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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 Electrottype 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 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.⁴ The other four—statutes providing judges

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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).

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

3. See generally *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505 (Mass. 1975).

4. See *infra* notes 5-8 and accompanying text.

with authority to grant involuntary dissolution for oppressive or similar acts in the corporation,⁵ reasonable expectations as the most widely accepted standard to trigger such judicial relief,⁶ buyout at a judicially determined fair price as the preferred remedy for such violations,⁷ and permitting minority owners to sue for breach of fiduciary duty in a direct, individual action as opposed to a derivative claim⁸—have each achieved even broader consensus than the enhanced fiduciary duty holding of *Donahue* and *Wilkes*.⁹ Together the five developments reflect a legislative and judicial recognition of the predicament 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 mi-

5. See, e.g., MODEL BUS. CORP. ACT § 14.30 (2005).

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

7. See, e.g., MODEL BUS. CORP. ACT § 14.34(e).

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

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 92-96 and accompanying text.

nority investor in the closely held firm.¹⁰ 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 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 CLOSELY HELD BUSINESS FIRMS CIRCA 1976

Donahue and *Wilkes* were at the center of a fundamental re-orientation 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

10. See *infra* notes 22-32 and accompanying text.

and ultimate authority in making business decisions.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,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.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.¹⁴

11. See, e.g., MODEL BUS. CORP. ACT. §§ 7.28, 8.01, 8.41 (2005) (describing rights of shareholders, directors, and officers). See generally CHARLES R. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS, CASE AND MATERIALS 153 (6th ed. 2010).

12. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

13. See, e.g., F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.07 (3d ed. 2006) [hereinafter CLOSE CORPORATIONS: LAW AND PRACTICE].

14. See Thompson, *supra* note 8, at 701.

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 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."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

15. *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993).

of groups to which the co-venturers belong.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.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: "Then don't do that!"¹⁸ In a similar vein, would 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-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.¹⁹ At the time of *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.²⁰ Since the corpo-

16. See, for example, the law merchant discussed in HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS* 15 (3d ed. 1983).

17. See *infra* notes 80-103 and accompanying text.

18. *Henny Youngman Jokes: Doctor Jokes*, FUNNY2.COM, <http://www.funny2.com/henny.htm> (last visited Mar. 23, 2011).

19. See Robert B. Thompson, *The Taming of the Limited Liability Companies*, 66 U. COLO. L. REV. 921, 925 (1995).

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. This created 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 could possibly provide the combination depending on the state's approach to limited liability. See MASS. GEN. LAWS ch. 62, § 8(a) (repealed 2008).

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 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*

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

21. Under the General Utilities doctrine, the corporation's distribution of appreciated property to its shareholders did not cause the corporation to realize taxable gain, thus avoiding a tax at the corporate level. See *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935); I.R.C. § 311(a)(2) (1954). The Tax Reform Act of 1986 § 631 eliminated the General Utilities doctrine. Tax Reform Act of 1986 § 631, 26 U.S.C. § 337 (2006). To avoid a tax at the individual level it was common to zero out corporate income by paying out salaries. See Robert B. Thompson, *The Taming of the Limited Liability Companies*, 66 U. COLO. L. REV. 921, 929-30 (1995).

22. See *infra* note 104.

23. F. HODGE O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* 27 (1958).

24. There was some earlier writing. See generally Norman Winer, *Proposing a New York "Close Corporation Law"*, 28 CORNELL L.Q. 313 (1943).

O'Neal,²⁵ Elvin Latty,²⁶ George Hornstein,²⁷ and Carlos Israels²⁸ 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 provisions providing unanimity or supermajority requirements that provided participants a veto over corporate action.³⁰ Other statutory changes loosened formalities³¹ and provided for charter provisions that permitted dissolution at will.³² Scholars and legislators of this period expressed belief in contracting similar to that expressed by the modern day proponents of LLCs.³³ In the decade before *Donahue* and *Wilkes*, many states had passed special statutes dealing with the close corporation that again were focused on broadened freedom of contracting.³⁴ The first two editions of O'Neal's landmark Close Corporations treatise, which had been published prior to the Massachusetts decisions, focused on agreements that would navigate around unwanted public corporation

25. O'Neal was dean at three law schools—Mercer, Duke, and Washington University—and also taught at Vanderbilt and the University of Mississippi. *F. Hodge O'Neal, 73, Ex-Law School Dean*, N.Y. TIMES, Jan. 24, 1991, <http://www.nytimes.com/1991/01/24/obituaries/f-hodge-o-neal-73-ex-law-school-dean.html>.

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).

27. See generally George Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1951).

28. See generally Carlos D. Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948).

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).

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

31. See F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE § 1:18 (Rev. 3d ed., 2010) [hereinafter O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs] (discussing statute).

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

33. See 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, *Ribstein and Keatinge on Limited Liability Companies* § 1.2, at 2 (1998); Martin I. Lubaroff & Paul M. Altman, Delaware Limited Liability Companies, in DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 20.4 (R. Franklin Balotti & Jesse A. Finkelstein eds., 1998); see also *infra* note 129 and accompanying text.

34. See O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs, *supra* note 31, §§ 1:15-1:19.

characteristics and suggested changes in law to permit such actions.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. 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.³⁶ This was a "Brandeis brief" spelling out the close corporation predicament and it spread through O'Neal's other works. The 260-page paperback published in 1961 tripled by the time it was published in hardback in 1975.³⁷ Key ideas were incorporated as part of the close corporation treatise.³⁸ As a regular practice O'Neal wrote to the lawyers in every published close corporation and oppression case; thus, it is not surprising that he wrote and talked to Mr. Egan, the lawyer for Mr. Wilkes.³⁹

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 1930s⁴⁰ and such a provision had been included in the Model Business Corporation Act from the earliest inception of that project in the 1940s.⁴¹ The first edition of the Model Business Corporation Act Annotated, published in 1960, reports fourteen states with statutes that authorized

35. See generally F. HODGE O'NEAL, *supra* note 23; F. HODGE O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* (2d ed. 1972) [hereinafter *CLOSE CORPORATIONS: LAW AND PRACTICE* (2d ed. 1972)].

36. F. HODGE O'NEAL & JORDAN DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: SQUEEZE-OUTS IN SMALL ENTERPRISES*, ch. 3-5 (1961) [hereinafter *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES*].

37. See generally F. HODGE O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* (1975) [hereinafter "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS].

38. F. HODGE O'NEAL, *supra* note 23; *CLOSE CORPORATIONS: LAW AND PRACTICE* (2d ed. 1972), *supra* note 35.

39. Interview with Jack Egan, son of David Egan, in Springfield, Mass. (Oct. 15, 2010).

40. See ILL. REV. STAT. ch. 308, § 351 (1933); PA. CONS. STAT. ANN. §§ 364, 429 (1933). California had a similar law from 1931 to 1933. See Henry W. Ballentine, *A Critical Survey of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357, 392 (1934).

41. Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 709 n. 68 (1993) (reporting early history).

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courts to order involuntary dissolution for oppression,⁴² and by the time of the second edition—a decade or so later—the number of states had grown to twenty-four.⁴³ That number, however, overstates the reach of the remedy. Any relief required a judicial order and most judges still felt that killing a corporation was not something they should do.⁴⁴ Oppression was not defined in the statute and courts were not ready to give it a broad reach. *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.⁴⁵

Case precedent at the time was stronger from abroad than from the United States. The United Kingdom had enacted an oppression remedy in 1948⁴⁶ and there were some early cases that provided for broader interpretations of relief and remedies.⁴⁷ Allen Afterman, an Australian scholar writing in an American law review, linked oppression in the United Kingdom and other commonwealth statutes to conduct that frustrated participants' reasonable expecta-

42. 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).

43. 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).

44. See, for example, 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 (1942))); *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.").

45. *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).

46. Companies Act 1948, 11 & 12 Geo. 6, c. 38, § 210 (Eng).

47. See, e.g., *Meyer v. Scottish Co-op Wholesale Society*, [1958] S.C. 3 (H.L.) 66 (appeal taken from Scot.) (providing relief to a minority shareholder under section 210); *In re H.R. Harmer, Ltd.*, [1958] 3 A.L. 689 (appeal taken from Scot.) (finding relief under section 210 where father's behavior oppressive); *Ebrahimi v. Westbourne Galleries Ltd.*, [1972] A.C. 2 (H.L.) 1289 (appeal taken from Eng.) (permitting winding up under section 222; permitting relief based on broad grounds based on the participants overall relationship in the company).

tions, heralding what has become a dominant trend in American case law.⁴⁸

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."⁴⁹ He repeated that same statement in new versions of the *Close Corporation* and *Oppression* treatises in 1972 and 1975 adding additional case illustrations.⁵⁰ In the *Oppression* treatises, he summarized the impact this way:

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.⁵¹

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.⁵² 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

[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

48. See generally Allen B. Afterman, *Statutory Protection for Oppressed Minority Shareholders: A Model for Reform*, 55 VA. L. REV. 1043 (1969).

49. CLOSE CORPORATIONS: LAW AND PRACTICE, *supra* note 13, at 108.

50. CLOSE CORPORATIONS: LAW AND PRACTICE (2d ed. 1972), *supra* note 35, at 45; "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS, *supra* note 37, at 508.

51. EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES, *supra* note 36, § 8.02 at 194; "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS, *supra* note 37, at 584.

52. *Id.* § 8.02, at 192, 194 (calling for judicial discrimination in applying the business judgment rule in close corporations).

some of the content of the law of fiduciaries are employed to deal with instances of oppression.⁵³

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.”⁵⁴ Here is the governor on unregulated application of fiduciary duty and the antecedent for *Wilkes* use of the “selfish ownership” concept to address the same conflict.

What *Donahue* and *Wilkes* did was link the close corporation predicament to a fiduciary duty remedy that was more likely to be employed in a close 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 Corp. v. Mesa Petroleum Co.* decision did a decade later in the takeover context.⁵⁵ Their 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 cases⁵⁶ required the “plaintiff [to] . . . show . . . that impermissible motives predominated in the making of the decision in question.”⁵⁷ 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.⁵⁸ 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 dis-

53. Alfred Hill, *The Sale of Controlling Shares*, 70 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)).

54. Symposium, *Close Corporation*, 52 NW. U.L. REV. 345, 396 (1957).

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

56. See *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980).

57. *Id.* at 292.

58. *Unocal*, 493 A.2d at 951.

cussed. First, the court 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.⁵⁹ Second, the court recognized the intimacy and illiquidity of the minority's investment and the vulnerability that resulted from that.⁶⁰ The combination is what the court called a trap, and what has been referred to here as the predicament of a minority owner.⁶¹

The facts of *Donahue* are not the most severe example of the plight just described, viewed within the context set out in the

59. *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 513 (Mass. 1975).

[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).

60. *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 per cent 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.

Id. (citation omitted).

61. *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).

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.⁶² 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.⁶³ 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 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).⁶⁴

The facts in *Wilkes* possessed more of the characteristics of the plight described by O'Neal and by the court in *Donahue*.⁶⁵ 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 declined 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.⁶⁶ The Court

62. *Id.* at 508-11.

63. *Id.* at 509-11. The remainder of the facts in this paragraph are taken from the court's description on pages 509-11.

64. *Id.* at 511.

65. *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 659-63 (Mass. 1976). The remainder of the facts in this paragraph are taken from the court's description on pages 659-63.

66. *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 the legitimate sphere of the controlling directors.⁶⁷ As in *Donahue*, the court noted the intimacy and multifaceted nature of the participants' relation to the enterprise and tied it to the investors' expectations in entering into the venture.⁶⁸

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

67. *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. (citations omitted).

68. *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 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).

of selfish ownership.⁶⁹ As a result, Wilkes received the salary he would have received had he remained an officer and director.⁷⁰

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.⁷¹ Moreover, the court properly understood the intimate and multifaceted relationship that often characterizes the participants' relationship in the closely held enterprise.⁷² 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.⁷³

69. *Id.* at 663.

70. *Id.* at 665.

71. *In re Kemp & Beatley, Inc. v. Gardstein*, 473 N.E.2d 1173, 1178 (N.Y. 1984).

The statutory concept of “oppressive actions” can, perhaps, best be understood by examining the characteristics of close 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.

Id. (citations omitted).

72. *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.”

Id. (quoting CLOSE CORPORATIONS: LAW AND PRACTICE (2d ed. 1972), *supra* note 35, at 21-22).

73. *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.

Again, the court notes the impact of illiquidity in contrast to an investment in a public corporation;⁷⁴ 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.⁷⁵

After *Donahue* and *Wilkes*, and particularly in the decade following *Kemp & Beatley*, the pace of legislative and judicial protection for minority shareholders 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.⁷⁶ 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 complementary and each reflects the same source—the close corporation pre-

Id. (citation omitted).

74. *Id.* at 1179.

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.

75. *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).

76. Thompson, *supra* note 8, at 704.

dicament 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.⁷⁷ 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.⁷⁸ And unlike the period 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.⁷⁹ 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.⁸⁰

(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

77. 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) [hereinafter O'NEAL & THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBER].

78. 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. 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").

79. See, e.g., *G & N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227, 243 (Ind. 2001) (noting that oppression was 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 Massachusetts Business Corporation Act, Chapter 127 Acts of 2003*, 88 MASS. L. 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 state's anti-takeover statutes).

80. Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 395 (1992).

is specified in the statute.⁸¹ 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 investors in entering into the enterprise.⁸² Although there were oppression statutes in many states at the time of *Donahue*, the continuing spread of these statutes after *Donahue* and the willingness to incorporate reasonable expectations as the touchstone has made the statute an effective remedy for oppression.⁸³

(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 *Kemp & Beatley* recognized. In some states, a buyout is authorized by statute.⁸⁴ In other states, courts have used their general remedial power to order a buyout.⁸⁵ But the result is that there is specific authority for buyouts in half of the states.⁸⁶ The move to buyouts can be seen in comparing two empirical studies on either side of *Wilkes*. In a study of the 1960-1976 period, Professors Hetherington and Dooley, surveying fifty-four involuntary dissolution cases in the sixteen years that mostly preceded *Wilkes*, found no relief in half of the cases, involuntary dissolution in sixteen,

81. See MINN. STAT. ANN. § 302A.751 (West 2004); N.D. CENT. CODE § 10-19.1-115 (2009).

82. See O'NEAL & THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBER, *supra* note 77, § 7:13.

83. See *supra* note 8; see also *supra* text accompanying notes 42-43 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 1979 N.Y. Laws, 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.

84. Often this buyout is at the option of the majority shareholder after a minority has petitioned for dissolution. See N.Y. BUS. CORP. LAW § 1104-a (McKinney 2003); MODEL BUS. CORP. ACT. ANN. § 14.34 (4th ed. 2008). In other states, statutes list buyout among various possible remedies. See, e.g., N.J. STAT. ANN. § 14A:12-7 (West 2003).

85. See e.g., *Maddox v. Norman*, 206 Mont. 1, 669 P.2d 230 (1983). See generally O'NEAL & THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBER, *supra* note 77, § 7:19.

86. See O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs, *supra* note 31, § 9:18.

buyouts in three, and other relief in four.⁸⁷ 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.⁸⁸

(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.⁸⁹ 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.⁹⁰ The American Law Institute's adoption of a direct cause of action in a closely held corporation has spurred judicial movement in this direction.⁹¹

(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.⁹² There have been contrary holdings by some courts refusing to apply an equal opportunity right in particular contexts.⁹³ Delaware has put it in broader terms of preferring contractual solutions to judicial ones: "Tools of good corporate [governance] are designed to give a

87. John A.C. Hetherington & Michael Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 63-75 (1977).

88. Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25, 50-53 (1987).

89. See O'NEAL & THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBER, *supra* note 77, § 7:08 (collecting direct causes of action in an oppression setting).

90. See *id.* § 7:07 (describing different reasons courts have given for permitting direct individual causes of action).

91. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.01(d) (1994).

92. See O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs, *supra* note 31, § 9:18 (providing chart for cases in individual states).

93. *Toner v. Baltimore Envelope Co.*, 498 A.2d 642, 654 (Md. Ct. App. 1985); *Sundberg v. Lampert Lumber Co.*, 390 N.W.2d 352, 357 (Minn. Ct. App. 1986); *Dela-houssaye v. Newhard*, 785 S.W.2d 609, 614 (Mo. Ct. App. 1990).

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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.⁹⁴ 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.”⁹⁵ A number of states follow Massachusetts in analogizing to the fiduciary duties of partners.⁹⁶

The statutory oppression remedy and the common law enhanced fiduciary duty action are complimentary and sometimes effectively substitutes.⁹⁷ 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.”⁹⁸ Many courts have defined oppression by reference to reasonable expectations or fiduciary duty.⁹⁹ 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,¹⁰⁰ Ohio,¹⁰¹ and Indiana¹⁰²—use an enhanced fiduciary duty to provide relief to a minority shareholder facing the closely held corporation predicament as the overlap in the excerpts from *Donahue* and *Kemp & Beatley* illustrate.¹⁰³

94. *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993).

95. *McLaughlin v. Schenck*, 220 P.3d 146, 155 (Utah 2009).

96. *See River Mgmt. Corp. v. Lodge Props., Inc.*, 829 P.2d 398, 401 (Colo. Ct. App. 1991); *Battaglia v. Battaglia*, 596 N.E. 2d 712, 716 (Ill. Ct. App. 1992); *Fought v. Morris*, 543 So. 2d 167, 170-71 (Miss. 1989); *Gigax v. Repka*, 615 N.E.2d 644, 649 (Ohio Ct. App. 1992); *A. Teixeira & Co., Inc. v. Teixeira*, 699 A.2d 1383, 1386-87 (R.I. 1997).

97. *See Thompson*, *supra* note 8, at 700.

98. *Brodie v. Jordan*, 857 N.E.2d 1076, 1079 n.3 (Mass. 2006).

99. *See, e.g., Jorgenson v. Water Works, Inc.*, 582 N.W.2d 98, 107 (Wis. Ct. App. 1998) (noting that oppressive conduct of those in control is closely related to breach of fiduciary duty owed to minority shareholders). *See generally* O’NEAL & THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 31, § 9:27.

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

101. *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).

102. *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.”).

103. *See supra* notes 59-83 and accompanying text.

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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.¹⁰⁴

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.¹⁰⁵ 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."¹⁰⁶ 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.¹⁰⁷ 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.

104. And that list is narrowed further by various holdings even in those states. See, e.g., *Little v. Waters*, No. 12155, 1992 WL 25758, at *8 (Del. Ct. Ch. Feb. 11, 1992) (using reasonable expectations to determine breach of fiduciary duty); *Donofrio v. Matassini*, 503 So. 2d 1278, 1281-82 (Fla. Dist. Ct. App. 1987); *Richards v. Bryan*, 879 P.2d 638, 648 (Kan. Ct. App. 1994); *Beard v. Love*, 173 P.3d 796, 804-05 (Okla. Civ. App. 2007) (allowing for dissolution in a case involving oppression).

105. See *Davis v. Sheerin*, 754 S.W.2d 375, 383 (Tex. Ct. App. 1988) (ordering buy-out of interest owned by minority shareholder at fair market value); *Duncan v. Lichtenberger*, 671 S.W.2d 948, 953-54 (Tex. Ct. App. 1984) (affirming jury verdict awarding damages to two minority shareholders who were not receiving compensation).

106. HARRY HENN, *LAW OF CORPORATIONS* 512 (2d ed. 1970).

107. MODEL BUS. CORP. ACT. ANN. § 7.32(a) (4th ed. 2008).

II. *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.¹⁰⁸ 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.¹⁰⁹ 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

108. See generally LARRY RIBSTEIN & ROBERT KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (3d ed. 2004).

109. The factors take their name from a 1954 appellate opinion, *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The case involved 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 parties essentially had swapped positions. See generally Thompson, *supra* note 8, at 931.

life, and free transferability of interest.¹¹⁰ 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.¹¹¹ 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-through tax status.¹¹² LLCs are now the most-used legal form for the closely held business.¹¹³

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.”¹¹⁴ 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 certainty in

110. 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 to 3T (1994) (repealed 1996).

111. See Treas. Reg. § 301.770-1 (effective Jan. 1, 1997).

112. O’NEAL & THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 31, ch. 5.

113. Rodney D. Chrisman, *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 FORDHAM J. CORP. & FIN. L. 459, 459-60 (2010) (reporting LLCs outpace corporations in most states; overall by a 2-1 margin).

114. Larry Ribstein, *Escaping the Nursing Home: Contracts in LLCs and Close Corporations*, W. NEW ENG. L. & BUS. CTR., *Annual Conference 2010: Fiduciary Duties in Closely Held Firms 35 Years after Wilkes v. Springside Nursing Home, Inc.*, http://web7.streamhoster.com/wnevideo/law/law_and_business/panel4_2010.html (last visited Apr. 7, 2011).

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.¹¹⁵ For example, in the 1980s, income tax changes removed what had been the benefit of having corporate level tax.¹¹⁶ While subchapter S permitted most small corporations to choose to have pass-through tax treatment, there were a few tax breaks in real estate or oil and gas that could only be achieved outside of subchapter S.¹¹⁷ 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.¹¹⁸ The professional incorporation statutes that had been passed by many states in the mid-twentieth century did not permit the same degree of liability-

115. 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).

116. 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. 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, § 631, 100 Stat. 2269, 2269-75 (1986) (codified as amended at 26 U.S.C. § 337 (2006)).

117. See O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs, *supra* note 31, at § 2:9.

118. *Id.*

shielding as in a traditional corporation.¹¹⁹ 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 family or close personal ties.¹²⁰ 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.¹²¹ In order to gain the favorable pass-through tax treatment LLCs had to provide for easy-exit, shared governance, and not provide entity permanence.¹²² These mandatory rules reduced the likelihood of the

119. *Id.*

120. 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).

121. Check the box refers to the IRS choice to permit unincorporated entities to choose whether they want to be taxed as individuals or corporations. *See* Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584 (Dec. 18, 1996) (codified at 26 C.F.R. pt. 301).

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

Donahue/Wilkes predicament. After “check the box,” state legislatures launched a widespread reformulation of their LLC statutes.¹²³ It became common to provide for manager-managed LLCs as well as a member-managed format.¹²⁴ Some statutes even provided for officers and directors so that even the labels would mimic the corporation.¹²⁵ Even more relevant for this discussion, almost all the states changed their rules about easy exit to remove a participant’s ability to end the relationship on terms that would provide anything more than being able to assign the income stream.¹²⁶ This move back toward permanence was itself driven by tax concerns; not the income tax concerns that had driven the early LLC movement, but the estate tax worries.¹²⁷ It turns out that 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.¹²⁸ 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: “*Wilkes*

123. 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.”).

124. REVISED UNIFORM LIMITED LIABILITY COMPANY ACT § 407 (2006), available at http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_final.pdf; DEL. CODE ANN. tit. 6, § 18-402 (2005).

125. See, e.g., MINN. STAT. ANN. § 322B.606 (West 2004) (manager-managed as the default governance in LLC).

126. Note the changes in Delaware law made in 1996. 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 (2005). The change thus flips which party needs to worry more about working out an agreement. A departing party who before had protection even if the agreement was silent now is locked-in unless alternative provisions are put into the agreement.

127. 26 U.S.C. § 2033 (2006).

128. 26 U.S.C. § 2703; Treasury Reg. § 20.2031-1 & 2 (as amended in 1965). See generally O’NEAL & THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 31, § 7:49.

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.”¹²⁹ The suggestion is that the trap is a relic of the past that investors are now able to use “sophisticated and coherent contracting technology.”¹³⁰ This approach recognizes that parties “need” to 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).¹³¹ Although courts in LLC cases regularly refer to the purpose of the statute as to give maximum effect of freedom of contract,¹³² maximizing contracting is also a principal purpose of corporations statutes 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.¹³³ 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.¹³⁴ 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.

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.¹³⁵ The choice is not unlike what faced the Massachusetts courts at the time

129. Ribstein, *supra* note 114.

130. *Id.*

131. See *supra* text accompanying notes 23-28.

132. *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999).

133. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *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.”).

134. MODEL 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.”).

135. The sticky defaults discussed in Deborah DeMott’s contribution to this Symposium is an example. Deborah A. Demott, *Investing in Work: Wilkes as an Employment Law Case*, 33 W. NEW ENG. L. REV. 497 (2011).

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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.”¹³⁶ That language itself has been used to order 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.¹³⁷ The cases include patterns that will be familiar to readers of close corporations cases—where one member locked the other out,¹³⁸ where there was a history of bad blood between the parties,¹³⁹ where there was no communication between the parties,¹⁴⁰ and where the parties had combined not speaking

136. 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 (2010) (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. ANN. § 17-76, 117 (West 2010); MINN. STAT. ANN. § 322B.833 (West 2004); N.H. REV. STAT. ANN. § 304-C:51 (West 2005); N.C. GEN. STAT. ANN. § 57C-6-02 (2009); N.D. CENT. CODE § 10-32-119 (2005).

137. See *supra* note 130 and accompanying text.

138. *Connors v. Howe Elegant, LLC*, No. 4003783, 2009 WL 242324, at *1 (Conn. Super. Jan. 8, 2009) (holding it to be 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).

139. *Lindsay v. Pacific Topsoils, Inc.*, No. 50558-1-1, 2003 WL 22121055, at *18 (Wash. Ct. App. Sept. 15, 2003) (holding that 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).

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

with multiple lawsuits.¹⁴¹ Similar reasoning has been extended to a three person entity divided equally between two sides.¹⁴² Where one of the two 50% owners made unilateral arrangements to the detriment of the LLC and the other owner leading 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.¹⁴³

Note that these are cases where there were gaps in the operating agreement despite the sophisticated and the coherent contracting technology available to them.¹⁴⁴ 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.¹⁴⁵ Judicial relief has been ordered under the “not reasonably practicable” standard due to where the operating agreement left the parties.¹⁴⁶ 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.¹⁴⁷

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.¹⁴⁸ Thus, eleven states use oppressive acts as the trigger (either alone or in

141. *Weinmann v. Duhon*, 818 So. 2d 206, 209 (La. Ct. App. 2002) (allowing 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).

142. *In re Silver Leaf, LLC*, 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).

143. *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).

144. *See, e.g., Weinmann*, 818 So.2d at 209; *Saunders*, 978 A.2d at 499; *Connors v. Howe Elegant, LLC*, No. 4003783, 2009 WL 242324, at *1 (Conn. Super. Jan. 8, 2009).

145. *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).

146. *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”).

147. *Weinmann*, 818 So. 2d at 210 (judicial dissolution is appropriate where both 50/50 owners express their wishes to no longer continue business with one another).

148. *See, e.g., HAW. REV. STAT. ANN.* § 428-801 (LexisNexis 2008) (oppressive, unfairly prejudicial conduct, not reasonably practicable to carry on the company’s busi-

combination with “unfairly prejudicial” or “not reasonably practicable”), incorporating the term that is found in the corporations statutes in the great majority of states.¹⁴⁹ 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.¹⁵⁰ Two other states use “necessary . . . [to protect] . . . the rights or interests of . . . complaining member[s]” which also has precedent in the corporate area.¹⁵¹ 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.¹⁵² While there has been some movement toward including a buyout at the request of the majority shareholder as part of involuntary dissolution statutes for LLCs, as has already occurred with close corporations,¹⁵³ the use of this type of provision is not as widespread as in the corporate statutes.¹⁵⁴

As a South Dakota case makes clear, the language permits dissolution even where the business could continue despite the parties’ disagreement and deadlock.¹⁵⁵ The facts of a Wisconsin case suggest how a capital call that is not needed could be oppressive.¹⁵⁶

ness with that member); IDAHO CODE § 30-6-70(e) (2005); 805 ILL. COMP. STAT. 180/35-1 (West 2006).

149. See, e.g., HAW. REV. STAT. ANN. § 428-801; IDAHO CODE § 30-6-70(e); 805 ILL. COMP. STAT. 180/35-1.

150. MINN. STAT. ANN. § 322B.833(2)(ii) (West 2004); N.D. CENT. CODE ANN. § 10-32-119(b)(2) (2005).

151. CAL. CORP. CODE § 17351(a)(2) (West 2006); N.C. GEN. STAT. ANN. § 57C-6-02(2) (2009).

152. S.D. CODIFIED LAWS § 47-34A-8014(ii) (2007).

153. 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).

154. Provisions in one operating agreement permitting majority interests to overcome dissolution got lost in a tangle of convoluted definitions of similar terms. *Ruth v. Home Health Care of Middle Tenn., LLC*, No. E2009-00845-COA-R3_CV, 2010 WL 744936, at *1 (Tenn. Ct. App. Mar. 3, 2010) (ambiguous operating agreement gets past summary judgment to show whether dissolution is allowed).

155. *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).

156. 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).

Another case found dissolution provided by the operating agreement to be triggered by a member's bad faith offer.¹⁵⁷

Other triggers for involuntary dissolution under LLC statutes include deadlock in eight states¹⁵⁸ and broad generic equitable grounds in two states.¹⁵⁹ In 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.¹⁶⁰

D. *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.¹⁶¹ For close corporations, its share is above its percentage of the national population, but still in the low single digits of the national market.¹⁶² For LLCs, it is in between—

157. *Decker v. Decker*, 726 N.W.2d 664, 671 (Wis. Ct. App. 2006) (judicial dissolution is upheld when triggered by an offer made in bad faith).

158. ARIZ. REV. STAT. ANN. § 29-785(A)(2) (1998); CAL. CORP. CODE § 17351(a)(4); KAN. STAT. ANN. § 17-76,117(b) (2007); MINN. STAT. ANN. § 322B.833(2)(i) (West 2004); N.H. REV. STAT. ANN. § 304-C:51(VI) (2005); N.C. GEN. STAT. § 576-6-02(2)(i) (2009); N.D. CENT. CODE § 10-32-119 (2005); UTAH CODE ANN. § 48-2c-1210(2)(a) (LexisNexis 2010).

159. TENN. CODE ANN. § 48-245-901, 902 (2002); WASH. REV. CODE § 25.15.275 (West 2005).

160. The discussion above draws on Chapter 5 of F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL & THOMPSON'S CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE Chapter 5 (Rev. 3d ed. 2010).

161. See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003).

162. Jens Dammann & Matthias Schundeln, *The Incorporation Choices of Privately Held Corporations*, SOC. SCIENCE RES. NETWORK, <http://ssrn.com/abstract=1049581> (last visited Jan. 23, 2011).

at the very top among the states, but overall with a market share just below double digits.¹⁶³

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.¹⁶⁴ 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.¹⁶⁵ 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).¹⁶⁶ Kobayashi and Ribstein, developing a similar data set, find no relation of substantive provisions of the law of the organizing state and that firms moving from a low quality state tend to move to another low quality state.¹⁶⁷ 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.¹⁶⁸ 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.¹⁶⁹

163. Jens Dammann & Matthias Schundeln, *Where are Limited Liability Companies Formed? An Empirical Analysis*, SOC. SCIENCE RES. NETWORK, <http://ssrn.com/abstract=1126257> (last visited Jan. 23, 2011).

164. *Id.* at 9.

165. *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.

166. *Id.* at 19.

167. Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1431989 (last visited Mar. 31, 2011).

168. *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. 3803-CC, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008); *Haley v. Talcott*, 864 A.2d 86 (Del. Ch. 2004).

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

But even in Delaware, its sophisticated judiciary is more than willing to use fiduciary duty and involuntary dissolution.¹⁷⁰ 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 was willing to order dissolution.¹⁷¹ 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.¹⁷² “With no reasonable exit mechanism” the court found the member could “exercise the only practical deadlock-breaking remedy available to him, and one that is also alluded to in the LLC agreement, the right to seek judicial dissolution.”¹⁷³

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. *Donahue* and *Wilkes* excelled at defining the problem that gave 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.

170. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2009 WL 73957, at *7 (Del Ch. Jan. 13, 2009).

171. *Id.* at *4-7 (dissolution is appropriate where there is a deadlock without any mechanism in the operating agreement to circumvent the stalemate).

172. DEL. CODE ANN. tit. 6, § 18-802 (2006); *Haley*, 864 A.2d at 94-98.

173. *Haley*, 864 A.2d at 88-89 (footnote omitted); *see also* *Connors v. Howe Elegant, LLC*, No. 4003783, 2009 WL 242324, at *13 (Conn. Super. Jan. 8, 2009) (following *Haley*, forcing member to exercise contractual exit would not permit LLC to proceed in a practicable way).

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.