

INVESTOR BEWARE: PROTECTION OF MINORITY STAKEHOLDER INTERESTS IN CLOSELY HELD LIMITED- LIABILITY BUSINESS ORGANIZATIONS: DELAWARE LAW AND ITS ADHERENTS

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I. INTRODUCTION

Majority stakeholders, through the ability to elect the board of directors of a corporation, often deny minority investors any voice in the direction of the enterprise.¹ Compounding this problem, majority shareholders may abuse this capability by advancing their interests to the disadvantage of minority shareholders.²

Justice Cardozo, while Chief Judge of the Court of Appeals of New York, fashioned an unequivocal definition of the duty of one business

1. See F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 1:02 (2d ed. 1997).

2. *Id.* at § 1:03, stating:

The losses which a minority shareholder suffers in a squeeze-out are sometimes catastrophic. He may be deprived of any effective voice in the making of business decisions. Not only that, he may be locked out of the company premises, and majority participants may be able to withhold from him information on the affairs of the business and on policies being adopted or decisions being made. In some states, no affirmative duty is imposed on majority shareholders, or the directors or officers whom they select, to furnish information to minority interests. A shareholder, it is true, has a common law or statutory right to inspect corporate books and records. Often, however, this right is frustrated because those in control of the corporation resort to long drawn-out litigation. They may force him to go to court each time he seeks to see the books.

Quite commonly when a participant invests in a close corporation he expects to work in the business on a full-time basis. He may put practically everything he owns into the business and expect to support himself from the salary he receives as a key employee of the company. Whenever a shareholder is deprived of employment by the corporation (as he frequently is in squeeze plays) he may be in effect deprived of his principal means of livelihood.

A shareholder may also find that his investment in the enterprise has become practically valueless. One of the most commonly used squeeze techniques is to withhold dividends. Even in the absence of the deliberate use of dividend-withholding as a squeeze technique, a close corporation, in order to avoid so-called "double-taxation", usually pays out most of its earnings in the form of salaries rather than as dividends. A dissatisfied shareholder cannot withdraw the funds he has invested, and he cannot find a purchaser for his interest. Seldom can anyone be found who is willing to buy a minority interest in a close corporation, especially if the company is divided by bitter disputes. A minority investor may have all or a substantial part of his capital invested in the company, and yet he cannot regain his capital without the consent of the very people with whom he is at loggerheads.

Id.

partner to another in *Meinhard v. Salmon*.³

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.⁴

In the last decade, Delaware and states that follow its lead in business law have abrogated common law protections for minority investors in close corporations. In *Nixon v. Blackwell*,⁵ the Supreme Court of Delaware held that, absent an election of statutory close corporation status, shareholders in close corporations have no special fiduciary obligations to one another.⁶ This ruling is in direct opposition to the trend in many other states.⁷

Over the last quarter century, many state courts have held that shareholders in close corporations owe one another fiduciary duties typical of partnership relationships.⁸ This judicially advanced rule protects the rights of minority shareholders by granting relief for shareholders who are oppressed by the majority and who are without any remedy under either contract or statute.⁹

Delaware lacks this common law protection for minority investors.¹⁰ Many states use Delaware business association law as a source of guidance.¹¹ Delaware's systematic view of corporate law influences the corporate management decision as to choice of state of incorporation.¹² In a frequently cited article, William Cary argues that Delaware law is adopted by many states as they seek business, jobs and

3. 164 N.E. 545 (N.Y. 1928).

4. *Id.* at 546.

5. 626 A.2d 1366 (Del. 1993).

6. *See id.* at 1380.

7. *See* Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1100 (1999) (stating that this is "one area in which Delaware corporate law is starkly at odds with the rest of the nation.").

8. *See* Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957); Comolli v. Comolli, 246 S.E.2d 278 (Ga. 1978); Smith v. Atlantic Property, Inc. 422 N.E.2d 798 (Mass. App. Ct. 1981); Cressy v. Shannon Continental Corp., 378 N.E.2d 941 (Ind. Ct. App. 1978) (holding that minority as well as majority shareholders may have fiduciary duties when they have power over corporate affairs).

9. *See* James M. Van Vliet, Jr. & Mark D. Snider, *The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap*, 18 N. ILL. U. L. REV. 239, 239 (1998). Minority shareholders are "trapp[ed] [in] a situation that [is] unacceptable to a shareholder who lacks the voting power to force a change and has neither a statutory nor contractual right to relief." *Id.* at 239.

10. *See Nixon*, 626 A.2d at 1380.

11. Ragazzo, *supra* note 7, at 1099.

12. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663 (1974) (contending that "Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards . . . In the management of corporate affairs, state statutory and case law has always been supreme, with federal intrusion limited to the field of securities regulation. Perhaps now is the time to reconsider the federal role").

lucrative franchise fees from manager-incorporators.¹³ Other commentators argue that states follow Delaware corporate law in an effort to maintain certainty in the business environment by incorporating well-established Delaware case law.¹⁴ Commentators disagree whether Delaware is leading a “race to the bottom”¹⁵ or a “race to the top.”¹⁶ Regardless of the debate, most agree that Delaware is victorious in the race.¹⁷ For minority investors in closely held businesses, clearly the outcome of the race is to their detriment.

As a result of the Delaware Supreme Court’s decision in *Nixon*, common law protections for close corporation minority shareholders in Delaware and the states that adhere to its law are no longer available. Shareholders in large publicly traded corporations might well be passive investors, who owe one another no fiduciary duties; however, this model does not fit the partner-like relationships in closely held businesses.

To address this incongruity, this note will 1) explore options to protect minority stakeholders under the Delaware scheme; 2) argue that

13. See Cary, *supra* note 12, at 663-68.

14. See generally Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290-91 (1977) stating:

[T]he competition between states will tend toward optimal legal systems regulating the market for capital; [and] (2) existing state corporation law (except for takeover statutes which are extraterritorial and monopolize a different market) is, in light of economic theory, consistent with what seems an optimal solution . . . An expanded federal role in corporate governance would almost surely be counterproductive. At the federal level, there is no mechanism by which optimal legal rules governing the shareholder-corporation relationship can be determined. One must turn to the proposals put forth by the advocates for further intervention. These, however, are at best academic guesswork, e.g. more power to shareholders, in which investors themselves are palpably disinterested, or at worst, generalized calls for more regulation which do not spell out content in any detail.

15. See Cary, *supra* note 12, at 665-66 (arguing that states have no alternative but to relax regulation to make the state attractive to managers who make the choice of state of formation); see also Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1510 (1992) (stating the competition among states is unattractive to the public interest); Ragazzo, *supra* note 7, at 1100, n.5, stating:

Proponents of the race-to-the-bottom theory argue that, in the absence of federal regulation, states have no choice but to compete with Delaware in relaxing corporate regulations to make their jurisdictions more attractive to managers who make incorporation decisions . . . [and] argue for federal intervention to prevent the worst abuses of the state competition system . . .

Id.

16. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 222, (1991); Ragazzo, *supra* note 7, at 1100, n.6, stating:

Law and Economics scholars argue that market forces require managers to select the jurisdiction of incorporation that maximizes share value by offering the most efficient corporate rules Proponents of this race-to-the-top view argue that Delaware’s dominance in the corporate arena demonstrates that its enabling approach to corporate regulation is the most efficient approach.

Id.

17. See Ragazzo, *supra* note 7, at 1100.

default fiduciary protections are the best solution under any form of closely held business association; and 3) suggest that states could better protect minority investors by making the default corporation status closely held, with the election to opt out of such status.

II. CLOSE CORPORATIONS: DELAWARE AND KANSAS EVOLUTION

In publicly held corporations, investors take a passive role in daily company operations, and possess the option to terminate the investment at any point through sale of their stock in the public markets.¹⁸ Conversely, investors in close corporations are locked into a non-liquid investment and minority investors may be subject to the whims of the controlling shareholders due to an inability to sell the stock.¹⁹

An inherent trait of close corporations is a lack of a ready market for business ownership interests.²⁰ Some business association theorists contend that generally, the close corporation is a general partnership that is incorporated to take advantage of the limited liability shield available in a corporation.²¹ Special close corporation statutes embody the general idea of partnership fiduciary duties in many states; due to lack of knowledge and other factors, however, the majority of close corporations organize under general corporation laws.²² Delaware law

18. See WILLIAM L. CARY & MELVIN A. EISENBERG, *CORPORATIONS, CASES AND MATERIALS* 242 (7th ed. 1995).

19. See *id.* at 389.

20. See Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match Specific Assets and Minority Oppression In Close Corporations*, 24 J. CORP. L. 913, 916 (1999), explaining that:

[T]he close corporation is the functional equivalent of the partnership. . . . The problem with close corporation law . . . is that despite this functional equivalence, shareholders cannot exit their investment as easily as partners who always have the power to trigger a buyout by dissolving the partnership by the express will of any partner at any time. . . . [T]he difficulty of exit is a flaw in the legal structure . . . [A] proposed solution is legislation that provides shareholders of close corporations with the same exit option that partners classically possess.

Id. at 916 (internal quotation marks omitted).

21. See J. A. C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 2-3 (1977) (explaining that because the expectations of the investors in the close corporation are that it will function as a partnership, and be relatively without dissension, that it should function as a partnership, with the same exit options for the minority investor).

22. See Tara J. Wortman, *Unlocking Lock-In; Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1386-95 (1995) (explaining that lawyers counsel clients forming close corporations to use sub-optimal shareholder agreements rather than close corporations statutes, because lawyers are less familiar with the close corporation statutes); *cf.* Nixon v. Blackwell, 626 A.2d 1366, 1380 n.19 (Del. 1993) quoting David A. Drexler, Lewis S. Black, Jr. and A. Gilchrist Sparks, III, *DELAWARE CORPORATION LAW AND PRACTICE*, § 43.01 (1993) stating:

[S]tatutory close corporations have not found particular favor with practitioners. Practitioners have for the most part viewed the complex statutory provisions underlying the purportedly simplified operational procedures for close corporations as legal quicksand of uncertain depth and have adopted the view that the objectives sought by the subchapter are

contains a separate set of statutes, designed to protect investors in eligible close corporations, imposing fiduciary duties among stakeholders.²³

To qualify under Delaware law as a statutory close corporation, the business entity must unequivocally elect such status in its certificate of incorporation, and must also meet certain qualifications: (1) no more than 20 shareholders; (2) transfer restrictions on the shares; and (3) no public offering of the shares.²⁴ The primary attraction of this business form is that the shareholder enjoys the capacity to participate in the management of the business while retaining the safety of limited liability and fiduciary obligations to minority stakeholders.²⁵

State common law also protects minority investors. *Donahue v. Rodd Electrotype Co.*²⁶ is the leading case recognizing the principles of minority shareholder protection by finding a common law close corporation. There, majority shareholders caused the corporation to purchase some of their own shares without offering the same terms to minority shareholders.²⁷ The Massachusetts Supreme Court held that close corporation stockholders owe “partnership-like” fiduciary duties to one another.²⁸ The court characterized a common law close corporation as containing: “(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction, and operations of the corporation.”²⁹ The court defined the duty owed by shareholders to one another in common law close corporations as a fiduciary duty of fair treatment.³⁰

achievable for their clients with considerably less uncertainty by cloaking a conventionally created corporation with the panoply of charter provisions, transfer restrictions, by-laws, stockholders’ agreements, buy-sell arrangements, irrevocable proxies, voting trusts or other contractual mechanisms which were and remain the traditional method for accomplishing the goals sought by the close corporation provisions.

Id.

23. See DEL. CODE ANN. tit. 8, §§ 341-356 (1999).

24. See DEL. CODE ANN. tit. 8, § 342 (1999). Other state codifications of this concept also compel variations of the following: inability to offer shares to the public, inability to transfer shares, limits to number of shareholders, and requirement for election by the shareholders. See Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207 (1980).

25. See DEL. CODE ANN. tit. 8, § 354 (1999) The statute allows contracts “to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholder and the corporation in a manner that would be appropriate only among partners.” *Id.*

26. 328 N.E.2d 505 (Mass. 1975).

27. *Id.*

28. *Id.* at 515. To peruse other cases holding that close corporation shareholders have partnership duties to one another, see *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957); *Comolli v. Comolli*, 246 S.E.2d 278 (Ga. 1978); *Smith v. Atlantic Property, Inc.* 422 N.E.2d 798 (Mass. App. Ct. 1981) (holding that minority as well as majority shareholders may have fiduciary duties when they have power over corporate affairs); *Cressy v. Shannon Continental Corp.*, 378 N.E.2d 941 (Ind. Ct. App. 1978).

29. *Donahue*, 328 N.E.2d, at 511. (holding such participation would make the majority shareholders controlling shareholders).

30. See *id.* at 515 (drawing from *Cardullo v. Landau*, 105 N.E.2d 843 (Mass. 1952) (creating a

Conversely, the Delaware Supreme Court in *Nixon* held that there is no common law close corporation.³¹ The court further stated that it “would be inappropriate judicial legislation for this Court to fashion a special judicially-created rule for minority investors.”³² As an alternative, the court observed that Delaware legislated the ability for shareholders of close corporations to alter their alliance contractually.³³

Investors in close corporations can provide rights to employment, management, dividends, and exit remedies by covenant.³⁴ However, notable limitations exist on the minority investor’s capacity to protect herself contractually. Investors may well find it impossible to plan for all variations of oppression of minority shareholders.³⁵

The formation of closely held business often involves unsophisticated investors; therefore, it is less likely that attorneys will be present to protect the expectations of all investors.³⁶ The reality that only five percent of eligible corporations elect close corporation status highlights the lack of competent legal advice to affirmatively choose this entity and its protections.³⁷

Commentators debate the lack of contractual provisions to protect minority shareholders by analyzing the transaction costs of the contract.³⁸ Most business ventures in formation stages require that all available capital be devoted to the ongoing enterprise, with none left over for the costs of drafting contract provisions for the protection of shareholders.³⁹

Without contractual protections, some state courts enforce an agreement among investors where no contract exists by quasi-

standard of “utmost good faith [and] loyalty”).

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

32. *Id.* at 1380-81.

33. See DEL. CODE ANN. tit. 8, §§ 341-356 (1999). Without this statute, such contracts may be void; see also *McQuade v. Stoneham*, 189 N.E. 234 (N.Y. 1934). The statutes provide for shareholder agreements that limit board powers or allow for board replacement by shareholders. See DEL. CODE ANN. tit. 8, §§ 341-356 (1999).

34. These contractual protections for minority shareholders are detailed in F. HODGE O’NEAL & ROBERT THOMPSON, O’NEAL’S CLOSE CORPORATIONS, chap. 7 (3d ed. 1998) and F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1997).

35. See *Ragazzo*, *supra* note 7, at 1129 n.154 (citing the case of *Davis v. Sheerin*, 754 S.W.2d 375 (Tex. App. 1988), where a finding of oppression was predicated on denial of shareholder status of the minority by the majority).

36. See O’NEAL & THOMPSON, *supra* note 34, § 2.20, at 54 (observing “the widespread reluctance of the participants in small businesses to obtain competent legal advice”) (also noting that “preventative legal advice is inexpensive when compared to the cost of litigation which may result from the failure to seek out competent legal assistance”).

37. See *Ragazzo*, *supra* note 7, at 1130 (citing O’NEAL & THOMPSON, *supra* note 34, § 2.20, at 54) The power to contract for protection of minority shareholders is significantly limited because “[t]he circumstances of potential future oppression cannot always be foreseen at the time of contracting.” *Id.*

38. See EASTERBROOK & FISCHER, *supra* note 16, at 222, 250.

39. See *id.*

contractual theory.⁴⁰ Courts may also fill contract gaps by asking what the parties would have contracted for had they considered the circumstances.⁴¹ However, court-made remedies in Delaware involving business formation are sparse at best.

Since *Nixon*, the Delaware Supreme Court returned to the problem of fiduciary duties among shareholders in close corporations only once, in *Riblet Products Corp. v. Nagy*.⁴² In this case, the court considered whether majority shareholders owed fiduciary duties to a minority shareholder regarding an employment contract breach.⁴³ The court found that express contractual provisions were dispositive of the employee-stockholder's rights, and enforced the remedy against the corporation rather than the majority shareholders.⁴⁴

More than fifty percent of Fortune 500 companies are incorporated in Delaware.⁴⁵ Delaware courts are a persuasive source of corporation law for many states.⁴⁶ The Kansas Court of Appeals, in *Hunt v. Data Management*,⁴⁷ followed Delaware's lead by finding that "[t]he law does not impose a strict fiduciary duty on a shareholder to act in the best interests of the corporation; a shareholder is free to act in his or her own self-interest."⁴⁸ The Court of Appeals also stated that because the Kansas Statute is taken from Delaware, that Delaware law is persuasive.⁴⁹ Similarly, Kansas followed Delaware finding there is no common law close corporation in Kansas, and that to create "protective

40. See Ragazzo, *supra* note 7, at 1106 n.39 for an exploration of quasi-contractual theory in duties owed by majority shareholders to minority shareholders.

41. See EASTERBROOK & FISCHER, *supra* note 16, at 222, 250. "The right inquiry is what the parties would have contracted for had transaction costs been nil." *Id.*

It makes sense . . . to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgement rule. The same approach could be used with salary, dividend and employment decisions in closely held corporations where the risks of conflicts of interest are greater.

Id. at 245.

42. 683 A.2d 37 (Del. 1996).

43. See *id.*

44. *Id.* at 40.

45. See R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* at F-1 (3d ed. 1998).

46. See *Kamen v. Kemper Fin. Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990); see also *Peller*, 911 F.2d at 1536 (affirming district court's "assum[ption] that Georgia would follow Delaware case law"); *Landy v. Amsterdam*, 815 F.2d 925, 929 (3d Cir. 1987) ("finding no Pennsylvania case in point, the district court predicted that Pennsylvania would follow the law of Delaware"); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) (finding that "Indiana takes its cues in matter of corporation law from the Delaware courts"); *Shoen v. AMERCO*, 885 F. Supp. 1332, 1341 n.20 (D. Nev. 1994) ("[o]n questions of corporation law, the Delaware Supreme Court and the Delaware Court of Chancery are persuasive authorities"); *Washington Bancorporation v. Said*, 812 F. Supp. 1256, 1265 (D.D.C. 1993) (finding that where governing law is not helpful, courts "turn to general principles of corporation law, particularly those decisions rendered in Delaware").

47. 985 P.2d 730 (Kan. Ct. App. 1999).

48. *Id.* at 731 (note that the court syllabus in Kansas is by the Court and authoritative).

49. See *id.* at 733 (citing *Achey v. Linn County Bank*, 931 P.2d 16 (1997)).

rules” for minority shareholders where a legislative remedy exists in close corporation statutes would be “inappropriate judicial legislation.”⁵⁰

Persuasive arguments exist that Delaware should, and may yet reverse course and find minimum fiduciary duties among shareholders in non-statutory close corporations.⁵¹ Default fiduciary protections would alleviate minority shareholder oppression when the parties fail to address the issue by contract. However, given the current trend in Delaware and states that are guided by its law, selection of statutory close corporation status or specific contract provisions constitute the only methods for protection of minority stakeholders.

III. FIDUCIARY DUTIES IN CORPORATIONS

A better understanding of proposed default fiduciary protections for minority stakeholders can be garnered by examination of existing corporation fiduciary duties. Although shareholders in Delaware corporations owe no fiduciary duty to one another, the organization’s corporate directors owe these duties to shareholders and the corporations for which they work.⁵² Included in these fiduciary responsibilities are duties of care and loyalty.⁵³ These concepts are codified into a comprehensive common law standard of performance for corporate directors.⁵⁴ The law of the state of incorporation governs the relationship between the directors and shareholders, and among shareholders.⁵⁵

The business judgment rule encompasses corporation fiduciary requirements for corporate directors in Delaware by outlining the duties

50. *Id.* at 731.

51. For an excellent treatment of this subject, see generally Ragazzo, *supra* note 7, at 1150-51 which suggests that:

If the Delaware courts do not develop special categories of duties to protect minority shareholders in closely held corporations, the Delaware entire fairness test may come to provide similar protection. Despite its general enabling philosophy, the Delaware courts have vigorously employed the entire fairness test to defend minority rights in self-dealing cases. In this regard, the depiction of Delaware as a jurisdiction that favors managerial flexibility over the rights of individual shareholders is something of a caricature . . . There is room for hope that Delaware has as much to learn from the nation as the nation has learned from Delaware.

52. See *Arnold v. Society for Sav. Bancorp, Inc.*, 678 A.2d 533, 539 (Del. 1996) (stating that directors may be liable for breach of fiduciary disclosure duty, but the corporation itself may not be held directly liable).

53. See *Corporate Director’s Guidebook*, 49 BUS. LAW. 1243, 1252 (1994).

54. REVISED MODEL BUSINESS CORPORATION ACT ANNOTATED, § 8.30(a) which states: “Each member of the board of directors, when discharging the duties of a director, shall act; (1) in good faith, and (2) in a manner the director reasonably believes in the best interests of the corporation.”

55. See, e.g., *Atherton v. Federal Deposit Ins. Corp.*, 117 S. Ct. 666, 673 (1997); *Kamen v. Kemper Fin. Servs., Inc.* 500 U.S. 90, 108-09 & n.10 (1991); *Draper v. Paul N. Gardner Defined Plan Trust*, 625 A.2d 859, 864-68 (Del. 1993); *McDermott Inc. v. Lewis*, 531 A.2d 206, 215-19 (Del. 1987).

owed to the corporation. The rule is a standard of judicial review, not a rule by which to measure fiduciary conduct.⁵⁶ The standard contains a presumption that directors' decisions are made with adequate information and a good faith belief that such decisions are in the best interests of the corporation. An action against the directors by a shareholder individually, or on behalf of the corporation derivatively, must rebut this presumption.⁵⁷ If the shareholder fails to rebut this, the court will not examine the merits of the underlying corporate decision under the business judgment rule.⁵⁸

The business judgment rule also contains the duties of care and loyalty. The duty of care obligates directors to exercise the care that a person in a like position would exercise under comparable circumstances.⁵⁹ The duty of loyalty is much broader than the duty of care. A thorough analysis of director loyalty examines three issues: interested director transactions; usurpation of corporate opportunities, and compensation.

At common law, courts could void a director's financial transactions with the corporation even if found fair and approved by disinterested directors.⁶⁰ In modern law, however, corporate business transactions with interested directors are not automatically voidable.⁶¹ The drafters of the Model Business Corporation Act⁶² reason that many insider transactions benefit the organization and its shareholders, and therefore, should not be automatically void.⁶³

56. See *Moran v. Household Int'l Inc.*, 490 A.2d 1059, 1076 (Del Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

57. See *Federal Deposit Ins. Corp. v. Benson*, 867 F. Supp. 512, 521 (S.D. Tex. 1994); *Federal Deposit Ins. Corp. v. Brown*, 812 F. Supp. 722, 724 n.2 (S.D. Tex. 1992).

58. See *Federal Deposit Ins. Corp. v. Stahl*, 89 F.3d 1510, 1517 (11th Cir. 1996).

59. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (to appraise a director's conformity with the duty of care responsibility, "the business judgment rule, 'bars judicial inquiry into actions taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes'").

60. See *Munson v. Syracuse, Geneva & Corning R.R. Co.*, 8 N.E. 355, 358 (1886) (invalidating any contract that is made by a corporate fiduciary in which she has a personal stake); *cf. Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991).

61. See *Oberly v. Kirby*, 592 A.2d at 467 (noting that Delaware law allows certain dealings between the corporation and directors). "As long as a given transaction is fair to the corporation, and no confidential relationship betrayed, it may not matter that certain corporate officers will profit as the result of it." *Id.* The court finds that transactions which are approved by "some neutral decision-making body" will withstand attack. *Id.*

62. MODEL BUS. CORP. ACT ANNOTATED AND OFFICIAL COMMENT (3d ed. 1996).

63. MODEL BUS. CORP. ACT ANNOTATED §§ 8.60-8.63 (3d ed. 1996) explains that:

[T]he essential character of interest conflict is often, unfortunately, misunderstood by the public and the media (and sometimes misunderstood, too, by lawyers and judges). Interest conflicts can and often do lead to baneful acts. The law regulates interest conflict transactions because experience shows that people often yield to the temptation to advance their self-interests and, if they do, other people may be injured. That contingent fear is sufficient reason to warrant caution and to apply special standards and procedures to interest conflict transactions.

Nonetheless, it is important to keep firmly in mind that it is a contingent risk we are dealing with—that an interest conflict is not in itself a crime or a tort or necessarily injurious

Similarly, "corporate opportunity" analysis examines whether the director breached her fiduciary duty of loyalty to the corporation by taking a corporate opportunity for her own benefit. In 1939, a "corporate opportunity" was defined by the Delaware Supreme Court, in *Guth v. Loft, Inc.*⁶⁴ An opportunity that becomes known to the director, fits the corporation's business, falls within the capabilities of the corporation, and which the corporate officer takes for herself is a corporate opportunity.⁶⁵ In modernity, the Delaware Supreme Court zealously follows *Guth*.⁶⁶ Recently, in *Broz v. Cellular Information Systems, Inc.*,⁶⁷ the court stated that the corporate officer could not take the opportunity as his own because "the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation."⁶⁸

Compensation of the officer is another corporate transaction scrutinized under the duty of loyalty analysis. Large corporate compensation packages for officers received attention by the media in recent years.⁶⁹ Most state statutes provide that corporate officer salaries are to be fixed by authority of disinterested directors.⁷⁰ Courts state that such compensation must be "reasonable."⁷¹ Reasonableness, in this context, is held to incorporate many factors, including officer competence, deductibility of the compensation under the Internal Revenue Code, a tie to corporation prosperity, and comparable salaries in like positions.⁷²

IV. TAXATION CONSIDERATIONS OF BUSINESS FORMATION

Critically important to minority investor protection is the choice of business organization. Selection of the business form is often driven by

to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of"; it is simply a state of affairs. Indeed, in many situations, the corporation and the shareholders may secure major benefits from a transaction despite the presence of a director's conflicting interest.

64. 5 A.2d 503, 511 (Del. 1939).

65. *See id.*

66. *See* *Yiannatsis v. Stephanis*, 653 A.2d 275 (Del. 1995); *Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980); *Kaplan v. Fenton*, 278 A.2d 834, 834 (Del. 1971); *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966); *Johnston v. Greene*, 121 A.2d 919, 919 (Del. 1956).

67. 673 A.2d 148 (Del. 1996).

68. *Id.* at 155.

69. *See* Byrne, *For a So-So CEO, \$95 Million in Cash*, BUS. WK., Oct. 20, 1997, at 40.

70. *See* DEL. GEN. CORP. LAW § 141(h); 2 MODEL BUS. CORP. ACT ANNOTATED, § 8.11 (3d ed. 1996).

71. *Rogers v. Hill*, 289 U.S. 582, 591 (1933) (finding that the compensation was not unreasonable, but noting that if the "payment has no relation to the value of services for which it is given, it is in reality a gift in part, and the majority stockholders have no power to give away corporate property"); *see also* *Blish v. Thompson Automatic Arms Corp.*, 64 A.2d 581, 605-06 (Del. 1948) (finding that compensation of director who had control of the Board of Directors was so great that it "constituted spoilage and waste of corporate funds").

72. *See* *Wilderman v. Wilderman*, 315 A.2d 610, 615 (Del. Ch. 1974) (stating that courts hesitate to examine the reasonableness of recompense when set by an impartial Board of Directors, but apply a more stringent inquiry when compensation is fixed by the recipient).

tax consequences rather than consideration of fiduciary protections available for minority investors. In recent times, the number and diversity of limited liability business organizations available grew as legislatures added new forms. The major catalyst for choosing a new form of limited liability entity is that it offers superior tax benefits over the double taxation ingrained in the corporate form.⁷³

The principal distinction between partnership and corporation taxation schemes is that partners pay one tax on partnership income while corporation investors ultimately incur two taxes on their investment. Corporations, other than subchapter S corporations,⁷⁴ incur a double tax by a levy on corporate income, followed by a tax on distributions to shareholders.⁷⁵ Conversely, partnerships do not pay federal income tax at the entity level, and taxation on income occurs at a pass-through level by taxation of the partner individually.⁷⁶ Partnership liabilities effectively increase a partner's basis, the baseline from which gain is calculated, in her partnership interest.⁷⁷ An increased basis decreases the amount of gain partners must recognize in distributions and the partnership taxation scheme allows recognition of losses to the extent of partnership basis.⁷⁸

Prior to the "check-the-box regulations," the Internal Revenue Service classified business organizations as either partnerships or "associations," with associations garnering corporation double taxation.⁷⁹ The Ninth Circuit, in *United States v. Kintner*,⁸⁰ classified as an association for tax purposes an unincorporated business organization "if it had more corporate than non-corporate characteristics."⁸¹ The IRS developed four criteria to determine whether an organization met the corporate or non-corporate taxation standards.⁸² These elements were whether the firm had: (1) continuity of life; (2) free transferability of shares; (3) centralized management; and (4) limited liability.⁸³ The IRS classified a firm that exhibited over two of these elements as an association, with corporate double taxation for federal income tax

73. See REV. PROC. 95-10 (establishing elements in which the Internal Revenue Service will grant an LLC partnership tax status).

74. See *id.*

75. See I.R.C. §§ 301-85 (1999).

76. See I.R.C. § 61(a) (7), §§ 701-61 (1999); see also WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, §§ 9.01-9.06 (2d ed. 1990).

77. See I.R.C. § 752(a) (1998); Treas. Reg. §§ 1.752-1, -2, -3 (1991); see also I.R.C §§ 752(b), 722, 733(1), 705(a) (2) (1998).

78. See I.R.C. § 731(a) (1), § 704(d) (1999).

79. See I.R.C. § 7701(a) (2), (3) (1999).

80. 216 F.2d 418 (9th Cir. 1954).

81. *Id.* at 428; see also Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 424 (1992); Treas. Reg. § 301.7701-2(a) (1) (as amended in 1993).

82. See Treas. Reg. § 301.7701-2 (a-e) (as amended in 1993).

83. See *id.*

purposes.⁸⁴

These former IRS regulations inspired state legislatures to enact statutes creating new forms of business entities with the limited liability characteristics of incorporation, yet retaining partnership tax advantages.⁸⁵ Before these statutes were enacted, however, business formation attorneys drafted business agreements that deliberately failed two of the four elements in the *Kintner* regulations in order to achieve partnership taxation status.⁸⁶

Recently, with the new check-the-box tax classification scheme, the IRS allows most unincorporated businesses that are not publicly traded to elect partnership-type pass through taxation.⁸⁷ These new tax regulations neutralize the rationale for the multiplicity of limited liability forms now available.⁸⁸

Check-the-box regulations, containing a simplified format that allows unincorporated entities to choose the entity's tax classification as either an association or partnership, replaced the *Kintner* regulations.⁸⁹ In establishing these new requirements, the Treasury removed the complex *Kintner* test and substituted an understandable form to file with the Internal Revenue Service.⁹⁰ These regulations, combined with state Limited Liability Company (LLC) and Limited Liability Partnership (LLP) statutes enacted in the 1990's, enable unincorporated businesses to enjoy pass through single taxation and limited liability.

Some commentators cite this tax code simplification when proposing a simpler business framework for limited liability entities.⁹¹ Others take an opposite vantage point, stating that this view focuses too narrowly on tax considerations, overlooking the benefits of appropriate default rules to protect minority investors that plug gaps in contract and

84. *See id.*

85. *See* Keatinge et al., *supra* note 80, at 423-30 (detailing the numerous attempts by states to create LLCs that would meet the tests and achieve pass through taxation status).

86. *See* Tassma A. Powers & Deby L. Forry, Comment, *Partnership Taxation & The Limited Liability Company: Check out the Check-the-Box Entity Classification*, 32 LAND & WATER L. REV. 831, 847-48 (1997) (stating that "[p]rior to the check-the-box regulations, articles of organizations and operating agreements were strategically drafted to intentionally avoid being classified as associations. An inordinate amount of time, energy, and resources were used in attempting to draft articles of organization which lacked two of the four corporate resemblance factors"); *see also* ROBERT L. WHITMIRE ET AL. FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS: STRUCTURING AND DRAFTING AGREEMENTS, §§ 2.01-2.04 (2d ed. 1996).

87. *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 409 n.2 (1999) (citing Treas. Reg. §§ 301.7701-1, -2, -33 (1998) ("providing that a domestic eligible entity including a business firm other than a corporation, joint stock company, insurance company or bank, is not treated as a corporation for income tax purposes unless it elects this treatment").

88. *See id.*

89. *See* Treas. Reg. § 301.7701-3 (1998).

90. *See* Treas. Reg. § 301.7701-3(c) (1998).

91. *See id.*; *see also* David M. Deaton, *Check-the-Box: An Opportunity for States to Take Another Look at Business Formation*, 52 S.M.U. L. REV. 1741, 1744 n.20 (1999) (arguing that the check-the-box taxation standards obviate the need for the myriad of limited liability business forms, and proposing that only the general partnership, the LLC, and the corporation are needed in the new tax environment).

statute.⁹² One analyst advocates the creation of a pure contractual entity, finding that the very minimal default fiduciary duties in a LLC too cumbersome.⁹³

A primary principle of business organization law is that controlling owners of non-incorporated firms are vicariously liable for firm debts.⁹⁴ The new LLC and LLP statutes, combined with check-the-box tax election, allow controlling owners to enjoy liability limited to the extent of their investment without incurring corporate double taxation, or the limits of Subchapter S incorporations.⁹⁵ The major difficulty, however, is that the new Delaware statutes, and statutes in those states that follow Delaware law, rely heavily on contractarian principles and fail to adequately protect many investors in closely held businesses.

V. PROTECTION OF MINORITY STAKEHOLDERS IN LLCs

Delaware LLCs offer minority investors limited liability, but very minimum fiduciary protections other than those provided for by contract.⁹⁶ The creation of new business forms such as the LLC and LLP is propelled by the conviction that the corporate income tax is unfair, and that limited liability should be accessible to businesses without double taxation.⁹⁷ Members of an LLC may exert control over the

92. See Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence From LLCs*, 73 WASH. U. L.Q., 369, 377-84 (1995) (stating there is other rationale for the multiple choices of business entity other than taxation, including coherent terminology, gap-filling, the combination of baseline rules and contract flexibility, and efficiency considerations).

93. See generally Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 409, 450 (1999) (advocating pure freedom to contract in a new entity so investors in economic associations do not "face the Scylla-and-Charybdis choice of either accepting a risk of vicarious liability or subjecting themselves to the inappropriate default rules of a business association statute that is designed for completely different settings").

94. See e.g. UNIF. PARTNERSHIP ACT § 15 (1914) (providing that partners are jointly liable for partnership obligations); REV. UNIF. PARTNERSHIP ACT § 306(a) (1997) (providing that partners are jointly and severally responsible for partnership obligations).

95. I.R.C. § 1361 (1999) provides partnership pass through taxation for entities that:

S corporation defined

In general-For purposes of this title, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

(b) Small business corporation.-

In general.-For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an eligible corporation and which does not-

have more than 75 shareholders,

have as a shareholder a person (other than an estate, a trust described in subsection (c) (2),

or an organization described in subsection (c) (6) who is not an individual,

have a non resident alien as a shareholder, and

have more than 1 class of stock.

96. See DEL. CODE ANN, TIT. 6 § 18-1101 (1999).

97. See Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 881 (1995) (stating that some reformers advocate limited liability because they perceive tort litigation as unchecked and that they discern that the double taxation inherent in the corporate form is unsound policy).

business, avoid personal liability, and may elect partnership type taxation for the business.⁹⁸ The LLC form allows the utmost flexibility in business formation through its adherence to freedom to contract principles.⁹⁹

Delaware LLC law, rooted in the contractarian form of business association, allows investors the freedom to arrange their affairs by contract in most any manner they choose.¹⁰⁰ Within their identical LLC acts, Delaware and Kansas endeavor to devise a business form that is very simple to create, is totally an entity of contract, and has minimum residual fiduciary duties.¹⁰¹

Indeed, the statutes enacted by these two states allow maximum freedom to contract around fiduciary duties in LLC operating agreements, while implicitly warning the courts not to void express contract provisions.¹⁰² These statutory provisions allow the operating agreement, the primary LLC contract, to nearly waive fiduciary duties completely.¹⁰³ Delaware's deliberate omission of default fiduciary duties

98. See LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES, §§ 1.04, 3.05, at 1-6 (1996); see also Claire Moore Dickerson, *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 417, 426 (1995); Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 476 (1994); Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21, 36 (1994).

99. See DEL. CODE ANN. tit. 6 § 18-1101 (1994).

100. See Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135, 146-65 n.133, 174-75 (1995) (stating that Delaware's LLC statute is a clearly different approach than the RUPA-based Uniform Limited Liability Company Act and has a noted dearth of default rules and highlights the freedom of the parties to create their own contract).

101. David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 459 n.167 (1998) (explaining that a number of states, including Delaware (and Kansas in its almost identical LLC statute) have created a business organization that is purely one of contract, with no compulsory or residual fiduciary duties).

102. See DEL. CODE ANN. Tit. 6, § 18-1101 (1999); KAN. STAT. ANN. § 17-76,134(b) (1999).

The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager:

Any such member or manager or other person acting under an operating agreement shall not be liable to the limited liability company or to any such other member or manager for the member's or manager's or other person's good faith reliance on the provisions of the operating agreement; and

The member's or manager's or other person's duties and liabilities may be expanded or restricted by provisions in an operating agreement.

DEL. CODE ANN. Tit. 6, § 18-1101; see also KAN. STAT. ANN. § 17-76, 134 (the Kansas Statute has minor wording variations, such as referring to "chapter" as "act.>").

103. Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 21 (1995) (finding this expansion of contractual freedom exciting, and also noting that LLC "members

diverges from the promulgated Uniform Limited Liability Company Act which attempts to include default fiduciary duties that cannot be waived by contract.¹⁰⁴

One such duty, the fiduciary duty of loyalty, has been defined and modified by the courts over many decades.¹⁰⁵ Now, Delaware and Kansas allow parties to the operating agreement to define the nature of the duty of loyalty by contract. However, both states stop short of disallowing the total elimination of the duty by contract.¹⁰⁶ It is inconsistent to require the duty of loyalty not be waived, but then to allow the parties to define the loyalty itself in the operating agreement. If it is required as a default rule for protection of investors, it makes no sense to allow for its waiver through a narrow definition of the duty.

This incongruity allows courts to find the operating agreement contract controls, or alternately to find a residual fiduciary duty of loyalty beyond the contract.¹⁰⁷ Similarly, this ambiguity could cause the courts to devise a whole new scheme illuminating the LLC duty of loyalty.¹⁰⁸

Commentators argue that default fiduciary duties “level the playing field” among parties to the operating agreement contract who may lack bargaining leverage or information.¹⁰⁹ Without baseline fiduciary duties, the controlling shareholders can inequitably allocate wealth within the enterprise.¹¹⁰ One alternative view advocates the ability to completely waive fiduciary duties on a free-market theoretical basis, with the default consisting only of a member duty of good faith to other members.¹¹¹

The crucial issue is whether the state will truly allow for maximum

can waive default [fiduciary] duties by a provision in their operating agreements”); *see also* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 570-94 (1997) (stating that non-waivable fiduciary duties are lacking in efficiency and that “fiduciary duties should be broadly waivable in partnerships and other unincorporated firms”).

104. *See* UNIF. LIMITED LIABILITY CO. ACT, 6A U.L.A. 429 (1996).

105. *See* Cohen, *supra* note 100, at 493 n.191 (1998) (citing *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939); *Lincoln Stores v. Grant*, 34 N.E.2d 704 (Mass. 1941); *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928); *Globe Woolen Co. v. Utica Gas & Elec.*, 121 N.E. 378 (N.Y. 1918)).

106. *See* Cohen, *supra* note 100 at 462 n.192.

107. *See id.* at 462, 463 n.191, n.192 (stating that “the duty of loyalty, difficult to explain precisely, has been previously defined through expensive litigation. Now states are permitting the parties to agree by contract to the meaning of the duty, but are not allowing the elimination of that duty. This seems contradictory”). Cohen further explains that because states do not rely on the contractual process enough to completely do away with the duty of loyalty, it will induce more litigation to determine the parameters of the LLC operating contract. *See id.*

108. *See id.*

109. *See generally id.*

110. *See id.* at 493 n.194 (citing Stephen C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43, 62 (1994)).

111. *See* Ribstein, *supra* note 102, at 21-22 (stating that the ideal LLC statute will allow comprehensive ability for members to waive any provision of the act, including fiduciary duties). “[T]he vague statutory limitations on the members’ power to waive fiduciary duties are perverse because they leave in doubt the validity of many types of contracts.” *Id.*

contractual freedom or will impose some paternalistic duty to protect people from a poorly struck bargain. Recently, in a case of first impression, *Elf v. Jaffari*,¹¹² the Delaware Supreme Court considered whether a choice of forum clause in a Delaware LLC operating agreement may strip the Delaware Chancery Court of jurisdiction. The court held that the operating agreement contract controlled the choice of jurisdiction, even though the Delaware LLC Act itself gave jurisdiction to the Chancery Court.¹¹³

Due to the Delaware Legislature's construction of the LLC Act as one which allows the maximum freedom to contract, and the finding of the court in *Elf v. Jaffari*, default protections for minority stakeholders are virtually nonexistent under the Delaware LLC scheme.¹¹⁴ Given the lack of minimal fiduciary duty protections under Delaware law, perhaps the protection for minority investors can only be found in contract law.

Delaware's ringing ratification of freedom to contract principles in its LLC act highlights the contract law tension between private ordering and equity.¹¹⁵ A time-honored touchstone of contract law is the freedom to arrange one's affairs by contractual provisions.¹¹⁶ The courts will enforce the contractual bargain lacking proof of duress, fraud, or some similar rationale for questioning the consent of the contracting parties.¹¹⁷ Judicial intervention is nonetheless justified when the requirements of good faith or those of fair dealing are circumvented.¹¹⁸ One method of judicial reordering of private contracts is through the doctrine of unconscionability.¹¹⁹

112. 727 A.2d 286 (Del. 1999).

113. See *id.* at 294-95 (holding that the policy of the LLC act is to encourage maximum ability of the parties to shape their business organization by contract). Inclusion of a clause in operating agreement that required disputes to be arbitrated in California validated. See *id.*

114. *Id.* (finding that "the policy of the [LLC] Act is to give the maximum effect to the principle of freedom of contract and to the enforceability of LLC agreements . . .").

115. See generally Tamara Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1209-10 (1995) (exploring the "contractarian" viewpoint versus the position of those who advocate default fiduciary duty rules). Contemporary legal scholarship has reclassified fiduciary duties as contractual in nature. Indeed, they define the business organization itself as a bundle of contracts, and changing the analysis from one involving fiduciary duties to one of contract. See *id.* This new analysis flips established default rules on their heads. See *id.*

116. See Kathleen D. Fuentes, *Limited Liability Companies and Opting-Out of Liability: A New Standard for Fiduciary Duties?*, 27 SETON HALL L. REV. 1023, 1056 n.232-33 (1997) (citing J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, LAW & CONTEMP. PROBS., (Spring 1995), at 38) (stating that "[t]he bargain principle is a core value . . . recogniz[ing] that entering into a contract is a serious matter and that a contract between the parties is to be respected and enforced by the courts, subject to widely accepted limitations that subvert the bargaining process, such as fraud and duress").

117. See Hynes, *supra* note 115, at 38.

118. See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. A (1981) (outlining that good faith incorporates "faithfulness to a common purpose and consistency with the justified expectations of the other party" and that bad faith dealings are excluded because of violations of "community standards of decency, fairness or reasonableness").

119. See U.C.C. § 2-302, 1A U.L.A. 15-16 (1989). Section 2-302 reads in pertinent part:

If the court as a matter of law finds the contract or any clause of the contract to have been

The unconscionability doctrine¹²⁰ provides courts with a device to reorder oppressive operating agreements in order to bring unsophisticated parties or those lacking bargaining power to an equal footing with the perceived oppressors.¹²¹ Some commentators, seeking to assuage the fears of advocates of compulsory fiduciary duties, cite this judicial mechanism as a panacea.¹²² However, courts may hesitate to apply unconscionability principles to an investor who is sophisticated enough to become a member of an LLC, but may fail to contract for unforeseen contingencies.

Clearly, Delaware law provides no certain default protections for minority stakeholders in non-statutory close corporations and LLCs absent the general requirement that stakeholders deal fairly with one another. Investors may, therefore, look to Limited Liability Partnerships to provide the proper mix of single taxation, limited liability, control, and default baseline fiduciary duties between investors.

VI. LLP MINORITY INVESTOR PROTECTIONS

The LLP may better protect the expectations of investors who lack the financial capability to engage the services of an attorney to protect them by contract.¹²³ Many newly-formed businesses consist of a small number of investors, the majority of whom are actively engaged in managing the enterprise, with a limited quantity of cash to invest.¹²⁴ Participants incapable of a capital contribution may alternately commit

unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

U.C.C. § 2-302, 1A U.L.A. 15-16 (1989). *See also* James J. White and Robert S. Summers, Uniform Commercial Code § 4-3, at 137 (4th ed. 1995) (instructing that two measures of unconscionability are viewed as “procedural” and “substantive.”). A contract is procedurally unconscionable when there is a defect in the formation such as disparity of bargaining power or lack of meaningful choice such as in a contract of adhesion. *See id.* A contract is substantively unconscionable when material terms of the contract are skewed towards one party or are oppressive. *See id.*

120. *See id.*

121. *See* Jones Distrib. Co. v. White Sonsol. Indus., Inc., 943 F. Supp. 1445, 1460 (N.D. Iowa 1996) (stating unconscionability is a question of law for the judge); *see also* Potomac Plaza Terraces, Inc. v. QSC Prods., Inc., 868 F. Supp. 346, 353 (D.D.C. 1994); Sosa v. Paulos, 924 P.2d 357, 360 (Utah 1996).

122. *See* Fuentes, *supra* note 115, at 1065 n.273 (citing Williams v. Walker-Thomas Furniture Co., 350 F.3d 445-49 (D.C. Cir. 1965)). “The Williams court noted that courts generally view unconscionability as including an absence of meaningful choice by one party and terms unreasonably favorable to the other. . . . The court further explained that “meaningful choice can be overcome by a gross inequality of the parties’ bargaining power.” *Id.* at 1063.

123. *See* Fallany O. Stover, *The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice*, Q287 ALI-ABA 173, 184, 209 (1999) (stating that “[u]n sophisticated businesses that cannot afford the transaction costs of completing an elaborate operating agreement or have not even considered entering into a written agreement at all will almost always be better off choosing the LLP”).

124. *See id.* at 209.

services to the new business.¹²⁵

Investors in such minority positions often find that the default rules of corporation law cause serious difficulties with oppression by the majority.¹²⁶ Limited Liability Partnerships, however, allow such minority investors the freedom to couple partnership fiduciary protections with limited liability.¹²⁷

The LLP form is a blend of corporate and partnership structure.¹²⁸ Texas was the first state to establish an LLP statute in 1991,¹²⁹ and designed its LLP legislation to allow partnerships some measure of protection against partner personal liability, both in professional and non-professional firms.¹³⁰ A short time after the enactment, the IRS ruled that LLPs would receive partnership pass through taxation status.¹³¹ Delaware was the third state to enact a LLP statute in 1993, again showing its leadership in the business arena.¹³² This form of business entity swept the nation, with only Vermont now lacking a LLP statute.¹³³

Other events also increased the popularity of the LLP. In the wake of the savings and loan fiasco in the 1980s, many law and accounting partnerships faced huge liabilities resulting from legal actions by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation.¹³⁴ Basic partnership law holds partners personally liable for any debt that outstrips firm assets.¹³⁵

125. See *id.*

126. See generally Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation from Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 ALA L. REV. 909, 924-28 (detailing such problems as the lack of ability to sell minority position shares, the ability of the majority to elect the board and thus designate the officers, and the ability of the majority to withhold dividends, while paying themselves salaries); see also Stover, *supra* note 122, at 199 n.65.

127. See Stover, *supra* note 122, at 209-10 (stating that unsophisticated parties entering into a business often lack the financial resources to fashion a complex operating agreement of an LLC, and so will improve their positions by choosing the LLP).

128. See Carol R. Goforth, *Limiting the Liability of General Partners in LLPs: An Analysis of Statutory Alternatives*, 75 OR. L. REV. 1139, 1150 (1996) (stating that LLPs, like LLCs, obfuscate the differentiation between traditional partnerships and the corporate form).

129. See 1991 TEX. GEN. LAWS 901, § 84.

130. See Ronald E. Mallen, *Ethics/Malpractice Issues: The Professional and Ethical Issues Facing the Attorney-Employee*, in THE BEST ENTITY FOR DOING THE DEAL, at 995 (PLI CORP. LAW & PRACTICE COURSE HANDBOOK Series No. B-937, 1996).

131. See Priv. Ltr. Rul. 92-29-016 (Apr. 16, 1992).

132. See Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1067 (1995) (stating that "[a] basic principle of general partnership law is that each individual partner is personally liable for all partnership obligations to the extent they exceed the assets of the partnership." However under the LLP concept, partners have no liability for claims emerging from conduct in which they lacked personal entanglements); Mallen, *supra* note 132 at 995.

133. See VT. STAT. ANN tit. 11, § 1207 (Supp. 1997).

134. See Joseph S. Naylor, *Is the Limited Liability Partnership Now the Entity of Choice for Delaware Law Firms?*, 24 DEL. J. CORP. L. 145, 152 (1999) (explaining that many lawsuits were brought against accountants and lawyers of insolvent savings and loans and banks. Many prestigious Texas law and accounting firms faced insolvency themselves after huge litigation losses surrounding the collapse of many financial institutions).

135. See *e.g.*, UNIF. PARTNERSHIP ACT § 7, 6 U.L.A. 125 (1995); see also REVISED UNIF.

The LLP shares certain characteristics with the LLC, such as pass through taxation, elements of control, and a certain amount of limited liability.¹³⁶ The main advantage of choosing the LLP form over the LLC, however, is that the LLP is controlled by a well-developed system of partnership law.¹³⁷ Partners in a LLP are generally subject to the identical rights and obligations that exist in partnership law, but escape personal liability for negligence or other wrongdoing where the partner is not directly involved as a participant or supervisor.¹³⁸ While the LLC provides a greater liability protection for supervisors than the LLP, a concomitant tradeoff is reduced fiduciary duty protection for investors in the LLC.

Forming a Delaware LLP is a straightforward procedure; it requires applicants to register with the Office of Secretary of State, and requires that the partnership name provides notice of the liability status by including the words "Registered Limited Liability Company," or its abbreviation, "L.L.C."¹³⁹ Additionally, the Delaware LLP statute requires a minimum insurance obligation.¹⁴⁰ The statute requires the

PARTNERSHIP ACT (1997) (which preserves this standard); DEL. CODE ANN. TIT. 6, § 1513-15 (1999).

136. See Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 BUS. LAW. 85, 106-07 (1995) (explaining that "LLPs are relatively new entities that combine the features of a general partnership with limited liability," however, "LLP partners remain liable for their own negligent or wrongful acts . . .," and in most states, are liable for the wrongdoing of those under their supervision).

137. See Naylor, *supra* note 130, at 155, (stating that the LLP offers a package of limited liability and general partnership fiduciary duties).

138. See DEL. CODE ANN. tit. 6, § 1515 (1999). which states in pertinent part:

(b) Subject to subsection (c) of this section, a partner in a registered limited liability partnership is not liable, either directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for any debt, obligation or other liability of or chargeable to the partnership or another partner or partners, whether arising in contract, tort or otherwise, while the partnership is a registered limited liability partnership.

(c) Subsection (b) of this section shall not affect the liability of a partner in a registered limited liability partnership for the partner's own negligence, wrongful acts or misconduct or that of any person under his direct supervision and control.

139. DEL. CODE ANN. tit. 6, § 1545 (Supp. 1998).

140. See Del. CODE ANN. tit. 6, § 1546(a-d) (Supp. 1998) provides in pertinent part:

A registered limited liability partnership shall carry at least \$1,000,000 of liability insurance of a kind that is designed to cover the kinds of negligence, wrongful acts, and misconduct for which liability is limited by § 1515 (b) of this title and which insures the partnership and its partners.

If, in any proceeding, compliance by a partnership with the requirements of subsection (a) of this subsection is disputed, the issue shall be determined by the court, and the burden of proof of compliance shall be on the person who claims the limitation of liability under s 1515 (b) of this title.

If a registered limited liability partnership is in compliance with the requirements of subsection (a) of this section, the requirements of this section shall not be admissible or in any way be made known to a jury in determining an issue of liability for or extent of the debt or obligation or damages in question.

A registered limited liability partnership is considered to be in compliance with subsection (a) of this section if the partnership provides \$1,000,000 of funds specifically designated and segregated for the satisfaction of judgments against the partnership or its partners based on the kinds of negligence, wrongful acts, and misconduct for which liability

firm to carry at least one million dollars of liability insurance or proof that such sum is set aside for liability contingencies.¹⁴¹

Depending on expense, this minimum insurance requirement may negate any benefit that a small start up business organization could garner from a Delaware LLP. This obligation could preclude many new businesses from choosing this business association form. By limiting the LLP form to those who can arrange insurance or set aside such a large sum, the Delaware legislature may have effectively deterred those most in need of partnership fiduciary protections from taking advantage of them.

VI. PURE CONTRACT OR RESIDUAL FIDUCIARY DUTIES?

Should the law protect minority stakeholders above the terms of the investor's contract? A primary uncertainty for investors in closely held business organizations is that each investor's objectives and needs may vary during the life span of the enterprise.¹⁴² Failure to contractually anticipate death or divorce of an investor, with resulting shifts of control, may lead to disputes among the parties.¹⁴³ Controlling parties can withhold dividend payments or otherwise burden minority stakeholders.¹⁴⁴

Conversely, partnership law alleviates majority oppression of the minority stakeholder by allowing partner withdrawal at any time.¹⁴⁵ Certainly, a withdrawing stakeholder can incur liability to the other partner if the investor withdraws in transgression of an existing contractual agreement.¹⁴⁶ However, under those conditions, the penalty is derived by the explicit consequence of bargaining by the parties.¹⁴⁷

is limited by § 1515 (b) of this title by:

Deposit in trust or in bank escrow of cash, bank certificates of deposit, or United States Treasury obligations; or

A bank letter of credit or insurance company bond.

141. *See id.*

142. *See* Dennis S. Karjala, *F. Hodge O'Neal Corporate and Securities Law Symposium: Limited Liability Companies*, 73 WASH. U. L. Q. 455, 466 (1995) (explaining that uncertainties such as death, divorce and intergenerational transfers can wreak havoc on contractual arrangements. Majority stakeholders may receive salaries while excluding dividend payments to minority shareholders).

143. *See id.*

144. *See id.*

145. *See id.* (citing UNIF. PARTNERSHIP ACT §§ 31(1) (b), 31(2), 42 (1914)); *see also* REV. UNIF. PARTNERSHIP ACT §§ 601(1), 701 (1993).

The 1914 UPA speaks of events of 'dissolution', while the 1993 statute's notion of withdrawal from the enterprise is referred to as 'dissociation.' The distinctions are largely unimportant for purposes of the present discussion, so [the author] . . . use[d] the term 'withdrawal' to include the relevant events under both versions of the UPA.

Karjala, *supra* note 142, at 466.

146. *See id.*

147. *See id.*

Corporation law, however, furnishes no right of withdrawal for non-controlling stakeholders, resulting in the lock-in of minority investor capital with no right of dividends or return of the investment.¹⁴⁸

There are conflicting positions on the proper remedies for this situation.

Two major opposing positions exist between advocates of freedom to contract in the business organization and those who favor fiduciary protections for minority stakeholders.¹⁴⁹ The key idea that “the close corporation is the functional equivalent of the partnership” was expressed in 1977.¹⁵⁰ Under this analysis, small business investors organize under the corporation statutes merely to achieve the benefit of limited liability.¹⁵¹ However, close corporation investors lack the same ability as partners to exit the investment by withdrawal.¹⁵²

Alternatively, freedom of contract advocates explain that minority stakeholders can sell to co-investors, however, majority co-investors do not need to buy out powerless minority shareholders when they already control the entity.¹⁵³ This analysis finds the lack of an exit remedy as a flaw within the legal framework of corporations.¹⁵⁴ The proposed solution embodied in close corporation statutes allows the election of close corporation status, with its fiduciary protections.¹⁵⁵ However, the problem with these statutes is that the investors most in need of protection lack the sophistication and legal advice to choose them.¹⁵⁶

Conversely, contractarian advocates argue that in a close corporation the limited number of shareholders and their overlapping management responsibilities naturally align majority and minority investor interests.¹⁵⁷ Under this analysis, small enterprise investors choose the corporate form to minimize agency costs.¹⁵⁸ This view points out that shareholders choose to incorporate rather than to form a partnership because they value constancy and stability of the corporate

148. See *id.* at 466-67 (citing the extensive scholarship on the problem compiled by Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699 (1993)).

149. See generally Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression In Close Corporations*, 24 J. CORP. L. 913, 916-20 (1999).

150. John A.C. Hetherington & Michael Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 2 (1977); see also *Donahue v. Rodd*, 328 N.E.2d 505, 512 (Mass. 1975).

151. See Hetherington & Dooley, *supra* note 150, at 2.

152. See Rock & Wachter, *supra* note 149, at 916.

153. See *id.*

154. See *id.*

155. See generally Wortman, *supra* note 22.

156. See *id.* at 1381-96.

157. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 228-52 (1991); see generally Jason Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992); Charles R. O'Kelly, *Filling the Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992).

158. See Rock & Wachter, *supra* note 149, at 917.

form.¹⁵⁹ The promoters of pure contract in business formation argue that adding an exit or buyout option above any for which the parties contracted will undermine the bonds that tie the parties together toward a common goal.¹⁶⁰ In this theory, shareholders in close corporations should hold no fiduciary duties to each other, and close corporation statutes should contain no supplementary protections that do not exist in publicly held corporations.¹⁶¹

One expansion of the contractarian analysis looks specifically at start-up enterprises.¹⁶² This analysis argues that the inability to exit the enterprise is crucial to its success.¹⁶³ To allow investors or those stakeholders with critical ideas or expertise to easily exit the venture midstream would harm the business and likely cause its failure.¹⁶⁴ This view advocates the idea that investor lock-in is critical to the success of start-up enterprises, and that to allow any exit would cripple the enterprise.¹⁶⁵ Lock-in also promotes capital investment and creditor protection, by maintaining capital within the enterprise without the threat of withdrawal.¹⁶⁶

VIII. CONCLUSION

The clear problem under the Delaware business scheme for closely held enterprises is that the minority stakeholders most in need of some exit remedy or fiduciary duty protection are the ones least likely to seek legal advice. This lack of counsel makes investors unlikely to choose statutory close corporation status or to adequately protect themselves by contractual provisions.¹⁶⁷ This failure within the close corporation statutes is shown by the very low percentage of eligible corporations that elect the status and lack protection by contract.¹⁶⁸

The current trend in Delaware law is one that clearly advocates the freedom to contract in business formation. The LLC statute purposely states that its policy is to allow for maximum freedom to contract.¹⁶⁹ Similarly, *Nixon v. Blackwell*¹⁷⁰ constrains fiduciary and exit remedies to corporations that explicitly elect close corporation status. The LLP statutes provide limited fiduciary and exit protection to minority investors, but require a one million-dollar insurance policy that may

159. *See id.*

160. *See id.*

161. *See id.*

162. *See generally* Rock & Wachter, *supra* note 149, at 918.

163. *See id.* at 919.

164. *See id.*

165. *See id.*

166. *See id.* at 920.

167. *See generally* Wortman, *supra* note 22.

168. *See id.* at 1387.

169. *See* DEL. CODE ANN. tit. 6, § 18-1101 (1999).

170. 626 A.2d 1366 (Del. 1993).

effectively preclude the choice for those investors most in need of the partnership form.

Unincorporated businesses without benefit of legal advice often will fall under default partnership protections, which allow for fiduciary duties and exit remedies, but provide no personal liability protection for investors. The next level of investor sophistication envelops those who are worldly enough to seek limited liability, but who may lack the knowledge, financial resources, or competent legal advice to protect themselves from unforeseen future contingencies by contractual means.

One remedy for those who fall into this gap in protection would be statutory default exit provisions and fiduciary protections for corporations that meet the close corporation tests.¹⁷¹ Turning the current close corporation election procedure on its head would easily protect the minority investors in such enterprises while allowing those corporations who do not fall within its provisions to escape the close corporation constraints. Sophisticated entities that may fall within the statute typically would have access to legal advice, which would allow them to deselect the status and provide for pure contractual remedies.¹⁷² Also, LLC provisions should allow for baseline exit rights and fiduciary duties that sophisticated investors could contract around if necessary.

Another remedy to protect minority investors is to advocate attorney education in this area. Obviously, those organizations that should be choosing close corporation status fail to do so in large percentages. Investors could achieve protection at a cost that is not prohibitive through Continuing Legal Education in this area advocating close corporation status, by providing standard forms that could be used to facilitate inclusion of fiduciary protections and exit options in the LLC form. These alterations would allow minority investors to gain tax advantages coupled with limited liability and reasonable exit options protections.

171. Interview with Stephen A. Ramirez, Associate Professor of Law, Washburn University, Topeka, KS (Sept. 12, 2000).

172. *See id.*