Allocating the Roles for Contracts and Judges in the Closely Held Firm

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Georgetown Public Law and Legal Theory Research Paper No. 10-66

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ALLOCATING THE ROLES FOR CONTRACTS AND JUDGES IN THE CLOSELY HELD FIRM

ROBERT B. THOMPSON*

INTRODUCTION

When cases continue to be debated decades after they were decided it is usually because of how they changed the law at the time of the decision and/or because of what they contribute to resolving new legal problems arising in the current period.\(^1\) This article uses those two benchmarks to analyze *Wilkes v. Springside Nursing Home, Inc.*\(^2\) and its immediate precedent from the prior year, *Donahue v. Rodd Electrotype Co.*\(^3\) Looking at these cases in the context of the changes to the law at the time they were decided (the focus of Part I below), their most lasting impact was not on the equal opportunity principle, or de facto dividend regulation, or even partnership fiduciary duty rules, but on how they changed the dominant legal framework for viewing the closely held firm. Indeed the primary change following those cases has been in the legislative and judicial

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\(^1\) There are additional reasons, of course, one of which would be the descriptive power of the language, for example *Meinhard v. Salmon*’s “punctilio” standard. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). That case probably meets all three predictors for longevity. See generally Robert B. Thompson, The Story of Meinhard v. Salmon: Fiduciary Duty’s Punctilio, in CORPORATE LAW STORIES (J. Mark Ramseyer ed. 2009).


embracing of a greater role for judicial involvement as opposed to just leaving parties to their own contracting as the preferred legal response to address the specific predicament of investors in a closely held firm.

The particular legal remedy in those cases, an enhanced fiduciary duty among participants in a closely held corporation, is only one of five that have developed since then as widely accepted legal principles in this area. The other four—statutes providing judges with authority to grant involuntary dissolution for oppressive or similar acts in the corporation, reasonable expectations as the most widely accepted standard to trigger such judicial relief, buyout at a judicially determined fair price as the preferred remedy for such violations, and permitting minority owners to sue for breach of fiduciary duty in a direct, individual action as opposed to a derivative claim—have each achieved even broader consensus than the enhanced fiduciary duty holding of Donahue and Wilkes. Together the five developments reflect a legislative and judicial recognition of the predicament

4 See infra notes 5-8 and accompanying text.


6 See, e.g., MINN. STAT. ANN. § 322B.833 (West 2004).


9 See Mary Siegel, Fiduciary Duty Myths in Close Corporate Law, 29 DEL. J. CORP. L. 377, 382 (2004) (asserting even the most generous interpretation cannot transform the Massachusetts law of fiduciary duties in close corporations into anything resembling a true majority rule). However, even fiduciary duty has done better than Professor Siegel suggests. See infra notes 102-106 and accompanying text.
that minority investors find themselves when there has been a falling out among
the participants in an intimate, illiquid enterprise characterized by centralized
control and permanence. They also reflect legislative and judicial recognition that
contracting alone is an insufficient response to the reality experienced by such an
investor so that the possibility (albeit not the guarantee) of judicial relief is a
beneficial legal rule to be provided by the state.

Part II explores the extent to which investors in limited liability companies
("LLCs"), a new form of organizing a closely held firm that was not available at
the time of *Donahue* and *Wilkes*, face a parallel dilemma. The intimacy of the
relationship in most LLCs and the multiple connections of the participants to the
business are often as true in the LLC as they are in the close corporation. LLC
rules have replicated the illiquidity and permanence of the corporation in a closely
held setting. The menu of possible responses is the same, including contracting or
judicial relief. LLC proponents see contracting as something fundamentally
different in the LLC as opposed to the close corporation, but this is a path the law
of the closely held firm has been down before. In fact, the LLC contracting
debate looks a lot like the close corporations law reform discussions of the 1950s
and 1960s, before *Donahue*, when contracting was seen as the preferred solution
for the worries of a minority investor in the closely held firm. Thus, the
guidance of *Donahue* and *Wilkes* will be relevant as legislatures and courts again
have to address whether contracting is now better equipped to address the limits
of bounded rationality and other aspects of the human condition such that the

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10 See infra notes 22-32 and accompanying text.
judicial involvement provided in the five strands of close corporation law reform are no longer necessary in the twenty-first century.

I. Changing the Law Applicable to Closedly Held Business Firms Circa 1976

Donahue and Wilkes were at the center of a fundamental reorientation in how American law defines the roles for contracting and judges in shaping the governance relationship of participants within closely held corporations. Subpart A begins with a discussion of the traditional corporate attributes that have long defined corporations and the problems created for a closely held business in such a legal regime. Subpart B briefly covers possible remedies that would be available in such a context including self-help, contractual protections, and relief from a judge. Subpart C addresses the corporate law environment for closely held businesses as it existed at the time the cases were brought, how the cases changed the law, and how the law developed in the time thereafter. It turns out that the courts’ framing of the problem was more important than the particular solution provided in these cases. What we take away from Donahue and Wilkes should be more about the distinctive approach to the role of contracts and courts and less as to the specific remedy.

A. The Predicament of Minority Investors in a Closely Held Corporation
The holdings of *Donahue* and *Wilkes* were a judicial recognition of the disconnect between the traditional corporate attributes, found in the statutes and the common law of the fifty states, and the realities of a closely held business relationship. The usual corporate attributes reflect the needs of a publicly held corporation. For example, corporations statutes provide for the separation and specialization of function (and the various efficiencies that may come from such specialization) among shareholders as the providers of capital, officers as the day-to-day managers, and directors as the monitors and ultimate authority in making business decisions.\(^\text{11}\) The centralized control of all corporate powers in the board of directors, the core of corporate governance law, permits an efficiency that will be most useful to a large, sprawling business enterprise. Entity permanence, continuing beyond the death or withdrawal of any one participant, permits the entity to make long-term plans without having to hold capital aside to redeem shares of individual investors. Judicial deference to the private ordering within the corporation and to the decisions of the centralized majoritarian bodies, deference most visible in the business judgment rule,\(^\text{12}\) similarly reduces the ability of individual investors to interfere with the centralized decisions. Free transferability and limited liability permits the development of public markets. In turn, these markets provide a source of liquidity from outside the corporate


structure that lessens the lock-in effect of permanence and provides constraints on
the possible excesses of centralized control.

In the context of a closely held business, however, these corporate norms
have markedly different effects because the relationship is both intimate and
illiquid. Illustrating the first characteristic, the closely held firm is often both a
vehicle for investment of the participant’s money capital and human capital.
Shareholders in a closely held firm often expect to be employed and have a
meaningful role in management as well as a return on their investment.\textsuperscript{13}
Decisions vitally important to participants, such as their employment, are
controlled by the majority shareholders through the board. When harmony
between participants disappears, a common occurrence given the human
condition, those with the levers of control in the corporation can terminate
employment, deny dividends, or force the minority out of the business on terms
set by the majority. The harm can be more intense given that in many closely
held firms, there are familial relationships or other long-term personal
relationships that are at risk in addition to the investment and employment
relationship.\textsuperscript{14}

The economic reality of the absence of a public market for the entity’s
shares deprives investors in the closely held firm of the same liquidity and ability
to adapt available to investors in a public corporation. The permanence of the
corporate form further compounds the dilemma. Without a job, and in the

\textsuperscript{13} See, e.g. \textbf{F. Hodge O’Neal, Close Corporations: Law and Practice}\n(1958).§1.07.

\textsuperscript{14} See supra note 8 at 701.
absence of dividends, the minority shareholder may face an indefinite future with no return, financial or otherwise, on the contributions made to the enterprise.

B. The Menu of Possible Responses to Such a Predicament

The predicament just described arises within a legal entity that combines centralized control/majority rule with entity permanence and the lack of an exit, so that a minority investor, after a falling out, faces the possibility of no money forever (or at least until the majority relents, or the minority gives up, or the parties are able to reach a resolution among themselves). There are a variety of possible responses one might take, or tell others to take, in trying to plan so as to not be caught in such a situation. One approach is to choose wisely in co-venturers. Another would be to work harder at relationships, to keep small squabbles from festering and growing. Such approaches have always been necessary in general partnerships given the unlimited liability that can arise from actions of one’s partners and the practical loss to all partners that can occur when intimate relationships in a small enterprise break down.

A second set of *ex ante* steps would be to structure the relationship so both parties would have sufficient incentives to work for the common good and not pursue opportunistic conduct. This is most easily done in a 50/50 venture or where both parties have separate inputs that the enterprise needs. When buying a minority position, the task becomes more difficult, but the Delaware Supreme Court has pointed to “tools of good corporate practice” by which minority
shareholders “may enter into definitive . . . agreements” that “may provide for elaborate earnings tests, buy-out provisions, voting trusts or other voting agreements.”\textsuperscript{15} Such contracting has long been part of the planning that practitioners undertake in the close corporation relationship.

Beyond such self-help, participants could look to other dispute resolution devices, such as family ties or by appealing to the norms of groups to which the co-venturers belong.\textsuperscript{16} Dispute resolution could also be specified by contracts (including e.g. arbitration or automatic dissolution) or could be provided by the state by authorizing a judge to put limits on permanence via an ordering of involuntary dissolution or finding a breach of fiduciary duty.\textsuperscript{17}

One other response might be termed the Henny Youngman solution, reflecting one of the stand-up comedian’s recurring one liners set up by a patient complaining to the doctor of a particular pain, and the doctor’s simple advice: “Stop doing that.”\textsuperscript{18} In a similar vein, why wouldn’t a savvy investor avoid a legal entity that produces such results in favor of one such as a partnership, which provides for shared governance, relatively easy exit, and a judicially-enforced fiduciary duty? Why then would any non-majority investor choose to do business in the corporate form? The answer is that the choice of business form has been made in the context in which three separate decisions are bundled. When selecting a business form one simultaneously gets a liability rule as to non-

\textsuperscript{15} Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993).
\textsuperscript{16} See, for example, the law merchant discussed in \textit{Harry G. Henn & John R. Alexander, Laws of Corporations} 15 (3d ed. 1983).
\textsuperscript{17} See notes 90-113 infra and accompanying text..

\textsuperscript{18} See \url{http://www.funny2.com/henny.htm}
participants, a tax status as to the government, and a governance relationship among co-venturers.

Participants are not indifferent to what they want from a business form—the magic answers to the three relationships in the bundle are limited liability as to outsiders, the lowest taxes as to the government, and usually some sort of shared governance as to the relationship with co-venturers.\textsuperscript{19} At the time of \textit{Donahue/Wilkes}, and as had been true for most of the twentieth century until that point, the corporation was the dominant business form to provide limited liability and still provide a lower tax bill.\textsuperscript{20} Since the corporate rate had long been lower than the individual rate an owner could retain within the corporate treasury any income produced by the business that was not needed by the participants’ immediate needs, pay the lower corporate income tax rate, and, if you did your planning correctly, eventually get the remaining sums out of the corporation.


\textsuperscript{20} Until 1982, the highest individual tax rate always exceeded the highest corporate tax rate. See Joseph A. Pechman, Federal Tax Policy 299-305 (5th ed. 1987). For example, in 1942 the highest individual rate was 88% while the rate in the top corporate bracket was 40%, id. at 313, 321, creating an incentive to use the corporate form if a double tax could be avoided when the corporate earnings were distributed to participants and if other tax provisions (for example, basis rules, deductions, exemptions) did not eliminate the advantage from the rate differential. Other business forms such as the Massachusetts Business Trust (see Massachusetts General Laws, chapter 62, § 8(a)) could possibly provide the combination depending on the state’s approach to limited liability.
without paying a second corporate level tax by coming under the General Utilities doctrine. 21

These two immediate benefits, lower taxes and avoiding liability to outsiders, dominated the third (governance) area of inquiry. Academics and lawyers, as discussed below, focused on the power of contracts to address any adjustments that needed to be made in the relations among co-venturers, including adjusting rules as to centralized control, majority rule, and permanence. 22 But parties were not always sure they wanted to spend money (that otherwise could be used to build the nascent business) to engage in elaborate planning. Like couples contemplating marriage, parties entering into a closely held business relationship failed to adequately plan for what would happen if they had a falling out. As with marriage, even raising the issue could adversely impinge on the trust thought necessary to make the relationship work.

C. Viewing 1975/1976 as a Fulcrum in Corporate Law’s Approach to the Closely Held Firm


22 See infra note 114.
A more particular view of the world of close corporations at the time of the *Donahue* and *Wilkes* decision in 1975 and 1976 is also a necessary foundation for understanding the changes the cases brought about. For most of the history of American corporate law up until that time, statutes and judicial decisions laid down the same rule for governance of both publicly-held and close corporations.\(^{23}\) In the period after World War II,\(^{24}\) scholars such as F. Hodge O’Neal,\(^{25}\) Elvin Latty,\(^{26}\) George Hornstein,\(^{27}\) and Carlos Israels\(^ {28}\) described the differences between public and close corporations and urged changes in the law. Many of these early efforts were devoted to gaining increased room for contracting for participants in close corporations to avoid the unwanted rules that made the public corporation form worrisome.\(^ {29}\) Thus, statutes permitted charter or bylaw

\[\text{\small 23 F. HODGE O’NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE 27 (1958).}\]

\[\text{\small 24 There was some earlier writing. See generally Norman Winer, Proposing a New York “Close Corporation Law”, 28 CORNELL L.Q. 313 (1943).}\]


\[\text{\small 26 Latty was dean at Duke Law School and was an important figure in the drafting of the North Carolina corporations law changes in 1956, a key statutory change in the 1950’s. See E.R. Latty, The Close Corporation and the New North Carolina Business Corporation Act, 34 N.C. L. REV. 432, 438 (1956).}\]

\[\text{\small 27 See generally George Hornstein, Stockholders ’ Agreements in the Closely Held Corporation, 59 YALE L.J. 1040 (1951).}\]

provisions providing unanimity or supermajority requirements that provided participants a veto over corporate action.\textsuperscript{30} Other statutory changes loosened formalities\textsuperscript{31} and provided for charter provisions that permitted dissolution at will.\textsuperscript{32} Scholars and legislators of this period expressed belief in contracting similar to that expressed by the modern day proponents of LLCs.\textsuperscript{33} In the decade before \textit{Donahue} and \textit{Wilkes}, many states had passed special statutes dealing with the close corporation that again were focused on broadened freedom of contracting.\textsuperscript{34} The first two editions of O’Neal’s landmark Close Corporations treatise, which had been published prior to the Massachusetts decisions, focused

\textsuperscript{29} See, e.g., McQuade v. Stoneham, 189 N.E. 234, 238 (N.Y. 1934) (refusing to enforce a contract that interfered with the unfettered discretion of directors to run the corporation).

\textsuperscript{30} \textbf{N.Y. STOCK CORP. LAW} §§ 1, 9 (1948) (adding section 9 authorizing charter provisions establishing a high quorum or vote requirement).


\textsuperscript{32} \textbf{N.C. GEN. STAT.} § 55-125 (1973) (current version at \textbf{N.C. GEN. STAT.} § 55-14-30(2) (2009)).


\textsuperscript{34} See \textbf{O’NEAL & THOMPSON, supra} note 31, §§ 1:15-1:19.
on agreements that would navigate around unwanted public corporation characteristics and suggested changes in law to permit such actions.\textsuperscript{35}

Another O’Neal project of this period had categorized the voluminous ways that a minority shareholder could be oppressed or squeezed out in a closely held firm\textsuperscript{36} This initial Oppression/Squeeze Out volume, published in 1961, included dozens of sections itemizing the causes of squeeze outs and then two more chapters describing the techniques used to squeeze out before detailing methods to avoid squeeze out and ideas for changes in legal rules.\textsuperscript{37} This was a “Brandeis brief” spelling out the close corporation predicament and it spread through O’Neal’s other works.\textsuperscript{38} The 260-page paperback published in 1961 tripled by the time it was published in hardback in 1975.\textsuperscript{39} Key ideas were incorporated as part of the close corporation treatise.\textsuperscript{40} As a regular practice O’Neal wrote to the lawyers in every published close corporation and oppression


\textsuperscript{36} F. Hodge O’Neal & Jordan Derwin, Expulsion or Oppression of Business Associates: Squeeze-Outs in a Small Enterprise, Chapters 3-5 (1961).

\textsuperscript{37} Louis B. Brandeis, New World Encyclopedia, http://www.newworldencyclopedia.org/entry/Louis_D._Brandeis (last visited Jan. 29, 2011) (“The Brandeis Brief became the model for future Supreme Court presentations as they would continue to consider economics, sociology, history, and expert opinions.”).

\textsuperscript{38} See generally F. Hodge O’Neal, “Squeeze-Outs” of Minority Shareholders Expulsion or Oppression of Business Associates (1975).

case; thus, it is not surprising that he wrote and talked to Mr. Egan, the lawyer for Mr. Wilkes.41

But even here, the focus was on contracts and other arrangements to avoid squeeze outs, and legislative changes that would permit such planning. There had been involuntary dissolution statutes based on oppression since the early 1930s42 and such a provision had been included in the Model Business Corporation Act from the earliest inception of that project in the 1940s.43 The first edition of the Model Business Corporation Act Annotated, published in 1960, reports fourteen states with statutes that authorized courts to order involuntary dissolution for oppression,44 and by the time of the second edition—a decade or so later—the number of states had grown to twenty-four.45 That number, however, overstates the reach of the remedy. Any relief required a judicial order and most judges still


44 Model Bus. Corp. Act § 90 (1st ed. 1960) (listing six states with laws substantially similar to the Model Act’s provisions, two as basically similar, four using “unfairness” to the minority, and three closely resembling, one of which was also included in the prior category).

45 Model Bus. Corp. Act § 97 (2d ed. 1969) (listing seven states with identical laws or at least laws identical in substance; thirteen with comparable laws (one of which omits oppression and is excluded from this count); three substantially similar to oppression; and two phrased as when necessary to protect the rights of a substantial number of shareholders).
felt that killing a corporation was not something they should do.\textsuperscript{46} Oppression was not defined in the statute and courts were not ready to give it a broad reach. \textit{Baker v. Commercial Body Builders}, an early Oregon decision, outlined a long list of possible remedies under the Oregon statute, but its definition of oppression, viewed from a twenty-first century perspective, looks narrow.\textsuperscript{47}

Case precedent at the time was stronger from abroad than from the United States. The United Kingdom had enacted an oppression remedy in 1948\textsuperscript{48} and there were some early cases that provided for broader interpretations of relief and remedies.\textsuperscript{49} Allen Afterman, an Australian scholar writing in an American law review, linked oppression in the United Kingdom and other commonwealth

\textsuperscript{46} See, e.g., cases from states with seemingly broad statutes, Bator v. United Sausage Co., 81 A.2d 442, 444 (Conn. 1951) (“Dissension . . . not a ground for dissolution unless it goes so far as to render it impossible to carry on the corporate affairs.”) (citing Olechny v. Thadeus Kosciuszko Soc’y, 24 A.2d 249); Polikoff v. Dole & Clark Bldg. Corp., 184 N.E.2d 792, 795 (Ill. App. Ct. 1962) (“[T]he remedy of [dissolution] is so drastic that it must be invoked with extreme caution.”).

\textsuperscript{47} Baker v. Commercial Body Builders, Inc, 507 P.2d 387, 393-95 (Or. 1973) (defining oppression by reference to a visible departure from the standards of fair dealing, but including no specific reference to reasonable expectations and other terms that have become more common since).

\textsuperscript{48} Companies Act, 1948, 11 & 12 Geo. 6, c. 38, §210 (Eng).

statutes to conduct that frustrated participants’ reasonable expectations, heralding what has become a dominant trend in American case law.\textsuperscript{50}

Fiduciary duty, likewise, was a possible source of relief, but one that minority shareholders could not regularly rely on in a squeeze-out setting and one that reform advocates had not chosen to make their primary argument. O’Neal wrote in 1958, in the first edition of his close corporations treatise, that there was support for using fiduciary duty: “many of the older decisions and practically all of the recent ones indicate that controlling shareholders, in some circumstances at least, owe fiduciary duties to minority shareholders.”\textsuperscript{51} He repeated that same statement in new versions of the \textit{Close Corporation} and \textit{Oppression} treatises in 1972 and 1975 adding additional case illustrations.\textsuperscript{52} In the Oppression treatises, he summarized the impact this way:

\begin{quote}
In spite of the principles of majority rule and the business judgment rule, the courts in this country are moving steadily, though slowly and often clumsily and gropingly, to provide a remedy for oppressed minority shareholders. This they are doing principally by imposing a fiduciary duty on controlling shareholders and corporate directors for the benefit of minority interests, and by gradually expanding the scope of that fiduciary duty.\textsuperscript{53}
\end{quote}


\textsuperscript{51} 2 O’Neal, \textit{Close Corporations} ), \textit{supra} note 13, at 108

\textsuperscript{52} 2 F. Hodge O’Neal, \textit{Close Corporations: Law and Practice} (2d ed. 1972) at 45. F. Hodge O’Neal, “Squeeze-Outs” of Minority Shareholders Expulsion or Oppression of Business Associates (1975) at 508..

\textsuperscript{53} O’Neal & Derwin, \textit{supra} note 37, §8.02 at 194; O’Neal supra note 39 at 584.
A principal reason for all those adverb qualifiers in the last O’Neal description was judicial deference to business decisions. O’Neal described it as a too eager willingness to invoke the business judgment rule.\textsuperscript{54} This, in turn, arose from the ambiguity as to fiduciary duty in the closely held firm; if there were no fiduciary duty in a particular context, there would be no judicial involvement.

One prominent article of the period observed that

\begin{quote}
[I]t is clear that controlling shareholders are not fiduciaries in the strict sense; and indeed they could not be, for the classic fiduciary concept is incompatible with the principle that the stockholder majorities shall effectively govern. However, the vocabulary and some of the content of the law of fiduciaries are employed to deal with instances of oppression.\textsuperscript{55}
\end{quote}

An important close corporation symposium of the period noted that “[t]he application of the term ‘fiduciary’ to the majority’s duty towards the minority is of little value because of the difficulty of reconciling the majority’s trust obligation with his right of selfish ownership.”\textsuperscript{56} Here is the governor on unregulated application of fiduciary duty and the antecedent for \textit{Wilkes} use of the “selfish ownership” concept to address the same conflict.

What \textit{Donahue} and \textit{Wilkes} did was link the close corporation predicament to a fiduciary duty remedy that was more likely to be employed in a close

\textsuperscript{54} \textit{Id.} §8.02 at 192 (calling for judicial discrimination in applying the business judgment rule in close corporations) at 194;

\textsuperscript{55} Alfred Hill, \textit{The Sale of Controlling Shares}, 70 \textit{Harv. L. Rev.} 986, 1014-15 (1957) (“Actually the so-called fiduciary rule of the insiders is invoked by the courts when selfishly motivated conduct exceeds certain bounds of fairness, as when the corporation is overcharged for property or services, or minority stockholders are frozen out of the enterprise . . . .” (footnote omitted)).

corporation setting without the same uncertainty of the prior case law. They broke through the deference of the business judgment rule in the same way that the *Unocal* decision did a decade later in the takeover context.57 There defensive tactics taken by a target board in the face of a takeover did not evidence the obvious self-dealing (such as directors on the opposite side of a transaction from the corporation) that would deny the directors the presumption of the business judgment defense. Prior cases58 required the “plaintiff [to] . . . show . . . that impermissible motives predominated in the making of the decision in question.”59 Yet because of what the *Unocal* court termed the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation” in taking such actions, it prescribed an enhanced duty that required additional judicial review (of the threat and the proportionality of the defense) before the business judgment presumption was applied.60 For similar reasons (and a decade before *Unocal*) the Massachusetts courts conclude that existing law would lead to invocation of the business judgment rule too quickly and therefore impose their own enhanced review.

That breakthrough was informed by the court’s clear understanding of the plight of the minority investor as previously discussed. First, the court

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57 **See generally** *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).


59 *Id.* at 292.

60 *Unocal*, 493 A.2d at 951.
acknowledged majority control that is the reality of the corporate form and the
unlikelihood of being able to challenge such conduct under the fiduciary limits
just described. 61 Second, the court recognized the intimacy and illiquidity of the
minority’s investment and the vulnerability that resulted from that. 62 The


[T]he power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders.

The minority can, of course, initiate suit against the majority and their directors. Self-serving conduct by directors is proscribed by the director’s fiduciary obligation to the corporation. However, in practice, the plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors.

Id. (footnote omitted) (citations omitted).

62 Id. at 514-15.

Thus, when these types of “freeze-outs” are attempted by the majority stockholders, the minority stockholders, cut off from all corporation-related revenues, must either suffer their losses or seek a buyer for their shares. Many minority stockholders will be unwilling or unable to wait for an alteration in majority policy. Typically, the minority stockholder in a close corporation has a substantial percentage of his personal assets invested in the corporation. The stockholder may have anticipated that his salary from his position with the corporation would be his livelihood. Thus, he cannot afford to wait passively. He must liquidate his investment in the close corporation in order to reinvest the funds in income-producing enterprises.

At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation . . . .

The minority stockholder, by definition lacking fifty percent of the corporate shares, can never “authorize” the corporation to file a petition for dissolution under G.L. c. 156B, § 99(a), by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.
combination is what the court called a trap, and what has been referred to here as the predicament of a minority owner.63

The facts of *Donahue* are not the most severe example of the plight just described, viewed within the context set out in the O’Neal treatises, but it does show a minority shareholder left with no liquidity at a time that the majority shareholder used company funds to provide such liquidity for himself.64 The president (Rodd) and the plant superintendent (Donahue) had in effect purchased the company where they had each been working for the prior two decades.65 Rodd was clearly the more central of the two. He owned 80% of the company’s 200 shares and was the dominant force at the company, even mortgaging his house to provide for cash for company expenditures. The two continued to lead the company for the next nine years when they each gave way to two sons of Rodd who became respectively president and plant superintendent. The problem

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*Id.* (citation omitted).

63 *Id.* at 515.

Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority. This is the capstone of the majority plan. Majority “freeze-out” schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. When the minority stockholder agrees to sell out at less than fair value, the majority has won.

*Id.* (citations omitted).

64 *Id.* at 508-11.

65 This description of the facts in this paragraph are taken from the court’s description at 580-581.
that was litigated arose five years later when Rodd retired from the board and as
treasurer and company funds were used to repurchase the remaining forty-five of
his shares that he had not previously given to his children. There is no indication
that Donahue had been fired or anything other than normal retirement, but
nevertheless he and his wife had no liquidity for their stock. After the
corporation’s use of corporate funds to pay Rodd, Donahue and his wife sought
the same $800 per share price for their twenty shares (in contrast to the price they
had been offered during the previous four years from $40 to $200 per share).71

The facts in Wilkes possessed more of the characteristics of the plight
described by O’Neal and by the court in Donahue.72 There, four acquaintances
acquired land and established a nursing home, an enterprise that quickly proved
profitable for all participants. After thirteen years, the plaintiff, Wilkes,
challenged the sale of a portion of the corporation’s property to Quinn, another of
the original four investors and the informal managing director. As a result, Quinn
ended up paying more for the property, the relationship between Quinn and
Wilkes began to deteriorate, Wilkes’s salary was eliminated, and the others
deprecated to reelect him as a director. Again the court, (four of the five members
having also joined the Donahue decision) defined the issue in terms of the
position of a minority shareholder in a closely held corporation.76 The Court

71 Id. at 511.

72 This description of the facts in this paragraph are taken from the court’s
(Mass. 1976).

76 Id. at 662-63.
recognized the illiquidity of the minority’s investment and the various ways that control can be misused beyond the equal opportunity context in *Donahue*, each of which would be met by the same refrain of judicial deference to legitimate sphere of the controlling directors.\(^7\) As in *Donahue*, the court noted the intimacy and multi-faceted nature of the participants’ relation to the enterprise and tied it to the investors’ expectations in entering into the venture.\(^8\)

\(^7\) *Id.* at 662.

In the *Donahue* case we recognized that one peculiar aspect of close corporations was the opportunity afforded to majority stockholders to oppress, disadvantage or “freeze out” minority stockholders. In *Donahue* itself, for example, the majority refused the minority an equal opportunity to sell a ratable number of shares to the corporation at the same price available to the majority. The net result of this refusal, we said, was that the minority could be forced to “sell out at less than fair value,” since there is by definition no ready market for minority stock in a close corporation.

“Freeze outs,” however, may be accomplished by the use of other devices. One such device which has proved to be particularly effective in accomplishing the purpose of the majority is to deprive minority stockholders of corporate offices and of employment with the corporation. This “freeze out” technique has been successful because courts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors and employees, which essentially involve management decisions subject to the principle of majority control. As one authoritative source has said, “[M]any courts apparently feel that there is a legitimate sphere in which the controlling [directors or] shareholders can act in their own interest even if the minority suffers.”

*Id.*

\(^8\) *Id.* at 662-663.

The denial of employment to the minority at the hands of the majority is especially pernicious in some instances. A guaranty of employment with the corporation may have been one of the “basic reason[s] why a minority owner has invested capital in the
The instrument used by the court in both cases to provide relief for minority shareholders frozen out of a closely held corporation was an enhanced fiduciary duty of utmost good faith and loyalty, expanded in *Wilkes* to include consideration of the majority’s right of selfish ownership. 79 As a result, Wilkes received the salary he would have received had he remained an officer and director. 80

There is a remarkable similarity in the approach of the Massachusetts courts in these two cases and that of the New York Court of Appeals—a few years later—in holding that judicial relief was appropriate to a minority investor under that state’s involuntary dissolution statute. The New York high court anchored its interpretation of the statute on the characteristics of the close corporation. 81 Moreover, the court properly understood the intimate and firm.” The minority stockholder typically depends on his salary as the principal return on his investment, since the “earnings of a close corporation . . . are distributed in major part in salaries, bonuses and retirement benefits.” Other noneconomic interests of the minority stockholder are likewise injuriously affected by barring him from corporate office. Such action severely restricts his participation in the management of the enterprise, and he is relegated to enjoying those benefits incident to his status as a stockholder. In sum, by terminating a minority stockholder’s employment or by severing him from a position as an officer or director, the majority effectively frustrates the minority stockholder’s purposes in entering into the corporate venture and also deny him an equal return on his investment.

*Id.* (alteration in original) (footnote omitted) (citations omitted).

79 Id at 663.

80 Id at 665.


The statutory concept of “oppressive actions” can, perhaps, best be understood by examining the characteristics of close
multifaceted relationship that often characterizes the participants’ relationship in the closely held enterprise.\(^{82}\) And as with the prior cases and previous academic writing, we see the recognition of the impact of statutory norms in creating the risk of oppression.\(^{83}\) Again, the court notes the impact of illiquidity in contrast to corporations and the Legislature’s general purpose in creating this involuntary-dissolution statute. It is widely understood that, in addition to supplying capital to a contemplated or ongoing enterprise and expecting a fair and equal return, parties comprising the ownership of a close corporation may expect to be actively involved in its management and operation.

\(\text{Id.}\) (citations omitted).

\(^{82}\) \(\text{Id.}\)

As a leading commentator in the field has observed: “Unlike the typical shareholder in a publicly held corporation, who may be simply an investor or a speculator and cares nothing for the responsibilities of management, the shareholder in a close corporation is a co-owner of the business and wants the privileges and powers that go with ownership. His participation in that particular corporation is often his principal or sole source of income. As a matter of fact, providing employment for himself may have been the principal reason why he participated in organizing the corporation. He may or may not anticipate an ultimate profit from the sale of his interest, but he normally draws very little from the corporation as dividends. In his capacity as an officer or employee of the corporation, he looks to his salary for the principal return on his capital investment, because earnings of a close corporation, as is well known, are distributed in major part in salaries, bonuses and retirement benefits.”

\(\text{Id.}\) (quoting O’NEAL, CLOSE CORPORATIONS (2d ed.), supra note 35, at 21-22)

\(^{83}\) \(\text{Id.}\) at 1178-79.

Shareholders enjoy flexibility in memorializing these expectations through agreements setting forth each party’s rights and obligations in corporate governance. In the absence of such an agreement, however, ultimate decision-making power respecting corporate policy will be reposed in the holders of a majority interest in the corporation (see, e.g., Business Corporation Law, §§ 614, 708). A wielding of this power by any group controlling a corporation may serve to destroy a stockholder’s vital interests and expectations.
an investment in a public corporation; and as an addition to the prior analysis, the New York court adopted what at the time had been a relatively recent move to using reasonable expectations to measure whether there was sufficient cause for judicial intervention.

After Donahue and Wilkes, and particularly in the decade following Kemp & Beatley, the pace of legislative and judicial protection for minority shareholders

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_Id._ (citation omitted).

As the stock of closely held corporations generally is not readily salable, a minority shareholder at odds with management policies may be without either a voice in protecting his or her interests or any reasonable means of withdrawing his or her investment. This predicament may fairly be considered the legislative concern underlying the provision at issue in this case; inclusion of the criteria that the corporation’s stock not be traded on securities markets and that the complaining shareholder be subject to oppressive actions supports this conclusion.

_Id._

Defining oppressive conduct as distinct from illegality in the present context has been considered in other forums. The question has been resolved by considering oppressive actions to refer to conduct that substantially defeats the “reasonable expectations” held by minority shareholders in committing their capital to the particular enterprise. This concept is consistent with the apparent purpose underlying the provision under review. A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.

Given the nature of close corporations and the remedial purpose of the statute, this court holds that utilizing a complaining shareholder’s “reasonable expectations” as a means of identifying and measuring conduct alleged to be oppressive is appropriate.

_Id._ (citations omitted).
increased dramatically. The focus on contracting that had dominated the 1950s and 1960s gave way to judicial action. Among the fifty states, there were parallel developments providing for judicial action via fiduciary duty and by means of a court granting relief under an equity-sounding oppression statute. The result is that there have been five distinct movements of the law toward providing broader relief for minority investors in a close corporation. The enhanced fiduciary duty of Wilkes and Donahue may be the least used, depending upon how you count, but the larger point is that in most states the five doctrines are complimentary and each reflects the same source—the close corporation predicament recognized in Wilkes and Donahue. The five developments include:

   (1) Authorizing a court to cabin entity permanence in contexts where there has been a showing of oppressive or similar behavior by the majority. All but eleven states now provide such a way around corporate permanence if there has been oppression or conduct by the majority that is unfairly prejudicial to the minority. Courts in several states echo the New York court’s finding that these statutes were designed by the legislature to provide additional remedies for minority shareholders beyond those previously provided. And unlike the period

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86 See supra note 8.

87 See F. Hodge O’Neal & Robert B. Thompson, O’Neal & Thompson’s Oppression of Minority Shareholders and LLC Members § 7.11 (Rev. 2d ed. 2009).

88 See McLaughlin v. Schenck, 220 P.3d 146, 155 (Utah 2009) (“T)he legislature intended to protect shareholders from oppression and misconduct by those in control. To construe the Act’s provisions to require the same fiduciary duty for publicly held and closely held shareholders would not adequately protect close corporation shareholders.”); Fulton v. Callahan, 621 So. 2d 1235, 1252 (Ala.
prior to *Donahue*, these statutes have been widely used to provide relief to
minority shareholders. Even in the states that do not have an oppression statute,
there is little evidence of opposition to providing a judicial way out of
permanence. 89 Delaware and a few other states are outliers as to this trend, but
Delaware ought to be considered a special case, given that any special rules for
close corporations have the potential to create uncertainty among public
corporations that provide a significant share of the Delaware state revenues. 90

(2) In half of the states, courts or legislatures have, like New York, used
“reasonable expectations” to define oppression, a concept that looks to the context
as described in *Donahue*, *Wilkes*, and *Kemp & Beatley*. In some states this
standard or something similar is specified in the statute. 91 In most of the states,
adoption has followed a pattern set forth in *Kemp & Beatley* where the court
recognizes a decision normally within the authority of directors and the majority
under corporate law will, in a close corporation, often frustrate the expectation of

1993) (noting that inclusion of oppression reflected “the legislative extension of
the remedy to do more than just protect or rescue the underlying assets of the
corporation from willfully destructive conduct of controlling shareholders”).

89 See, e.g., G & N Aircraft, Inc. v. Boehm, 743 N.E.2d 227, 243 (Ind. 2001)
(noting that oppression intentionally deleted from the code because of concern
that it might be abused in a hostile takeover, a reason not relevant in the context
of a close corporation); Jerry Cohen & Jonathan C. Guest, *The New
Rev. 213, 213 (2004) (noting that to facilitate legislative adoption of the new
business corporation act required non-disturbance of *Donahue* and its progeny
and the statute’s anti-takeover statutes).

90 Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 Wash. U.

investors in entering into the enterprise.\textsuperscript{92} Although there were oppression statutes in many states at the time of \textit{Donahue}, the continuing spread of these statutes after \textit{Donahue} and the willingness to incorporate reasonable expectations as the touchstone has made the statute an effective remedy for oppression.\textsuperscript{93}

(3) Also important to the effective development of the oppression remedy was the development of a consensus that a buyout was the appropriate remedy when oppression had been shown. Again this was a combined result of legislative changes and judicial interpretations reflecting the legislative purpose in providing a judicial remedy that \textit{Kemp & Beatley} recognized. In some states, a buyout is authorized by statute.\textsuperscript{94} In other states, courts have used their general remedial power to order a buyout.\textsuperscript{95} But the result is that there is specific authority for buyouts in half of the states.\textsuperscript{96} The move to buyouts can be seen in comparing two empirical studies on either side of \textit{Wilkes}. In a study of the 1960-1976 period, Professors Hetherington and Dooley, surveying fifty-four involuntary

\textsuperscript{92} See supra note 87 at §7:13..

\textsuperscript{93} See supra note 8. See text accompanying notes 44-45 infra for a discussion of the spread of oppression statutes. New York itself did not have an oppression statute at the time of Donahue and Wilkes, see L.1979, c. 217, § 1 (adding §1104-a) so that the New York statute and the broad interpretation of the statute in Kemp & Beatley illustrates this trend.  

\textsuperscript{94} Often this buyout is at the option of the majority shareholder after a minority has petitioned for dissolution. \textit{See} \textbf{N.Y. BUS. CORP. ACT} §1104-a (year); \textbf{MOD. BUS. CORP. ACT.} §14.34 (2008). In other states, statutes list buyout among various possible remedies. \textit{See}, e.g. \textbf{N.J. Rev. stat.} §14A:12-7


\textsuperscript{96} \textit{See} \textbf{O’NEAL & THOMPSON}, \textit{supra} note 3131, § 9:18.
dissolution cases in the sixteen years that mostly preceded *Wilkes*, found no relief in half of the cases, involuntary dissolution in sixteen, buyouts in three, and other relief in four.97 When Professor Haynsworth performed a similar study in the 1984-1985 period, there had been a significant increase in the number of cases and a dramatic shift with buyouts in twenty cases (of the thirty-seven cases), involuntary dissolution in ten, and no relief only in four.98

(4) Minority shareholders seeking to enforce fiduciary duties are usually permitted to bring a direct individual action as opposed to derivative claim in the name of, and on behalf of, the corporation.99 The result is to expand the possibility of relief and again to focus courts on the relationship within the close corporation. Courts permit direct relief where the only interested parties are two individuals or sets of shareholders—one who is in control and the other who is not; other courts analogize a small corporation, to a partnership where direct claims are permitted; still others observe that a derivative claim is unnecessary where only the complaining shareholder is disadvantaged by the actions taken by the majority. 100 The American Law Institute’s adoption of a direct cause of

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99 See O’Neal & Thompson, supra note 87, §7:8 . (collecting direct causes of action in an oppression setting).

100 See O’Neal & Thompson, supra note 87, §7: (describing different reasons courts have given for permitting direct individual causes of action).
action in a closely held corporation has spurred judicial movement in this
direction.  

(5) Since Donahue and Wilkes, courts have continued to hold that
majority shareholders in a close corporation have an enhanced fiduciary duty so
as to provide relief to minority shareholders in a close corporation after a falling
out among the parties.  There have been contrary holdings by some courts
refusing to apply an equal opportunity right in particular contexts.  Delaware
has put it in broader terms of preferring contractual solutions to judicial ones:
“Tools of good corporate [governance] are designed to give a purchasing minority
stockholder [an] opportunity to bargain for protection before parting with
consideration.  It would do violence to normal corporate practice and our
corporation law to fashion” a judicial remedy for which the parties had not
contracted.  But as a Utah court recently put it, “the Delaware approach . . .
stands in sharp contrast to the fiduciary duty standard followed by the majority of
states.”  A number of states follow Massachusetts in analogizing to the
fiduciary duties of partners.

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RECOMMENDATIONS § 7.01(d) (1994).

See O’Neal & Thompson, supra note 3131, §9:18 (providing chart for cases
in individual states).

Sundberg v. Lampert Lumber Co., 390 N.W.2d 352, 357 (Minn. Ct. App. 1986);

The statutory oppression remedy and the common law enhanced fiduciary duty action are complimentary and sometimes effectively substitutes. 107 A Massachusetts court held, for example, “[t]he standards used to determine a breach of fiduciary duty are often the same used to define oppression.”108 Many courts have defined oppression by reference to reasonable expectations or fiduciary duty.109 Given this development, it makes little sense to consider enhanced fiduciary duty by itself rather than part of an shareholder’s cause of action for oppression in which the statutory standard in the more common illustration. Practically, the enhanced fiduciary duty doctrine fills a gap in the coverage of oppression in that three of the eleven states that do not have an oppression statute—Massachusetts,110 Ohio,111 and Indiana112—use an enhanced


107 See Thompson, supra note 8, at 700.


111 Crosby v. Beam, 548 N.E.2d 217, 221 (Ohio 1989) (noting that the majority used its controlling position for personal enrichment depriving the plaintiff of the benefit of his investment and the opportunity to share in corporate profits).
fiduciary duty to provide relief to a minority shareholder facing the close held corporation predicament as the overlap in the excerpts from Donahue and Kemp & Beatley illustrate. As a result, only Delaware, Florida, and a half dozen of our smaller states lack either statutory or judicial authority for providing a judicial means to prevent the corporate attributes of centralized control/majority rule and entity permanence from being used to frustrate the reasonable expectations of participants in a closely held business.

The overall result is that a remarkable consensus has developed in the years since Donahue and Wilkes that the predicament or plight of minority investors in a closely held business warrants the possibility (but not the requirement) of judicial review to provide liquidity where the minority investor is receiving no money in contradiction of the parties’ expectations in the venture.

112 G & N Aircraft, Inc. v. Boehm, 743 N.E. 2d 227, 243 (Ind. 2001) (permitting court to order buyout for breach of fiduciary duty); Melrose v. Capitol City Motor Lodge, Inc. 705 N.E. 2d 985, 990 (Ind. 1998) (“Courts have traditionally interpreted fiduciary dut[y] differently for closely-held corporations as opposed to publicly held corporations for which most of . . . statutory norms were established.”).

113 See supra notes 86-90 and accompanying text.


This consensus has arisen in spite of a decades-long reform tradition expanding
the room for contracting in the closely held firm. Harry Henn, writer of a widely-
used corporations’ treatise of the period, noted that “drafting . . . enabled close
corporations to achieve most of their legitimate object[ives] thereby rendering the
present situation tolerable.”\(^{116}\) Changes made to the Model Act in the early 1990s
were in some ways the culmination of the contracting evolution within close
corporations. The annotation to section 7.32 notes that the provision legitimizes
all of the agreements that planners of a close corporation would want.\(^{117}\) But the
five developments outlined above have continued. Henn’s conclusion that the
situation was tolerable has turned out not to be widely accepted given the close
corporation predicament. Even the sophisticated contracting envisioned by
section 7.32 of the Model Act has not removed the need for a judicially-provided
route around permanence for those who have made an investment in the closely
held firm when there later occurs a falling out among participants and corporate
governance permits one set of participants to make decisions for what had been a
shared enterprise.

\[\text{II, } \textit{Donahue/Wilkes Application to LLCs in the Twenty-First Century}\]


Longevity for a judicial opinion in terms of its impact on the law turns not just on how it turned heads at the time it was handed down, but also on its application to new situations so that successive generations of judges and lawyers believe the principles of the case remain useful in addressing evolving contexts that arise. The LLC provides an opportunity to make such an evaluation as to the lasting impact of Donahue and Wilkes. This Part considers the beginnings of LLCs in the late 1970s and their rapid growth which occurred in the early 1990s. Part B then asks if investors in LLCs face the same or similar predicament as those in close corporations. Part C returns to the legal responses to the predicament of the minority investor in a closely held firm considered in Part I and asks how they would apply in the LLC context. Part D then looks at data on where LLCs organize to suggest Delaware is appealing to a specific segment of the LLC market where contracting may be more efficient and more likely to be used.

A. The Origins of LLCs

The early history of LLCs in America is a now familiar story (and entirely postdates Donahue and Wilkes). The Wyoming and then Florida legislatures passed the initial statutes, but there really could not be any significant use of the form until the IRS blessed LLCs as providing pass-through taxation.118 The initial IRS approval turned on the Kintner factors requiring an entity seeking non-

corporate tax status to have a majority of non-corporate attributes, using attributes similar to the ones discussed at the beginning of this article.119 Given the requirements of *Kintner*, investors desiring the corporate factor of limited liability, needed to avoid the other named corporate factors of centralized control, continuity of life, and free transferability of interest.120 As a result, early LLC statutes provided these non-corporate features, even put in a bullet-proof format in various states. Then, in the mid-1990s, the IRS changed positions, withdrew from refereeing which non-corporate entities could get pass-through tax status and which could not, and left it to the choice of the planners through a “check the box” provision.121 Thereafter, most states changed their LLC statutes to provide more in the way of centralized control and certainly more in the way of entity permanence since those changes would no longer endanger the entity’s pass-

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119 The factors take their name from a 1954 appellate opinion, *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The case involved in a context in which the private planners sought to be a corporation given the historical tax advantages discussed above. To do so, the court in *Kintner* said an enterprise must have at least three of the four named corporate characteristics *Id.* at 422-24. As the changes in the tax law moved toward leading parties more often to seek non-corporate or pass-through tax treatment, the same approach continued to be used, even though the the parties essentially had swapped positions. *See generally* Thompson, *supra* note 8, at 931.

120 An entity could not have more than two corporate characteristics and still get non-corporate tax treatment. *See* 26 C.F.R. §§301.7701-1 et seq. (1994) (repealed 1996).

121 *See* Treas. Regs. §301.770-1 (effective Jan. 1, 1997).
through tax status.\textsuperscript{122} LLCs are now the most-used legal form for the closely held business.\textsuperscript{123}

There are multiple possible explanations for this story. Professor Larry Ribstein, who rightfully deserves a central place in explaining LLCs, describes the move in his contribution to this Symposium as “freeing small firms to adopt standard forms that suited their needs.”\textsuperscript{124} I think it is more likely that LLCs grew initially because a small subset of investors were not able to gain their preferred answers to the three questions that are bundled when one chooses a particular legal form of business. The three basic questions for which participants seek answers in choosing the legal form within which to organize, previously discussed in Part I, are: (1) a favorable legal rule in their relationship toward outsiders who deal with the business (limited liability); (2) a favorable legal rule in their relationship with government (lower taxes); and (3) satisfactory rules in the relationships with co-venturers. Since the three questions are bundled within the choice of business form decision there is the possibility of having to trade off disadvantages or uncertainty in one area to gain more beneficial advantages or

\textsuperscript{122} O’NEAL \& THOMPSON, \textit{supra} note 31, ch. 5.

\textsuperscript{123} Rodney D. Chrisman, \textit{LLCs are the New Kings of the Hill: An Empirical Study of the Number of LLCs, Corporations, and LLPs Formed in the United States Between 2004-2007 and How LLCs were Taxed for Tax Years 2002-2006}, 15 \textit{FORDHAM. J. CORP. \& FIN. L.} 459, 459-60 (2010) (reporting LLCs outpace corporations in most states; overall by a 2-1 margin).

certainty in other areas. As noted in the previous part, my view is that if there is any conflict among the three areas, the first two questions almost always dominate the third in the choice of business firms. Limited liability and lower taxes usually are seen as providing a real and immediate benefit. Governance rules of centralized control and permanence may not be the best fit for a closely held business, but possible disadvantages are likely to be seen as uncertain and distant. Participants do not think (or do not want to contemplate) that their relationship will falter, and if it they do think about it, they assume, perhaps naively, that they can deal with it.

At the time that LLCs were created there were some investors who could not achieve the favorable bundle of limited liability, pass-through-tax treatment, and satisfactory governance. See Carol R. Goforth, Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result, 45 Hastings L.J. 1223, 1282 (1994); Park McGinty, The Limited Liability Company: Opportunity for Selective Securities Law Deregulation, 64 U. Cin. L. Rev. 369, 425 (1996).

For example, in the 1980s, income tax changes removed what had been the benefit of having corporate level tax. While subchapter S permitted most small corporations to choose to have pass-through tax treatment, the highest individual tax rate always exceeded the highest corporate tax rate. See Joseph A. Pechman, Federal Tax Policy 299-305 (5th ed. 1987). For example, in 1942 the highest individual rate was 88% while the rate in the top corporate bracket was 40%, id. at 313, 321, creating an incentive to use the corporate form if a double tax could be avoided when the corporate earnings were distributed to participants and if other tax provisions (for example, basis rules, deductions, exemptions) did not eliminate the advantage from the rate differential. Tax reform in 1986 ended the General Utilities doctrine which was a principal method of avoiding a double tax for businesses using the corporate form. See Tax Reform Act of 1986, Pub. L. 99-514, s 631, 100 Stat. 2269, 2269-75.
tax treatment, there were a few tax breaks in real estate or oil and gas that could only be achieved outside of subchapter S. Since limited liability was essentially only available in the corporate form, these firms could not get both limited liability and the lowest tax treatment within the same business structure. Perhaps more important to the spreading adoption of LLCs was a second group that could not get the favorable combination. Professional firms, such as accountants, traditionally had been restricted in their ability to incorporate and thereby gain limited liability. The professional incorporation statutes that had been passed by many states in the mid-twentieth century did not permit the same degree of liability-shielding as in a traditional corporation. LLC statutes offered a way to achieve a more accommodating limited liability rule in the professions.

B. Do Investors in LLCs Share the Predicament Identified in Donahue/Wilkes?

Do minority investors in LLCs find themselves in the same predicament or trap that motivated the Massachusetts court to act in Donahue and Wilkes? As a first cut, the LLC shares with the traditional close corporation the characteristics of intimacy and illiquidity that are at the heart of the oppression analysis. LLCs are usually relationships among a very small set of participants, often linked by

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128 Id.
129 Id.
family or close personal ties.\textsuperscript{130} As with close corporations, the participants often play multiple roles in the enterprise. They provide the necessary capital and the management; they look to the enterprise not just for a return on their investment, but also for a job. It is a greater part of their life than the publicly-held enterprise is to the participants in that entity. Being cut-off from the LLC will disrupt a relationship that is more intimate and intense than in a publicly-held company.

Like investors in close corporations, investors in a LLC have no market for their interests. This illiquidity means that if, because of a death, disability, or change of position in life, they need to get cash for their investment, they cannot look to the market for liquidity as can investors in a public corporation. And, if they are forced out by the other participants, they may be left with little or no return on what they have put into the business.

In the initial LLCs (those formed under a statute that existed prior to “check the box”), this risk was considerably less than for investors in a minority position in a close corporation.\textsuperscript{131} In order to gain the favorable pass-through tax treatment LLCs had to provide for easy-exit, shared governance, and not provide

\textsuperscript{130} But not always—it is possible to be a publicly held LLC even if there may be corporate-type taxation. See generally Kahn v. Portnoy, No. 3515-CC2, 2008 WL 5197164 (Del Ch. Dec. 11, 2008).

\textsuperscript{131} Check the box refers to the IRS choice to permit unincorporated entities to choose whether they wanted to be taxed as individuals or corporations. See Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (1996) (codified at 26 C.F.R. pt. 301).
entity permanence. These mandatory rules reduced the likelihood of the

*Donahue/Wilkes* predicament. After “check the box,” state legislatures launched

a widespread reformulation of their LLC statutes. It became common to

provide for manager-managed LLCs as well as a member-managed format. Some statutes even provided for officers and directors so that even the labels

would mimic the corporation. Even more relevant for this discussion, almost

delete this sentence

all the states changed their rules about easy exit to remover a participant’s ability to end the relationship on terms that would provide anything more than being able to assign the income stream. This move back toward permanence was itself

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132 See United States v. Kintner, 216 F.2d 418, PINCITE (9th Cir. 1954); see generally Thompson, *supra* note 8, at 931.

133 See Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 *Wake Forest L. Rev.* 883, 932-33 (2005) (“[F]ollowing the passage of the ‘check-the-box’ regulations, there was no longer a tax-driven need for state statutes to deny the LLC certain corporate characteristics. In response, many state legislatures eliminated or restricted the withdrawal and dissolution rights that had served to combat a continuity of life finding.”).


136 Compare the changes in Delaware law made in 1996, http://delcode.delaware.gov/sessionlaws/ga138/chp360.shtml. Prior to 1996, its LLC statute provided that, unless otherwise provided, a member had the right to resign upon giving six months notice and then the right to receive, within a reasonable time, the fair value of the member’s ownership interest. 1992 Delaware Laws Ch. 434 (H.B. 608). Effective in 1996, the default rule flipped and now provides that a member can resign only as set out in the operating agreement. Del. Code Ann. Tit. 6 §18-603. The change thus flips which party needs to worry more about working out an agreement. A departing party who
driven by tax concerns; not the income tax concerns that had driven the early LLC movement, but the estate tax worries.\textsuperscript{137} It turns out the best way to keep valuation down for estate tax is to be able to point to restrictions on getting out, which will reduce the value.\textsuperscript{138} Again, the possibility of getting a definite tax advantage in the foreseeable future trumps the less accessible possibility of being disadvantaged if there were to be a falling out among the participants.

Going back to the menu of possible responses to this predicament or trap, the preferred solution for many in the LLC discussion is private contracting. Turning again to Professor Ribstein’s contribution to this Symposium, note the optimism permeating the LLC form as opposed to the close corporation of an earlier day: “\textit{Wilkes} and similar close corporation cases are the product of an earlier time when closely held firms lacked sophistication and coherent contracting technology and therefore needed significant judicial assistance to fill the significant gaps in their contracts.”\textsuperscript{139} The suggestion is that the trap is a relic of the past that investors are now able to use “sophisticated and coherent contracting technology.”\textsuperscript{140} This approach recognizes that parties “need” to

\begin{itemize}
\item before had protection even if the agreement was silent now is locked-in unless alternative provisions are put into the agreement. .
\end{itemize}

\textsuperscript{137} 26 U.S.C. §2033.

\textsuperscript{138} 26 U.S.C.A. §2703; Treasury Reg. §20.2031-1 & 2. See generally O’Neal & Thompson supra note at §7:49.

\textsuperscript{139} Ribstein, \textit{supra} note 124.

\textsuperscript{140} Id.
address allowing members to exit via buyout or dissolution, and even more, assumes they will do so successfully.

Think again about the world before *Donahue/Wilkes* and contemplate the belief in contracts that motivated those early pioneers—vetoes, agreements to arbitrate and the rest (with little reliance on fiduciary duty). Although courts in LLC cases regularly refer to the purpose of the statute as to give maximum effect of freedom of contract, maximizing contracting is also a principal purpose of corporations statues in general and provisions relevant to close corporations in particular. For decades, corporations statutes have been referred to as enabling statutes, which, of course, means deferring to the parties’ contracts. For close corporations in particular, section 7.32 of the Model Business Corporation Act is intended to cover all the key contracts that a planner would want to use in close corporations. There are some differences with LLCs, principally in the ability of the parties to contract around fiduciary duty or involuntary dissolution statutes, but the difference is not as great as the language of some courts and commentators might lead you to believe.

141 *See supra* text accompanying notes 23-21 and accompanying text.


143 *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 2 (1991) (“The corporate code in almost every state is an ‘enabling’ statute. An enabling statute allows managers and investors to write their own tickets, to establish systems of governance without scrutiny from a regulator.”).

144 *MOD. BUS. CORP. ACT* § 7.32 (2005) (see official comment) (“Section 7.32(a) validates virtually all types of shareholder agreements that, in practice, normally concern shareholders or their advisors.”).
Consider also the continuing bounded rationality problems of investors in the closely held firm and the extent to which more immediate tax motivations still dominate decision-making. 145 The choice is not unlike what faced the Massachusetts courts at the time of Donahue and Wilkes—is there a benefit to having a vehicle for judges to provide liquidity when there has been a falling out among the parties and the rules chosen for tax reasons have an unexpected result of permitting those in the majority to continue using the minority’s money for an indefinite period?

C. Involuntary Dissolution Statutes for LLCs

As they have been in close corporations, involuntary dissolution statutes have been the dominant means for working out the extent to which there should be a role for courts in providing liquidity when there has been a falling out among the parties and one party is left locked into, or squeezed out of, the entity. LLC involuntary dissolution statutes primarily come in two flavors. Almost all states permit a court, in its discretion, to order dissolution when it is “not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.” 146 That language itself has been used to order

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145 The sticky defaults discussed in Deborah DeMott’s contribution to this Symposium is an example. AMELIA CITE DEMOTT

146 See MASS. GEN. LAWS ch. 156C, § 44 (2008); MASS. GEN. LAWS ch. 109, § 45. Only a handful of states do not include such a provision. See ALASKA STAT. § 10.50.400, 405 (YEAR) (impossible for the company to carry on the purposes of the company). The other states omitting “not reasonably practicable” do provide for dissolution upon deadlock. See KAN. STAT. § 17-76, 117 (YEAR);
dissolution in many cases where the parties cannot get along, such as in a two-person entity where there is evidence of a breakdown in the relationship between the parties. The cases include patterns that will be familiar to readers of close corporations cases—where one member locked the other out, where there was a history of bad blood between the parties, where there was no communication between the parties, and where the parties had combined not speaking with multiple lawsuits. Similar reasoning has been extended to a three person entity divided equally between two sides. Where one of the two 50% owners made unilateral arrangements to the detriment of the LLC and the other owner leading

**MINN. STAT. ANN. § 322B.833 (YEAR); N.H. REV. STAT. § 304-C:51 (YEAR); N.C. GEN. STAT. § 57C-6-02 (YEAR); N.D. CENT. CODE § 10-32-119 (YEAR).**

147 *See supra* note 130 and accompanying text.

148 Connors v. Howe Elegant, LLC, No. 4003783, 2009 WL 242324, at *1 (Conn. Super. Jan. 8, 2009) (no longer reasonably practicable to carry on business when one of the two 50/50 partners shut the other partner out of the business and transferred all funds out of the LLC account).

149 Lindsay v. Pacific Topsoils, Inc., No. 50558-1-1, 2003 WL 22121055, at *18 (Wash. Ct. App. Sept. 15, 2003) (substantial “history of bad blood” shown in the lower court was enough to show that it was no longer reasonably practicable to carry on business).

150 Polak v. Kobayashi, No. 05-330-SLF, 2008 WL 4905519, at *5 (D. Del. Nov. 13, 2008) (judicial dissolution where two 50/50 partners no longer communicated and each were acting to the detriment of the other).

151 Weinmann v. Duhon, 818 So.2d 206, 209 (La. App. 5th Cir. 2002) (allowance for dissolution where there were two members representing forty percent of the company who had differing ideas of how the LLC should be run and where there was no alternative method for dissolution in the operating agreement).

152 In re Silver Leaf, L.L.C., No. 20611, 2005 WL 2045641, at *1, *12 (Del. Ch. Aug. 18, 2005) (ordering dissolution but refusing to name participant as receiver; court said evidence indicated that business was simply a penny stock fraud).
to a cessation of a business or personal relationship, and the sole asset no longer existed, the court ordered dissolution under a “not reasonably practicable” standard.\footnote{153}

Note that these are cases where there were gaps in the operating agreement despite the sophisticated and the coherent contracting technology available to them.\footnote{154} Courts do refer to the operating agreement in deciding whether judicial intervention is appropriate. Thus, a court defined the statutory standard by reference to the purpose clause of the agreement.\footnote{156} Judicial relief has been ordered under the “not reasonably practicable” standard due to where the operating agreement left the parties.\footnote{157} A Louisiana court pointed to provisions that permitted one member to fire another, but then permitted the other members to rehire the fired member, and another provision by which any member could assign a portion of an interest to a spouse and thereby become immune from expulsion by unanimous vote.\footnote{158}

\footnote{153} Saunders v. Firtel, 978 A.2d 487, 499 (Conn. 2009) (affirmed dissolution of the LLC where one of the two 50/50 members acted to the detriment of the LLC and to the other member).


\footnote{156} In re Seneca Investments, LLC, 970 A.2d 259, 263 (Del. Ch. 2008) (failure to make distributions along with other operating agreement violations was not enough for judicial dissolution).

\footnote{157} In re Silver Leaf, 2005 WL 2045641, at *11 (noting that “[g]iven [the LLC’s] ownership structure and Operating Agreement, Silver Leaf is no longer able to carry on its business in a reasonably practicable manner”).
About one third of the states use statutory language that tracks the close corporation approach to involuntary dissolution based on oppressive acts toward the minority or similar language.\footnote{See, e.g., HAW. REV. STAT. \S\ 428-801 (1999) (oppressive, unfairly prejudicial conduct, not reasonably practicable to carry on the company’s business with that member); IDAHO CODE \S\ 30-6-70(e) (2010); 805 ILL. COMP. STAT. 180/35-1 (2010).} Thus, eleven states use oppressive acts as the trigger (either alone or in combination with “unfairly prejudicial” or “not reasonably practicable”), incorporating the term that is found in the corporations statutes in the great majority of states.\footnote{Id.} Two more use “unfairly prejudicial” language that grew out of the involuntary dissolution context in the corporate setting, usually intended to expand the reach of judicial action.\footnote{MINN. STAT. ANN. \S\ 322B.833(2)(ii) (West 2004); N.D. CENT. CODE \S\ 10-32-119(b)(2) (2010).} Two other states use “necessary . . . [to protect] . . . the rights or interests of . . . complaining member[s]” which also has precedent in the corporate area.\footnote{CAL. CORP. CODE \S\ 17351(a)(2) (YEAR); N.C. GEN. STAT. \S\ 57C-6-02(2) (2009).} South Dakota in 2009 moved to the revised Uniform Limited Liability Company Act language of “not reasonably practicable to carry on the company’s business with that member,” which suggests a focus on the majority’s relationship with the minority member.\footnote{Weinmann, 818 So. 2d at PINCITE (judicial dissolution is appropriate where both 50/50 owners express their wishes to no longer continue business with one another).} While there has been some movement toward including a buyout at

\footnote{Weinmann, 818 So. 2d at PINCITE (judicial dissolution is appropriate where both 50/50 owners express their wishes to no longer continue business with one another).}
the request of the majority shareholder as part of involuntary dissolution statutes for LLCs, as has already occurred with close corporations, the use of this type of provision is not as widespread as in the corporate statutes.

As a South Dakota case makes clear, the language permits dissolution even where the business could continue despite the parties’ disagreement and deadlock. The facts of a Wisconsin case suggest how a capital call that is not needed could be oppressive. Another case found dissolution provided by the operating agreement to be triggered by a member’s bad faith offer.

Other triggers for involuntary dissolution under LLC statutes include deadlock in eight states and broad generic equitable grounds in two states. In

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164 **CAL. CORP. CODE** § 17351(b)(1); Dickson v. Rehmke, 78 Cal. Rptr. 3d 874, 879-80 (Cal. Ct. App. 2008) (alternative decree issued by the court allowing members to purchase minority interest in order to avoid dissolution).


166 Kirksey v. Grohmann, 754 N.W.2d 825, 832 (S.D. 2008) (Meierhenry, J., concurring) (stalemate can lead to judicial dissolution, as there are few other available alternatives to handle the deadlock).

167 See generally Lynch v. Carriage Ridge, LLC, 668 N.W.2d 562 (Wis. App. 2003) (judicial dissolution was not appropriate in situation where there was an accusation of a breach of the operating agreement).

general, LLCs are starting from a position where the law is more open to a judge being able to grant dissolution than was true for corporations law a half-century ago, but not as far along as corporate law has moved currently, where there is legislative or judicial authority for judicial relief after oppressive acts in all by a handful of states.\textsuperscript{171}

D. \textit{The Role of Contracts in LLCs}

While I suggest limits on the willingness to accept the perfection of contracts, or their relative attractiveness as to gap-filling, this is not to say that there are not differences in sophistication and ability to use contracts. Indeed, the beginning of a segmentation of the market can be seen in the pattern of LLC usage. Compare Delaware’s share of the LLC market to its share of the market for public corporations and for close corporations generally. Its share of the public corporation market approaches 60% and it takes 85% or more of the market for public corporations that incorporate outside their headquarters state.\textsuperscript{172}


\textsuperscript{170} \textsc{Tenn. Code Ann.} §48-245-901, 902 (2010); \textsc{Wash. Rev. Code} §25.15.275 (2010).

\textsuperscript{171} The discussion above draws on Chapter 5 of \textsc{F. Hodge O’Neal & Robert B. Thompson, O’Neal & Thompson’s Close Corporations and LLCs: Law and Practice} Chapter 5 (Rev. 3d ed. 2010).
For close corporations, its share is above its percentage of the national population, but still in the low single digits of the national market.\textsuperscript{173} For LLCs, it is in between-- at the very top among the states, but overall with a market share just below double digits.\textsuperscript{174}

Empirical work by Jens Dammann and Matthias Schundeln indicates that Delaware does much better in attracting LLCs (and close corporations) that organize outside the state of their principal place of business.\textsuperscript{175} As to those entities with the largest numbers of employees, Delaware’s share of firms organized under its laws gets close to its share of public corporations that organize outside of their principal place of business.\textsuperscript{176} Dammann & Schundeln suggest LLCs are more likely to flee for states with more lax governance structure (measured by duty of care standards and if the majority can dissolve the corporation).\textsuperscript{177} Kobayashi and Ribstein, developing a similar data set, find no relation of substantive provisions of the law of the organizing state and that firms


\textsuperscript{175} Id. at 9.

\textsuperscript{176} Id. A much smaller percentage of LLCs organize outside of their principal place of business so that Delaware’s overall share of LLCs is lower than its 60% or so share of publicly-held corporations.

\textsuperscript{177} Id. at 19.
moving from a low quality state tend to move to another low quality state.¹⁷⁸

Both studies rely on the number of employees as a proxy for size since neither
had access to the number of owners, a size metric more likely to make a
difference for LLC governance provisions.

In the absence of such ownership data, Delaware LLC cases provide some
anecdotal data suggesting Delaware’s attractiveness to a specific subset of the
closely held entity marketplace.¹⁷⁹ There appears to be a pattern of sophisticated
investors willing to plan beyond the statutory default rules and willing to pay for
such planning. If this is so, it is not surprising that Delaware is more willing to
permit members to contract around the fiduciary duty of loyalty and waive the
right to petition a court for dissolution.¹⁸⁰

But even in Delaware, its sophisticated judiciary is more than willing to
use fiduciary duty and involuntary dissolution.¹⁸¹ In a Delaware case where there
was deadlock at the board level and no means around deadlock because of terms
intentionally included in the operating agreement, Chancellor Chandler refused to
use fiduciary duty to cabin how the parties used their veto power, but nevertheless

¹⁷⁸ Bruce H. Kobayashi & Larry E. Ribstein, Jurisdictional Competition for

¹⁷⁹ See, e.g., In re Seneca Investments LLC, 970 A.2d 259 (Del. Ch. 2008); R & R
Capital LLC v. Buck & Doe Run Valley Farms, LLC, No. 3624-CC, 2008 WL

¹⁸⁰ CHARLES R.T. O’KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND
OTHER BUSINESS ASSOCIATIONS, CASE AND MATERIALS 538 (6th ed. 2010).

¹⁸¹ Fisk Ventures, LLC v. Segal, No. 3017-CC, 2009 WL 73957, at *7 (Del Ch.
was willing to order dissolution.\textsuperscript{182} Even where an agreement provides for an exit mechanism, Vice-Chancellor Strine ordered dissolution under the statutory “not reasonably practicable” standard because the agreement’s mechanism did not relieve one of the two 50% members of his obligation as a personal guarantor for the LLC mortgage.\textsuperscript{183} “With no reasonable exit mechanism” the court found the member could “exercise the only practicable deadlock-breaking remedy available to him and one that is also alluded to in the LLC agreement, the right to seek judicial dissolution.”\textsuperscript{184}

**CONCLUSION**

The Massachusetts Supreme Judicial Court cases of thirty-five years ago merit the place at the center of this Symposium, both for how they changed the law of the closely held firm in the 1970s and what they can tell us about limited liability companies in the twenty-first century. Their greatness, however, is not necessarily as often surmised. Fiduciary duty, partnership attributes, and equal opportunity remain part of the legacy, but as the law has evolved in the time since, oppression, reasonable expectations, and buyouts have taken a more prominent role. \textit{Donahue} and \textit{Wilkes} excelled at defining the problem that gave

\textsuperscript{182} \textit{Id.} at *4-7 (dissolution is appropriate where there is a deadlock without any mechanism in the operating agreement to circumvent the stalemate).

\textsuperscript{183} 6 \textbf{Del. Code Ann.} It. 6, § 18-802 (2006); \textit{Haley}, 864 A.2d at 94-98 .

\textsuperscript{184} \textit{Haley}, 864 A.2d at 88-89 (footnote omitted); \textit{see also} Connors v. Howe Elegant, LLC, No. 4003783, 2009 WL 242324, at *13 (Conn. Super. Jan. 8, 2009) (following \textit{Haley}, forcing member to exercise contractual exit would not permit LLC to proceed in a practicable way).
rise to a variety of possible solutions that are still developing. The predicament of
the investor in the closely held business, so clearly set out in *Donahue* and refined
in *Wilkes*, thus moved from the academy and some British decisions into the
mainstream of American law where it has remained ever since.

In recent years limited liability company law has grown dramatically, but
there remain recurring parallels to how the law of close corporations developed
over the twentieth century. In close corporations law, the initial hostility to
carving out different rules, or even to enforcing agreements that parties made for
their own governance, gave way to a widespread acceptance of freedom of
contract. But even then, as illustrated in *Donahue* and *Wilkes*, courts recognized
that there was a need to provide a judicial fail-safe where the parties’ planning left
gaps that would defeat parties’ expectations in entering into the legal relationship.
In recognizing a role for involuntary dissolution based on oppression and a greater
recognition of fiduciary duty than was apparent twenty years ago, LLC law is
following in the path of the development of close corporation law. In that
journey, too, *Donahue* and *Wilkes* provide guidance. There will remain
differences over the relative roles of contracts and judges, and that line may
divide differently for different types of LLCs, but the question that the
Massachusetts Supreme Judicial Court confronted in *Donahue* and *Wilkes* will
continue to require both judicial attention and that of the participants in their
contracts.