CLOSE CORPORATION REMEDIES AND THE EVOLUTION OF THE CLOSELY HELD FIRM

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LARRY E. RIBSTEIN*

ABSTRACT

This Article examines the law of closely held firms from an evolutionary perspective. The corporate tax and constraints on the availability of limited liability forced closely held firms to compromise their planning objectives and choose standard forms that did not fully reflect their needs. These planning problems forced courts to construct duties and remedies that did not relate to the parties' contracts. The famous close corporation case of Wilkes v. Springside Nursing Home, Inc.\(^1\) classically illustrates this problem. The advent and spread of the limited liability company significantly increased the availability of suitable standard forms for closely held firms. As a result, courts now can focus on fully effectuating the parties' contracts rather than creating remedies the parties may not have wanted. This analysis has implications for potential improvements in contracting for closely held firms.

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INTRODUCTION

Business associations are complex and long-term contracts for which detailed planning is inherently difficult. Statutes and flexible judicial gap-filling often supplement explicit contracts in this context. The development of business association statutes depends on the general legal and economic environment over time. The availability of improved statutes, in turn, affects both the parties’ contracts and the nature of appropriate judicial remedies.

The most significant changes in the law of business associations over the last thirty years relate to small firms. During this period, business forms for closely held firms evolved from the general partnership and close corporation to the dominance of the flexible limited liability form. Closely held firms had to choose between the higher transaction costs of these earlier forms and the higher tax or liability costs of standard forms better tailored to small firms’ needs. This compromise compounded the inherent problems of high-cost customized planning in small firms. As a result, small firms became wards of the courts, with judges rewriting their agreements.

3. A recent study shows that in 2007 approximately two-thirds of business formations were LLCs. See Rodney D. Chrisman, LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs 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, 460 (2010).
4. RIBSTEIN, supra note 2, 95-117.
5. See id.
The 1997 “check-the-box” tax rules set in motion a fundamental change in closely held firms. These rules freed small firms to adopt standard forms that suited their needs and motivated state legislatures to modify their laws accordingly. The resulting explosion of statutes and private contracts reshaped small firms and changed the courts’ role in adjudicating cases involving these firms.

Wilkes v. Springside Nursing Home, Inc. illustrates the changes in the law of closely held firms. The Massachusetts Supreme Judicial Court confronted businessmen whose contract was hopelessly unsuited to their business relationship. Like many other small firms of the time, this was a partnership wrapped in a corporation. Although the firm had all the trappings of a coequal relationship among active participants, it lacked the partnership mechanism for resolving the disputes that inevitably arise in such a relationship. The court had to decide between leaving the parties to stew in their imperfect planning and rescuing them by rewriting their agreement. The court did the latter, creating confusion for business people but delight for generations of law professors.

This Article discusses the coming of age of small firms in three distinct stages marked by important legal developments which reduced small firms’ contracting costs and increased their opportunity to adopt suitable agreements. In the first stage, most closely held firms were general partnerships, a form that is designed for the smallest firms.

In the second stage, the growing importance of limited liability caused many small firms to incorporate while keeping their partnership characteristics. Wilkes shows that this was an unhappy compromise that necessitated judicial intervention into the parties’ contracts. While courts and legislatures loosened the constraints on the close corporation form, this loosening did little to help firms like the nursing home in Wilkes because it required small firms to do costly planning in order to remodel the corporate form to suit their needs. The application of the corporate tax to corporate-like firms deterred firms and legislatures from taking the logical step of adopting limited liability business forms designed for partnership-type firms.

The third stage was heralded by the adoption of “check-the-box” taxation, which finally eliminated the tax constraints on small firms’ choice of business form. This change opened the floodgates

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for the limited liability company (LLC), which proved to be the flexible limited liability form small firms were looking for. Small firms could have the contracts they wanted without tax concerns. This reduced the need for judicial interference in the governance of closely held firms and led to the application of more contract-based judicial remedies.

As we will see, the next step is up to lawyers, courts, and legislatures. Lawyers need to help their clients take advantage of the planning flexibility the law now gives them. Courts should more explicitly recognize the contractual nature of remedies for oppression and deadlock. Public and private lawmakers need to provide business people with a more complete set of standard forms.

This Article begins by discussing the small firm’s infancy as a general partnership, whose default rules suited only the very smallest firms. Part II discusses the small firm’s adolescence in the era of the close corporation, when firms had to choose between limited liability and the contractual freedom available to general partnerships. Part III discusses the small firm’s adulthood as limited liability companies, with the ability to choose from a range of standard forms and state laws. The Article then shows how this evolution of business forms has affected judicial dissolution remedies in recent LLC cases. Part V discusses the implications of potential future evolution in small firms’ contracting technology.

I. INFANCY: GENERAL PARTNERSHIP

The earliest small firms were partnerships, which began as intimate, usually family, relationships.8 They were referred to as “compagnia,” which means those sharing bread, reflecting their origins in households.9 Kinship ties were an important mechanism for controlling agency costs. As Kerim Bey told James Bond in From Russia with Love, “all of my key employees are my sons. Blood is the best security in this business.”10 Partnership law reflects this intimacy in several ways.11 First, each partner is vicariously liable for

11. See RIBSTEIN, supra note 2, at 39-64.
all of the firm’s debts. This liability, which is imposed irrespective of the partnership agreement, reinforces the need for intimacy and the other rights discussed below.

Second, partnership default rules are designed for the smallest firms, with provisions for equality in profit and loss sharing,\textsuperscript{12} voting,\textsuperscript{13} and partners’ power to block important acts\textsuperscript{14} and to bind the firm.\textsuperscript{15}

Third, traditional partnership fiduciary duties reflect partnership’s intimacy. In the famous case of Meinhard \textit{v.} Salmon, Justice Cardozo described the partner’s duty as “the punctilio of an honor the most sensitive.”\textsuperscript{16} The court’s application of the duty to the defendant under the facts of that case—that is, for failing to include plaintiff in a much bigger deal the defendant was offered because of his superior skills—seems to assume the sort of close-knit relationship in which the parties share everything like brothers.

Fourth, partners have no default power to transfer their management rights in the partnership without their co-partners’ consent.\textsuperscript{17} This follows from partners’ default management rights and vicarious liability, since partners would want to control who holds these strong powers.

Fifth, the Uniform Partnership Act allows any partner to dissolve a partnership that has no remaining agreed term simply by expressing the will to do so or dissociating from the firm.\textsuperscript{18} When this happens the partnership liquidates.\textsuperscript{19} Even if the partnership has a remaining agreed term, it can still be dissolved and forced to liquidate by any partner other than one who acted wrongfully (under the original U.P.A.)\textsuperscript{20} or by half the remaining partners (under the Revised U.P.A.).\textsuperscript{21} Partnership law further encourages dissolution and liquidation by traditionally restricting inter-partner litigation to an accounting, which typically happens only at dissolution.\textsuperscript{22} These rules leave partners subject to the risk that their co-

\textsuperscript{12} Rev. Unif. P’ship Act § 401(b) (1997); Unif. P’ship Act § 18(a) (1914).
\textsuperscript{13} Rev. Unif. P’ship Act § 401(f); Unif. P’ship Act § 18(e).
\textsuperscript{14} Rev. Unif. P’ship Act § 401 (j); Unif. P’ship Act § 18(h).
\textsuperscript{16} Meinhard \textit{v.} Salmon, 164 N.E. 545, 546 (N.Y. 1928).
\textsuperscript{17} See Rev. Unif. P’ship Act § 503; Unif. P’ship Act §§ 26, 27.
\textsuperscript{20} Unif. P’ship Act § 38(2).
\textsuperscript{21} Rev. Unif. P’ship Act § 801(2).
\textsuperscript{22} The accounting is provided for in Unif. P’ship Act § 28. The rule that the accounting is the exclusive remedy is a case law development. See 2 Alan R. Brom.
partners will use the dissolution power to walk off with valuable skills and assets. For example, in Page v. Page a managing brother used dissolution to essentially take the business from his brother who had invested heavily in it and was only just beginning to see a payoff.23 This risk of opportunism is justified by a strong assumption that the parties did not expect the firm to survive serious disagreement, litigation, or member departure.

Although the above default rules are appropriate only for the smallest and most intimate firms, many small firms consist of arms’ length relationships and some passive investors. These firms need a business form better suited to their needs, particularly including limited liability and greater continuity. As we will see in the next part, firms seeking limited liability traditionally have been channeled into the corporate form, which poses different but equally daunting problems for small firms.

II. Adolescent Identity Crisis: The Close Corporation

Small firms seeking to leave the intimacy contemplated by general partnership law and venture into the world needed a different legal vehicle. The corporate form’s limited liability became increasingly valuable as firms’ tort liabilities expanded during the twentieth century. But the corporation was designed for large firms, with features such as significant separation between management and ownership, complex capital structures, and publicly tradable shares.24 The closely held corporation was a contradiction in terms, as its nickname “incorporated partnership” suggests.25 Even closely held firm owners dissatisfied with the intimacy of the partnership form did not necessarily want to go to the other extreme of corporate-type boards of directors and formal shareholder meetings. These people needed a limited liability firm that combined partnership and corporate aspects under the partnership heading.

Although states were free to develop such statutes, they did not do so. Tax law helps explain why. A firm taxed as a corporation under Subchapter C of the Internal Revenue Code has to pay taxes at the firm level when it earns income and at the owner level when it distributes the income as dividends.26 A partnership taxed

BERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP, § 6.08(c) (2011).

24. See RIBSTEIN, supra note 2, at 65-75.
25. See id. at 96.
under Subchapter K of the Internal Revenue Code could avoid a separate tax on entity-level income because it was not a separate entity for tax purposes. This was usually better than the “double” corporate tax, especially for closely held partnership-type firms that tend to distribute most of their cash to the owners. But partnerships that adopted limited liability were stuck with the corporate tax. The “Kintner regulations,” which defined what the tax code called “associations,” subjected firms to the corporate tax if they had certain supposed entity characteristics, including limited liability. As the IRS applied the regulations, the corporate tax became essentially a tax on limited liability.

These tax rules left limited liability firms with little demand for “limited liability partnership”-type business forms. If the firms were going to be taxed as corporations, they might be better off with standard entity features, such as separation of management and control to manage retained earnings and continuity of life, to protect against taxable distributions of these earnings. In any event, small firm owners could limit the tax costs of incorporation by maximizing their tax deductions. The fact that corporate tax rates were lower than individual rates mitigated the effect of the remaining double corporate tax. The lack of demand for the limited liability partnership gave state legislatures little incentive to supply it.

Congress also actively channeled small firms into the corporate form by enacting Subchapter S of the Internal Revenue Code in 1958, which enabled small corporations to get many of the tax advantages of partnership. Congress significantly loosened the re-
quirements in 1982\textsuperscript{34} and 1996\textsuperscript{35} while, at the same time, states were making the limited partnership a viable alternative to incorporation, the consequences of partnership taxation were becoming more favorable, and political pressure was increasing to abandon the separate corporate tax.\textsuperscript{36} Subchapter S attempts to keep small firms in the corporate fold by offering them a simple and straightforward alternative to the complexities of Subchapter K.\textsuperscript{37} Subchapter S’s one-class-of-stock requirement\textsuperscript{38} restricts these corporations from using complex capital structures that could enable high tax bracket owners to shift income to those in lower tax brackets.

Courts also accommodated the close corporation form. After initially refusing to adjust corporate norms to fit closely held firms, courts took account of the increasing number of close corporations and started to enforce their agreements.\textsuperscript{39} But closely held firms faced limits in the extent to which they could remodel the corporate form. For example, \textit{Clark v. Dodge} enforced an agreement eroding the power of a board to decide on distributions and who would be the firm’s general manager, but only because the board retained some power to determine whether the manager was providing good service and dividends were appropriate.\textsuperscript{40} Also, courts were willing to enforce a shareholder voting agreement that departed a little from corporate-style one share one vote,\textsuperscript{41} but not one that looked too much like a statutory voting trust.\textsuperscript{42}


\textsuperscript{37} Treas. Reg. § 1.701-2 (2004); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 17:3 (2d ed. 2008).

\textsuperscript{38} I.R.C. § 1361 (b)(1)(D).


\textsuperscript{40} Clark v. Dodge, 199 N.E. 641 (1936).

\textsuperscript{41} Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 49 A.2d 603 (Del. 1946).

\textsuperscript{42} Abercrombie v. Davies, 130 A.2d 338 (Del. 1957).
Despite the courts’ and Uncle Sam’s best efforts to herd closely held firms into the corporate corral, the close corporation ultimately was an evolutionary dead end. The problem came in dealing with agreements that did not fully anticipate the problems that arose on breakup or exit. Enforcing partnership-type direct control by individual members or factions creates a need for partnership-type mechanisms for settling the inevitable disputes among members. Yet close corporations that failed to plan for breakup were stuck with corporate default rules that locked feuding members into a permanent entity without hope of selling their shares on the open market or enabled a controlling faction to force a frozen-in owner to sell out at a bargain price.

Although courts at first held they had no inherent power to dissolve in these situations, legislatures amended the statutes to give courts this power. Then the courts had to decide individual cases. The problem for the courts is that there are both costs and benefits of enabling members to exit firms, and the balance depends on particular firms’ needs. Statutes can do no more than provide default rules that at least roughly fit many firms’ expectations and that provide suitable platforms for contracting. Default rules cannot precisely anticipate the needs of the range of firms that do not have contracts. More importantly, it is not clear what a firm wants when it decides to be a corporation but looks like a partnership. This leaves close corporations that do not have agreements even worse off than partnerships that do not have agreements.

The freeze-out scenario illustrates the problems of close corporations. We have seen that the partnership feature of dissolution-at-will may enable a partner to opportunistically seize value that co-partners help create. Partnership statutes craft a rough compromise that lets partners escape most partnerships while providing for continuity in partnerships for an agreed term. In this situation partners are particularly likely to have investments tied up in the firm. It is much less clear what the parties to a close corporation wanted when the corporation statute simultaneously tells the parties they lack the power to exit at will but then empowers courts to allow exit in some cases. An early commentator praised a court that denied dissolution where opportunism might have been a prob-

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44. See supra note 23 and accompanying text.
45. See supra note 21 and accompanying text.
lem. But the parties may not have wanted to be locked together in the firm either.

State close corporation law has advanced from its earliest days, particularly regarding break-up, and particularly by enactment of statutes like that in New York, which lets holders of 20% or more of the corporation’s shares petition for dissolution for looting, waste, or “illegal, fraudulent or oppressive actions” by those in control. In re Kemp & Beatley permitted dissolution under this provision where close corporation managers denied distributions to former employees that had formerly been given to all shareholders because this frustrated their “reasonable expectations.”

The oppression remedy, as applied in cases like Kemp & Beatley, arguably improves on the remedies available at the time of Wilkes. However, the remedy does not significantly alleviate the essential indeterminacy inherent in firms that are neither quite corporations nor partnerships. The problem is that it is not clear what shareholders reasonably expect when neither the statute nor the agreement provides for dissolution. Should shareholders get special rights just because they are also employees, or should employees get special rights because they are also shareholders? Should owners who are former employees be entitled to distributions just because everybody got them when everybody was both a shareholder and an employee? Does it matter that making payments to non-employees could cause all of the firm’s payouts to be characterized as taxable dividends rather than tax-deductible salaries? Did the shareholders expect a buyout in this situation? If not, should the buyout price reflect continuation of distributions? Given these ambiguities, a dissolution standard based on the parties’ “reasonable expectations” invites courts to make up contracts for the parties. This problem is not helped by statutory provisions permitting

47. N.Y. BUS. CORP. LAW. § 1104–a (McKinney 2003).
50. Five years after Kemp, the New York Court of Appeals refused to give a cause of action for improper termination to a fired employee who was also a minority shareholder and was paid pursuant to his employment agreement. See Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1312-13 (N.Y. 1989). The court reasoned that “[i]t is necessary in this case to appreciate and keep distinct the duty a corporation owes to a minority shareholder as a shareholder from any duty it might owe him as an employee.” Id. at 1313. A strong dissent relied on Kemp, as well as Pace and Wilkes discussed below, among other cases. Id. at 1315 (Hancock, J., dissenting).
parties opposing dissolution to buy out the plaintiff at fair value, since it is not clear why the plaintiff should be entitled to exit just because he sues, or on what assumptions the court should base its determination of “fair value.”

The indeterminacy of close corporation law is especially evident when the oppression remedy meets an actual contract. For example, in *In re Pace Photographers, Ltd.*, the parties agreed that a stockholder who “desires to sell his shares” could sell to the other stockholders at a below-market formula price. Petitioner sued to dissolve for oppression and his co-shareholders offered to buy petitioner’s stock for the agreed price pursuant to the New York provision. The court held that the contractual buyout provision only applied to a voluntary offer to sell or shareholder death and not to a statutory dissolution proceeding in the absence of explicit language to that effect. Plaintiff therefore could avoid the buyout price by suing for dissolution rather than offering his shares for sale. Although the provision’s interaction with the statute was ambiguous, the court compounded the problem by making little effort to reconcile the two.

At least in the above New York cases, the parties might be said to have implicitly adopted the statutory remedy. Things get messier in a state like Massachusetts which lacks such a provision. In the famous *Donahue v. Rodd Electrotype Co.*, the court allowed a minority holder the same opportunity for a buyout that the controlling shareholder got in connection with an estate planning reshuffling of interests. It is not clear why a 20% holder who declined to invest in the business should get the same opportunity as the controlling shareholder who had invested and run the business, particularly where there was *neither* an agreement that entitled the minority holder to this valuable right of being able to “tag along” with the majority owner’s sale, *nor* a statute providing for judicial dissolution.

This brings us to the follow-up to *Donahue*, *Wilkes v. Spring-side Nursing Home, Inc.*, which involved a situation similar to *Kemp*—that is, a former employee who claims to have been shut

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51. See N.Y. BUS. CORP. LAW, § 1118.
52. *In re Pace Photographers, Ltd.*, 525 N.E.2d 713, 714 (N.Y. 1988).
53. *Id.* at 715.
54. *Id.* at 718.
55. *Id.*
56. *Id.* at 717-18.
out of employment and other benefits that he expected from his investment. Wilkes involved even harder facts than Kemp since, while Gardstein quit, Wilkes was fired, apparently without cause. Moreover, the parties seem to have thought harder in Wilkes about what their deal was—they clearly wanted to be partners, and were incorporated only for liability reasons. In other words, they squarely faced the classic tradeoff between limited liability and partnership discussed above.

Whatever the parties in Wilkes might subjectively have wanted, what they did was incorporate, which seemingly subjected them to the corporate statute. The result was the structural dissonance of a “partnership” in corporate form. This is a hybrid business association with no clear default rules. For example, if this firm really was a partnership, Wilkes could have sued for dissolution as an excluded partner rather than being left with only a suit for back pay. If it was not, then Wilkes at that time in Massachusetts had no statutory remedy. The parties could not even have counted on the Donahue rule, since that case was decided only a year before Wilkes. As in Donahue, the court spun a contract out of gossamer expectations, and gave Wilkes the salary he would have made had he stayed employed. Wilkes’s status as a shareholder somehow also got him a guarantee of employment even without a contract to that effect.

States tried to improve the close corporation contracting technology by enacting special statutes that explicitly validated partnership-type agreements in close corporations. Small firms might have been expected to gravitate to these provisions, particularly once courts used the statutes to develop a special jurisprudence that

59. Id. at 661.
60. Id. at 659.
61. See Bromberg & Ribstein, supra note 22, § 7.06(c) (discussing types of misconduct that can serve as a ground of judicial dissolution in general partnerships).
62. See Donahue, 328 N.E.2d at 505.
63. Wilkes, 353 N.E.2d at 665.
64. Indeed, Deborah DeMott’s contribution to this symposium characterizes Wilkes as changing the traditional default rule of employment at will. See Deborah A. DeMott, Investing in Work: Wilkes as an Employment Law Case, 33 W. NEW ENG. L. REV. 497 (2011).
differed from corporations. But this did not happen. Small firms wanted to be real partnerships rather than ersatz partnerships in corporate form. Despite the special close corporation provisions and the structural similarities between close corporations and partnerships, general corporation law arguably still applied to small corporations that did not contract explicitly or that failed to elect and qualify under the close corporation provisions. Some courts have had a hard time accepting this. They continue to analogize close corporations to partnerships, though it is not clear what this means. They still do not trust the parties’ choices even as these choices become more explicit. For example, Zion v. Kurtz held that a corporation could qualify for Delaware’s special close corporation treatment even if it failed to make the requisite statutory election.

Few firms ultimately opted for special close corporation status. Small firms recognized that these statutes were an uneasy compromise because, whether or not the firms were essentially partnerships, they faced costs as long as they were called corporations, “close,” or otherwise. The expectations of firms that operated in the corporate form never quite matched the default agreement the legislation supplied, and the courts could not fill this gap. As discussed in the next section, small firms fled the corporate form altogether as soon as the tax laws were changed to eliminate the need for compromise.

III. FINDING A ROLE MODEL: THE LLC

The migration to LLCs that transformed the closely held firm began with tax reform in the 1980s. By the mid-1980s only two states (Wyoming in 1977 and Florida in 1982) had adopted LLC
But three events helped change the political equilibrium. First, the Tax Reform Act of 1986 reduced top individual tax rates below top corporate tax rates and eliminated favorable capital gains treatment, thereby making corporate taxation costly for almost all firms.

Second, Georgia’s 1988 passage of a new limited partnership act allowed limited partners to fully participate in the control aspect of the partnership without having personal liability. The Georgia statute forced the IRS to decide whether a limited partnership with managing limited partners could be a tax partnership. An affirmative answer would force the IRS to decide whether an LLC, which has no general partners, also could be a tax partnership. If the IRS refused to accommodate the Georgia limited partnership, it would have had to define the level of control and liability the general partners needed to have for the firm to be taxed as a partnership. Although the IRS delayed a ruling on the tax status of the Georgia statute, the day of reckoning with these issues was approaching.

A third key event in the evolution of the LLC was when Congress decided to characterize publicly traded partnerships as corporations. Congress sought with this provision to head off mass disincorporations of corporations into limited partnerships intended to take advantage of the reduction of personal income tax rates. The law also lifted the burden of preventing this result from the tax classification rules.

These events set the stage for a 1988 Internal Revenue Service ruling classifying a limited liability company—that is, a non-corporate firm all of whose members had limited liability—as a tax partnership. Within six years all but three states had adopted LLC statutes. The states continued tinkering with the provisions to press against the limits of the tax classification rules. By the end of

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72. Id. at 86.
73. The following discussion of the three events is drawn from Ribstein, supra note 2, at 120-22.
77. Ribstein, supra note 2, at 121.
81. See Ribstein & Keatinge, supra note 37, § 1:2.
the 1990s, all states had adopted LLC statutes. The IRS gave up trying to distinguish between tax partnerships and tax corporations and adopted the “check-the-box” rule which allowed non-publicly traded firms to decide whether they wanted to be taxed as partnerships or corporations. Governance structure was now separated from tax structure. LLCs could adopt corporate-type governance and still be subject to the partnership tax, or they could remain partnership-type firms under state law while electing to be taxed as corporations under Subchapter S or Subchapter C of the Internal Revenue Code.

LLC statutes have continued to evolve after adoption of check-the-box. States are evidently competing in a race to keep local firms from fleeing to Delaware’s sophisticated lawyers and courts. Since firms now could adopt corporate-type terms without fear of subjecting themselves to the corporate double tax, the LLC could finally evolve into the flexible mix of corporate and partnership features small firms had always wanted instead of having to choose between the intimate general partnership and the unwieldy corporation. Among other things, LLC statutes included default provisions for centralized management and for pro rata sharing of management and financial rights, in contrast to the equal rights in partnership law. States also amended their LLC statutes to provide that, unlike partnerships, LLCs no longer dissolved because of the exit of a single member. These moves facilitated the creation of corporate-type entities that delegated power to managers and to controlling shareholders.

The evidence concerning state competition for LLCs suggests that this competition revolves around three general formats. Delaware dominates the market for larger LLCs, perhaps because these firms value Delaware’s flexible statute and sophisticated planning. Many states compete to encourage local firms not to form in Delaware by giving them Delaware-type flexibility. The remaining states that are not actively innovating and offering mainly uniform rules may be trying to offer local small firms enough default rules

82. Id.
84. Perhaps surprisingly, many LLCs have chosen the latter course. See Chrisman, supra note 3, at 480-83.
86. See Ribstein, supra note 2, at 137-92 (discussing features of modern LLCs).
87. See Kobayashi & Ribstein, supra note 85.
and judicial protection so that their members do not have to engage in costly planning or worry about being victimized by improvident agreements.

IV. MATURITY

The full statutory recognition of LLCs gave closely held firms a robust contracting platform and thereby enabled them to avoid the uncertainty created by close corporation cases like Wilkes. Closely held firms now can choose statutes that accommodate their contracting needs without having to compromise these objectives to get limited liability and favorable tax treatment. This enabled courts to focus on full-fledged enforcement of the parties’ contracts rather than on general statutory oppression standards. This Part shows how courts have responded by analyzing recent LLC judicial dissolution cases.

A. Judicial Dissolution in LLCs and Close Corporations

Judicial remedies continue to be necessary in LLCs as in close corporations because, as in all firms, managers, and controlling owners may exercise power that can be abused, and because LLC statutes either do not provide for any default exit right or deny a leaving partner the right to a buyout of her interest. A dissociated LLC member often is left, sometimes unexpectedly, with a non-managing equity interest. LLC statutes eliminated partnership-type default exit-at-will after “check-the-box” enabled LLCs to have corporate-type continuity of life without having to worry about being taxed like corporations. Family firms’ incentive to reduce estate and gift taxes also spurred the new provisions. The tax code provides that valuation of partnership interests can take account of statutory restrictions on liquidation rights but not those imposed merely by agreement. Even without this tax incentive, many LLCs would want to restrict exit to protect against draining cash for buyouts or to reduce the risk of member opportunism of the sort discussed above in connection with Page v. Page.

88. In some cases such provisions have caused particular and unexpected hardship. See Holdeman v. Epperson, 857 N.E.2d 583 (Ohio 2006) (involving estate of deceased member); Lieberman v. Mossbrook, 208 P.3d 1296 (Wyo. 2009) (protracted litigation concerning rights of a dissociated member frozen into an economic-only interest).


90. See supra note 23 and accompanying text.


Without a cash-out right, LLC members need a default judicial exit route to protect them from oppression by controlling holders.\footnote{91. See Douglas K. Moll, Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 WAKE FOREST L. REV. 883, 968 (2005).} Most LLC statutes, including Delaware\footnote{92. DEL. CODE ANN. tit. 6, § 18-802 (2005).} and New York,\footnote{93. N.Y. LTD. LIAB. CO. LAW § 702 (McKinney 2010).} authorize judicial dissolution only “when[ ] it is not reasonably practicable to carry on the business in conformity with the” parties’ agreement, with a minority of states adding close corporation-type oppression grounds.\footnote{94. Id.; see Jens Dammann & Matthias Schündeln, Where are Limited Liability Companies Formed? An Empirical Analysis app. III, tbl. 10a-d (Revised June 28, 2010) (Univ. of Tex. School of Law, Law and Economics Research, Paper No. 126, 2010), available at http://ssrn.com/abstract=1633472 (tabulating LLC statutory dissolution remedies); Thompson, supra note 49.}

Even without these statutory provisions, courts likely would apply flexible remedies that do not relegate the parties to the literal contractual language. This conclusion does not rest on behavioral psychology, norms, or other reasons for hesitating to enforce contracts.\footnote{95. See Benjamin Means, A Contractual Approach to Shareholder Oppression Law, 79 FORDHAM L. REV. 1161 (2010) (analyzing these considerations in relation to close corporation oppression remedies but concluding that the remedies are justified on contractual grounds).} Rather, it simply recognizes the costs and infeasibility of contracting for every contingency in long term contracts.\footnote{96. Id. at 1166.} As discussed below,\footnote{97. See infra Part IV.D.2.} this approach to interpretation is consistent with standard contractual rules such as the implied covenant of good faith and fair dealing. It assumes that rational contracting parties recognize the limits of their foresight—that is, have “bounded rationality.”\footnote{98. See Herbert A. Simon, A Behavioral Model of Rational Choice, in MODELS OF MAN, SOCIAL AND RATIONAL: MATHEMATICAL ESSAYS ON RATIONAL HUMAN BEHAVIOR IN A SOCIAL SETTING 99 (1957); Daniel Kahneman, Maps of Bounded Rationality: Psychology for Behavioral Economics, 93 AMER. ECON. REV. 1449 (2003); Oliver E. Williamson, The Economics Of Organization: The Transaction Cost Approach, 87 AM. J. SOC. 548, 553-54 (1981).}
serts,\textsuperscript{99} that LLC statutes eliminate the need for judicial gap-filling. No statute or agreement can cover all the contingencies involved in a complex and open-ended contract like a business association. My point instead is that, by providing a clearly non-corporate structure of default rules and a variety of state statutes, LLCs make it easier than close corporations for parties to reach agreements that approximate their ex ante expectations. Courts can then fill in the gaps using the contract and statute as general guidelines rather than having to construct a contract from a whole cloth as in \textit{Wilkes}.

Judicial opinions in close corporations tend to proceed from a generalized notion of what the minority shareholder expected from the deal—that is, the ability to get distributions or salary, without regard to the express and implied contract terms. By contrast, courts in LLC cases increasingly have focused on what parties actually put in their contracts, interpreted in light of the statutory standard form they used as a basis for their business agreement. Instead of asking what reasonable parties would want if they could contract cheaply, courts now tend to ask what the specific parties actually wanted given what they contracted for.

LLC cases reflect this subtle but important difference from close corporation law even under LLC statutory provisions that resemble traditional close corporation language. For example, \textit{Decker v. Decker} dissolved a firm for a member’s misbehavior in deliberately sabotaging an “I cut you choose” buy-sell agreement.\textsuperscript{100} Although the court applied close-corporation-type oppression language in the Wisconsin LLC statute,\textsuperscript{101} its holding was consistent with a standard contractual good faith analysis of blocking behavior intended to thwart the expected operation of a contractual provision. Also, \textit{Roemmich v. Eagle Eye Development, LLC}, applying the “unfairly prejudicial” basis of judicial dissolution in the North Dakota statute,\textsuperscript{102} denied plaintiff a forced buyout on the ground that the plaintiff could reasonably expect only more information and an opportunity to participate in decision-making rather than continued employment in the firm.\textsuperscript{103} And \textit{Horning v. Horning Construction, LLC} denied a locked-in member’s request for judicial dissolution because the statute had no default exit right.

\textsuperscript{99} Thompson, \textit{supra} note 49.
\textsuperscript{100} \textit{Decker v. Decker}, 726 N.W.2d 664, 670 (Wis. Ct. App. 2006).
\textsuperscript{101} \textit{Id.} at 669; see also \textit{WIS. STAT.} § 183.0902 (2002).
\textsuperscript{103} \textit{Id.} at *40
noting that the legislature had deliberately restricted exit in the statute.104

The Delaware/New York-type judicial dissolution standard105 gives courts more reason to focus on the parties’ contracts by requiring the courts to consider whether the parties can carry on the firm “in conformity with” the parties’ agreement. Recent Delaware and New York cases illustrate the enhanced role of the agreement under this provision. In *Fisk Ventures, LLC v. Segal*, an investor used its veto power under the operating agreement to refuse to permit additional funding of a biotech firm that would have diluted its interest.106 Delaware Chancellor Chandler held that the resulting deadlock made it “not reasonably practicable to carry on the business in conformity with a limited liability company agreement” under the Delaware LLC Act.107 The court’s attention to the contract language is evident from its refusal to force the investor to resort to his put right to avoid the deadlock.108 The court noted that the investor had a contractual right not to exercise the put right and reasoned:

> If . . . deadlock cannot be remedied through a legal mechanism set forth within the four corners of the operating agreement, dissolution becomes the only remedy available as a matter of law. The Court is in no position to redraft the LLC Agreement for these sophisticated and well-represented parties.109

*Lola Cars International, Ltd. v. Krohn Racing, LLC*, applied the *Fisk* standard in similarly denying a motion to dismiss a dissolution action under the same Delaware provision.110 The court again held that the plaintiff did not have to exercise voluntary buyout and

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105. *See supra* text accompanying notes 92-104; *infra* text accompanying notes 106-137.
109. *Id.* at *6.
termination rights to avoid dissolution. The court interpreted the contractual termination provision as not displacing the statutory dissolution remedy, reasoning that

the Operating Agreement nowhere requires that a member terminate the Operating Agreement solely in accord with its stipulated termination provisions. Thus, the Court cannot conclude that these terms are exclusive. It simply cannot be true that a number of nonexclusive, permissive termination clauses in the Operating Agreement can preclude judicial dissolution as provided for in the Act.

The court ultimately denied dissolution after trial, again relying on the operating agreement:

The Court concludes by emphasizing that a party to a limited liability company agreement may not seek judicial dissolution simply as a means of freeing Lola itself from what it considers a bad deal. This is so even if the Member Parties’ relationship has—as here, due largely to pressure applied by Lola both within and without the litigation context—been badly damaged. Endorsing such a rule would allow for one party—unfairly—to defeat the reasonable expectations of its counterparty. Moreover, the Member Parties in their private ordering effort embraced a provision within the Operating Agreement that allows for disenchantment. . . . [I]t is not for the Court to terminate, or rewrite, the Operating Agreement.

In Vila v. BVWebTies LLC, Vice Chancellor Strine ordered the dissolution of an LLC owned in equal shares by television personality Bob Vila and businessman George Hill. Although the operating agreement required both owners’ consent to all business decisions, the owners had fundamental disagreements about the

111. Lola Cars Int’l, Ltd., 2009 WL 4052681, at *6 (“The Operating Agreement provides a buy-out mechanism in the event of a member dispute; this self-help disenchantment provision, however, is entirely voluntary.”).

112. Id. (footnote omitted).

113. Lola Cars Int’l, Ltd. v. Krohn Racing, LLC, No. C.A. Nos. 44-79-VCN, 4886-VCN, 2010 WL 3314484, at *24 (Del. Ch. Aug. 2, 2010) (footnotes omitted). The court explained its apparent change of heart from the denial of the motion to dismiss by noting that the level of managerial misconduct proved at trial fell short of the complaint’s allegations, which bore on the practicability of continuing the LLC. Id. at *24 n.275. However, it is not clear how this misconduct mattered under the court’s earlier expectations-based analysis.


115. Id. at *2.
direction of the business, and Vila had terminated the license for his intellectual property that the firm needed to operate. The court ordered dissolution despite the company’s continued earnings. As in the above cases, the court applied the parties’ agreement rather than ad hoc equitable principles. V.C. Strine reasoned that

[what Hill wishes to do is to pursue a business having nothing to do with the basic purpose for which WebTies was formed and to do so over the objection of one of its two managers. Of course, the existence of a deadlock would not necessarily justify a dissolution if the LLC Agreement provided a means to resolve it equitably. But the LLC Agreement does not contain a buy-sell arrangement or any other provision (such as one providing for the appointment of an agreed-upon third manager) to resolve the deadlock. Rather, the LLC Agreement contemplates that a member or manager may seek judicial dissolution. This is what Vila has done, and he has succeeded in proving that dissolution is warranted.]

A New York court attended to the operating agreement in rejecting dissolution in In re 1545 Ocean Avenue, LLC. The complaint alleged that the parties were deadlocked. The court was careful to distinguish the statutory standard for dissolving an LLC, which did not explicitly include deadlock, from that for dissolving a close corporation, which did. The court reasoned that since the Legislature, in determining the criteria for dissolution of various business entities in New York, did not cross-reference such grounds from one type of entity to another, it would be inappropriate for this Court to import dissolution grounds from the Business Corporation Law or partnership Law to the LLC.

Despite the standard for dissolution enunciated in LLCL 702, there is no definition of “not reasonably practicable” in the context of the dissolution of a limited liability company. . . . Such standard, however, is not to be confused with the standard for the judicial dissolution of corporations . . . or partnerships. . . .

116. Id. at *5.
117. Id. at *6.
118. Id.
119. Id. at *7-14.
120. Id. at *8 (footnotes omitted).
122. Id. at 593.
123. See N.Y. BUS. CORP. LAW § 1104 (McKinney 2003).
Limited liability companies . . . fall within the ambit of neither the Business Corporation Law nor the Partnership Law.124

The court held that the statute’s reference to carrying on “in conformity with the operating agreement” requires “initially a contract-based analysis.”125 The court refused to dissolve based solely on the LLC’s failure to hold meetings not required by the agreement, or on member disagreement where the agreement provided for action unilaterally by the manager.126 The court left open the possibility of dissolving if the LLC is still operating, but only if it could not realize the firm’s purpose stated in the operating agreement.127 Post 1545 Ocean cases in New York have been guided by what one commentator characterized as its “contract-based analysis.”128

It follows from the distinct contract-based nature of the judicial dissolution remedy in LLCs that courts would refuse to characterize LLCs as simply another kind of “incorporated partnership.” Thus, the court in 1545 Ocean reasoned:

The LLC . . . clarifies its scope by defining ‘limited liability company’ as ‘an unincorporated organization of one or more persons having limited liability . . . other than a partnership or trust.’ Thus, the existence and character of these various entities are statutorily dissimilar as are the laws relating to their dissolution.129

124. In re 1545 Ocean Avenue, LLC, 893 N.Y.S.2d at 594-95 (citation omitted).
125. Id. at 596.
126. Id.
127. Id. at 597.
129. In re 1545 Ocean Avenue, LLC, 893 N.Y.S.2d at 595 (internal citations omitted).
Similarly, a federal court refused to allow an LLC member to bring a shareholder oppression action under the New Jersey Business Corporation Act.130

Although the contract-based approach arguably represents a technological improvement over vague close corporation remedies, it is not clear that all courts will sign onto this approach. Thus, the Massachusetts Supreme Judicial Court characterized an LLC as a “closely held corporate entity” and applied the Donahue-Wilkes analysis.132 Massachusetts has heavily invested in developing this line of cases and evidently is reluctant to discard it. This could be viewed as an illustration of the desirable jurisdictional choice LLC statutes offer. Whatever the apparent attractions of the contract-based approach, it is not clearly superior for all firms, including those that seek to take advantage of a substantial body of local law based on the corporate approach.

C. Limits of Contract: Opting Out of Judicial Dissolution

As discussed above, a statutory judicial dissolution remedy can be an important aid to contracting given the parties’ inability to fully specify the terms of a long-term open-ended contract such as an LLC operating agreement. But should the parties be able to dispense with the cost and uncertainty of a court proceeding, even where a contract-based dissolution standard minimizes judicial interference with the agreement?

The Delaware Chancery Court answered this question by enforcing an explicit contractual waiver of the judicial dissolution remedy. The relevant operating agreement in R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, provided:


131. Indeed, there was confusion even in some early Delaware LLC cases. Haley v. Talcott ordered dissolution in two-member LLCs based on a Delaware corporate provision permitting dissolution in this situation, and despite the existence of a contractual buyout right. Haley v. Talcott, 864 A.2d 86, 96-97 (Del. Ch. 2004). In re Silver Leaf, LLC ordered dissolution where the members were deadlocked under the operating agreement, distinguishing Haley only because the firm had three members and therefore was not eligible for relief. In re Silver Leaf, LLC, No. Civ. A. 20611, 2005 WL 2045641, at *10, n.86 (Del. Ch. Aug. 18, 2005).

Waiver of Dissolution Rights. The Members agree that irreparable damage would occur if any member should bring an action for judicial dissolution of the Company. Accordingly each member accepts the provisions under this Agreement as such Member’s sole entitlement on Dissolution of the Company and renounces such Member’s right to seek a court decree of dissolution or to seek the appointment by a court of a liquidator for the Company.133

The court held that this effectively barred an action for judicial dissolution by a member, although another clause of the agreement permitted dissolution upon court decree in an action for a member (that is, by the personal representative or assignee).134 This was the first case to enforce an agreement that contemplated neither judicial dissolution nor arbitration.135 The court reasoned that

[the allure of the limited liability company . . . would be eviscerated if the parties could simply petition this court to renegotiate their agreements when relationships sour. Here, the sophisticated members of the seven Waiver Entities knowingly, voluntarily, and unambiguously waived their rights to petition this Court for dissolution or the appointment of a receiver under the LLC Act. This waiver is permissible and enforceable because it contravenes neither the Act itself nor the public policy of the state.136

[There are legitimate business reasons why members of a limited liability company may wish to waive their right to seek dissolution or the appointment of a receiver. For example, it is common for lenders to deem in loan agreements with limited liability companies that the filing of a petition for judicial dissolution will constitute a noncureable event of default. In such instances, it is necessary for all members to prospectively agree to waive their rights to judicial dissolution to protect the limited liability com-

135. See Ribstein & Keatinge, supra note 37, § 11:5, at 96 n.31 (discussing cases holding the parties could substitute arbitration for dissolution). R & R Capital, LLC leaves open what types of contractual provisions constitute waivers of the judicial dissolution remedy. For example, Lola, discussed supra notes 110-113, held that an agreement that provided for various causes of termination by the parties did not explicitly exclude the possibility of judicial dissolution.
pany. Otherwise, a disgruntled member could push the limited liability company into default on all of its outstanding loans simply by filing a petition with this Court.\textsuperscript{137}

D. \textit{Specific Duties to Members}

Even without a statutory judicial dissolution remedy, courts could give relief to oppressed minority holders for breach of a fiduciary or other duty to individual members. This theory might justify remedies like those in \textit{Wilkes} and \textit{Donahue}.\textsuperscript{138} However, important questions concern the nature and existence of the relevant duties.\textsuperscript{139} Moreover, if no such duties exist, it is questionable whether courts should, in effect, bring them in through the back door of the oppression remedy.

1. \textit{Fiduciary Duties}

Individual members may be owed fiduciary duties. However, the fiduciary approach has limited reach. Fiduciary duties are appropriate only where owners delegate open-ended power over their investments to agents.\textsuperscript{140} In this situation a duty to refrain from self-interested conduct is justified as the best way to ensure effective judicial supervision of the agent’s conduct. But owners exercise their voting power in the firm on their own behalf to protect their interests against co-owners’ and managers’ selfish conduct. Burdening owners with a duty to refrain from self-interested conduct could undermine the self-protective function of owners’ voting rights. Accordingly, controlling owners, acting solely as such, should not be deemed to have a default fiduciary duty of disinterested conduct either to the firm or to individual owners. Owners’ conduct should be subject only to the implied covenant of good faith and fair dealing which, as discussed below, depends on the rights and duties provided for in the parties’ agreement.

It is not clear whether the remedies in cases like \textit{Donahue} and \textit{Wilkes} can be justified on the basis of a breach of duty by the corporation’s \textit{managers} to minority shareholders. Some states provide

\begin{itemize}
\item \textsuperscript{137} \textit{Id.} at *7-8.
\item \textsuperscript{138} See Moll, \textit{supra} note 91, at 910 n.96.
\item \textsuperscript{139} For a review of various duties courts have devised to assist minority shareholders in close corporations, and the gaps in these duties, see Judd F. Sneirson, \textit{Soft Paternalism for Close Corporations: Helping Shareholders Help Themselves}, 2008 Wis. L. Rev. 899, 904-914.
\item \textsuperscript{140} See Larry E. Ribstein, \textit{Are Partners Fiduciaries?}, 2005 U. ILL. L. REV. 209, 215.
\end{itemize}
for duties to individual close corporation shareholders.\textsuperscript{141} Some also clarify the existence of duties to individual LLC members.\textsuperscript{142} Massachusetts has extended its \textit{Donahue-Wilkes} analysis to this context.\textsuperscript{143}

There are, however, strong arguments against creating such duties. First, since the fiduciary duty inherently is one to refrain from self-interested conduct, a non-self-interested manager should not be liable to anyone for breach of fiduciary duty even if she favored some members over others. Courts often could face difficulties trying to decide which of several constituencies a non-conflicted member should have favored. For example, \textit{In re Allentown Ambassadors, Inc.} permitted a claim against a manager of a baseball league organized as a North Carolina LLC for breaching a fiduciary duty to a member in part by not giving it the same opportunities as other teams to go dark.\textsuperscript{144} It may not be clear in such a case whether the manager should have sacrificed the league’s interest for that of a particular member by cancelling some of the games.

Second, any duty of managers of a closely held firm to minority owners would indirectly be one by the controlling owners, as in \textit{Donahue} and \textit{Wilkes}. Even if courts insist that the manager has a duty to act on behalf of all the owners, the manager still will obey those who can fire him. Moreover, as discussed above, the fiduciary duty is one to refrain from acting self-interestedly, rather than to act in a particular way or for a particular constituency. Even a manager acting for controlling owners might breach her duty by self-dealing, but the duty and remedy for breach are owed to the firm or all of its members rather than only to the minority owners as in \textit{Donahue} and \textit{Wilkes}.

\begin{itemize}
\item \textsuperscript{142} Sneirson, \textit{supra} note 139, at 964-65. As for recognition of duties to individual members under LLC law, see Laugh Factory, Inc. v. Basciano, 608 F. Supp. 2d 549, 565 (S.D.N.Y. 2009) (New York law); \textit{In re Allentown Ambassadors, Inc.}, 361 B.R. 422, 461 (Bnkr. E.D. Pa. 2007) (although the applicable North Carolina LLC statute and operating agreement provided for a duty only to the LLC, the court applied the duty under North Carolina’s close corporation law); \textit{REV. UNIF. LTD. LIAB. CO. ACT} (RULLCA) § 409(a), (g) (2006) (providing that members and managers of LLC owe fiduciary duties to the company and to the other members).
\item \textsuperscript{143} See \textit{supra} text accompanying note 132.
\item \textsuperscript{144} \textit{In re Allentown Ambassadors, Inc.}, 361 B.R. at 429-30.
\end{itemize}
Even if a manager has breached a fiduciary duty to the firm, the appropriate remedy in a closely held firm might be a suit by individual owners rather than entrusting prosecution of the claim to the allegedly wrongdoing managers. The derivative remedy is designed for publicly held firms where the owners cannot easily coordinate to manage the claim. All injured owners of a closely held firm might be able to join a direct suit. Even if the shareholders sue individually, the claim would still effectively be a joint claim on behalf of the firm rather than one on behalf of a particular group of (minority) shareholders.

Apart from who can sue, the dissolution remedy differs from the classic damage remedy in a fiduciary duty case. Dissolution addresses the absence of an external market for the owner’s shares by providing an internal market. The intimate nature of these firms supports a default rule that bundles litigation with breakup rather than saddling a going concern with acrimonious litigation. However, judicial dissolution for misconduct can give a weapon to an opportunistic minority shareholder. A less drastic damage remedy accordingly may be more cost-effective. Bundling litigation with dissolution is more appropriate for the intimate default general partnership than for the more general-purpose LLC. Consistent with these principles, the court in 1545 Ocean said that an LLC cannot be dissolved merely because of managerial self-dealing under the statutory contract-oriented standard discussed above unless the conduct was “contrary to the contemplated functioning and purpose of the limited liability company.” The court held that dissolution was unnecessary where the LLC’s main business (a renovation project) was close to completion and could be handled under the existing management structure.

Where dissolution is too drastic but damages do not provide adequate relief the court may be tempted to order a buyout, as in Donahue, or an equitable damages remedy such as the wages ordered in Wilkes. Courts fashioning such remedies may have to con-

145. Larry E. Ribstein, Litigating in LLCs, 64 Bus. Law. 739, 753-55 (2009) [hereinafter Litigating in LLCs].
146. See id.
147. Id.
150. Id. at 129-32.
tend with the absence of statutory authorization. This result might be defended on the ground that a dissolution order often results in a buyout in any case. Ordering a buyout may give the plaintiff less leverage to insist on a higher price depending on how the court structures the buyout. On the other hand, assuming LLC statutes are designed to give greater weight to the parties’ agreements than close corporation statutes, courts in LLC cases should hesitate to alter statutory remedies that the parties may have relied on.

2. Good Faith

Although fiduciary duties arguably are inappropriate in litigation between controlling and minority owners, the minority may be entitled to a remedy under the implied contractual covenant of good faith and fair dealing. Courts applying this doctrine provide a remedy that is consistent with the parties’ expectations inferred under the express terms of the agreement.

The implied covenant of good faith and fair dealing would not justify relief in some prominent close corporation cases. The basic problem in these cases, as discussed throughout this Article, is that the parties’ attempt to combine partnership substance and corporate form renders their contract incoherent. Although the courts might purport to rely on the parties’ expectations, as discussed above these are generalized expectations of fair treatment, not those based on the specific deal. Close corporation oppression gives the parties an exit right they did not bargain for and without any clear breach of duty.

Wilkes, Donahue, and Kemp & Beatley illustrate the problems of applying the implied good faith covenant in close corporations in the absence of any contractual basis for relief. There was no express contract at all in Donahue on which to hang the put right the court gave to the minority shareholder. Wilkes ignored an explicit corporate arrangement that empowered the directors to fix officer pay and the shareholders to elect directors. Dissolution in Kemp & Beatley could not be based on an implied contractual covenant analysis because the parties had no contract that could reasonably be interpreted as giving non-employees a right to distributions.


152. See Oregon RSA No. 6, Inc. v. Castle Rock Cellular of Oregon Ltd. P’ship, 840 F. Supp. 770, 775-77 (D. Or. 1993), aff’d, 76 F.3d 1003 (9th Cir. 1996) (illustrating this approach to the implied covenant).
Plaintiffs’ claims in the recent Delaware and New York LLC dissolution cases discussed above could rest more comfortably on the implied good faith covenant. The “not reasonably practicable” statutory standard assumes that the parties would not want to be forced to continue in a contractual relationship whose agreed purpose had no reasonable chance of fulfillment. Moreover, the courts apply the standard with reference to the contract the parties actually made rather than their generalized expectations or the contract they wish they could have made under better legal conditions. In Fisk, Lola, 1545 Ocean, and Vila the parties were at an impasse and the contract provided for no way out. In 1545 Ocean, the court refused to let the parties out of a deal that was still viable despite the sort of manager misconduct that might have justified judicial dissolution of a close corporation. Although the plaintiffs in these cases wanted to escape their deals, the courts made exit contingent on the deals they had made. In Vila, the court held that Vila’s conduct, which plaintiff sought to make the subject of a breach of fiduciary duty action, was covered by the contract and therefore should be treated in a breach of contract action.

It is important to distinguish the good faith covenant from a cause of action based on fiduciary breach or controlling shareholder opportunism. The reference to “good faith” is misleading, since the remedy is based on the contract’s having a gap rather than on morally blameworthy conduct. If the defendant breached a fiduciary duty, a separate action for breach is appropriate unless the firm is small enough to require bundling the remedy for breach with exit or dissolution. If the defendant has not breached a fiduciary duty, then the court should provide a remedy only if this would be consistent with the parties’ agreement whether or not the defendant’s conduct could be considered unfair or grasping for some reason.

V. The Future of Closely Held Firms

This Article has shown that LLCs represent a significant step in the evolution of closely held firms. This step was enabled by tax
changes, which in turn spurred state legislatures and lawyers to craft statutory standard forms and agreements that better fit the parties’ expectations than was feasible with the close corporation. These changes, in turn, transformed judicial dissolution into an extension of the parties’ contract similar to the contractual implied covenant of good faith and fair dealing, in contrast to the analogous close corporation remedy which called for courts to make up contracts out of parties’ general expectations. The closely held firm is still evolving. This Part identifies some specific challenges and opportunities raised by this Article’s analysis.

A. Judicial Dissolution Standards

We have seen that courts and legislatures are just beginning to recognize and apply the contractual analysis in LLC cases. Lawmakers still need to more fully recognize the fundamental differences between LLCs and close corporations regarding the importance and feasibility of contracting.

This fuller recognition should begin with the wider adoption of statutory language that tracks the contract based on the Delaware-New York model. Legislatures should reject close-corporation-type language such as that found in the Revised Uniform Limited Liability Company Act § 701(a)(5), which provides for judicial dissolution based on “illegal,” “fraudulent,” or “oppressive” acts without a clear reference to the agreement. Direct damage actions adequately address such party misconduct. In contrast, allowing members to exit via buyout or dissolution involves complex balancing of costs and benefits that the parties need to address in their agreements. The legislature therefore should invite the courts to bring those contracts to bear to the extent possible rather than focusing on the isolated element of party misconduct. Party misconduct may be insufficient to justify dissolution, as in 1545 Ocean, or unnecessary given the parties’ deadlock, as in Lola and Fisk. The contractual approach also requires legislators to clarify whether the parties should be able to waive judicial dissolution, as the Delaware chancery court held in R & R.

159. RULLCA § 701(a)(4), like several other LLC statutes, combines this language with “not reasonably practicable” grounds. See supra note 94 and accompanying text (summarizing LLC statutory provisions). The presence of this contractual standard in the section reinforces the notion that the subsection (5) ground does not depend on the contract.

160. See supra subpart IV.B. (discussing these cases).

161. See supra note 137 and accompanying text.
Even if the statutes clearly provide that the contract controls, the courts must decide whether and to what extent the parties have waived or limited the statute in particular agreements. *Fisk* and *Lola*, for example, refused to force the parties to use voluntary buyout provisions as an alternative to seeking judicial dissolution.\(^{162}\) This suggests that the parties can avoid judicial dissolution only by either explicitly waiving it as in *R & R* or by providing that contractual buyout or termination is the exclusive way to end the relationship. The courts might relax the standard and, for example, hold that the parties have implicitly opted out of dissolution if they provided for extensive conflict resolution procedures even if they have not explicitly made these procedures exclusive.

An additional question concerns the future of the oppression remedy in close corporations. The parties’ ability to choose the LLC form arguably reduces the need for an oppression remedy in close corporations. This Article has shown that the LLC contracting technology significantly reduced the need for broad judicial relief that effectively rewrites the parties’ contract. However, this does not necessarily mean that contracting parties should be punished for not choosing the correct contract or standard form, since that would involve a possibly unwarranted assumption about the feasibility of careful planning in closely held firms.\(^{163}\) The close corporation form might be preserved as part of the menu of contracting choices for unsophisticated parties who need special judicial help. The long run need for this option will depend on the continued evolution of LLC statutes and case law.

B. Improving Contracting Technology

This Article has characterized judicial dissolution as a contractual mechanism for responding to unforeseeable changes where owners cannot cheaply exit via sale of their shares. Because LLCs provided an alternative to the close corporation, courts’ role in judicial dissolution cases can shrink. LLCs have not, however, addressed all contracting problems in closely held firms. The parties to closely held firms, as with all long-term contracts, always will

\(^{162}\) See *supra* notes 106-113 and accompanying text.

\(^{163}\) Although it is questionable that altering or restricting contracts appropriately addresses any such contracting problems, these issues are beyond the scope of this Article. See *Means*, *supra* note 95, at 1199 (arguing that parties’ ability to choose the LLC form should not restrict the availability of the oppression remedy).
need some judicial help dealing with contracting gaps. The LLC is only one of many likely future developments that could affect judicial remedies. The following subsections discuss other developments that might affect the need for and nature of judicial assistance in closely held firms.

1. More Statutes

One mechanism for additionally improving contracting in closely held firms is to offer more standard forms. LLCs currently are an open-ended standard form used by widely varying firms. Delaware law contemplates that parties will do a lot of tailoring, which invites many contractual loose ends.

Additional standard forms would enable closely held firms to economize on contracting costs by finding default rules that better fit their needs. For example, professional firms, very small general partnership-type firms, and startups considering eventually going public could have their own standard forms.

Choice-of-law rules in the U.S. address some of the need for more standard forms by enabling firms to choose a business association law from any of the fifty-one U.S. jurisdictions and count on having that law enforced in every other jurisdiction. As discussed above, U.S. jurisdictions compete at least to the extent of trying to keep the larger local firms from organizing under Delaware law. Although there is little direct evidence that these efforts have paid off in more formations for the more innovative states, jurisdic­tional choice has spurred legislative innovations.

Even robust jurisdictional choice may not have produced an optimal number of forms. There may be many more ways to deal with the problems addressed by oppression and buyout remedies than statutes now provide. For example, statutes might “nudge” the parties toward more suitable contracts. The optimal number of default rules depends on a variety of factors, particularly including lawyers’ and courts’ ability to produce an adequate “network” of form agreements, interpretations and case law to fully utilize the forms. Although additional forms may have a declining marginal value, it is difficult to determine the point at which the production

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164. See Kobayashi & Ribstein, supra note 85 (discussing the evidence that large LLC’s are typically forming in Delaware, similar to large corporations).
165. See Sneirson, supra note 139, at 915-18.
of new standard forms should stop. New forms always will be neces-
sary to keep up with changes in the contracting environment, and
the value of a particular new form is rarely clear at the time it is
promulgated. For example, the LLC seemed to have little value
from the time Wyoming first introduced it in 1977 until the tax
changes thirteen years later. Moreover, even if new forms may
have little value, unsuccessful innovations may not impose substan-
tial costs.167

A potential problem with relying solely on state legislatures to
produce new forms is that they may not have very strong incentives
to innovate. Individual state legislators capture little of the reward
from investing the time and effort necessary for crafting a standard
form and having it enacted, may have many more valuable rent-
seeking opportunities, and risk harm to their reputations from un-
successful or unexpectedly costly statutes.168 Lawyers and bar
groups have done much of the work in innovating standard forms
and stand to earn rewards from capturing reputational benefits of
spearheading legislation and creating increased legal business in
their home states.169 But lawyers have incentives to benefit them-
selves at the expense of contracting parties, face free-rider
problems in proposing legislation, and must make tradeoffs be-
tween the time they spend earning current fees and the time they
invest in legislation. It follows that there is room for a better sys-
tem of producing new private or statutory standard forms. Poss-
sibilities include strengthening currently weak intellectual property
rights for privately generated standard forms.170

167. See William J. Carney, Limited Liability Companies: Origins and Anteced-

168. For discussions of legislators’ incentives to innovate, see Stephen Clowney,
Property in Law, OHIO ST. L.J. (forthcoming); Brian D. Galle & Joseph Kieran Leahy,
Innovation in Decentralized Governments, 57 EMORY L.J. 1301, 1333 (2009); Gillian
Hadfield & Eric Talley, On Public Versus Private Provision of Corporate Law, 22 J. L.
ECON. & ORG. 414, 416-19 (2006); Bruce H. Kobayashi & Larry E. Ribstein, Law as
Byproduct: Theories of Private Law Production 3-5, 13 (Univ. of Cal. eScholarship,
org/uc/item/9mg4g1dn; Susan Rose-Ackerman, Risk Taking and Reelection: Does Fed-

169. See Larry E. Ribstein, Lawyers as Lawmakers: A Theory of Lawyer Licens-

170. See Bruce H. Kobayashi & Larry E. Ribstein, Law’s Information Revolution
25 (Univ. of Ill. College of Law, Working Paper No. LBSS11-03, 2011), forthcoming 53
2. Better Lawyering

Another way to improve closely held firm contracting technology is through better lawyering both in advising on choice of law and form and crafting customized agreements. Some of the stickiness of the close corporation might be due to lawyers’ unwillingness to invest the time in learning about new contracting technologies as long as they can convince clients to stick with existing forms. Moreover, the case law on application and interpretation of LLC agreements indicates significant problems with the state of the drafting art, although the case law obviously is skewed toward problematic agreements. Increasing competition in the legal profession171 may address these lawyering problems and lead to more innovation of legal tools.

3. Private Adjudication

Dissolution remedies so far have been fashioned by public courts. The spread and development of arbitration and other private dispute resolution172 may affect both contracting and adjudication in closely held firms. Parties turning to arbitration may also turn to private forms and rely less on state-provided standard forms. Arbitration also may reduce the amount of case law available, thus reducing the benefits of using publicly provided standard forms.

VI. CONCLUSION

*Wilkes* and similar close corporation cases are products of an earlier time when closely held firms lacked sophisticated and coherent contracting technology and therefore needed significant judicial assistance to fill the significant gaps in their contracts. The corporate tax and constraints on the availability of limited liability forced closely held firms to compromise their various planning objectives. Many firms, like Springside Nursing, ended up trapped in a form that did not suit their needs. Yet just as the Massachusetts Supreme Judicial Court was deciding *Wilkes*, the faraway Wyoming legislature was inventing a solution—a new business form called the limited liability company that has since swept the country. The ending of the age of the close corporation calls for new judicial approaches.


Future developments are likely to have similar effects. Judicial opinions and statutes should fully reflect these changes in the legal environment of closely held firms.