes for close corporations both allow entrepreneurs to plan their relationship while obtaining the benefit of limited liability for owners. This is important because it fosters capital formation and makes dispute resolution more efficient. If there is an enforceable contract to follow, a court does not need to rely on vague and shifting notions of fiduciary duties or reasonable expectations. In fact, litigation may not be necessary at all. Furthermore, "one of the reasons that *ex ante* agreements are preferred is that, at the time the agreement is made, the parties do not know which

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285. "[S]hareholders' expectations in a close corporation . . . may not always be reflected in articles of incorporation, bylaws, shareholders' agreements or other writings. Participants often expect to participate in management and that their contribution will be recognized in the form of salary even though those matters are not contained in any written document." Thompson, *Corporate Dissolution*, *supra* note 17, at 214.

286. See *infra* notes 336-38 and accompanying text.

287. See, e.g., *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984).

side [of a dispute] they will be on; therefore, they are more likely to be reasonable in the negotiation.<sup>288</sup>

*D. Problems With These Approaches*

Despite the significant benefits of the above-described approaches, they have serious shortcomings, some of which are discussed below.<sup>289</sup>

*Litigation is Inefficient and Uncertain.* Few would dispute that most litigation in modern-day America is expensive and time-consuming.<sup>290</sup> Even when armed with a clearly defined legal right or an express written contract, enforcing one's rights through litigation can be inefficient. Fiduciary-duty analysis and the reasonable expectations text exacerbate this problem by injecting added unpredictability.<sup>291</sup> A simple breach of contract lawsuit is likely to take a lot less time – and a lot less money – than a lawsuit based on a nebulous concept like breach of fiduciary duty or frustration of reasonable expectations. Moreover, even if the plaintiff is ultimately successful, justice delayed is justice denied, as the saying goes.

Consider the *Wilkes* test, which basically requires the defendants to establish that they had a “legitimate business purpose” for taking the action of which the plaintiff is complaining and, if the defendants do so, allows the plaintiff to establish that that legitimate business purpose could be achieved through a less harmful alternative.<sup>292</sup> Could a better recipe for judicial intrusion be devised? In many cases, a court may need to engage in extensive fact-finding and entertain hours of testimony from experts to determine if a business purpose is “legitimate.” Even worse, the court essentially must try to predict the future when it has to

288. Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 HOFSTRA L. REV. 175, 204 (2004).

289. Due to the relative dearth and/or infancy of statutory and judicial responses to oppression in LLCs, the following discussion focuses on the drawbacks of these approaches in the context of corporations.

290. Cf. James M. Van Vliet & Mark D. Snider, *The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap*, 18 N. ILL. U. L. REV. 239, 242-43 (remedies “require court proceedings that are too expensive in terms of cost or time, or both, to be a practical solution” for minority shareholder).

291. See Shannon W. Stevenson, *The Venture Capital Solution to the Problem of Close Corporation Shareholder Fiduciary Duties*, 51 DUKE L.J. 1139, 1177 (2001).

292. See *supra* notes 184-89 and accompanying text.

“weigh the legitimate business purpose . . . against the practicability of a less harmful alternative.”<sup>293</sup>

The “reasonable expectations” test suffers from a similar flaw. This test often focuses on the parties’ understandings when the corporation was formed but the litigation may not occur until many years later; therefore, it injects unreliability into the process due to the fallibility of human memory. The “reasonable expectations” test also seems overtly subject to manipulation by the minority shareholder who may falsely claim that certain “understandings” were reached during formation. Further, the test focuses on what the majority “knew or should have known” were the plaintiff’s expectations and whether those expectations were reasonable; either or both of these factors may not always be clear. It is also unclear how to treat the “expectations” of those who acquire their shares from one of the corporation’s founders, such as through inheritance or a divorce settlement. While many areas of the law suffer from similar imprecision, this will come as small consolation to the parties litigating over the meaning of such terms. As one commentator observes:

The proper protection of expectations presupposes . . . their accurate identification. . . . Memories can fade and recollections can differ, especially when money is on the line. When the law seeks to protect expectations elsewhere, it takes at least some care with the identification of the problem. . . .

If not carefully applied, the doctrine of shareholder expectation will destroy one of the most important expectations a business person can have – predictability in the rules of the game.<sup>294</sup>

Going back to the hypothetical example at the beginning of this Article,<sup>295</sup> assume that A and B, in their capacity as a majority of the directors or managers, decide to terminate C’s employment. It is tempting to jump to the conclusion that A and B have done this so that, in effect, the business will pay or distribute more of its earnings to them than to C. Suppose, however, that other “red flags,” such as a con-

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293. *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976).

294. Kleinberger, *supra* note 17, at 1155-56; *see also* Matheson & Maler, *supra* note 173, at 688 (“critics of the emerging [reasonable expectations] model can rightly point to its flaws, such as its vague standards and the nearly boundless discretion it puts in the hands of trial courts . . .”).

295. See discussion *supra* Introduction.

current increase in A's and B's own salaries and suspension or reduction of dividends, are not present. Suppose further that A and B argue that C's performance was sub-par or even incompetent or dishonest. Did A and B have a "legitimate business purpose" for firing C? Can C show that there are other means to achieve this legitimate business purpose that would be less harmful to his interests? Alternatively, did C have a reasonable expectation of continued employment even if his performance was poor? Are the parties able, years later, to recall accurately their reasonable expectations when they became shareholders?<sup>296</sup> How is a court to figure out whether C was satisfactorily performing his job or not?<sup>297</sup> Is the focus on the plaintiff's reasonable expectations unfair to the defendants?<sup>298</sup> These determinations are intensely fact-specific. Courts have even sometimes found that firing a minority shareholder for unsatisfactory job performance *did* constitute oppression.<sup>299</sup>

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296. See Sean R. Matt et al., Comment, *Providing a Model Responsive to the Needs of Small Business at Formation: A Focus of Ex Ante Flexibility and Predictability*, 71 OR. L. REV. 631, 685-86 (1992), for a proposal that would allow shareholders to specify their expectations in writing by obtaining the approval of all other shareholders.

297. As two commentators observed:

The *Wilkes* case is a good example of the difficulties courts have with the employment issues that frequently overlay close corporation cases. For example, was the court correct in saying that there was no legitimate business purpose in terminating Wilkes' employment? On the one hand, we are told that there was no misconduct and that Wilkes "had always accomplished his assigned share of the duties competently." The court, however, made no attempt to determine whether Wilkes' services were still needed. Apparently he was not replaced, suggesting overstaffing. By not appreciating the norms of the employment relation, the court stumbled badly, inferring a right to continued employment, subject only to proof of misconduct. Such a right is so far at variance with employment practice anywhere that its insertion in the case undermines the logical application of the legitimate business purpose standard.

Rock & Wachter, *supra* note 107, at 934 (footnotes omitted); see also Kleinberger, *supra* note 17, at 1154 ("[T]he contours of [oppression] are imprecise, and 'good guys' and 'bad guys' alike suffer from that imprecision.").

298. Professor Dalley argues that if reasonable expectations are determined when the parties invest, "some disproportionate rights and benefits [for the] majority holder should be part of those expectations." Dalley, *supra* note 288, at 180 (footnote omitted). Also, restricting those rights will reduce the "control premium" that a future investor would be willing to pay, which will eliminate some investment opportunities and raise the cost of capital. See *id.* at 221-22.

299. See, e.g., *Hughes v. Sego Int'l Ltd.*, 469 A.2d 74, 77 (N.J. Super. 1983); *In re Imperatore*, 512 N.Y.S.2d 904, 905 (N.Y. App. Div. 1987) ("While the petitioner could not reasonably complain if his salary were reduced based upon inadequate performance, in this case his salary was totally eliminated."); see also Matheson & Maler, *supra* note

*Dissolution or Buy-Out May be an Inappropriate Remedy.* While some oppression statutes provide remedies other than dissolution,<sup>300</sup> many are not so flexible.<sup>301</sup> Even if a buy-out right is recognized as an alternative to dissolution, the “minority member who has spent years building a business may not want to relinquish the enterprise at any price. . . . A fair market value buy-out may not adequately compensate for lost opportunities.”<sup>302</sup> Alternatively, at least one court applying fiduciary duty analysis has found that a forced buy-out of a minority shareholder’s shares was an improper remedy because “it placed the plaintiff in a significantly *better* position than she would have enjoyed absent the wrongdoing, and well exceeded her reasonable expectations of benefit from her shares.”<sup>303</sup> In other words, because stock in a closely held corporation inherently lacks a trading market, ordering a buy-out may be viewed as giving the plaintiff a windfall.

Further, a dissolution-only scenario could actually prevent the aggrieved shareholder from obtaining relief. For example, assume that the majority shareholders have effectively looted the company by paying themselves exorbitant salaries or entering into “sweetheart” transactions with related entities.<sup>304</sup> If the corporation were dissolved, the sale of its assets on dissolution would likely fetch only a fraction of what the company would have been worth but for the majority’s misconduct. Furthermore, if the “extreme” remedy of dissolution<sup>305</sup> is the only reme-

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173, at 671 (“In Minnesota, for example, case law began to suggest that a minority shareholder who was also employed by the corporation simply could not be fired.”) (discussing *Pedro v. Pedro*, 489 N.W.2d 798 (Minn. Ct. App. 1992)). See generally Art, *supra* note 209, at 398 (concluding that “the focus on the minority’s expectations rather than on the majority’s duties tends to subvert the principle of majority rule in corporate governance and to penalize conduct of the majority even when justified”). But see *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554 (N.J. Super. 1979), *aff’d*, 414 A.2d 994 (N.J. Super. 1980), *cert. denied*, 425 A.2d 273 (N.J. 1980).

300. See *infra* note 308.

301. See, e.g., *Giannotti v. Hamway*, 387 S.E.2d 725, 733-34 (Va. 1990) (finding dissolution exclusive remedy for oppression under the Virginia statute).

302. Miller, *supra* note 87, at 463.

303. *Brodie v. Jordan*, 857 N.E.2d 1076, 1081 (Mass. 2006). See *infra* notes 339, 342-48 and accompanying text.

304. See *supra* notes 94-98 and accompanying text.

305. *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270, 274 (Alaska 1980) (“Liquidation is an extreme remedy . . . . Absent compelling circumstances, courts often are reluctant to order involuntary dissolution.”).

dy for oppression, the majority may be reluctant to offer equity interests to employees, thereby reducing the likelihood of widespread employee ownership of businesses.<sup>306</sup> For these reasons, and because dissolution is viewed as less necessary for corporations than for partnerships,<sup>307</sup> many statutes authorize alternative remedies<sup>308</sup> and courts – even in the absence of statutory authorization – have granted other remedies in oppression cases.<sup>309</sup> The strategy of these statutes is to cause courts to aid minority shareholders more often by promoting orders not as drastic as buyout or dissolution orders.<sup>310</sup> In other words, “[b]y permitting courts to provide lesser equitable remedies, especially a buyout, [legislatures] made it easier for the minority shareholder to prevail on the underlying claim.”<sup>311</sup>

*Equity Buy-Back Issues.* The usual remedy in a minority shareholder oppression case is a court-ordered buy-out of the plaintiff’s stock at

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306. Brown, *supra* note 240, at 166.

307. Unless otherwise agreed in a partnership agreement, a partner in an at-will partnership can trigger the dissolution of the partnership simply by withdrawing by express will. *See supra* note 71 and accompanying text. Historically, this dissolution right (or power) was more necessary to a partner than a shareholder because partners are jointly and severally liable for the debts and obligations of the partnership. Shareholders, not facing personal liability outside a veil-piercing situation, have less need for “easy” dissolution. *See* Bradley, *supra* note 17, at 825.

308. *See, e.g.*, MICH. COMP. LAWS ANN. § 450.1489 (2008); MINN. STAT. ANN. § 302A.751 subd. 1 (2007); N.J. STAT. ANN. § 14A:12-7 (2008).

309. *See, e.g.*, Brenner v. Berkowitz, 634 A.2d 1019 (N.J. 1993); Balvik v. Sylvester, 411 N.W.2d 383 (N.D. 1987); Masinter v. WEBCO Co., 262 S.E.2d 433 (W. Va. 1980); *see also* Art, *supra* note 209, at 402-04; Moll, *supra* note 8, at 893-94 (“As the alternative forms of relief have broadened over the years, orders of actual dissolution have become less frequent.”) (citations omitted); Thompson, *Corporate Dissolution*, *supra* note 17, at 194 (“[C]ourts increasingly grant alternative remedies even in the absence of specific statutory authorization.”); Matheson & Maler, *supra* note 173, at 679 (many states concluded “that their courts have broad powers to impose a range of equitable remedies”).

310. *See* Bradley, *supra* note 17, at 824. However, Professor Bradley finds such provisions troublesome because they “seem[ ] to reinforce the cavalier attitudes of many judges toward the plight of abused minority close corporation shareholders.” *Id.*

311. Matheson & Maler, *supra* note 173, at 670 (discussing the New Jersey statute). The authors continued: “Although as a theoretical matter the determination of whether a minority shareholder has been oppressed involves an inquiry separate from what remedy is appropriate, as a practical matter the harshness of the remedy inevitably plays a role in the initial finding of oppression.” *Id.*

“fair value.”<sup>312</sup> Unfortunately, the involuntary dissolution statutes that contain this phrase typically fail to define it, resulting in “significant disagreement about what fair value means.”<sup>313</sup> Even if the statutes did provide a definition, the lack of a public market for the stock makes valuing the stock of a closely held business extremely difficult.<sup>314</sup> Further, even if the aggrieved minority shareholder recovers the value of his shares (whatever that amount may be), “fair value” only measures the value of the *stock*. But it is likely that one of the main reasons why the shareholder became a shareholder was the promise of a *job*.<sup>315</sup> As Professor Moll writes: “the fair value buyout fails to provide any compensation for the value of a lost job or a lost management position – two central components of the close corporation shareholder’s investment return.”<sup>316</sup> Finally, requiring the buy-out of a minority shareholder, who may own a very substantial interest in the business could impose steep and unanticipated costs on the remaining owners or the corporation. Oftentimes, this could require the corporation to take on debt to raise funds with which to

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312. See Moll, *Fair Value*, *supra* note 17, at 295.

313. Moll, *Fair Value*, *supra* note 17, at 310. Two positions have developed on the meaning of fair value. One school of thought posits that the fair value of a minority shareholder’s shares is the price that a willing buyer would pay for it in an arm’s length transaction, i.e., its fair market value, and that a “minority discount” and/or a “marketability discount” is therefore appropriate. A competing school of thought posits that the fair value of a minority’s shares should be his proportionate share of the value of the entire business, and that discounts would not be appropriate. For support of the latter view, see *id.*

314. Valuing a closely held business is more an “art” than a “science” because there is no built-in appraiser in the form of a stock market and there is no universally agreed-upon measure of value. Thus, many valuation disputes will become a “battle of the experts.” See, e.g., Rock & Wachter, *supra* note 107, at 939-40 (customary valuation techniques do “not work well in most close corporations because the required data is not available. The company may have very limited past performance, the management may be too untested to allow reliable future predictions, and the company’s products or services may be too novel to allow easy comparisons with seasoned firms.”).

315. “For many close corporation investors, the desire for employment (and, to some extent, for management participation) is the principal enticement motivating their decision to commit capital to a venture.” Moll, *Fair Value*, *supra* note 17, at 340.

316. Moll, *Fair Value*, *supra* note 17, at 342 (footnote omitted); see also Douglas K. Moll, *Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution*, 1999 U. ILL. L. REV. 517. This concern would also apply to a “squeeze-out” merger where the minority shareholder is only granted appraisal rights (also known as dissenters’ rights) to receive the fair value of his stock, but cannot pursue other claims. See, e.g., *Sound Infniti, Inc. v. Snyder*, 186 P.3d 1107 (Wash. Ct. App. 2008).

pay the plaintiff, unless the parties can agree on other payment and collateral terms.<sup>317</sup>

*Current Relief Doesn't Prevent Future Problems.* If a remedy other than dissolution or a buy-out is awarded, a likely shortcoming is that it will be inherently short-term and fragile – it will not make the defendants and the plaintiff “get along” in the future. For example, consider the recent case of *Brodie v. Jordan*,<sup>318</sup> decided by the Supreme Judicial Court of Massachusetts, the same court that had decided *Donahue*<sup>319</sup> and *Wilkes*<sup>320</sup> about thirty years earlier. In *Brodie*, the plaintiff was a widow who had inherited one-third of the shares of a closely held corporation from her deceased husband.<sup>321</sup> After the husband's death, the defendants (the other two shareholders) froze the plaintiff out of the business by refusing to pay dividends or repurchase her shares, and by not allowing her access to company information, which she claimed would have facilitated selling her shares to a third party.<sup>322</sup>

The defendants did not appeal the finding that they had breached their fiduciary duties; instead, the issue before the court was the proper remedy.<sup>323</sup> Although the court acknowledged that many other jurisdictions had considered a buy-out the proper remedy in such a situation, it noted that the reason they did so was because most of those cases arose in states that have involuntary dissolution statutes (unlike Massachusetts).<sup>324</sup> Thus, the *Brodie* court noted that other state courts “have understandably inferred the power to order the lesser remedy of a buyout.”<sup>325</sup> However, the *Brodie* court found that a buy-out was not a proper remedy because it would have unduly rewarded the plaintiff by

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317. As Professor Thompson noted: “A mandatory buyout statute would permit any minority shareholder to impose on the majority the costs of replacing the minority's capital even if the minority had played a substantial role in bringing about the breakdown of relations.” Thompson, *Corporate Dissolution*, *supra* note 17, at 223.

318. 857 N.E.2d 1076 (Mass. 2006).

319. *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975).

320. *Wilkes v. Springside Nursing Home, Inc.*, 352 N.E.2d 657 (Mass. 1976).

321. *Brodie*, 857 N.E.2d at 1078-79.

322. *See id.* at 1079.

323. *Id.* at 1080.

324. *See id.* at 1082 n.7.

325. *Id.*



providing a buyer for her stock, something that she would have had trouble finding in a closely held corporation.<sup>326</sup>

So, what magical remedy did the court award instead? The court remanded the case, but gave the lower court “guidance”: “*Prospective injunctive relief may be granted to ensure that the plaintiff is allowed to participate in company governance, and to enjoy financial or other benefits from the business, to the extent that her ownership interest justifies.*”<sup>327</sup> Given that the defendants had previously treated the plaintiff so poorly that she had to sue them, we can be fairly sure that the defendants will not comply with whatever prospective injunctive relief is awarded. We will also likely see the parties back in court in the near future.

*Professor Dalley’s Objections.* Professor Paula Dalley argues that it is a mistake to impose fiduciary duties on shareholders at all, calling it “a judicial invention stimulated by a desire to provide relief to minority stockholders who later regretted their own or their decedent’s bargains and encouraged by scholars advocating a neo-marxist view of investing.”<sup>328</sup> Professor Dalley believes that traditional corporate law is sufficient to protect minority shareholders<sup>329</sup> and that the usual justifications given for imposing fiduciary duties on shareholders have “serious weaknesses.”<sup>330</sup> For example, one common justification is that closely held corporations resemble partnerships in many ways. Professor Dalley

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326. *See id.* at 1081-82.

327. *Id.* at 1082 (emphasis added; footnotes and citations omitted). To be fair, the court also noted that the lower court could compel the payment of dividends; reasonable expectations of ownership could be found by an evidentiary hearing; and money damages are appropriate for breaches that create quantifiable deprivations. *See id.*

328. Dalley, *supra* note 288, at 222.

329. For example, controlling shareholders likely will also serve as directors, which would subject them to the fiduciary duties that corporate law imposes on directors. Professor Dalley uses the example of the denial of employment to a minority shareholder. Ordinarily, this board decision would not involve a conflict of interest and thus would likely be protected by the business judgment rule. However, if the termination of the shareholder was followed by salary increases for the other directors, then “they would be interested and the transaction would be subject to an entire fairness standard.” *Id.* at 215. One wonders, however, whether the directors would be so blatant about increasing their own salaries shortly after terminating a minority shareholder, or if the increased salaries could not be justified if they are required to work harder as a result of the absence of the terminated shareholder.

330. *See id.* at 186.

reminds us, however, that partners face unlimited personal liability for the obligations of the business, which means that they should have a greater ability to expel other partners or exit the business and curtail their own liability than should shareholders.<sup>331</sup> Additionally, due to the broad powers of partners to bind the partnership,<sup>332</sup> it makes sense to subject them to the same fiduciary duties that agents owe to principals under general agency law rules. In sum, the differences between partnership rules and corporation rules “have important purposes related to the nature of liability, and should distinguish partnerships not only from publicly held corporations, but also from close corporations.”<sup>333</sup> Further, partnership law itself is not terribly protective of a partner’s right to work at the partnership and be involved in management.<sup>334</sup> Professor Dalley also observes that imposing fiduciary duties on shareholders conflicts with many other principles of American law. For example, with respect to contract law, courts apply default rules when there is no written agreement; when there are no relevant default rules, courts look to what the parties *would* have agreed to, not what the courts believe the parties *should* have decided.<sup>335</sup>

Although Professor Dalley raises several good points, her suggestion to return to more traditional rules does not seem to hold much promise of reducing strife in closely held corporations. For one thing, it does not make advance planning any more likely. Moreover, under Professor Dalley’s approach an aggrieved shareholder must still sue the defendants and prove that a board decision was motivated by a conflict of interest to overcome the business judgment rule and invoke entire fairness review. Also, even if the plaintiff is successful, director duties have traditionally been interpreted as running to the corporation and not to the shareholders, so it is unclear whether such actions must be brought as derivative actions and whether relief would be available to the plaintiff.

*Do People Actually “Contract”?* The literature is replete with statements that minority shareholders in closely held businesses often fail adequately to plan their investment.<sup>336</sup> As reasons for this, commen-

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331. See *id.* at 187-93.

332. *Id.* at 187.

333. *Id.* at 189.

334. See *id.* at 191-92.

335. See *id.* at 202 (footnotes omitted).

336. See, e.g., Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the*

tators often cite the following characteristics that are common among shareholders of close corporations: (1) a relative lack of sophistication, (2) their failure to anticipate the possibility that they will be unfairly treated by the majority, (3) their optimism and overly trusting nature, (4) their hesitancy to raise difficult issues during the business's formation for fear of damaging the trust between the owners, and (5) their desire to avoid the legal fees that would be involved in drafting protective provisions.<sup>337</sup> Another frequently invoked explanation is incompetent counsel.<sup>338</sup>

On the other hand, some commentators are skeptical that the lack of advance contracting was the result of ignorance or similar causes.<sup>339</sup>

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*Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (“[P]articipants 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.”); Matheson & Maler, *supra* note 173, at 660 (closely held “business relationships often begin with little or no pre-planning for an eventual (if not inevitable) breakup.”).

337. See, e.g., Bradley, *supra* note 17, at 840 (lack of advance planning may be explained as “a naive complacency, an overly trusting nature, bad legal advice or a blunder”); Chittur, *supra* note 17, at 131 (“Because people generally avoid complex and expensive planning in small businesses, certain problems are difficult to anticipate even when the parties attempt to articulate mutual expectations. Absent an adversarial setting, they keep lawyer involvement to the minimum . . . . Given the desire to curtail start-up costs, and the personal relationship of the parties, the minimal articulations leave gaps that surface in due course.”) (footnote omitted); O’Neal, *supra* note 17, at 881 (“[M]inority participants in a close corporation may not anticipate dissension or oppression, and indeed may be unaware of their vulnerability . . . .”); Siegel, *supra* note 10, at 447-48 (excuses for not engaging in advance planning “seem limited to situations where (i) the parties are unwilling to write contracts due to their harmonious relationship, (ii) the minority is too unsophisticated to appreciate the need for protection, or (iii) the minority could not get the majority to agree to such provisions”); Thompson, *Corporate Dissolution*, *supra* note 17, at 224 (“Parties entering into a business relationship are not always willing to fully explore the ramifications of possible disputes if things were to go wrong.”).

338. To put it humorously:

Poor drafting in LLC and partnership agreements is endemic. Too often the agreements are based upon forms and lack the necessary customization to the needs and expectations of the parties. Too often the agreements fail to address likely fact changes . . . . None of us would “take a stab” at drafting a defined benefit plan or try to “throw together” a Form S-1 registration statement. But all too often partnership and operating agreements are drafted by attorneys who have some idea of what they are doing. Just not enough of an idea.

See Rutledge, *supra* note 35, at \*18.

339. Transaction costs can also impact whether parties decide to contract. See Easterbrook & Fischel, *supra* note 220, at 299.

They point out that the shareholders were savvy enough to choose the corporate form to limit their personal liability, which evidences an awareness of at least some legal rules. It is logical, then, to assume that the investor will be aware of other legal rules.<sup>340</sup> Therefore, if a person became a minority shareholder without engaging in any advance planning, that should be viewed as a rational choice to rely on the normal, default rules of corporate governance.<sup>341</sup> Further, even if it was not an informed choice, the minority and majority may still not have chosen to adopt (or been able to agree on the terms of) protections for the minority shareholder.

In an insightful 2003 article, Manual A. Utset argued that two “self-control” problems were also responsible for the widespread lack of planning in closely held corporations: procrastination and “projection bias.” Basing his arguments on psychological, economic, and other social science research, Professor Utset argued that an intertemporal decision-maker (i.e., a person making a decision about his future actions, or that will affect his future well-being) often will exhibit “time-inconsistent preferences” (i.e., his later preferences will not match his earlier preferences).<sup>342</sup> This can lead even a well-informed shareholder to repeatedly procrastinate entering into contracts that he believes will be beneficial over the long-term. For example, if a prospective minority shareholder will incur immediate costs in drafting an employment contract (such as attorney fees), but will not realize the benefits from the contract until some future period (such as when the majority attempts to terminate the minority’s employment), he will repeatedly procrastinate in entering into the contract if he believes that the benefits of postponing the agreement date by X amount of time (by deferring the costs associated with drafting the agreement) will exceed the loss from delaying the agreement date for X amount of time. The result is that even a well-informed shareholder may never get around to entering into contracts that he believed were necessary and beneficial or may procrastinate in gathering the information necessary to make decisions.<sup>343</sup> And if he

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340. Easterbrook and Fischel argue that when investors are aware of the tax consequences of the corporate forms they select, they are usually knowledgeable of other consequences as well. *See id.*

341. *See generally* Utset, *supra* note 8, at 1347.

342. To put it differently, if a decision-maker has time-consistent preferences, “when the future arrives and it is time to act, the decision-maker will follow through in accordance with her original preferences.” *Id.* at 1351.

343. *See id.* at 1350-51.

does enter into a contract, it will likely be incomplete or inappropriate because a “projection bias” may cause him not to appreciate the extent to which future conditions may vary from present conditions.<sup>344</sup> Because of such self-control problems, many minority shareholders “who leave their contracts incomplete . . . do so, not based on complex strategic considerations, but on fairly straightforward human motivations.”<sup>345</sup> An approach to minority owner oppression that advocates increased planning, such as the one set forth in this Article, will need to recognize these psychological motivations in order to be effective.

Empirical evidence also indicates that investors often fail to engage in advance planning. In 2003, Sandra K. Miller reported the results of an empirical study designed to determine, among other things, whether the “unparalleled frontier of contractual freedom”<sup>346</sup> in LLCs was actually resulting in well-drafted operating agreements negotiated on a “level contractual playing field.”<sup>347</sup> To that end, Professor Miller distributed a questionnaire to more than 3,000 business attorneys in California, Delaware, New York, and Pennsylvania.<sup>348</sup> Some of the results suggest that minority LLC members remain at risk for majority abuse, despite their ability to bargain for protective provisions. For example, the survey respondents indicated that they represent majority LLC members much more frequently than minority LLC members.<sup>349</sup>

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344. Professor Utset also argued that “projection bias” leads to nonexistent or incomplete contracts. In other words, in deciding now whether to enter into a contract that will affect his future (and, if so, the terms of the contract), a person must make a prediction about his future “preferences.” Often, however, a person’s ability to predict his future preferences is very limited, and people often mistakenly assume that their future preferences will be the same as their current preferences. These incorrect predictions will lead to poor contracts. Incorrect predictions of future preferences are particularly likely if a person is in a “hot” psychological state (e.g., anger, fear, etc.) either at the time of the original decision or the time in the future that is affected by the decision. *See id.* at 1368-80. In the context of close corporations, Professor Utset argues that at the time of forming the corporation, “a shareholder will project her current cold-state preferences and will tend to underappreciate the full magnitude of her own and the other party’s temptations to take harmful actions in future hot states.” *Id.* at 1374.

345. *Id.* at 1335.

346. *See Miller, supra* note 33, at 360.

347. *Id.* at 355.

348. *Id.* at 355-56. Approximately 25% of the recipients completed the survey.

349. Consolidating the responses from all four states, Professor Miller found that an average of 56% of the respondents “frequently represent majority LLC owners . . . while an average of only 20% reported frequent representation of minority LLC owners.” *Id.* at 388. Although some of this difference can be explained by the fact that

Also, only 8% of the respondents indicated that their “usual” LLC operating agreement “contains an absolute buy-out provision exercisable by minority owners,” but 73% of the respondents said that it did not.<sup>350</sup> Tellingly, 20% indicated that their “usual” operating agreement gives the “majority owners the absolute right to force the LLC to buy them out at the fair market value.”<sup>351</sup> The study also suggested that many practitioners are unfamiliar with the “default” buy-out rights of LLC members, as very high percentages incorrectly answered questions concerning their states’ LLC statutes on this topic.<sup>352</sup> Further, only about 14% of the respondents indicated that their “usual” operating agreement allows for judicial dissolution of the LLC upon illegal, fraudulent or oppressive conduct.<sup>353</sup> Finally, more than two-thirds of the respondents believed that “many” operating agreements “are based on form agreements that are not extensively negotiated.”<sup>354</sup>

Although Professor Miller cautions against drawing broad generalizations from a limited study, these results are sobering. She believes continued judicial monitoring will be necessary because greed and self-interest can flourish in contractarian relationships, especially where there is unequal bargaining power.<sup>355</sup>

*Problems with Special Close Corporation Statutes.* Many statutes for close corporations do not apply unless the corporation elects to be governed by the statute, or “opts in.”<sup>356</sup> This is unfortunate because it is

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many LLCs have only one member (who, of course, would be the “majority” member), Professor Miller nonetheless found this disparity “somewhat disturbing, both because of the traditional vulnerability of the private minority investor and also because of the statutory and judicial emphasis on, and deference to, the contractual operating agreement.” *Id.*

350. *Id.* at 391.

351. *Id.* To be fair, Professor Miller points out that, due to the wording of the questions and other factors, it is “difficult to draw clear conclusions about practitioners’ practices regarding buy-out clauses.” *Id.*

352. *See id.* at 392-93.

353. *Id.* at 397.

354. *Id.* at 399.

355. *See id.* at 404. Although an initial goal of the contractarian movement was to limit unwarranted judicial interference, even-handed judicial review is now more important due to flexible statutes. *Id.*

356. *See supra* note 240. One professor finds that the opt-in requirement is “inconsistent with a remedial approach to close corporation laws and is a mistake.” Bradley, *supra* note 17, at 820. Further, the opt-in requirement “preclude[s] the realization of the remedial goals in nonelecting corporations.” *Id.* at 843.

likely that the shareholder who has done little or no planning – and thus is probably a shareholder in a corporation that has not elected statutory close corporation status – is the one that needs the most protection from his lack of foresight. Furthermore, even if a corporation does “opt in,” there are few default rules that come with this election: “these statutes simply enable the parties to create contracts or to specify in the corporate charter a panoply of options that deviate from the standard format of corporate governance. These ‘self help’ provisions”<sup>357</sup> give the parties little guidance on *what* they should do, except hire an attorney.

### III. PROPOSALS

#### A. General Considerations

*What Does the “Typical” Minority Owner Want? Do We Know?* It is easy to list several ideas a prospective minority owner should consider: an employment agreement; a buy-sell agreement; a provision in the articles of incorporation allowing the minority to dissolve the business upon certain events; a guarantee of representation on the managing body of the business; and a veto power over certain major business decisions.<sup>358</sup> These ideas are important because both the corporation and the LLC otherwise provide the majority with many ways to abuse the minority.

Upon reflection, however, it seems these ideas may be appropriate only for the “typical” closely held business, i.e., one with two to four founders, all of whom are actively involved in management and expect to have an “equal say” in business decisions. While this type of closely held business is certainly common, it is by no means the only type. What about businesses with more centralized management and passive investors? What about businesses that are investment vehicles for sophisticated owners? What about businesses owned by the descendants of the original founders? Is it possible to create a “one size fits all” solu-

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357. Siegel, *supra* note 10, at 385; *see also* Bradley, *supra* note 17, at 830 (“The election to be a close corporation alone does not assure the realization of shareholder expectations. Governance, employment, salary or other economic-return allocation rights are not automatically prescribed for individual shareholders. A bargain must still be struck . . .”); Karjala, *supra* note 226, at 691-92 (arguing it is difficult or impossible to “determine a ‘default setting’ for closely held enterprises that better meets the parties’ expectations than does the general law”).

358. *See supra* notes 119-78 and accompanying text.

tion that addresses more than a few topics,<sup>359</sup> or must we further differentiate closely held businesses, not by whether they are corporations, LLCs, or something else, but by their management and ownership characteristics? Is it feasible to create different default rules for different types of businesses?

*Different “Management Styles” in Different Businesses.* In a 1997 article,<sup>360</sup> Professors Dale Oesterle and Wayne Gazur proposed rejecting the current “bizarre system of small business classification”<sup>361</sup> in favor of a new type of business entity: the limited liability entity (LLE). The authors envisioned an LLE statute that would provide three sets of default rules from which business owners could choose when forming an LLE: one for firms where all of the equity owners are active in the business (“Type I businesses”); one for firms with several active equity owners and some passive investors (“Type II businesses”); and a third for firms with a substantial number of “sophisticated,” but passive investors (“Type III businesses”).<sup>362</sup> The goals of this system would be to “minimize the confusion of parties who are not legally sophisticated, and . . . minimize the opportunities for deceit.”<sup>363</sup>

For the Type I businesses, the authors envisioned a “modern adaptation of the rules of a general partnership,”<sup>364</sup> but with limited liability. The authors suggested, among other things, that the Type I default rules would provide (in most cases, absent a contrary agreement) that: (1) all owners participate equally in the management of the firm; (2) all owners receive equal salaries; (3) that any payments in return of one owner’s capital must be made to all owners; (4) if an owner becomes incapacitated or dies, he or his estate could require the company to redeem his ownership interest; (5) ownership interests are not freely transferable; (6) a majority of the owners must agree to “major firm decisions”; and (7) managers owe a duty of loyalty.<sup>365</sup> Importantly, an owner-manager’s

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359. Professor Moll has attempted to articulate a series of “hypothetical understandings” concerning dividends where close corporation shareholders have failed to articulate or formalize their “understandings” on this issue. Moll, *Dividend Policy*, *supra* note 17, at 876; *see id.* at 876-923.

360. Oesterle & Gazur, *supra* note 56.

361. *Id.* at 104.

362. *Id.* at 131.

363. *Id.* at 129.

364. *Id.* at 145.

365. *Id.* at 145-46.



removal for cause would allow the firm to stop paying his salary, and pay a “risk-free rate of return” on his capital account or force the removed manager to leave the firm for a cash payment equal to his “allocated share of the firm’s assets, based on liquidation values and net of damages caused by his or her misconduct.”<sup>366</sup> However, if an owner-manager were removed without cause the default rules would allow him to sue for breach of contract or request a court to dissolve the company.<sup>367</sup>

As for the default rules for Type II businesses, Oesterle and Gazur felt that the passive investors needed “special protections from opportunistic behavior by the insiders,”<sup>368</sup> particularly a continuing right to have the firm repurchase their ownership interest for “cash equal to a proportionate share of the firm’s value.”<sup>369</sup> The precise nature of this put option could be controlled by contract, particularly if it was triggered by any misconduct by the insiders. Other important provisions would: (1) impose on the insiders a duty to report periodically to the passive investors, (2) subject the insiders to duties of loyalty, and (3) require the insiders to refrain from reckless or intentional misconduct.<sup>370</sup>

As discussed above,<sup>371</sup> a proposal calling for a new type of business entity, whether in addition to or in replacement of the current forms,<sup>372</sup> probably will not receive a warm reception today. Although the current “alphabet soup”<sup>373</sup> of business organizations is confusing and redundant, it is probably here to stay. Nonetheless, this approach does aptly identify different “management styles” of closely held businesses and many default rules that would be appropriate for each. These differences, and the risks prevalent in each, can be used to effectively inform the choices that prospective business owners make.<sup>374</sup>

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366. *Id.* at 146.

367. *Id.*

368. *Id.* at 147.

369. *Id.*

370. *Id.*

371. *See supra* notes 59-66 and accompanying text.

372. Oesterle and Gazur did not advocate replacing all of the currently existing business forms with the LLE structure. *See Oesterle & Gazur, supra* note 56, at 124.

373. “The term ‘alphabet soup’ gained currency in the early days of the New Deal as a description of the proliferation of new [government] agencies such as WPA and PWA.” *Chrysler Corp. v. Brown*, 441 U.S. 281, 286 n.4 (1979).

374. *See Oesterle & Gazur, supra* note 56, at 130 (summarizing the three groups and describing investor and management styles). Type I businesses are comprised of a small number of equity investors all of whom actively participate in the business. *Id.*

*Should Prospective Business Owners Be Forced to Engage in Advance Planning? Are Better Default Rules the Answer?* Given that corporations and other business forms exist by legislative grace, the state may impose any conditions on their formation or use as it sees fit. For example, the state could require the prospective owners of all closely held businesses, before forming their business entity, to engage in pre-formation negotiations or discussions about any or all of the planning techniques discussed above. The state could even go so far as to require that certain agreements or charter provisions be in place before the entity is formed.

Although such an approach may result in many business owners having appropriate protections in place, its pitfalls are overwhelming. Any attempt to *require* negotiations or to mandate certain charter provisions – even if somewhat tailored to the different “management styles” of small businesses – would be both over- and under-inclusive given the myriad and particularized needs of small businesses and their individual owners. For example, although it may be appropriate in many cases to consider whether an employment agreement is needed, this certainly is not always the case – so why should the state require pointless discussions? Also, there certainly will be situations that call for “unusual” planning that would not be reflected in any state requirements. In other words, a finite list of mandated discussions could give prospective business owners the false impression that these are the *only* topics that should be addressed. Moreover, the costs involved in such a system would likely be prohibitive for many prospective business owners in conducting statutorily-mandated negotiations or discussions,<sup>375</sup> not to mention the state’s costs and difficulties in monitoring compliance.

A possible solution would be to change the various statutory default rules to be more protective of minority owners, but allow the parties to “contract around” those rules if they so choose. This is basically the ap-

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Type II businesses include passive equity investors who demand protections from majority control of the business by insiders. *Id.* Type III businesses would be “completely open-ended” due to the sophistication of their owners and their likely use of counsel. *Id.* at 147-48 (discussing the potential for investment bankers and venture capitalists to refine and tailor complex entities to their needs).

375. *Cf.* Thompson, *Corporate Dissolution*, *supra* note 17, at 224 (“For those hearty investors willing to undertake such a search, the costs can be prohibitive, both from the increased involvement of an attorney and the seemingly open-ended nature of trying to protect all participants’ interests from all possible evils.”).

proach that Oesterle and Gazur used to create sets of LLE default rules that seem to capture fairly well the risks to the minority owner in businesses with different management styles. One problem, however, is applying those rules to *several different statutes*, which Oesterle and Gazur avoided by using a new business form (the LLE). For example, if a state has separate statutes for corporations, LLCs, and partnerships (and LLPs) and adopts sets of default rules only for Type I and Type II businesses, it must apply those rules to three different statutes, resulting in six different sets of default rules.<sup>376</sup> Given the number and complexity of current business organization statutes, this approach would likely breed more confusion than assistance. And this assumes that we only need two sets of new default rules.

More importantly, would legislatures be good at writing default rules to protect minority owners without unduly burdening the majority's right to some "selfish ownership"<sup>377</sup> or giving the minority a *weapon* rather than a shield? Outside of partnership statutes and a few other examples, there isn't much reason to believe that legislators would be. After all, the "law assumes that parties know their own interests best."<sup>378</sup> Even if it were otherwise, the costs to determine what the default rules should be and evaluating them over time – probably based only on anecdotal evidence – would likely be high. For these reasons, today there are few statutory attempts at rules that are *themselves* protective of minority shareholders or LLC members, other than involuntary dissolution statutes; most statutes instead allow shareholders

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376. See Oesterle & Gazur, *supra* note 56, at 127-28. To be fair, RUPA would like not require much modification because its default rules are more protective of a minority owner than are corporate and LLC statutes. See *supra* notes 68-78 and accompanying text.

377. Wilkes, 353 N.E.2d at 663 (citing Alfred Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 1013-15 (1957)). According to Professor Hill, insiders owe a fiduciary duty to minority shareholders to refrain from engaging in "selfishly motivated conduct which exceeds certain bounds of fairness," such as overcharging the corporation for property or services, freezing minority stockholders out of the enterprise, or devising a corporate transaction "which is technically legal but yields what are deemed unconscionable advantages to the insiders." Hill at 1014-15. "[I]t is clear that the controlling stockholders are not fiduciaries in the strict sense; and indeed they could not be, for the classic fiduciary concept is incompatible with the principle that stockholder majorities shall effectively govern." *Id.* at 1015.

378. Dalley, *supra* note 288, at 205.

or LLC members to *create* protective provisions without concern about their enforceability.<sup>379</sup>

This approach recognizes that the best person to decide what a small business owner needs is the owner himself. So perhaps the best the state can do from an *ex ante* perspective is to make sure that prospective business people are *adequately warned* of the risks that they are undertaking, and then rely on the fact that most people will act in their rational self-interest to protect themselves from these risks to the extent that they feel appropriate. Although it is true that this should be the job of lawyers and that many people still will not do what is “good for them,” under the current system prospective business owners too often rush headlong into business without appreciating these risks, or even being aware of them at all. This needs to change. States also need to make it much easier and less expensive for business owners to engage in advance planning. Lastly, we must also provide incentives to reduce the “human” motivations such as procrastination that may cause business owners to fail to adequately plan.

*Would a “No Fault Divorce” Statute Be a Better Idea?* Professor John H. Matheson and R. Kevin Maler recently proposed a model statute that would function like a “statutory buy-sell agreement” for all non-public companies.<sup>380</sup> Essentially, this proposed statute would give a minority shareholder a “put” option to require the company to repurchase all (but not less than all) of his shares at any time for any or no reason.<sup>381</sup> Generally, the purchase price of the stock would be at its *fair market* value, including discounts for “minority and marketability reasons.”<sup>382</sup> However, if the sale were “in connection with the resignation or removal of the [minority] owner as a director, officer, manager, or employee of the business,” then *full value* (i.e., no discounts) must be paid.<sup>383</sup> Payment would be made in cash, unless the company convinced a court that a cash payment was impractical, in which case the court would determine the payment terms.<sup>384</sup> Also, the company would have a “call” option to purchase all (but not less than all) of the minority

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379. See *supra* notes 356-57 and accompanying text.

380. Matheson & Maler, *supra* note 173, at 691.

381. *Id.*

382. *Id.* at 694.

383. *Id.* at 692.

384. See *id.*

shareholder's shares at any time for "full value" in cash.<sup>385</sup> In either case, the price (either fair market value or full value) would be determined by the parties or, if they could not agree, by one or more appraisers.<sup>386</sup> This statutory buy-sell provision would not apply if the parties had a written buy-sell agreement.<sup>387</sup> It also would not preempt any remedies for oppression otherwise available to a minority shareholder, but if the shareholder "prefers a buyout, the incentive to litigate is in most cases reduced to the amount of the discount" between full value and fair market value.<sup>388</sup>

This approach is rather attractive: it would provide the minority shareholder who did not engage in advance planning with a built-in "exit strategy" and remove the problem of having to litigate whether the majority's acts were oppressive. Still, by focusing exclusively on a buy-out remedy and the termination of the minority shareholder's interest in the business, this approach seems too concerned with "the end" and not concerned at all with the parties' relationship before that point. As discussed above, a buy-out may not be an appropriate remedy if the business has struggled for many years and now is about to "take off."<sup>389</sup> In such a case, the present value of the business may not be an accurate measure of its actual worth to the owners. In sum, this approach seems part of a still-to-be-discovered comprehensive approach. While admirable, it is not complete; it makes it easier to get a "no-fault divorce,"<sup>390</sup> but does not give the marriage a better chance of succeeding in the first place. A more comprehensive approach would involve "pre-marital counseling." In other words, if the parties can be required to engage in some examination of their objectives, understandings, and concerns *before* starting a business, the chances for later strife decrease.

### B. A Proposed Approach

The following section: (1) proposes a method to systematically inform prospective owners of closely held businesses about the dangers of oppression, common forms of planning that may address those dan-

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385. *Id.*

386. *Id.*

387. *Id.* at 695.

388. *Id.* at 697. Litigation to establish oppression would still be necessary if the shareholder wanted relief other than a buy-out.

389. *See supra* note 302 and accompanying text.

390. *See Matheson & Maler, supra* note 173, at 699.

gers, and the importance of consulting an attorney when forming a business; (2) proposes a method to track confidentially the “choices” that prospective owners make; (3) suggests that the statistical results of those choices should be compiled and made known to future prospective business owners to guide them in making their own choices; (4) argues that several different “standard form” agreements and provisions should be made easily available without cost to prospective business owners (with, of course, conspicuous warnings that form agreements should not be used blindly without the assistance of counsel); and (5) argues that more continuing-education programs concerning advance planning are needed. The following section further considers the benefits of LLPs and revisits the question of whether default rules that are protective of minority business owners may some day be realistic. Because no system for addressing the problem of minority owner oppression can be perfect, however, the following also considers some shortcomings of this approach and argues that fiduciary-duty analysis and oppression statutes must remain in place.

*Educating Prospective Business Owners: a “Buyer-Beware” Approach.* As argued throughout this Article, prospective business owners often are unaware of the risks of oppression in closely held businesses. As such, a central suggestion made in this Article is that before any business organization whose existence requires a state filing may be formed, all of the prospective equity owners of the organization must be required to read and sign a “warning” document. This document would be prepared by the state government, reviewed periodically by the state’s bar association (or an appropriate subcommittee thereof) for accuracy and made available on the web site of the state agency that handles business formations (typically the secretary of state). Until the secretary of state receives a copy of the document that is signed by all of the prospective owners of the business, along with a representation that those persons constitute all of the persons who are currently contemplated to be owners,<sup>391</sup> it should refuse to accept for filing any business’s charter documents.<sup>392</sup> Importantly, this filing process would not allow

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391. If the contemplated business will have only one owner, then these warnings would be unnecessary.

392. Professor Utset argues that any change to the incorporation process should not increase the chance that prospective investors would be subject to pre-incorporation (promoter) liability. For that reason, he suggests a two-tier incorporation process in which corporations would continue to be easily formed – and thus get the immediate

the state to reject a filing if the prospective owners chose to ignore the advice; instead, it only would require them to acknowledge that they have been made *aware* of the information contained in the document. In this sense, it is akin to the Surgeon General's warnings on packages of cigarettes, as opposed to an unenforceable ban on smoking.

What information should the warning document contain? Appendix A to this Article contains a prototype of such a document loosely based on Michigan statutes, but an explanation of the general principles that should be used to guide the drafting process is in order. First, the document should advise the prospective owners that even though they can form a business organization without an attorney, the state strongly suggests that they hire an attorney.<sup>393</sup> It should also advise them that they should consult an attorney who is experienced in business law and that they should be aware that such an attorney likely will be engaged to represent the *business* rather than the individual owners.<sup>394</sup> Thus, the warning should advise that each of the prospective owners should consider engaging separate counsel.

Here, a reader of the document who is either relatively unsophisticated or unwilling or unable to spend money on attorney fees may become alarmed; he may wonder whether he is able to afford to form a business and whether the process is overly complicated and time consuming, making the business formation infeasible. As such, the warning should state that there are several issues that the prospective owners should discuss among themselves before visiting an attorney (if they choose to do so) and, to the extent that they can work out some of the issues among themselves, they will save money on attorney fees.<sup>395</sup>

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benefit of limited liability. However, the second tier, which could be "used as a vehicle to provide disclosure to shareholders about applicable default rules and to address potential shareholder procrastination," would involve the filing of an amendment to the articles of incorporation. The second tier could also be used to educate shareholders about the dangers of minority oppression and give them a forum to discuss their respective expectations concerning the business. Until the amendment is filed, Professor Utset's envisioned system would allow any shareholder to dissolve the corporation at will for any or no reason. Utset, *supra* note 8, at 1392-93.

393. "Minority participants should be informed of the importance of retaining legal counsel at the inception of the business rather than later on, and of drafting buy-out provisions and other protections necessary in the event of a future disagreement." Miller, *supra* note 33, at 407.

394. See *supra* note 3.

395. As Professor Kleinberger wrote:

Clients on tight budgets can do much of the initial discussion on their own. The

Next, the warning would be divided into two sections, one for Type I businesses and one for Type II businesses. This distinction would apply regardless of whether the parties were contemplating forming a corporation, an LLC, or some other entity. After explaining the differences between these different types of businesses, the document would direct the reader to the appropriate section explaining the risks and planning opportunities associated with each.<sup>396</sup>

For Type I businesses, the document would explain the assumptions that are being made about the parties' expectations. These assumptions would include that each owner expects to: (1) be employed by the business and draw a reasonable salary; (2) have an "equal voice" in business decisions, similar to a member of the board of directors in a corporation, a member in a member-managed LLC, or a manager in a manager-managed LLC; and (3) have his equity repurchased by the company if he were to be fired, die, etc. The document would then explain how the statutory default rules in place (both for corporations and for LLCs) would not protect those expectations if one of the minority owners had a falling out with the majority owners. The document would also briefly explain the various planning techniques that would address those concerns (again, both for corporations and LLCs). In an effort not to appear overwhelming, the document would clearly state that standard form agreements and provisions, which the parties could use as a starting (but not ending) point in their own drafting, are available in the manner described below.

The section addressing Type II businesses would proceed along similar lines. It would begin with a discussion of the assumptions being made about the parties' expectations, divided between the prospective active owners and the prospective passive owners. As for the active owners, the assumptions are likely the same as above: expectations of employment, having a say in management, etc. Thus, the document could refer them back to the sections dealing with Type I businesses.

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lawyers can supply a letter describing the issues in plain English terms and giving examples of problematic solutions. The clients can then discuss matters among themselves, and for each issue either reach a tentative agreement on an approach or develop specific concerns for further discussion. The lawyers can then rejoin the process, to clarify and test the understanding and eventually to develop a legal structure to effectuate the business objectives.

Kleinberger, *supra* note 17, at 1166.

396. With Type III businesses (firms with a large number of sophisticated, passive equity owners) or other types of businesses where extensive attorney involvement is likely, a warning probably is not necessary.



The passive investors, while not desiring employment, may or may not wish to serve in some management role, such as serving as a director, but not an officer, of a corporation. They should also consider “special protections from opportunistic behavior by the insiders,”<sup>397</sup> such as buy-out rights triggered on demand or upon specific events, as well as rights to access information about the business. As above, the document would then explain how, even with the ability to sue, these expectations likely will not be realized if there is a falling out with the other investors they have not engaged in advance planning. It would also describe some of the available methods of planning to protect the owners’ interests.

The document should not be overly long or unnecessarily complex; if it were, many prospective business owners may be inclined to ignore it or only skim it. It should also be written, for lack of a better term, in plain English with a minimum of legal terminology, a maximum of bullet points and short, declarative sentences. The goal of this document is not to explain the law comprehensively; rather, the goal is to put investors on notice of their risks and some of their options. The next step will be up to them. Again, the document will encourage readers to consult with an attorney and will also attempt to allay their fears that they cannot afford an attorney or that attorney consultations would be a waste of time and money.

The other goal of this document would be to encourage readers to overcome their natural procrastination. Studies have shown that, even when a person realizes the benefit of taking an action, he nonetheless is likely to procrastinate in taking the action.<sup>398</sup> Before long, it may be too late, as the benefits of taking the action may no longer be possible. One method to address procrastination is to include a worksheet where readers can record the actions that they wish to take and set deadlines, as suggested at the end of Appendix A.

*Measuring the Choices Made by Business Owners and Publishing the Statistical Results.* What choices about advance planning do properly informed small business owners make when they start their businesses? We seem to have very little data on this question, although commentators have argued (without much empirical evidence) that there is a widespread lack of planning in closely held businesses.<sup>399</sup> We can

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397. Oesterle & Gazur, *supra* note 56, at 147.

398. *See generally* Utset, *supra* note 8, *passim*.

399. *See supra* note 336 and accompanying text.

measure how many corporations do or do not elect to be governed as statutory close corporations under a given state's law, but the evidence that we have about the prevalence of more important planning techniques, such as employment agreements and buy-sell agreements, is mostly anecdotal. How many minority shareholders in closely held businesses have employment agreements and/or buy-sell agreements? We do not really know. Moreover, even if we did know that say, 20% of the minority owners of Type I businesses obtained employment agreements, that would not necessarily mean that the other 80% found such agreements unimportant, because the other 80% may not have been sufficiently aware of the need for such an agreement. Statistics thus could result in a false impression about the "market voting" on the importance of such agreements.

But what if we could be sufficiently confident that all prospective business owners had been given an opportunity to consider the costs and benefits of obtaining an employment agreement and/or a buy-sell agreement? What if we also knew that a high percentage decided to pursue one, thus indicating that the "market" considers these agreements important? What could we do with this information? One obvious choice would be to use it to draft "default" rules in the relevant business entity statutes. As discussed above, however, this Article argues against that approach, at least for the time being.

Instead, a beneficial use of this information would be to use it to educate *other* prospective business owners. For example, if a prospective business owner knew that a high percentage of business owners who have preceded him chose to get an employment agreement and/or a buy-sell agreement, or undertake other forms of advance planning, he very likely would take notice and seriously consider whether he should do the same.<sup>400</sup> On the other hand, if he knew that only a very small percentage had chosen to obtain a provision in the articles that would allow dissolution of the business at the request of a minority owner, he may determine that the benefits of obtaining such a provision are too remote, or that the resistance of the owners would be too high, and decide not to

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400. For the argument that observing the contractual choices made – and not made – by parties in the close corporation context may not be an accurate indication of which choices are appropriate or beneficial for large numbers of close corporations, see Utset, *supra* note 8, at 1386. However, if a system is designed to counter the dangers of shareholder procrastination and "projection bias" about which Professor Utset is concerned, see *supra* notes 342-44 and accompanying text, then over time it should prove to be a more accurate reflection of what "good" choices are.

pursue that option. Although the business owner should make these decisions with his attorney, prior “market voting” can help inform decisions about advance planning. Presently, there is very little, if any, such statistical information available to prospective business owners.

Of course, to make this information available, it must first be gathered. This Article therefore proposes that states require the owners of a business to complete a questionnaire concerning their advance-planning choices, as a condition to forming a business entity. The state should then use the information from all such questionnaires to compile a continuously updated database. Although a suggested form of questionnaire (based on the Michigan corporate and LLC statutes) appears in Appendix B of this Article, a few primary observations are in order.

First, it is vitally important that the questionnaire be kept confidential by the state – and that business owners are so assured. If prospective owners of a closely held business believe that the public could access information about their private affairs, they will be reluctant to complete the questionnaire honestly. To that end, the questionnaire set forth in Appendix B conspicuously states that it will be kept confidential and only used for statistical purposes.<sup>401</sup> At the same time, the questionnaire cannot be left optional – completion of it should be required as a condition of forming a business entity so that the data gathered by this process is reasonably accurate and robust.

In addition, the questionnaire needs to be segregated into different categories, based both on: (1) whether the business will be a corporation, an LLC, a partnership, or some other entity; and (2) which of Oesterle and Gazur’s types the business will be.<sup>402</sup> This will allow the data to be compiled so that future prospective business owners may easily locate their prospective type of business and see what forms of advance planning are popular among similarly situated owners. Finally, the state must publish the information, preferably on a Web site, and keep it current.

*Making “Form” Agreements Easily Available and Educating Professionals.* Taking the steps described above will help improve the likelihood that prospective owners of closely held businesses will be

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401. It would probably also be necessary to amend the relevant statutes to provide that such questionnaires must be kept confidential by the state, and not be subject to disclosure under applicable freedom of information (FOIA) statutes. Appendix B contemplates that questionnaires would be destroyed after they are processed.

402. See *supra* notes 362-63 and accompanying text.

properly informed of the risks they face and the steps they can take to protect themselves. But making people aware that they need to do something does not necessarily mean that a large percentage of them will actually follow through, particularly if the task is complex and very likely should be done with the assistance of an attorney. And while it is true that one can lead a horse to water but cannot make it drink, more must be done to make the actual implementation and execution of planning easier to accomplish.

To this end, the bar association of each state should undertake to make available form agreements and charter provisions for the various types of entities. These forms should be drafted and periodically reviewed by the appropriate committee of the bar. To be sure, this is not a revolutionary idea; form books are widely available. However, form books vary greatly in quality; instead, a sort of “official” bank of forms would be a valuable resource for prospective business owners and their attorneys, particularly attorneys who are not well-versed in business formation. This should reduce transaction costs (i.e., attorney fees) and may reduce owner procrastination by making the task seem less imposing.

But form agreements are just that – forms. Most of them will serve as useful starting points but will need to be tailored to the parties’ needs by a knowledgeable attorney. Also, if prospective business owners (or their attorneys) thoughtlessly use the forms like simple fill-in-the-blanks documents, they likely will end up with agreements that do not work well or that conflict with other agreements or the company’s charter documents. As such, all the forms should come with a conspicuous warning that they do not constitute legal advice and should not be used without the advice of *competent* counsel.

A related suggestion is that bar associations should undertake more comprehensive educational programs about advance planning opportunities in closely held businesses, not just for lawyers, but for other professionals, such as accountants, that may be involved in forming small businesses. Although many bar associations and private organizations offer such programs, particularly in states with continuing-legal-education requirements, an increase in the offerings would be beneficial.

*What About LLPs?* In states that have “full shield” statutes,<sup>403</sup> the best choice for a prospective minority business owner may be the

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403. See *supra* notes 42-50 and accompanying text.

LLP.<sup>404</sup> The LLP is just a general partnership with a slight but important modification, which results in partners not being liable for the partnership's debts. In most other respects, LLPs are subject to the same rules as partnerships, which in their default form are very protective of partners.<sup>405</sup> Thus, planning to protect a minority owner is far less critical in an LLP than in a corporation or LLC, and LLPs may be less expensive to form, even if a partnership agreement is needed. At the very least, prospective business owners should be aware of the LLP form if a full-shield version is available.<sup>406</sup>

*Default Rules in the Future?* For many reasons, it would not be wise at this time to try to create default rules that would protect minority owners of closely held businesses.<sup>407</sup> Nonetheless, as more statistical information becomes available concerning the actual choices made by prospective business owners, certain choices may appear overwhelmingly popular. For example, if data were to indicate that 90% of owners in Type I businesses obtain buy-sell agreements specifying that they are entitled to have their stock repurchased at fair market value if they are ever terminated from their employment, then it might make sense to draft a statutory default rule that so provides but let the parties opt out of it if they wish. Obviously, any recommendations need to await the data.

*Drawbacks.* One shortcoming of the approach advocated in this Article is that it does not address currently existing businesses. Thus, this approach should not be used as to *replace* the current remedies in close business disputes; fiduciary-duty analysis and oppression statutes will still be needed. A related problem, and another reason that the current remedies available to minority owners must remain intact, is that even a "large-scale boom"<sup>408</sup> in planning will not anticipate every future

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404. J. Mark Meinhardt, Note, *Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited-Liability Business Organizations: Delaware Law and Its Adherents*, 40 WASHBURN L.J. 288, 304 (2001) (after finding that Delaware LLCs and non-statutory close corporations do not offer sufficient fiduciary-based protections to minority investors, the author states that "investors may, therefore, look to [LLPs] to provide the proper mix of single taxation, limited liability, control, and default baseline fiduciary duties between investors").

405. See *supra* notes 68-78 and accompanying text.

406. Appendix A does not contain information about LLPs because Michigan has only a "partial shield" LLP statute. See *supra* note 45.

407. See *supra* notes 375-79 and accompanying text.

408. Chittur, *supra* note 17, at 139 ("Careful planning could forestall some conflicts

dispute between owners of a closely held business. The reported cases repeatedly have shown that owners of closely held businesses find remarkably “creative” and unanticipated ways to oppress one another.<sup>409</sup> The most that probably can be accomplished is to identify the major areas of concern and hope that the parties adequately address them. Nevertheless, this would be an improvement over the current system, in which many prospective business owners do not engage in *any* advance planning.

An additional problem with this Article’s approach is that a court may interpret the *absence* of a particular agreement as authorizing or immunizing particular conduct by the majority. For example, assume that a minority shareholder, despite being warned that he should have an employment agreement, does not obtain one. Does that mean that the majority can freely terminate the minority’s employment without worrying that they might be acting in an oppressive manner? It seems to be a compelling argument for the majority to make: (1) the minority owner was expressly warned about the importance of having an employment agreement, yet decided that he did not need one; and therefore (2) the minority owner impliedly agreed to at-will employment. Nonetheless, it probably would be unwise to accept this argument automatically. The minority owner’s failure to obtain an employment agreement might be still be explained by reasons other than that he accepted at-will employment and it would still be necessary to determine why there was no employment agreement in place.<sup>410</sup> However, this Article’s approach should lead to more advance planning, which in turn should lead to fewer disputes arising, or at least fewer litigable issues.

Other possible objections are that the proposed system will unduly scare prospective business owners, or that it will lead to unacceptably high “transaction costs” (e.g., attorney fees) if parties who likely would

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and resolve some others. Nevertheless, inadequately planned close corporations will always remain part of the picture . . . . The necessity for a meaningful approach to the conflicts remains strong, and will not be obviated by even a large-scale boom in planning.”).

409. For some “inventive” means of oppression, see Van Vliet & Snider, *supra* note 300, at 258-61.

410. The minority owner’s failure to obtain an employment agreement could be due to: (1) wanting to avoid the time and expense involved in negotiating the agreement and having an attorney reduce it to writing; (2) a simple oversight; (3) a failure by the minority owner to see why it would be a good idea to have an employment agreement; or (4) laziness or procrastination. Of course, if the parties did address an issue in an agreement, it presumptively should be controlling.

have foregone negotiating advance-planning documents are frightened into insisting on them. In the worst-case scenario, the parties' negotiations could lead to an impasse and a promising business would never be formed. This objection does not appear overly persuasive; the proposed warning document in Appendix A is designed to reassure minority owners that they can easily avoid some of the worst types of oppression by relatively straightforward planning. In any event, with decisions as momentous as quitting one's "real" job, forming a business with other investors, and contributing a large portion of one's life savings to the venture, prospective owners should be given as much information as reasonably possible. Again, the current system does not ensure that this information transfer actually takes place consistently; too often it depends on the quality of the prospective owner's attorney, if he even hired an attorney. Increased transaction costs are certainly possible if the proposed system works; advance planning is not free, either in terms of money (attorney fees) or time (client attention). If these costs are not acceptable in light of the anticipated benefit of reducing future disputes and litigation, steps should be taken to help minimize these costs. As such, one of the proposals in this Article is that form agreements, based on the gathered data, should be easily available to help "jump start" the parties' planning process.

Further, this Article's proposals do not address "second generation" owners,<sup>411</sup> such as those who inherit their ownership interest or acquire it in a divorce or other proceeding. It thus may help to require businesses and/or transferors to take reasonable steps to ensure that these types of "later" owners receive the disclosure document set forth in Appendix A at or before the time that they acquire their interest (although they may not have sufficient bargaining leverage to insist on anything). Finally, the state's costs would increase as a result of monitoring compliance, keeping the disclosure document appropriately updated, and compiling the statistics resulting from the questionnaires set forth in Appendix B. These, however, would seem to be small prices for the societal benefit of reduced conflicts and litigation in closely held businesses.

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411. Second-generation owners who inherit minority interests in LLCs may lack the foresight or ability to renegotiate an existing LLC agreement. See Miller, *supra* note 33, at 401.

## CONCLUSION

Small businesses constitute the vast majority of American businesses.<sup>412</sup> Countless individuals and families depend on them for their livelihoods. Yet often the closely held business can become a vehicle for minority owner oppression. While the law provides the minority owner some avenues of relief through the innovations of fiduciary duty analysis from the *Donahue* and *Wilkes* cases and their progeny, as well as involuntary dissolution statutes, these are blunt instruments that should be used only as a last resort. Advance planning offers a much more viable, appropriate, and cost-efficient alternative. Too often this tool gathers dust instead of being used.

Will the solution advocated in this Article put an end to abuse of minority owners in corporations and LLCs? Of course not. No amount of planning will cover all situations and developments that occur in the future, so the current remedies provided to minority owners must remain in force. The law must remain flexible to deal with unforeseen situations: “For centuries, the law has assumed that (1) power creates opportunities for abuse and (2) the devious creativity of those in power may outstrip the prescience of those trying, through ex ante contract drafting, to constrain that combination of power and creativity.”<sup>413</sup> But few would likely disagree that an increase in advance planning by minority owners will make their abuse less commonplace, or that advance planning would at least provide a more efficient mechanism to remedy the abuse than protracted litigation over vague, fact-intensive concepts such as “legitimate business purposes,” “oppression,” “reasonable expectations,” and the like. Although it has long been recognized that careful planning offers the minority owner a much better chance of avoiding or remedying abuse, the time has now come to make that planning more likely to actually occur.

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412. See Siegel, *supra* note 10, at 378 (“[C]lose corporations constitute the vast majority of American businesses.”). Cf. Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 287 (1990) (“[f]amily-owned businesses alone represent [95%] of all United States businesses. . . .”); Moll, *Dividend Policy*, *supra* note 17, at 844 (“the vast majority of corporations in this country are close corporations”).

413. BISHOP & KLEINBERGER, *supra* note 46, § 14.05[4][a][ii]; see also GEVURTZ, *supra* note 23, at 457-58 (“a major justification for fiduciary duty rules is that the law cannot expect individuals to anticipate all of the circumstances in which they should have contracted for protection from abuse”).



## APPENDIX A

Proposed Pre-Formation Disclosure Document  
(Based on Michigan corporate and LLC statutes)

## FORMING A SMALL BUSINESS IN MICHIGAN

## INTRODUCTION

**CONGRATULATIONS!** You have taken the first step toward forming your small business. While we strongly suggest that you consult an attorney, we have compiled this booklet to highlight some important things that you should think about before you form your business if you are not going to be the only owner of the business. In fact, we think that these things are so important the State of Michigan will require you to (1) sign an acknowledgment that you have received this booklet and (2) complete a questionnaire – on a completely confidential basis, of course – about your decisions. We use these questionnaires to compile a database so that future business owners can see what others decided to do. You can review the database at [www.\\_\\_\\_\\_\\_](http://www._____).

\*Note: If you are going to be the *only* owner of the business, then you do not need to complete the questionnaire.

**Visit an Attorney.** Again, we strongly advise you to consult an attorney when forming a business. You should consult an attorney who is experienced in business law. Ask friends and family members for suggestions, or consult your local or state bar association. You should also be aware that most attorneys represent the *business* – not the individual owners. It may be in your best interests to hire your own attorney to represent *your* interests.

You may think that hiring an attorney will be too expensive and time-consuming. While that's possible, we believe that the benefits usually are greater than the costs. If you form your business carelessly, problems could be in store down the road – not just for the business, but for you personally too. Also, we have made several “form” agreements and documents available for you and your attorney to use for free, which may reduce your costs. And do not forget that the more the business owners can discuss what their expectations about the business are and

decide “business issues” before consulting an attorney, the less their expenses will be.

**What Kind of Business Should You Choose?** One of the first choices that you need to make is whether you want to form a corporation, a limited liability company (LLC), or some other type of entity. There are advantages and disadvantages with each business form, and this document is *not* meant to give you advice about that topic. You should consult with a professional (attorney or accountant) to decide what type of business you should form.

**What Will the Management of Your Business Be Like?** The rest of this document is divided into two sections: (1) the first is for what we call a “Type I business,” a small business where *all* of the owners expect to be active in the business as employees and/or managers, and (2) the second is for what we call a “Type II business,” a small business where *some* of the owners will be active in the business as employees and/or managers but there will be one or more passive (non-active) owners. *Which of the following correctly describes your planned small business?*

- **Type I:** all of the owners (e.g., shareholders or LLC members) will be active in the business as employees and/or managers – Read Part I
- **Type II:** some of the owners (e.g., shareholders or LLC members) will be active in the business as employees and/or managers but some of the owners will be passive (non-active) investors – Read Part I AND Part II (starts on page \_\_\_)
- **Other:** Read Part I AND Part II

#### PART I: SMALL BUSINESSES WHERE ALL OWNERS ARE ACTIVE

**What Are Your Expectations?** Whether you are forming a corporation, an LLC, or some other type of entity, if you are like many prospective owners of a business, you may have the following expectations:

- *Your Employment:* you may expect to work for the business and be paid a salary.

- *Others' Employment:* you may expect that the other owners will also work at the business and be paid the same salary as you if they work as hard as you do.
- *Role in Management:* you may expect to have a role in management, such as by being a member of the board of directors (if a corporation) or a manager (if an LLC).
- *No Self-Dealing:* you probably do not want the company to engage in conflict-of-interest transactions with the other owners (such as hiring relatives or buying property at an inflated price), unless the terms are fair and the transaction benefits the company.
- *Stock Buy-Backs:* you may expect that the company will buy back your stock (if a corporation) or membership interest (if an LLC) if you die, become disabled, or simply want to leave the business to do something else.
- *Transfer Restrictions:* you may want to restrict the other owners' ability to transfer their stock (if a corporation) or membership interests (if an LLC) to outside parties.

These may or may not correctly describe your expectations, and you may have additional expectations. Regardless, the point is that the *Michigan corporation and LLC statutes do not automatically protect these expectations, unless you take steps to protect your expectations.*

**How Your Expectations May Be Frustrated:** Without any advance planning, the expectations described above could go “up in smoke” if you are a minority owner and you have disputes with the other owners (who own a majority of the company). This is because Michigan corporation and LLC statutes assume “majority rule.” Here are some things that could go wrong for you if you are a minority owner and *do not plan ahead:*

- *Your Employment:* business owners are not guaranteed employment. Instead, you will probably be an “at will” employee who can be fired for any reason – or no reason.
- *Others' Employment:* the majority can increase their own salaries over your objections.
- *Role in Management:* the majority has no obligation to elect you as a director or manager, or they could remove you from those positions.

- *No Self-Dealing*: the majority can engage in conflict-of-interest transactions over your objections.
- *Stock Buy-Backs*: neither the company nor the other owners have to buy back your stock (if a corporation) or membership interest (if an LLC) if you die, become disabled, or want to leave the business. In a Michigan LLC, you have no right to withdraw from membership unless your LLC's operating agreement gives you that right.
- *No Transfer Restrictions*: stock (if a corporation) and membership interests (if an LLC) may be freely transferred to outside parties.

**Some Ways You Can Protect Your Expectations:** The above discussion isn't intended to scare you – it's meant to help you understand how to protect yourself. Of course, even if you do not take any of the actions briefly described below, things may still turn out well for you because you may always “get along” with the other owners and even if you do not, you may be able to sue them. But if starting a business is a major event in your life and you want to protect your investment of time and money, here are a few things to consider. Because your circumstances may be unique, we again strongly recommend that you consult an attorney. The following *isn't meant to be legal advice and it's only a partial list of things to consider*.

- *Your Employment*: an employment agreement could specify your salary (or how it is determined) and could provide that you may only be fired for “cause.”
- *Others' Employment*: a provision in the company's articles, bylaws, or an agreement signed by all the shareholders (if a corporation) or operating agreement (if an LLC) could provide that all salary increases must be approved by all of the directors (if a corporation) or members or managers (if an LLC).
- *Role in Management*: In a corporation, a shareholder voting agreement could obligate the other owners to elect you to the board of directors. Instead, the articles of incorporation could provide that “cumulative voting” is used to elect directors – in that case, even if you are a minority shareholder you may have enough shares to guarantee your election to the board. In a manager-managed LLC, the operating agreement could be drafted to provide that you will be one of the managers.

- *No Self-Dealing:* A provision in the bylaws (if a corporation) or operating agreement (if an LLC) could require that all conflict-of-interest transactions must be disclosed and can only be approved by all of the directors, managers, or members, as the case may be.
- *Buy-Sell Agreements and Transfer Restrictions:* A buy-sell agreement could obligate the business to buy back your stock (if a corporation) or membership interest (if an LLC) if you die, become disabled, leave the business, or other conditions occur. Also, a buy-sell agreement could prevent the owners from transferring stock or membership interests to outside parties, unless the business or the other owners are given a right of first refusal to buy it. The drafting of a buy-sell agreement involves important tax and other considerations and should be done in conjunction with an attorney. Alternatively, a provision in the articles of incorporation or articles of organization could give a minority owner the right to dissolve the business upon certain events, such as the termination of employment.

Do not worry if the above discussion sounds overwhelming. Many attorneys routinely deal with these sorts of agreements and documents. In addition, to help “jumpstart” your planning process, you should review the many standard form agreements and provisions which we have made available at [www.\\_\\_\\_\\_\\_](http://www._____). These documents, which are available for free, may be used a starting point for – but not the final result of – your own planning. Like any “generic” document, forms should be used carefully.

## PART II: SMALL BUSINESSES WHERE MOST OWNERS ARE ACTIVE, BUT SOME ARE PASSIVE INVESTORS

**What Are Your Expectations?** A “Type II” business is a small business where some of the owners will be active in the business as employees and/or managers but there will also be one or a few passive (non-active) owners.

Active Owners. If you are one of the “active” owners, you may have the expectations described in Part I of this document.

Passive Owners. If you are one of the “passive” owners (such as an investor who will rely on others to run the business), *not only should you read Part I above*, but you should also consider the following:

- *Management Issues:* you may want to have the ability to remove the active owners from any role in the management of the business if they engage in some form of misconduct or perform poorly. You may also expect to have a limited role in management, such as by being a member of the board of directors (if a corporation) or one of the managers (if an LLC).
- *Stock Buy-Backs:* you may want to obligate the company or the other owners to buy back your stock (if a corporation) or membership interest (if an LLC) upon certain events, particularly if the active owners engage in some form of misconduct.
- *Informational Rights:* you may want to have access to a great deal of information about the company's finances, business, and other issues.

**How a Passive Investor's Expectations May Be Frustrated:**

Without any advance planning, the expectations described above could go "up in smoke" if you are a minority owner and you have disputes with the other owners (who own a majority of the company). This is because Michigan corporation and LLC statutes assume "majority rule." Here are some things that could go wrong for you if you are a minority owner and do not plan ahead:

- *Management Issues:* you will not have a right to remove the active owners from management. In addition, the majority has no obligation to elect you as a director or manager, or they could remove you from those positions.
- *Stock Buy-Backs:* neither the company nor the other owners have to buy back your stock (if a corporation) or membership interest (if an LLC) at any time. In a Michigan LLC, you have no right to withdraw from membership unless your operating agreement gives you that right.
- *Informational Rights:* in a corporation, if you are only a shareholder, you have limited access to information about your corporation, and may be required to demonstrate a "proper purpose" for accessing information. In an LLC, if you are only a member, many times your requests for information must be "reasonable."

**Some Ways Passive Investors Can Protect Their Expectations:**

Here are a few ways to consider protecting the expectations described

above. Because your circumstances may be unique, we again strongly recommend that you consult an attorney. The following isn't meant to be legal advice and it's ***only a partial list of things you might consider.***

- *Management Issues:* A provision in the bylaws (if a corporation) or operating agreement (if an LLC) could provide that the active owners may be removed from management upon certain conditions.
- *Buy-Sell Agreements:* A buy-sell agreement could obligate the business to buy back your stock (if a corporation) or membership interest (if an LLC) upon certain conditions. The drafting of a buy-sell agreement involves important tax and other considerations and should be done in conjunction with an attorney. Alternatively, a provision in the articles of organization could give a minority owner the right to dissolve the business upon certain events, such misconduct by the active owners.
- *Informational Rights:* a provision in the articles of incorporation or bylaws (if a corporation) or the operating agreement (if an LLC) could specify that all owners are entitled to inspect all of the company's records, provided they give adequate advance notice and do not disrupt company business.

## CONCLUSION

Again, congratulations. Forming your small business is probably a major event in your life. Like all major decisions, you should proceed carefully and on a well-informed basis. Hopefully, this document has alerted you to some issues that you should consider and address with the other owners of the business. While it may be unpleasant to discuss what will happen in the event of future conflicts, we believe that all of the business's owners will benefit by having this discussion now, instead of later.

Finally, **do not procrastinate!** Studies have shown that people often repeatedly delay taking actions that they believe are in their best interests – sometimes until it's too late. To help you make sure that you follow through with the actions that you've decided to take or at least consider, we have included a worksheet for you to use following the signature page.

SIGNATURES

(Detach and Return to Department of Energy,  
Labor and Economic Growth)

All prospective owners of the business must sign below and return this page to the Michigan Department of Energy, Labor and Economic Growth with the articles of incorporation, articles of organization, or other applicable charter document. **Your business may not be formed until these signatures are received and all of the undersigned return the Confidential Questionnaire for Prospective Owners of Closely Held Businesses. (No questionnaire is necessary if there will be only one owner of the business.)**

By signing below, the owners represent that the undersigned constitute all of the persons who are currently contemplated to be owners of

\_\_\_\_\_  
[Name of Business]

***Do not sign unless you have actually read this document!***

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_ Date: \_\_\_\_\_

\_\_\_\_\_ Date: \_\_\_\_\_





APPENDIX B

Confidential Questionnaire for Prospective Owners  
of Closely Held Businesses

*The information gathered in this questionnaire is strictly confidential. It will be used only for statistical purposes. After we process your questionnaire, it will be destroyed.*

**Name of Business:**

**Your Name:**

**Which type of entity are you forming? (check one):**

- Corporation
  - Limited liability company (LLC)
  - Partnership
  - Limited liability partnership (LLP)
  - Other (explain)
- 

**How many owners of the business do you expect there will be?**

**Please choose which of the following that best describes the anticipated ownership and management characteristics of your business:**

- All of the equity owners (e.g., shareholders or LLC members) will be **active** in the business as employees and/or managers
  - Some of the equity owners (e.g., shareholders or LLC members) will be **active** in the business as employees and/or managers but some of the equity owners will be **passive** (non-active) investors
  - Other (explain)
-

**What type of owner do you expect to be (check one)?**

- Active employee/manager
- Passive investor

## FOR CORPORATIONS ONLY:

**Please check all of the following forms of “advance planning” that you have obtained prior to formation of the corporation:**

- Employment Agreement
- Buy-Sell Agreement
- Dissolution At-Will Provision
- Shareholder Voting Agreements
- Cumulative Voting
- Supermajority Shareholder Voting
- Preemptive Rights
- Arbitration Agreement
- Provisional Director Provisions
- Stock Transfer Restrictions
- Other (explain briefly):

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## FOR LIMITED LIABILITY COMPANIES (LLCs) ONLY:

**Please check all of the following forms of “advance planning” that you have obtained prior to formation of the LLC:**

- Employment Agreement
- Buy-Sell Agreement
- Dissolution At-Will Provision
- Supermajority Vote Provisions
- Fiduciary-Duty Provisions
- “Oppression” Provisions
- Preemptive Rights
- Arbitration Agreement
- Provisional Manager Provisions
- Other (explain briefly):

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