
A NEW DIRECTION FOR LLC RESEARCH IN A CONTRACTARIAN LEGAL ENVIRONMENT

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This Article discusses a survey on limited liability companies (LLCs) to which 770 attorneys responded in California, Delaware, New York, and Pennsylvania. Of the 770 attorneys who responded in these states, Delaware respondents reported a higher rate of experience with disputes than respondents in New York and Pennsylvania, and reported a higher rate of lawsuits filed than the respondents from California, New York, and Pennsylvania who stated they had handled majority/minority disputes. The findings challenge the view that greater contractual flexibility will necessarily lead to a decrease in disputes and/or judicial intervention. Many respondents lacked a basic understanding of the LLC members' statutory default buy-out rights, and only fourteen percent said their usual LLC agreement included the minority contractual protection of a dissolution for illegal, fraudulent, or oppressive majority conduct. The Article analyzes the survey results in light of recent LLC litigation, discusses the important role that courts can be expected to play in the articulation of standards of LLC member and manager conduct, and makes several policy recommendations regarding the course of future business entity education and research.

The emergence of the limited liability company has dramatically changed the business-law landscape.¹ Although the primary motivation in

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1. See Conrad S. Ciccotello & C. Terry Grant, *LLCs and LLPs: Organizing to Deliver Professional Services*, BUSINESS HORIZONS, Mar.–Apr. 1999, at 85 (indicating that nearly 25 times as many new LLC registrations occurred in 1996 as in 1992); Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 413–14 (2001) (analyzing the LLC movement and its impact on minority owner rights and remedies); Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 121–24 (2001) (comparing the rate of usage of LLCs and LLPs and advancing the theory that inherent characteristics of business entities are driving the business entity selection process rather than so-called “network externalities” linking practitioners to more established, but less suitable entities because of factors such as familiarity with contractual forms for traditional entities, judicial inexperience with new entities, etc.); Symposium, *The Future of the Unincorporated Firm*, 54 WASH. & LEE L. REV. 389–816 (1990) (a symposium containing a series of articles on freedom of contract, good faith, fiduciary duties and limited liability in the context of the limited liability company). See also ALA. CODE §§ 10-12-1 to 10-12-61 (Michie 1975); ALASKA STAT. §§ 10.50.010–10.50.995 (Michie 2000); ARIZ. REV. STAT. §§ 29-601 to 29-857 (1998); ARK. CODE ANN. §§ 4-32-102 to 4-32-1316 (Michie 2001); CAL. CORP. CODE §§ 17000–17705 (Deerings 1997); COLO. REV. STAT. ANN. §§ 7-80-101 to 7-80-913 (West Supp. 1999); CONN. GEN. STAT. ANN. §§ 34-100 to 34-242 (West 1997); DEL. CODE ANN. tit. 6 §§ 18-101 to 18-101-1109 (1999); D.C. CODE ANN. §§ 29-1301 to 29-1375 (1981); FLA. STAT. ANN. §§ 608.401–608.703 (West 1999); GA. CODE ANN. §§ 14-11-100 to 14-11-1109 (1994); IDAHO CODE §§ 53-601 to 53-672 (Michie 2000); ILL. COMP. STAT. 180/1-1 to 205/8.5 (1993); IND. CODE ANN. §§ 23-16-10-1 to 23-18-12-11 (Michie 1999); IOWA CODE ANN. §§ 490A.100–490A.1601 (1997); KAN. STAT. ANN. §§ 17-7601 to 17-7656 (1995); KY. REV. STAT. ANN. §§ 275.001–275.455 (Michie Supp. 2001); LA. REV. STAT. ANN. §§ 12:1301–12:1369 (West 1994); ME. REV. STAT. ANN. tit. 31 §§ 601–762 (West 1964); MD. CODE ANN. CORPS. & ASS’NS §§ 4A-101 to 4A-1103 (1999); MASS. ANN. LAWS ch. 156C §§ 1–68 (LAW CO-OP. 1996); MICH. COMP. LAWS ANN. §§ 450.4101–450.5200 (West Supp. 2001); MINN. STAT. ANN. §§ 322B.01–322B.960 (1995); MISS. CODE ANN. §§ 79-29-101 to 79-29-112 (1972); MO. ANN. STAT. §§ 347.010–347.740 (West 2001); MONT. CODE ANN. §§ 35-8-101 to 35-8-1307 (2001); NEB. REV. STAT. ANN. §§ 21-2601 to 21-2653 (West 1999); NEV. REV. STAT. ANN. §§ 80.010–86.590 (Michie 1999); N.H. REV. STAT. ANN. §§ 304-C:1 to 304-C:81 (1955); N.J. STAT. ANN. §§ 42:2B-1 to 42:2B-70 (West Supp. 2002); N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (Michie 2001); N.Y. LTD. LIAB. CO. LAW 32A §§ 101–1403 (McKinney 2002); N.C. GEN. STAT. §§ 57C-1-01 to 57C-10-07 (2001); N.D. CENT. CODE §§ 10-32-01 to 10-32-156 (2001); OHIO REV. CODE ANN. §§ 1705.01–05.58 (Anderson 2001); OKLA. STAT. tit. 18, §§ 2000–60 (1999); OR. REV. STAT. §§ 63.001–63.990 (1997); PA. CONS. STAT. § 8901–98 (West 1995); R.I. GEN. LAWS §§ 7-16-1 to 7-16-75 (1998); S.C. CODE ANN. §§ 33-43-101 to 33-43-1409 (Law. Co-op. Supp. 2002); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to 47-34-59 (Michie 1999); TENN. CODE ANN. §§ 48-201-101 to 48-248-606 (1999); TEX. REV. CIV. STAT. ANN. art. 1528n, § 1.01–11.07 (Vernon 1997); UTAH CODE ANN. §§ 48-2B-100 to 48-2B-157 (Supp. 2001); VT. STAT. ANN. tit. 11 §§ 3001–62 (1997); VA. CODE ANN. §§ 13.1-1000 to 13.1-1073 (Michie 1999); WASH. REV. CODE. § 25.15.005–25.15.902 (Michie Supp. 2002); W. VA. CODE §§ 31-B-101 to 31-B-1306

forming the LLC was to combine the benefit of limited liability with favorable flow-through partnership tax treatment, the LLC movement has also been driven by a desire to develop a business entity that would meet the special needs of the private entrepreneur.² In reaction to the explosive growth in tort liability,³ and a growing body of case law imposing heightened fiduciary duties upon partners and close corporation shareholders, legislators have sought a business entity that, through private contracting among participants, would limit legal liability to third parties on the outside, reduce legal strife internally among investors, and deter judicial intermeddling.⁴

To allow investors the maximum flexibility in structuring business relationships, most LLC statutes, including the Uniform Limited Liability Company Act, provide a series of default rules that become operative in the absence of an agreement to the contrary.⁵ The LLC statutes largely embrace the contractarian philosophy of business entities, an approach that presumes that investors will privately order their business relationships in a governing contractual document.⁶ In the context of the contractarian

(Michie 2001); WIS. STAT. ANN. §§ 183.0102–183.1305 (West 2002); WYO. STAT ANN. §§ 17-15-101 to 17-15-144 (Michie 2001).

2. See generally Louis A. Mezzullo, *Limited Liability Companies: A New Business Form?*, 21 TAX'N FOR LAW 296 (1993) (discussing the hybrid nature of the limited liability company); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 417–38 (1992) (discussing the legal and business aspects of the partnership and the limited liability company).

3. *Liability Awards Are on the Rise*, CORP. LEG. TIMES, June 2000, at 22 (indicating that according to a report by Jury Verdict Research, Horsham, Pennsylvania national jury awards in most liability suits have risen significantly and that products liability awards, in particular, have increased 137%). See generally Stephen D. Sugarman, *Doing Away With Tort Law*, 73 CAL. L. REV. 558 (1985) (analyzing the problems with the explosive growth in tort liability and exploring alternative systems of loss distribution). See also James A. Henderson, Jr., *The Boundary Problems of Enterprise Liability*, 41 MD. L. REV. 659, 662–76 (1982) (calling for a list of liability triggers to provide increased certainty in the law).

4. See Robert W. Hillman, *New Forms and New Balances: Organizing the External Relations of the Unincorporated Firm*, 54 WASH. & LEE L. REV. 613, 615 (1997) (examining the quest for limited liability in prior periods of history and indicating that the quest for limited liability is, in fact, an ancient activity in the law). See also 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, 883 (1995) (discussing the displeasure with evolving case law affecting small business entities and the hands-off LLC statutes that have been designed to increase both flexibility and autonomy in structuring the internal affairs of LLC members and managers).

5. See UNIF. LTD. LIAB. CO. ACT § 801 cmt. (1996). See also DEL. CODE ANN. tit. 6 §§ 18-101 to 18-101-1107 (1999) (exemplifying the use of default rules governing the LLC).

6. *Limited Liability and Opting-Out of Liability: A New Standard for Fiduciary Duties?*, 27 SETON HALL L. REV. 1023, 1025–34 (1997) (analyzing contractual freedom in the context of Delaware and New York LLCs).

framework, the business entity is largely understood as a cluster of rights and responsibilities rooted in the contractual arrangement of the parties.⁷

In the corporate arena, the contractarian philosophy has manifested itself in the growing number of statutory waivers of directors' liability that may be adopted by corporations.⁸ For partnerships, it has led to the statutory limitation of partners' fiduciary duties and the creation of default rules that defer to the partnership agreement.⁹ In the LLC context, the contractarian framework now offers LLC investors unparalleled freedom to limit their legal rights and responsibilities.¹⁰

After years of restricting the structure of LLCs under a mandatory business-entity tax-classification scheme, the IRS finally extended partnership status to all unincorporated entities without restriction. The now famous "Check-the-Box" Regulations heralded substantial revision of

7. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1821 (1989) (discussing the view of the corporation as a contractual creature and the function of corporate law as a mechanism for facilitating private contracting). See also Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 401–03 (1983) (advancing the proposition that private firms should be free to tailor their own corporate rules); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1259–60 (1982) (discussing the trend away from mandatory corporate rules). See generally Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) (advancing the theory that private individuals should be able to contractually define their rights and responsibilities).

8. See Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 380–81 (1988) (tracing the development of Delaware's first statutory provision enabling corporations to limit or exclude corporate directors' liability for any breach of the duty of care, and subsequent statutory provisions in other states permitting even broader exclusions from duty of care liability); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on The Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989) (underscoring the importance of the role of the court by observing that contractual innovation can be reconciled with a stable mandatory core of corporate law if we recognize that what is most mandatory in corporate law is not the specific substantive content of any rule, but rather the institution of judicial oversight). See generally *Symposium: Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (containing several articles that analyze the extent to which business entities should move away from mandatory rules of governance).

9. See J. Dennis Hynes, *The Revised Uniform Partnership Act: Some Comments on the Latest Draft of RUPA*, 19 FLA. ST. U. L. REV. 727, 752–59 (1992) (discussing new statutory provisions regarding the duty of loyalty and the standard of care); Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427, 428 (1991) [hereinafter Weidner, *Three Policy Decisions*] (indicating that RUPA moves away from the aggregate theory of partnerships toward the entity theory, provides increased stabilization through the modification of dissolution rules, and decreases the number of mandatory rules among partners); Donald J. Weidner, *A Perspective To Reconsider Partnership Law*, 16 FLA. ST. U. L. REV. 1, 38 (1988) (suggesting that reforms of UPA should focus in part upon the duties of loyalty and care).

10. See Oesterle, *supra* note 4, at 883 (discussing judicial interference in the private affairs of small business).

state LLC statutes, which are now quite varied across the country. Thus, these regulations created unprecedented freedom for states to revamp their LLC statutes.¹¹

How effective is this new private ordering of business relationships within the framework of the limited liability company? Are practitioners frequently turning to the LLC as the entity of choice instead of a corporation? What drives their decisionmaking processes? Given that LLCs have been developed based on a contractarian paradigm, how well represented are majority and minority members? Does the LLC provide a level contractual playing field? To what extent does the LLC agreement represent a well-negotiated legal contract? Are practitioners including minority protections in their operating agreements? How knowledgeable are practitioners about the default exit rights of the dissociating LLC member, and what sorts of buy-out provisions do they typically include in their LLC agreements? What experiences have practitioners had with disputes among LLC owners?

Although a significant body of research now exists on the application of various legal theories to the LLC,¹² very little empirical research has been done on the contractual provisions that practitioners are actually drafting into their LLC agreements.¹³ The purpose of the present study is to begin the development of an empirical base of knowledge of practitioners' LLC drafting provisions and experience working with LLCs.

The study employs a questionnaire that was distributed to 3,048 members of the business law-related sections of bar associations in four states: California, Delaware, New York, and Pennsylvania. A total of 770

11. See Rev. Rul. 88-76, 1988-2 C.B. 360-1 (1998); IRS Notice 95-14, 1995-1 C.B. 297 (1995), 26 C.F.R. §§ 301.7701-1 to 301.7701-3 (2001).

12. See CARTER G. BISHOP, *LIMITED LIABILITY COMPANIES* (1996) (providing an extensive treatise on limited liability companies); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, *LIMITED LIABILITY COMPANIES* (2001) (containing a detailed analysis of limited liability companies); BRIAN SCHORR, *SCHORR ON NEW YORK LIMITED LIABILITY COMPANIES & PARTNERSHIPS* (1994) (providing a treatise on New York limited liability companies and partnerships); Deborah A. DeMott, *LLCs, LLPs and the Evolving Corporate Form*, 66 U. COLO. L. REV. 1043, 1046 (1995) (discussing the discretionary authority for structuring LLC management). See also Sandra K. Miller, *What Remedies Should Be Made Available To the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. L. REV. 465 (1994) (discussing remedies for the LLC member); Karen Schwindt, *Limited Liability Companies: Issues in Member Liability*, UCLA L. REV. 1541, 1556-65 (1997) (discussing veil piercing in the case of the LLC member under various LLC statutes); Symposium, *Limited Liability Companies*, 25 STETSON L. REV. 255 (1995) (including articles on fiduciary duties, withdrawal, and dissolution rights).

13. See Ciccotello & Grant, *LLCs and LLPs*, *supra* note 1, at 87-90; Ribstein & Kobayashi, *supra* note 1, at tbls. I-IV.

practitioners, or 25%, responded to the survey. Because of inherent flaws in any survey research, and the potential for nonresponse bias, care should be taken to avoid generalizing the results of the study to the larger pool of practitioners who did not respond and to practitioners at large. Nevertheless, the survey provides an interesting window into the experience of the 770 practitioners who responded to the survey.

The questionnaire focused primarily upon six major areas of LLC practice concerning: 1) the frequency of use of the LLC, 2) the practitioner's experience representing majority and minority LLC owners, 3) the practitioner's familiarity with as well as practitioner's contractual practices regarding LLC member buy-out rights 4) the practitioner's experience with LLC disputes and litigation, 5) the practitioner's tendency to use contractual minority protections, and 6) the practitioner's views regarding LLC agreement negotiation.

The study reveals that approximately 46% of all respondents frequently use an LLC instead of a corporation in their respective home states of California, Delaware, New York, or Pennsylvania. Home-state LLC usage was highest in California and Delaware and lowest in New York and Pennsylvania. This suggests that some practitioners may indeed forum-shop for the most favorable LLC climate, while others may shy away from the LLC in states such as Pennsylvania, where the state tax and/or administrative environment is somewhat burdensome. The apparent pull away from LLC statutes with an adverse tax or regulatory environment is consistent with the theory advanced by Larry Ribstein and Bruce Kobayashi that inherent characteristics of business entities and their tax and regulatory environment rather than "network externalities" are the critical factors driving the business-entity choice.¹⁴

Overall, the respondents appear to represent majority LLC owners more frequently than minority LLC owners, at least in the states considered. While 56% of respondents indicated that they represented majority LLC owners either within or outside of their home states, only 20% reported representing minority LLC owners. While hasty generalizations beyond the respondents should be avoided, such skewed representation levels appear to warrant further attention and research. Also, only 14% of respondents indicated that their usual agreement contains the contractual right to dissolution by court order upon a showing of illegal, fraudulent, or oppressive conduct by majority owners.

14. Ribstein & Kobayashi, *supra* note 1, at 121–24.

The present study also found interesting and statistically significant differences in the dispute-handling experience of practitioners in the four states considered. Overall, approximately 26% of respondents indicated that they had handled a majority/minority LLC dispute. Approximately 36% of Delaware practitioners and 37% of California respondents said that they had handled such a dispute, in contrast to only 27% and 13% of New York and Pennsylvania respondents, respectively. Moreover, of the Delaware respondents who said they had handled majority/minority LLC disputes, half indicated that a suit had been filed. In contrast, of the practitioners in California, New York, and Pennsylvania who said they had handled disputes, 21%, 9%, and 25% reported that a suit had been filed. These findings tend to challenge the notion that greater contractual flexibility in business-entity statutes will lead to fewer disputes and/or less litigation.

The results further revealed a lack of familiarity among some respondents with default buy-out rights of LLC members. For example, in Pennsylvania, in the absence of an agreement to the contrary, a disassociating LLC member *does* have a default right to a buy-out. Nevertheless, approximately 56% of Pennsylvania practitioners responded “No” when asked if a member would have the right to a buy-out if he or she left the LLC prior to its winding up and the agreement were silent.

Over two-thirds of respondents indicated that they believed that many LLC agreements are based on form agreements that are not extensively negotiated. In supplementary comments, many practitioners expressed concern about the prevalence of form LLC agreements.

This Article suggests that the judicial role is likely to continue to be important, in light of the findings regarding dispute experience and litigation. It suggests that sweeping statements that the participant’s legal protections strictly begin and end with the LLC operating agreement are unhelpful,¹⁵ as are equally broad pronouncements of vague fiduciary duties. Instead, judicial elaboration of LLC participants’ duties should be based on rigorous judicial scrutiny of the facts and circumstances of each case. Expanded efforts to educate both the legal and business communities are recommended. Finally, future empirical study of different LLC regimes and an eventual reevaluation of the Uniform Limited Liability Company

15. See *Walker v. Res. Dev. Co.*, 791 A.2d 799, 812–13 (Del. 2000) (indicating that the “LLC member’s rights begin with and typically end with the Operating Agreement”); *Elf Atochem N. Am. Inc. v. Jaffari*, 727 A. 2d 286, 291 (1999) (emphasizing that the basic approach of the Delaware LLC Act is to provide members with broad discretion in drafting the Operating Agreement and the assurance that they can be virtually certain that the agreement will be enforced according with its terms).

Act are suggested. If it becomes apparent that disputes are indeed more prevalent under the less structured, more contractarian statutes, perhaps improved statutory default rules can be crafted, or more defined and/or mandatory rules can be developed for problem areas to increase certainty and guidance.

Part I of the Article provides an overview of the evolution of the LLC in the context of a contractarian environment. Part II discusses the focus of the present study and its methodology. Part III includes the results and a discussion of the implications. Part IV analyzes the survey results in light of recent LLC litigation and discusses the important role courts can be expected to play in defining member and manager conduct. It also makes several policy recommendations regarding the course of future business entity education and research. Part V contains the conclusion.

I. THE EVOLUTION OF THE LIMITED LIABILITY COMPANY

The limited liability company has had a fascinating history.¹⁶ Initially the IRS was slow to recognize the LLC, and legislators proceeded with caution in drafting LLC statutes.¹⁷ From the beginning, the *raison d'être* of

16. See Joseph A. Rodriguez, Comment, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 544-46 (1992) (tracing the evolution of the LLC from the 1970s).

17. See Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21, 23-24 n.3 (1994) (discussing the evolution of the limited liability company and discussing the transformation of the IRS position regarding the tax classification of non-corporate entities); Rodriguez, *supra* note 16, at 544-46. The modern establishment of limited liability company statutes began in Alaska during the early 1970s. A Texas oil company, wishing to conduct business in Alaska, sought a statute to conduct business with fewer expenses and restrictions. The principal purpose of the act was to provide an additional source of revenue to Alaska as a result of filing fees and annual taxes. The Alaska statute was not passed because of uncertainty regarding the federal tax treatment of the limited liability company. While taxation as a partnership was desirable, it was not clear whether such an entity would be taxed as a partnership or as a corporation. A private letter ruling could not be obtained on a timely basis and the Alaska bill was initially defeated. Subsequently, in 1977 Wyoming enacted a limited liability company statute in spite of the fact that issues concerning taxation remained unsettled. In 1982, Florida enacted a limited liability company statute. In 1990, Colorado and Kansas followed. In 1988, the Internal Revenue Service ("Service" or "IRS") issued Revenue Ruling 88-76, 1988-2 C.B. 361, the landmark ruling that held that a Wyoming limited liability company, none of whose members or designated managers were personally liable for any debts of the company, would be classified as a partnership for federal income tax purposes. In an effort to distinguish between a corporation and a partnership, the Service focused on the following factors: 1) the continuity of life, 2) centralization of management, 3) liability for corporate debts limited to corporate property, and 4) free transferability of interests. Applying the principles enunciated in *Larson v. Comm'r*, 66 T.C. 159 (1976), and Treasury Regulation 301.7701-2, the Service position was that the entity would be taxed as a corporation if it possessed more corporate characteristics than non-corporate characteristics. *Rev. Rul. 88-76* held that a Wyoming limited liability company lacked the corporate characteristic of continuity of life since the limited liability company

the LLC was to combine in a single business entity the corporate benefit of limited liability with the partnership advantage of flow-through taxation. Thus, legislators had to be careful that their legislative models would comply with IRS business-entity regulations, so that the IRS would grant partnership status to the LLC.¹⁸

The earliest LLC statutes were designed to be “bullet-proof” from IRS attack and made it impossible for the LLC to be formed under the state statute if the LLC possessed more “corporate” than non-corporate characteristics. At that time under the tax law, the taxpayer had to prove that the LLC *lacked* at least two of four characteristics typically associated with corporations: continuity of life, centralization of management, limited liability for corporate debts, and free transferability of interests. Consequently, the first wave of LLC statutes provided relatively little flexibility with regard to provisions concerning dissolution, transferability, or management.

Eventually, some LLC statutes were liberalized to allow practitioners flexibility with regard to dissolution events, but they contained a default rule that in the absence of an agreement to the contrary, an event such as a member’s death, bankruptcy, or incapacity caused the firm to dissolve unless a *majority in interest* of the remaining members agreed to continue the entity.¹⁹ Most of the LLC statutes tracked some or all of the language

would dissolve upon the death, retirement, resignation, expulsion, bankruptcy, or any other termination of a membership, unless the business were continued by the consent of all the remaining members. Further, the Wyoming limited liability company lacked the corporate characteristic of free transferability of interest. The member’s interest could be transferred only with the consent of all remaining members. Thus, the failure to possess more corporate than non-corporate features resulted in classification for tax purposes as a partnership. Miller, *supra*, at 23–24.

18. See generally Susan Pace Hamill, *The Limited Liability Company: A Possible Choice For Doing Business?*, 41 FLA. L. REV. TAX 721 (1989) (discussing the major features of the limited liability company and its advantages); Ribstein, *supra* note 2, at 417–38 (comparing and contrasting partnerships and limited liability companies).

19. Regulation 301.7701-2(b) (1) was amended in 1993. Previously, it provided that for limited partnerships, if the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist. See *Glensder Textile Co. v. Com.*, 46 B.T.A. 176, 185–86 (1942) (concluding that a limited partnership lacked continuity of life because upon the death, retirement, or incapacity of a general partner, the remaining general partners would have to agree to continue the partnership, and there was no assurance that they would do so). The court observed that the continuity of a partnership was not analogous to the chartered life of a corporation, which continues regardless of the death or resignation of its directors or stockholders. Sandra K. Miller, *Increased Flexibility of Limited Liability Company Operating Agreements Raises Questions About Tax Treatment*, 72 TAXES 622, 624–25 (1994) (discussing the typical withdrawal rules that were in effect in LLC statutes prior to the enactment of the Check-the-Box Regulations).

of former IRS regulation 301.7701-2(b)(2) in an effort to ensure the absence of the corporate characteristic of continuity of life.²⁰

As practitioners gained more experience with LLCs, they began to express concern about rigid, tax-driven rules, such as the requirement of unanimous approval to continue an LLC after a dissolution event, or the requirement that the LLC dissolve upon the occurrence of a wide range of events such as a member's death, bankruptcy, or disability. Practitioners sought increasing freedom in structuring the LLC and inundated the IRS with private-letter ruling requests regarding a wide variety of diverse LLC structures. Eventually the IRS's mandatory tax classification scheme became an administrative nightmare. Finally, nearly twenty years after the recognition of the first LLC, the IRS jettisoned its mandatory tax classification scheme and enacted the so-called "Check-the-Box" regulations that automatically tax unincorporated business entities, including LLCs, as partnerships unless a contrary election to be taxed as a corporation is filed.²¹

A. A NEW FRONTIER OF CONTRACTUAL FREEDOM IN THE WAKE OF
"CHECK-THE-BOX" IRS REGULATIONS

The Check-the-Box Regulations opened a new and unparalleled frontier of contractual freedom for the structure of the LLC. Prior to the enactment of the Check-the-Box Regulations, the majority of states gave LLC members an optional default power to withdraw from the LLC unless otherwise provided by the operating agreement.²² Under most statutes, dissociated members received the fair market value of their interest reduced by any damages for wrongful conduct.²³ Subsequent to the enactment of the Check-the-Box regulations, a number of LLC statutes were modified to eliminate their so-called contingent dissolution provisions. For example, the LLC statutes of Alabama,²⁴ Alaska,²⁵ Arizona,²⁶ California,²⁷

20. See Miller, *supra* note 19, at 624–25.

21. See BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 2.202[3] (6th ed. 1997) (discussing the regulations that presume that unincorporated domestic taxpayers are classified as partnerships for tax purposes).

22. See Carter G. Bishop, *Treatment of Members Upon Their Death and Withdrawal From a Limited Liability Company: The Case for a Uniform Paradigm*, 25 STETSON L. REV. 255, 259 (1995) (discussing the evolution of LLCs as the IRS position on tax classification became more liberal).

23. See *id.* at 297.

24. See ALA. CODE § 10-12-37 (Michie 1995) (providing that events of dissolution takes place upon occurrence of the first of the following events: written consent of all members to dissolve, when there is no remaining member subject to some special exceptions, when the LLC is not the successor in a merger or consolidation, or when there is a judicial dissolution because it is not reasonably practical to carry on business).

Colorado,²⁸ Delaware,²⁹ the District of Columbia,³⁰ and Florida³¹ stopped linking dissolution to events such as death, bankruptcy, or dissolution of a member. The Delaware LLC statute now presumes a perpetual existence unless the operating agreement provides to the contrary.³² Of course there remains considerable variation in the LLC dissolution provisions of different states.³³ By and large, however, LLCs can now be structured to have a perpetual existence, much like corporations.

In addition to changing dissolution provisions, a growing number of states have also enacted restrictions on the LLC member's right to have the LLC or other LLC members purchase his or her interest upon withdrawal from the LLC. Initially, the most common approach was to give the LLC member the power to withdraw, unless the operating agreement provided to the contrary, and to provide the dissociated member with the fair value of

25. See ALA. STAT. § 10.50.405 (Michie 2000) (providing for dissolution either upon the the time or events specified in the operating agreement, when all the members consent to the dissolution; or when the superior court decrees it is impossible to carry on the purposes of the company).

26. See ARIZ. REV. STAT. ANN. § 29-781 (2000) (providing for dissolution at the first occurrence of the time or happening of events specified in the articles of organization or operating agreement, the written consent of all the members, withdrawal by one member unless the business may be continued by one or more members pursuant to the operating agreement or consent from all remaining members, or entry of an administrative dissolution for failing to comply with enumerated rules).

27. See CAL. CORP. CODE § 17350 (Deerings 1997) (providing that an LLC shall be dissolved and its affairs wound up upon the first of the following to occur: at the time specified in the articles of organization or the happening of events in the operating agreement or articles of organization, or by the vote of a majority in interest of the members or a greater percentage specified in the articles of organization or the operating agreement).

28. See COLO. REV. STAT. § 7-80-801(1999) (indicating that the LLC will be dissolved either by the unanimous written agreement of all members or at the time of events specified in the operating agreement).

29. See DEL. CODE ANN. tit. 6 § 18-801(a) (1999) (providing for dissolution upon: the time specified in the agreement, unless no time is specified, in which case the company has a perpetual existence; upon the occurrence of events specified in the agreement; unless otherwise provided, consent of members to dissolve; if there are no members; or if a judicial decree of dissolution has been issued).

30. See D.C. CODE ANN. § 29-1347 (Supp. 2000).

31. See FLA. STAT. § 608.441 (West 1999) (providing for dissolution the time specified in the articles of organization or operating agreement, when no time is specified, in which case the company has a perpetual existence; upon the occurrence of events specified in the articles of organization; unless otherwise provided in the articles of organization or the operating agreement, upon the written consent of all members; if there are no members; or if a court decree that it is not reasonably practical to carry on business has been issued).

32. See DEL. CODE ANN. tit. 6 § 18-801(a)(1) (1998).

33. GA. CODE ANN. § 14-11-602-603 (2000) (indicating that dissolution occurs upon the time specified in the written operating agreement; upon the occurrence of events specified in the articles of organization or the operating agreement; at the time of approval by all members; unless otherwise provided in the articles of organization or the operating agreement, after 90 days of a dissociation event of any member, unless the LLC is continued by written consent of all members; or if a judicial decree has been issued that it is not reasonably practicable to carry on business).

his or her interest, less damages caused by the withdrawal.³⁴ Many states still permit the LLC owner to withdraw and be paid the fair market value of his or her interest unless otherwise provided in the operating agreement or articles of organization, subject to possible offsets for damages.³⁵ However, to enhance the LLC's usefulness as an estate and gift-tax planning vehicle,³⁶ a growing number of LLC statutes, including those seen in states such as Alabama,³⁷ Arizona,³⁸ California,³⁹ Colorado,⁴⁰ Georgia,⁴¹

34. See Bishop, *supra* note 22, at 297.

35. See ARK. CODE ANN. § 4-32-602 (Michie 2001) (permitting fair market value of the member's interest to be paid within reasonable time after dissociation unless otherwise provided by the agreement); CONN. GEN. STAT. ANN. § 34-180(c) (West 1997) (stating that unless otherwise provided in the operating agreement a member has the power to withdraw, subject to a possible offset for damages); D.C. CODE ANN. § 29-1327 (1998) (indicating that upon resignation of a member, unless otherwise provided, the member is entitled to the fair market value of the member's interest); WYO. STAT. ANN. § 17-15-120 (Michie 2001) (indicating in part that a member will not receive any part of a contribution to capital until, unless otherwise prohibited in the operating agreement, after 6 months notice).

36. A popular estate planning technique is to have the owner of a family business or owner of investments place the business and/or assets into a family limited partnership and to transfer all but a minority interest in the limited partnership to his or her children. Upon death, the decedent typically claims discounts in the valuation of the retained minority interest because of the fact that it is a minority interest, which lacks marketability. To enhance the discounts for minority ownership and for lack of marketability, tax planners initially were quite creative in placing severe contractual restrictions on the taxpayer's ability to sell, redeem, or otherwise liquidate his or her minority interest. The contractual restrictions were used in an attempt to justify the taking of minority discounts and discounts for lack of marketability of the limited partnership interest. To combat exploitation of minority and lack of marketability discounts, in 1990 Congress adopted IRC §§ 2701-04 in the Omnibus Budget Reconciliation Act. Section 2401(b) provides that if there is a transfer of an interest among family members, and the transferor and his family control the organization, the contractual restrictions on the transferor's liquidation rights will be completely ignored for business valuation purposes to the extent the contractual restrictions are *more* restrictive than the restrictions that would apply under state law, absent a private contract. Thus, there is a tax incentive to modify state statutes to provide restrictive default rules that restrict the right to sell, redeem, or otherwise liquidate an ownership interest in the business entity. See Robert R. Keatinge, *Universal Business Organization Legislation: Will it Happen? Why and When*, 23 DEL. J. CORP. L. 29, 52-62 (1998) (discussing the member dissociation rules and the estate and gift-tax planning implications). See generally Joseph M. Mona, *Advantages of Using a Limited Liability Company in an Estate Plan*, 25 EST. PLAN. 167, 167-72 (1998) (discussing the use of an LLC in an estate plan); Thomas I. Hausman, *Family Limited Partnerships*, 78 TAX NOTES 95, 95-113 (1998) (discussing the use of family limited partnerships in estate planning).

37. See ALA. CODE § 10-12-30 (Michie 1975) (providing that unless articles of organization or the operating agreement provide for the purchase of the former member's interest, neither the LLC nor the members shall be obligated to purchase the interest of a former member).

38. See ARIZ. REV. STAT. § 29-707 (2000) (providing that except as otherwise provided the withdrawn member does not have a right to receive a distribution by reason of withdrawal).

39. See CAL. CORP. CODE § 17252 (Deerings 1997) (providing that unless the operating agreement or articles of organization provide to the contrary, the withdrawn member shall not be entitled to payment for the member's interest in the LLC).

40. See COLO. REV. STAT. ANN. § 7-80-603 (1999) (indicating that there is no right to a distribution upon resignation or withdrawal other than what the member would be entitled to if he or she had not resigned or withdrawn).

Ohio,⁴² Michigan,⁴³ and Rhode Island,⁴⁴ have eliminated the member's rights to be paid a distribution of the fair market value of the interest upon withdrawal, in the absence of an agreement expressly bestowing such buy-out rights. Several other states do not expressly eliminate "distribution rights" as such, but contain other provisions that restrict the LLC member's right to withdraw and liquidate his or her LLC interest before the dissolution of the company. For example, Delaware's LLC statute provides that a member may resign only at the time or upon the happening of an event in the LLC agreement and that unless the LLC agreement provides otherwise, the member may not resign from the LLC prior to its dissolution and winding up.⁴⁵ The Florida, New York, and Oklahoma LLC statutes provide similar restrictions on withdrawal rights.⁴⁶ Washington's LLC statute provides that a member may withdraw from the LLC at or

41. See GA. CODE ANN. § 14-11-601 (1994) (restricting a distribution of the fair market value of the member's interest if the member voluntarily withdraws from the company).

42. See OHIO REV. CODE ANN. § 1705.16 (Anderson 2001) (indicating that, a member may withdraw only upon the occurrence of the events specified in writing in the articles of organization or the operating agreement).

43. See MICH. COMP. LAWS ANN. § 450.4305 (West Supp. 2001) (providing that until the effective date of withdrawal, a withdrawing member shares in distributions; and that an operating agreement may provide for an additional distribution to a withdrawing member, and if the agreement does permit withdrawal and is silent on an additional distribution, the withdrawing member is entitled to receive a distribution of the fair value of the member's interest).

44. See R.I. GEN. LAWS § 7-16-29 (1998) (indicating that unless as otherwise provided in an operating agreement, upon withdrawal of a member the withdrawn member shall not have the right to receive a distribution by reason of withdrawal but shall have only the rights of an assignee while the company is continued and upon completion of the winding up, less any damages if the withdrawal event violated the agreement).

45. DEL. CODE ANN. tit. 6, § 18-603 (1998) (prohibiting the LLC member from resigning prior to the dissolution of the company unless the LLC agreement provides otherwise). See also DEL. CODE ANN. tit. 6, § 18-604 (1998) (providing that except as otherwise provided in this subchapter, a member who resigns or otherwise ceases for any reason to be a member is entitled to receive a distribution per the LLC agreement, and that if not otherwise provided in the agreement, the member is entitled to receive the fair market value of the interest within a reasonable time after the resignation or cessation of membership).

46. See FLA. STAT. ANN. § 608.427 (West 1999) (providing that unless the operating agreement or articles of organization provide otherwise, a member may not resign from the LLC prior to its dissolution and winding up); N.Y. LTD. LIAB. CO. LAW 32A § 606 (McKinney 2002) (providing that a member may withdraw only at the time or upon the happening of events specified in the operating agreement and only in accordance with the operating agreement, and that unless the operating agreement provides otherwise, a member may not withdraw prior to the dissolution and winding up of the LLC); OKLA. STAT. tit. 18, § 2036 (1999) (indicating that unless the operating agreement specifically permits in writing the power to withdraw voluntarily, a member may not withdraw at any time, and providing for recovery of damages by the LLC if the withdrawal occurs as the result of wrongful conduct). See also Steven T. Ledgerwood, *A Focus on Unincorporated Businesses: Oklahoma LLCs v. Limited Partnerships: Choice of Entity for Valuation Discounts After 1997*, 22 OKLA. CITY U. L. REV. 611, 612-15 (1997) (discussing valuation discounts for estate- and gift-tax purposes and discussing the effects of locking-in the LLC owner).

upon the happening of events in the operating agreement and specifies that if the operating agreement does not provide otherwise, the member may not withdraw prior to the time for the dissolution and winding up of the company without written consent of all other members.⁴⁷

In the absence of mandatory tax classification rules, tax practitioners can now structure the LLC to possess many of the characteristics that have been traditionally associated with privately owned corporations. The newly developed freedom of contract created by the Check-the-Box regulations raises many interesting and pressing policy questions for the legal community. How have practitioners reacted to the liberalization of IRS tax-classification rules? To what extent are practitioners seizing new opportunities to use the LLC? Has the elimination of buy-out rights created a “lock-in” effect that has led to abuses of minority LLC owners? Are minority LLC owners potentially more vulnerable to a squeeze-out than a minority shareholder in a closely held corporation who, in many states, has the statutory protection of a judicial dissolution or buy-out in the event of deadlock or illegal, fraudulent, or oppressive conduct?⁴⁸ Are practitioners protecting minority LLC owners from oppressive majority conduct through contractual clauses in the operating agreement? These are some of the important issues addressed by the present study.

II. THE FOCUS OF THE LLC STUDY AND ITS METHODOLOGY

The questionnaire was designed to focus on six major areas of LLC practice: 1) the frequency of use of the LLC, 2) the degree to which practitioners represent majority owners and minority owners and their use of contractual protections, 3) the practitioner’s familiarity with and practices regarding LLC member buy-out rights, 4) the practitioner’s experience with LLC disputes and litigation, 5) the practitioner’s tendency

47. WASH. REV. CODE § 25.15.130 (Michie Supp. 2002).

48. See 3 MODEL BUS. CORP. ACT § 14.3 (3d ed. 1999). This code provides for a dissolution where:

- (i) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;
- (ii) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;
- (iii) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or
- iv) the corporate assets are being misapplied or wasted.

If a dissolution action has been instituted, section 14.30 provides that the corporation or one or more shareholders may elect to purchase all of the shares owned by the petitioning shareholder.

to use contractual minority protections, and 6) the practitioners' views regarding LLC agreement negotiation. Each of these areas raises important policy issues that the legal community should monitor as LLC cases emerge and as proposals for statutory reforms are suggested.

A. THE DEVELOPMENT OF THE QUESTIONNAIRE

The study consists of a questionnaire containing eleven specific questions regarding LLC usage and practice. The questionnaire was developed by the author and was pretested on a small group of members of the Business Law Section of the Pennsylvania Bar Association and on selected members of the Delaware Bar Association. Based on comments received from the pilot study, the questionnaire was modified and finalized. See Tables I and II below, containing the cover letter and the questionnaire mailed to the Business Law Section of the Pennsylvania Bar Association. Comparable questionnaires were mailed to Bar Association members in California, Delaware, and New York.

TABLE I: SAMPLE COVER LETTER DISTRIBUTED IN
PENNSYLVANIA

TABLE II: SAMPLE QUESTIONNAIRE DISTRIBUTED IN
PENNSYLVANIA

* Identical questionnaires were made up for California, New York and Delaware with the words "CA," "DE," or "N.Y." substituted for Pennsylvania or PA".

B. THE SAMPLE

In the spring of 2001 the questionnaire was mailed to business law practitioners in California, Delaware, New York, and Pennsylvania.

In California, the questionnaire was mailed to all 560 members of the Business Law Section of the San Diego County Bar Association and to a random sample of 500 of the approximately 1500 members the Business & Corporation Law Section of the Los Angeles County Bar Association.

In Delaware, the questionnaire was mailed to all 488 members of the Commercial Law, Corporate Law, and Real and Personal Property Sections of the Delaware Bar Association.

In Pennsylvania, the questionnaire was mailed to a random sample of 1,000 of the 2,372 members of the Business Law Section of the Pennsylvania Bar Association.

In New York, the questionnaire was mailed to a random sample of 500 of the 4,279 members of the New York State Bar Association.

TABLE III: BAR ASSOCIATION	MAILED	RESPONDED	RESPONSE RATE
California San Diego & Los Angeles County Business Law Sections	1,060	157	15%
Delaware Commercial, Corporate & Real & Personal Property Sections	488	182	37%
New York Business Law Section	500	132	26%
Pennsylvania Business Law Section	1,000	299	30%
TOTAL RESPONSES	3,048	770	25%

Respondents were assured in a cover letter that the individual results were confidential, and that individual responses would not be disclosed. Each questionnaire was assigned a number. Practitioners who failed to respond to the first questionnaire received a second questionnaire in the mail.

C. THE LLC STATUTES AND THEIR LOCAL ENVIRONMENTS

The states included in the present study are California, Delaware, New York, and Pennsylvania. The LLC statutes of these states vary with regard to the extent to which they include mandatory rules. The local tax environment in each state also varies. Overall, Delaware provides the least restrictive statutory framework of the four states while California, New York, and Pennsylvania impose varying degrees of structure.

The Delaware statute is designed to give maximum effect to the parties' freedom of contract and states that it is the policy of the LLC law to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability agreements.⁴⁹ The limited liability company agreement may be written or oral.⁵⁰ The statute places no restrictions on a person's duties and liabilities, which may be expanded or restricted by provisions in the limited liability company agreement.⁵¹ There are no provisions establishing a standard of care for members and/or managers or governing buy-outs upon dissociation from the firm. The unobtrusive regulatory environment is made complete by Delaware's tax structure, which imposes a \$100 annual tax upon LLCs and treats the Delaware LLC as a partnership unless classified otherwise for federal income tax purposes.⁵²

In contrast to the Delaware statute, the California, New York, and Pennsylvania LLC statutes create, to varying degrees, a network of default rules that apply, absent contrary provisions in the articles of organization or operating agreement.⁵³ In California, although statutory rules may be varied by the LLC's operating agreement, selected provisions pertaining to voting, notice, meetings, manager or officer modifications, and indemnification may be varied only by a change in the articles of

49. DEL. CODE ANN. tit. 6, §§ 18-101, 18-1101 (2000). See *Canto Fitzgerald, L.P. v. Cantor*, 26 DEL. J. CORP. L. 236 (2000). One of the few mandatory requirements is that the name shall contain the words "Limited Liability Company" or the abbreviation "L.L.C.," or the designation LLC. See DEL. CODE ANN. tit. 6, § 18-102(1) (2000).

50. DEL. CODE ANN. tit. 6, § 18-101(7) (2000).

51. DEL. CODE ANN. tit. 6, § 18-1101(c) (2) (2000).

52. See DEL. CODE ANN. tit. 6, § 18-1107(2000); DEL. TAX REP. ¶ 10-020, ¶ 200-574 (CCH 2001). (includes Technical Information Memorandum 98-1, dated April 24, 1998).

53. See CAL. CORP. CODE § 17005(a) (West 2001) (establishing the role of the LLC statute in the absence of contrary provisions in the articles of organization and operating agreement); N.Y. LTD. LIAB. CO. LAW § 401-08 (McKinney 2002) (setting forth provisions for management, voting rights, meetings, and notice of meetings except as provided in the operating agreement); PA. CONS. STAT. §§ 8901-98 (1995 & Supp. 2002) (providing various rules that apply except as provided in the operating agreement).

organization or in a written operating agreement.⁵⁴ The Pennsylvania and New York LLC statutes also place restrictions on the manner in which voting rights may be modified.⁵⁵

Unlike the Delaware statute, the California, New York and Pennsylvania LLC statutes all contain express provisions regarding the duties of managers.⁵⁶ Under the California statute, the manager owes the members the same fiduciary duties as those owed by a partner to a partnership.⁵⁷ Restrictions are imposed upon the manner in which a manager's duties may be modified.⁵⁸ Further, under the California LLC statute, no participant may be indemnified for a breach of the statutory fiduciary duty.⁵⁹ In contrast to the California statute, both the New York and Pennsylvania LLC statutes adopt corporate-style standards of care for managers.⁶⁰ While the Pennsylvania standard of care for managers may be varied,⁶¹ the New York standard is stated in absolute terms.⁶² Thus, express statutory provisions in California, New York, and Pennsylvania

54. CAL. CORP. CODE § 17005(b) (West 2001).

55. N.Y. LTD. LIAB. CO. LAW § 402 (McKinney 2002) (providing that no provision that provides for the vote or consent of a percentage in interest of members or class of members shall be amended without vote or consent of at least such percentage in interest of the members or such class of members). *See also* PA. CONS. STAT. § 8942 (1995 & Supp. 2002) (providing in part that except in writing in the operating agreement, unanimous vote is required to amend the operating agreement or to authorize a member or manager to act in contravention of the certificate of organization or operating agreement).

56. CAL. CORP. CODE § 17005(d) (West 2001) (adopting partnership-style fiduciary duties in the case of LLC managers); N.Y. LTD. LIAB. CO. LAW § 409 (McKinney 2002) (adopting a corporate-style standard of care indicating that a manager shall perform his or her duties in good faith and with the care of an ordinarily prudent person in like position under similar circumstances); PA. CONS. STAT. § 8943 (1995 & Supp. 2002) (providing that unless otherwise provided in writing in the operating agreement, the provisions pertaining to officers, directors, and shareholders are applicable to LLC representatives).

57. CAL. CORP. CODE § 17153 (West 2001).

58. CAL. CORP. CODE § 17005(d) (West 2001) (indicating that a manager's duties may be modified in a written operating agreement with the informed consent of the members).

59. CAL. CORP. CODE § 17155 (West 2001) (prohibiting indemnification arising out of a breach of fiduciary duties). *But see* N.Y. LTD. LIAB. CO. LAW § 202(k) (McKinney 2002) (1995 & Supp. 2002) (providing for indemnification of a member or manager or other person without restricting the circumstances that may trigger an indemnification).

60. N.Y. LTD. LIAB. CO. LAW § 409 (McKinney 2002) (indicating that a manager shall perform his or her duties in good faith and with the care of an ordinarily prudent person in like position under similar circumstances); PA. CONS. STAT. § 8943 (1995 & Supp. 2002) (unless otherwise provided in writing in the operating agreement, the provisions pertaining to officers, directors, and shareholders are applicable to LLC representatives).

61. PA. CONS. STAT. § 8943 (1995 & Supp. 2002) (stating that Subchapter B of Chapter 17 relating to officers, directors, and shareholders applies unless otherwise provided in writing in the operating agreement).

62. *See* N.Y. LTD. LIAB. CO. LAW § 409 (McKinney 2002) (providing a standard of care without any references to contrary provisions in the operating agreement).

attempt to foster the accountability of LLC managers by setting parameters for manager conduct.

The Delaware statute provides that unless the agreement provides otherwise, the member may not withdraw prior to the dissolution and winding up of the LLC.⁶³ The California LLC statute states that unless otherwise provided, a withdrawn LLC member is not entitled to payment for his or her interest.⁶⁴ The New York LLC statute similarly limits the member's default withdrawal rights. Unless the LLC operating agreement provides otherwise, the New York LLC member may not withdraw prior to the dissolution and winding up of the LLC.⁶⁵ In contrast, the Pennsylvania LLC member may obtain the fair market value of his or her interest within a reasonable time of dissociation from the LLC.⁶⁶

The state tax treatment of LLCs in California and Delaware is similar in that the LLC is usually taxed for state tax purposes as a partnership. In these states the characterization of the LLC as a partnership or a corporation follows the characterization established for federal income tax purposes.⁶⁷ Typically, the LLC is treated as a partnership and is not subject to the state franchise tax or corporate income tax in California and Delaware, unless the limited liability company has elected corporate status for federal purposes.⁶⁸ Also, the filing fees upon the LLC formation of the LLC, as well as state fees owed annually, are relatively modest in California and Delaware.⁶⁹

63. DEL. CODE ANN. tit. 6, § 18-603 (2000) (providing that unless the agreement provides otherwise, a member may not resign prior to the dissolution and winding up of the LLC).

64. CAL. CORP. CODE § 17152 (West 2001).

65. N.Y. LTD. LIAB. CO. LAW § 606(a) (McKinney 2002) (providing that notwithstanding anything to the contrary under applicable law, unless the operating agreement provides otherwise, a member may not withdraw from an LLC prior to the dissolution and winding up of the company).

66. PA. CONS. STAT. § 8933 (1995 & Supp. 2002) (discussing distributions upon an event of dissociation); PA. CONS. STAT. § 8948 (1995 & Supp. 2002) (stating that an operating provision may provide that a member may not voluntarily dissociate from the LLC).

67. 1 St. Tax Guide All States CAL. (CCH), § 10-261 (2000) (citing Notice No. 92-5, Franchise Tax Board, August 21, 1992); DEL. TAX REP. ¶ 10-020, ¶ 200-574 (CCH 2001) (includes Technical Information Memorandum 98-1, dated April 24, 1998); 1 St. Tax Rep. NY. (CCH), ¶ 10-535 (2000) (containing the New York State Tax Guide for New Businesses published by the New York State Department of Taxation and Finance, Publication 20).

68. See 1 St. Tax Guide All States CAL. (CCH), § 10-261 (2000) (citing Notice No. 92-5, Franchise Tax Board, August 21, 1992); 1 St. Tax Guide All States DEL. (CCH), § 10-308 (2001) (citing DEL. CODE ANN. tit. 6, § 18-1107 (2000)).

69. See 1 St. Tax Guide All States CAL. (CCH), § 10-261 (2000) (indicating that if a limited liability company is classified as a partnership for federal tax purposes it will be so classified for California purposes and that if it is classified as a corporation it must pay corporation taxes including a minimum tax under Rev. & Tax Code § 18633.5); DEL. TAX REP. ¶ 10-108 (CCH 2001) (indicating that

New York and Pennsylvania LLCs operate in a less favorable local tax environment than their California and Delaware counterparts. Although New York LLCs that are taxed as partnerships for federal purposes are not subject to income tax at the entity level, the New York LLC is liable for annual filing fees at a minimum of \$325 and a maximum of \$10,000.⁷⁰

The New York LLC is also subject to considerable filing fees and publication costs upon formation.⁷¹ Similarly, although Pennsylvania no longer taxes the LLC income on an entity level, LLCs remain subject to the Pennsylvania capital stock-franchise tax.⁷² Prior to 1998, Pennsylvania LLCs were also subject to the corporate net income tax.⁷³

III. THE RESULTS AND THE IMPLICATIONS

The results of the average responses per state and for the average responses for all four groups in the aggregate are summarized in graph form in Table IV, below, and also appear in Appendix A.

the filing fee for a certificate of formation is \$50, that an annual tax of \$100 is imposed, and that the fee for reserving a name is \$75 under DEL. CODE ANN. tit. 6, § 18-1105 and § 18-1107(2000)).

70. See 4 St. Tax Rep. N.Y. (CCH), § 99-797 (1997) (indicating that partners are not subject to New York income tax and that the term "partnership" includes LLCs classified as partnerships for federal tax purposes); 1 St. Tax Rep. N.Y. (CCH) ¶ 1-550(2000) (indicating that the annual filing fee equals \$50 multiplied by the number of members, with a minimum fee of \$325 and a maximum of \$10,000); New York State Tax Guide for New Businesses published by the New York State Department of Taxation and Finance, Publication 20; www.tax.state.ny.us and Form IT 204LL).

71. 1 St. Tax Rep. NY. (CCH) ¶ 1-610 (2000) (listing the variety of filing fees imposed on New York LLCs).

72. 2 St. Tax Rep. PA. (CCH) ¶ 100-801 (2000) (discussing the Pennsylvania capital stock-franchise tax and citing 72 P.S. § 7601). See also 1 St. Tax Guide All States PA. (CCH), § 10-258 (2001) (indicating that LLCs remain subject to the Pennsylvania Capital Stock and Franchise Tax and that, prior to 1998, were also subject to the corporate net income tax).

73. 1 St. Tax Guide All States PA. (CCH), § 10-258 (2001).

TABLE IV: TOTAL AVERAGE RESPONSES FOR ALL GROUPS

Q1: Do you frequently use a [CA, DE, NY, PA] LLC instead of a corporation or other business entity?

State By State Responses

Q1	Yes	No	N/A or Blank
CA	57%	42%	1%
DE	53%	31%	16%
NY	39%	52%	9%
PA	40%	47%	13%

Q2: Do you frequently use a non-[CA, DE, NY, PA] LLC instead of a corporation or other business entity?

State By State Responses

Q2	Yes	No	N/A or Blank
CA	33%	66%	1%
DE	6%	78%	16%
NY	39%	51%	10%
PA	25%	62%	13%

Q3: Do you frequently represent majority owners of [CA, DE, NY, PA] or non-[CA, DE, NY, PA] LLCs?

State By State Responses

Q3	Yes	No	N/A or Blank
CA	72%	27%	1%
DE	52%	35%	13%
NY	57%	33%	10%
PA	50%	37%	13%

Q4: Do you frequently represent minority owners of [CA, DE, NY, PA] LLCs and/or non [CA, DE, NY, PA] LLCs?

State By State Responses

Q4	Yes	No	N/A or Blank
CA	25%	74%	1%
DE	26%	60%	14%
NY	21%	69%	10%
PA	14%	72%	14%

Q5: In your usual LLC agreement for [CA, DE, NY, PA] or non- [CA, DE, NY, PA] LLCs, do you give the minority owners the absolute right to force the LLC to buy them out at the fair market value of their interests in the event of a dispute?

State By State Responses

Q5	Yes	No	N/A or Blank
CA	8%	85%	7%
DE	8%	63%	29%
NY	4%	80%	16%
PA	10%	69%	21%

Q6: In your usual LLC agreement for [CA, DE, NY, PA] or non- [CA, DE, NY, PA] LLCs, do you give the majority owners the absolute right to force the LLC to buy them out at the fair market value of their interests in the event of a dispute?

State By State Responses

Q6	Yes	No	N/A or Blank
CA	25%	67%	8%
DE	17%	53%	30%
NY	17%	67%	16%
PA	14%	72%	14%

Q7: If you were to form a [CA, DE, NY, PA] LLC tomorrow and the LLC agreement were silent, does a member have the right to a buy-out if he or she leaves the LLC prior to its winding up?

State By State Responses

Q7	Yes	No	N/A or Blank
CA	15%	69%	16%
DE	14%	52%	34%
NY	14%	61%	25%
PA	14%	56%	30%

Q8: Have you ever handled LLC majority/minority disputes involving [CA, DE, NY, PA] LLCs?

State By State Responses

Q8	Yes	No	N/A or Blank
CA	37%	62%	1%
DE	36%	49%	15%
NY	27%	63%	10%
PA	13%	73%	14%

**Q9: If you answered “yes” to question 8, was a lawsuit ever filed?
(Counting only those respondents who really did answer “Yes” to
Question 8 and disregarding N/A or Blank Responses**

State By State Responses

Q9	Yes	No
CA	21%	79%
DE	50%	50%
NY	9%	91%
PA	25%	75%

Q10: In your usual [CA, DE, NY, PA] LLC agreement, does the company dissolve by court order upon a showing of illegal, fraudulent, or oppressive conduct by majority owners?

State By State Responses

Q10	Yes	No	N/A or Blank
CA	25%	66%	9%
DE	4%	61%	35%
NY	16%	66%	18%
PA	14%	58%	28%

Q11: Do you believe that many LLC agreements formed under [CA, DE, NY, PA] law or elsewhere are based on form agreements that are not extensively negotiated?

State By State Responses

Q11	Yes	No	N/A or Blank
CA	81%	13%	6%
DE	58%	19%	23%
NY	59%	28%	13%
PA	70%	9%	21%

Care must be taken to avoid sweeping conclusions based on a short questionnaire that was distributed in only four states. There is always the potential for nonresponse bias (that is, the concern that the results may be skewed in some manner).⁷⁴ Further, a “Yes” or “No” questionnaire is by its very nature simplistic, and almost every questionnaire contains potential flaws. Nevertheless, the findings offer an interesting window into the inner workings of four different LLC statutory regimes, as experienced by the 770 practitioners who responded to the questionnaire.

A. THE FREQUENCY OF LLC USAGE WITHIN AND OUTSIDE OF THE PRACTITIONER’S HOME STATE

As can be seen from the above data in both Table IV and Appendix A, overall, approximately 46% of practitioners sampled say they frequently use a home-state (CA, DE, NY, PA) LLC instead of a corporation or other business entity. The percentage of practitioners who replied “Yes” climbs

74. See J. Scott Armstrong & Terry S. Overton, *Estimating Nonresponse Bias in Mail Surveys*, 14 J. OF MKTG. RES., 396–97 (1977) (citing methods, including comparing known values of the population such as age or income, or making subjective estimates of bias). There are several ways of estimating nonresponse bias. One approach developed by Scott Armstrong, Associate Professor of Marketing at the Wharton School, is to compare the results of early respondents to the results of late respondents to the survey. The assumption underlying this test is that subjects who respond *less readily* are more like *nonrespondents* than early respondents. “Less readily” can be defined as answering the survey later or as requiring more encouragement to answer.

In anticipation of the nonresponse bias potential in the present study, the results of respondents to a first letter requesting a reply to the survey were tracked separately from the results of respondents who replied to a second letter in the states of California and New York. An analysis of the early and late responders was conducted to draw inferences about the existence of nonresponse bias.

In New York, no differences were found between early and late responders except for Question 3, which asked whether the practitioner frequently represents majority owners of LLCs. A total of 68% of early respondents replied “Yes” to the question, whereas only 42% of the late respondents replied “Yes.”

In California, there were also no differences found between early and late responders except for question 4 which asked whether the practitioner frequently represents minority owners. A total of 36% of early respondents replied “Yes” to this question whereas only 8% of late respondents replied

The above analysis raises concerns about the ability to generalize the actual results of questions 3 in New York and question 4 in California. However, one can infer that nonresponse bias is not a major problem with respect to the other questions in the survey in New York and California. Since the early and late responders were not tracked separately in Pennsylvania and Delaware, it is impossible to infer directly that nonresponse bias is absent in Pennsylvania and Delaware. Nevertheless, the fact that so little nonresponse bias appeared in New York and California, suggests that outside of questions 3 and 4, nonresponse bias is unlikely to be a pervasive contaminating problem with respect to the results of Pennsylvania and Delaware. Yet, had a similar analysis of early and late responders been done in Pennsylvania and Delaware, it is conceivable that questions three and four, or possibly another question or two, could have turned up with a response bias.

to approximately 52% if we disregard the responses of practitioners who left the question blank or replied "N/A." These results corroborate the view that the LLC has become a widely accepted business entity in the legal community. The growing popularity of the LLC has been reported in at least two other empirical studies⁷⁵ and is a trend that is consistent with the nonempirical literature touting both the advantages of the LLC⁷⁶ and the rapid pace at which states have embraced LLC legislation over the last decade.⁷⁷

Responses to question 1 also illustrate that there is considerable variation in LLC usage among the four states considered. This variation in home-state usage supports the notion that the state and local legal and tax environment has an important impact on the choice of business entity. While only 39% of New York, and 40% of Pennsylvania practitioners said that they frequently use home state LLCs, as many as 57% of California respondents and 53% of Delaware respondents said they frequently use their applicable state's LLC instead of a corporation. The differences in home state LLC usage among the four states was found to be statistically significant at a confidence level of .01. This means that one can be 99% confident that the differences observed were not due simply to sampling differences.⁷⁸ If the frequency of LLC usage reported by attorneys is any indication of the popularity of the LLC as a choice of entity, the LLC appears to rank the highest in California and Delaware, and the lowest in New York and Pennsylvania.

The variation in the reported frequency of LLC usage among the four states is consistent with a recent estimate of the ratio of LLC filings with the Secretary of States in California, Delaware, New York, and Pennsylvania for the year 2000 shown in Table V. The ratio of LLC to total filings with the Secretary of State is highest in California and Delaware at 34% and 81%, respectively, and lowest in New York and Pennsylvania at 30% and 22%, respectively.

75. See Ciccotello & Grant, *supra* note 1, at 87 (providing a nationwide review of LLC registrations during 1992 to 1996 and reporting new LLC registrations as sixteen percent of all new registrations in 1996); Ribstein & Kobayashi, *supra* note 1, at 122 (reporting a preference of LLCs over LLPs in an empirical study of the use of LLCs and LLPs from 1993 to 1999).

76. See RIBSTEIN & KEATINGE, *supra* note 12, at 1.01.

77. See Miller, *supra* note 1, at 414.

78. See WILLIAM G. ZIKMUND, EXPLORING MARKETING RESEARCH, 624–27 and 778, tbl. A.4 Chi-Square Distribution (2000) (discussing the Chi-Square test for goodness of fit and its application to test for statistical significance); Armstrong & Overton, *supra* note 74, at 396–97 (citing methods, including comparing known values of the population such as age or income, or making subjective estimates of bias). Also, the author gratefully acknowledges the assistance of Ralph Greenberg, Professor of Accounting at Temple University, for conducting this statistical test.

TABLE V: ESTIMATED NEW REGISTRATIONS OF LLCs AND CORPORATIONS DURING THE YEAR 2000

STATE	ESTIMATED LLC FILINGS	ESTIMATED CORPORATE FILINGS	RATIO OF ESTIMATED LLC FILINGS TO ESTIMATED CORPORATE FILINGS
CA	33,261	99,100	34%
DE	47,904	59,071	81%
NY	25,265	84,891	30%
PA	459	2,110	22%

CALIFORNIA ESTIMATES: Based upon the number of documents found in a LEXIS-NEXIS search conducted on 5/21/01 using the INCORP library, the file CASOS (California Secretary of State). After an instruction to conduct a new search (.ns) the following search was entered: corporate record and date is 2000. The search revealed 99,100 documents. Thereafter, the specific search to estimate LLC filings was: limited liability companies and filing-date=2000 and 33,261 documents were found.

DELAWARE ESTIMATES: Based upon a telephone conversation with Cheryl Wyatt, Corporations Systems Specialist with the Secretary of State Division of Corporations in Delaware on 5/22/01 based upon a monthly internal report on new business registrations in Delaware. Secretary of State filings for Delaware are not recorded on LEXIS-NEXUS.

NEW YORK ESTIMATES: Based upon the number of documents found in a LEXIS-NEXUS search conducted on 5/21/01 in the INCORP library and the file NYSOS. After a new search command was given, the search was: foreign or domestic business and date is 2000, which revealed 84,891 documents. After a new search command was given,(.ns) the search was: limited liability company and date is 2000. The search revealed 25,265 documents.

PENNSYLVANIA ESTIMATES: Based upon a LEXIS-NEXIS search conducted on May 22, 2001 using the INCORP library, the PASOS file, a new search command(.ns) and the following search: Filing-date =2000 and name-(llc or l l c or l.l.c.).

The comparatively lower frequency of home-state LLC usage reported by New York and Pennsylvania practitioners may be explained, in part, by tax and/or administrative burdens imposed on LLCs in New York and Pennsylvania. Pennsylvania LLCs and S Corporations are both subject to the Capital Stock-Franchise tax. Further, prior to 1998, Pennsylvania LLCs were subject to a state corporate income tax. In light of this unfavorable state tax environment, Pennsylvania practitioners may be more inclined than practitioners from other states to use the limited partnership rather than the LLC. Also, since the corporate net income tax was only recently eliminated, Pennsylvania practitioners may be more accustomed to using the S Corporation in lieu of the LLC. In comments to the questionnaires, a number of Pennsylvania practitioners made reference to the Pennsylvania tax problem.

The comparatively lower frequency of LLC usage by New York practitioners may be explained in part by the annual filing fees applicable to New York LLCs and New York's LLC publication costs.⁷⁹ In comments, some New York practitioners complained about LLC publication costs, which one practitioner described as "bizarre." New York's unitary income tax was also cited as a deterrent to a parent⁸⁰ The practitioners' responses to Question 2 regarding the usage of out-of-state (non-CA, non-DE, non-NY, or non-PA) LLCs provide further insight into the variation that exists in LLC usage in the four different states. Table IV and Appendix A summarize the state-by-state breakdown of responses to Question 2, in which practitioners were asked whether they frequently use out-of-state LLCs.

It is noteworthy that only 6% of Delaware practitioners replied "Yes" when asked whether they frequently use non-Delaware LLCs, while as many as 33% of California practitioners, 39% of New York practitioners, and 25% of Pennsylvania practitioners reported that they frequently use out-of-state LLCs. The differences among the four states were found to be statistically significant at the .01 level. Thus, one can be 99% confident that the differences observed were not due simply to sampling variation.

79. See 4 St. Tax Rep. N.Y. (CCH), § 99-797 (1997) (indicating that partners are not subject to New York income tax and that the term "partnership" includes LLCs classified as partnerships for federal tax purposes); 1 St. Tax Rep. N.Y. (CCH) § 1-550 (2000) (indicating that the annual filing fee equals \$50 multiplied by the number of members, with a minimum of \$325 and a maximum of \$10,000); New York State Tax Guide for New Businesses published by the New York State Department of Taxation and Finance, Publication 20; www.tax.state.ny.us and Form IT 204LL).

80. See *infra* Appendix C for selected comments.

Further, the difference between the Delaware responses on one hand, and the California, New York, and Pennsylvania responses on the other hand, were also found to be statistically significant at the .01 level.

The results to question 2 regarding usage of out-of-state LLCs suggest that respondents may indeed be gravitating toward the most favorable state and local forums, and this pattern is consistent with the widely-held view that Delaware provides a favorable legal and tax environment, which attracts business.

The comparatively higher LLC usage in California and Delaware, coupled with the comparatively low rate of usage in out-of-state LLCs by Delaware respondents, are also consistent with the assertion made by Ribstein and Kobayashi that the inherent characteristics of the business forms, such as their state tax implications, appear to be a significant driving force in the business-entity selection process.⁸¹

B. THE REPRESENTATION OF MAJORITY AND MINORITY LLC INVESTORS

Overall, an average of 56% of respondents reported that they frequently represent majority LLC owners in question 3, while an average of only 20% reported frequent representation of minority LLC owners in question 4. To some extent, the reported disparity in majority and minority representation may be explained, in part, by the fact that many LLCs have only one owner.

Interestingly, on a state-by-state basis, a greater percentage of California and Delaware practitioners replied “Yes” when asked whether they frequently represent minority LLC owners. Although approximately 26% of California and Delaware practitioners said they frequently represent minority owners, only 21% and 14% of New York and Pennsylvania practitioners, respectively, replied “Yes” when asked whether they frequently represent the minority.

Although broad generalizations should be avoided, the comparatively low rate of minority LLC representation reported by practitioners who *did* respond is somewhat disturbing, both because of the traditional vulnerability of the private minority investor⁸² and also because of the statutory and judicial emphasis on, and deference to, the contractual

81. See Ribstein & Kobayashi, *supra* note 1, at 121–24.

82. See Miller, *supra* note 1, at 436–40.

operating agreement between the parties.⁸³ Relatively few state LLC statutes contain statutory remedies for oppressive conduct. Although California, New York, and Pennsylvania all have statutory remedies for unfairly prejudicial or oppressive conduct for corporate shareholders,⁸⁴ only California contains comparable remedies for LLC members.⁸⁵

The historic vulnerability of the minority private investor and the power of the majority to “lock in” minority participants have long been topics of academic discussion.⁸⁶ Classic oppressive majority tactics have included the withholding of distributions, the restriction or preclusion of employment, excessive compensation to majority owners, withholding information from minority members, violating procedural restrictions in corporate governance, and depriving the minority of a voice in corporate decisionmaking.⁸⁷

LLC member disputes are only now beginning to emerge in the judicial landscape of business entities, while the case law extending judicial protection to the minority LLC member is still in its infancy. In some cases, courts appear poised to challenge specific transactions that are blatantly unfair. Thus, in *Gee v. Bullock*, a Rhode Island Superior Court voided a transfer of LLC assets made fraudulently by one LLC member without the consent or knowledge of the other LLC member,⁸⁸ and a District Court of New York recognized the potential appropriateness of a

83. See *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A. 2d 286, 291 (1999) (indicating that it is the policy of Delaware’s LLC Act to give the maximum effect to the principle of freedom of contract and that commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members’ agreement be invalidated).

84. See CAL. CORP. CODE § 1800 (West 2001) (providing for dissolution in the event of unfairly prejudicial conduct); N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986 & Supp. 2002) (providing for judicial dissolution for holders of 20% of privately held corporations in the event of illegal, fraudulent, or oppressive actions by directors or those in control, or where assets or property is being looted, wasted, or diverted for private use by directors, officers, or those in control); 15 PA CONS. STAT. ANN. § 1981 (2001) (authorizing shareholders or directors of all business corporations to seek an involuntary winding up and dissolution when the acts of the directors or those in control are illegal, oppressive, or fraudulent; in certain cases in which assets are being misapplied; or wasted or in specified instances of deadlock).

85. See CAL. CORP. CODE § 17351(a) (2001) (authorizing an action by any member or manager to obtain a decree of dissolution in a variety of circumstances, including where there is deadlock or internal dissension, or where those in control have been guilty of, or have knowingly countenanced, persistent fraud, mismanagement, or abuse of authority).

86. See generally Sandra K. Miller, *A Note on the Definition of Oppressive Conduct by Majority Shareholders: How Can the Reasonable Expectation Standard be Reasonably Applied in Pennsylvania?*, 12 J. L. & COM. 51 (1992).

87. *Orchard v. Covelli*, 590 F. Supp. 1548, 1557 (1984) (outlining the typical tactics of minority shareholder oppression).

88. *Gee v. Bullock*, No. 96-2223, 1996 R.I. Super. LEXIS 51, at *16 (R.I. Super. Nov. 16, 1996).

derivative suit where a minority LLC owner picketed the LLC's bake shop in an apparent attempt to destroy the LLC's business.⁸⁹ The Delaware Chancery has also rescinded mergers or awarded damages where the contested transactions were conducted in a secretive, clandestine, or particularly unfair manner.⁹⁰

Other decisions emphasize the supremacy of the LLC operating agreement, however, and in a number of cases, courts have refused to intervene in the so-called private ordering process.⁹¹ As the Delaware Chancery Court has recently noted, "The LLC members' rights begin and typically end with the Operating Agreement."⁹² Thus, in *Elf Atochem North America, Inc. v. Jaffari*, the Delaware Supreme Court denied the right to a derivative lawsuit by the LLC where the LLC members had included an arbitration clause in the operating agreement.⁹³ The Court emphasized that it is the policy of the Delaware LLC Act to provide broad discretion in drafting the LLC agreement. The Court rejected plaintiff's argument that the LLC was entitled to institute a derivative suit notwithstanding an arbitration clause because the LLC as an entity had not been a party to the LLC agreement.⁹⁴ The Court's failure to intervene is

89. *Weber v. King*, 110 F. Supp.2d 124, 127–28 (2000) (involving a case that was dismissed for failure to join an indispensable party, but where the court recognized the potential appropriateness of a derivative lawsuit where plaintiffs had purchased a two-thirds interest of defendant's bake shop business by forming an LLC that was to serve as a vehicle through which the defendant could expand her bake shop business through a regional distribution of her baked goods). *See also* *Taurus Advisory Group, Inc. v. Sector Mgmt., Inc.*, No. CV960150830, 1996 Conn. Super. LEXIS 2272, at *4 (Conn. Super. 1996) (applying Delaware law and indicating that although there was no case law in Delaware regarding derivative suits against LLCs, the parties accepted the analogy to limited partnerships in which limited partners are treated like shareholders because of the similarity of their investment to that of corporate shareholders).

90. *See VGS, Inc. v. Castiel*, No. 17995, 2000 De. Ch. LEXIS 122, at *15 (Del. Ch. Aug. 31, 2000) (involving two minority LLC owners who had failed to notify a third majority member of a meeting at which the two minority members conspired to approve a merger that reduced the absent majority's control of the business from 75% to 37.5%); *Cole v. Kershaw*, No. 13904, 2000 De. Ch. LEXIS 117 (Del. Ch. Aug. 2000) (holding that entire fairness was the applicable standard of review and awarding damages to the plaintiff where the defendant had failed to give the plaintiff advance notice of a transaction that was adverse to plaintiff's interest).

91. *See Walker v. Res. Dev. Co.*, 791 A.2d 799, 813–14 (2000) (failing to grant the plaintiffs an equitable power to remove an LLC member for a breach of fiduciary duty because the parties had executed an LLC agreement that failed to expressly provide for a power of removal, an omission that the court found surprising in light of the fact that the participants knew that one of the members had a history of embarrassing the business, had experienced bouts of drunkenness and alcohol abuse, and had previously misrepresented his sophistication in financing transactions).

92. *See id.* at *41. *See also* *McConnel v. Hunt Sports Enters.*, 725 N.E.2d 1193, 1216 (Ohio App. 1999) (holding that although normally the fiduciary obligation would preclude competition, the defendant's competition was not prohibited since the LLC agreement permitted competition).

93. 727 A.2d 286, 293–94 (Del. 1999).

94. *See id.* at 293.

noteworthy, considering the severity of the allegations, which included alleged tortious interference with business relations and threatened violations of environmental laws and regulations.⁹⁵

In light of the disparity between the representation of majority and minority LLC owners reported by the respondents to the questionnaire, it is suggested that further research be conducted regarding the representation of minority LLC members. In addition, as further discussed below, Part IV recommends increased efforts to educate the business community as to the importance of retaining counsel for representation in the negotiation of the LLC operating agreement and of warning participants of the pitfalls of using simplistic contractual form agreements found in self-help, do-it-yourself LLC books.

C. BUY-OUT RIGHTS

Overall, only approximately 8% of respondents replied “Yes” when asked in question 5 whether their usual LLC agreement contains an absolute buy-out provision exercisable by minority owners, and 73% replied “No” to the same question. In contrast, 20% of respondents replied “Yes” when asked whether in their usual agreement they give majority owners the absolute right to force the LLC to buy them out at the fair market value of their interest.⁹⁶ It is difficult to draw clear conclusions about practitioners’ practices regarding buy-out clauses from the responses to questions 5 and 6. It is quite possible that practitioners had difficulty formulating answers to the buy-out questions because they had not employed a “usual agreement.” Also, some practitioners may be using various types of buy-out clauses, which use formulae other than the “fair market value of the interest.” The contractual buy-out clauses practitioners use are not absolute and may instead be tied to various conditional triggering events, or buy-out rights may be drafted in the form of a “right of first refusal.”⁹⁷ Notwithstanding the inherent shortcomings of the buy-out questions, it appears from the responses to questions 5 and 6 that a greater percentage of the respondents say they give absolute buy-out power to majority owners than to minority owners.

95. *Id.* See also *Albertson v. Magnetmakers, LLC*, No. 99-4931C, 2000 Mass. Super. LEXIS 34, at *1 (Mass. Super. 2000) (observing that under Massachusetts law a written agreement to arbitrate is enforceable and that it is immaterial whether claims are based in tort or contract).

96. See Tables IV and Appendix A.

97. See RIBSTEIN & KEATINGE, *supra* note 12, at app.A-4 § 11.3 (containing a Right of First Refusal).

D. DEFAULT EXIT RIGHTS

Question 7 of the Questionnaire asked practitioners whether, if they were to form an LLC tomorrow, a member would have the right to a buy-out if he or she left the LLC prior to its winding up. The question was asked to assess practitioners' familiarity with their states' default LLC member buy-out rights, which have undergone significant changes in recent years, as discussed in Part I.⁹⁸

The California LLC statute now provides that notwithstanding anything contrary under applicable law, unless an operating agreement provides otherwise, a member may not withdraw from the LLC unless the operating agreement provides to the contrary.⁹⁹ The Delaware and New York LLC statutes similarly provide that unless an LLC agreement provides otherwise, a member may not resign from an LLC prior to its dissolution and winding up.¹⁰⁰ In contrast, the Pennsylvania LLC statute provides in part that upon the occurrence of an event of dissociation that does not result in the dissolution of the LLC, the member is entitled to receive any distribution pursuant to the operating agreement, and within a reasonable time after dissociation, the fair market value of the interest.¹⁰¹ However, a separate section of the Pennsylvania LLC statute expressly authorizes the LLC agreement to prohibit voluntary dissociation prior to the dissolution and winding up of the company.¹⁰²

98. See Miller, *supra* note 1, at 415.

99. See CAL. CORP. CODE § 17252 (West 2001) (providing in part that unless the articles of organization or written operating agreement provide otherwise, the withdrawn member shall not be entitled to payment for the member's interest in the limited liability company, and that beginning on the date of the withdrawal, the withdrawn member shall have only the right of a holder of an economic interest).

100. See DEL. CODE ANN. tit. 6 § 18-603 (2001); N.Y. LTD. LIAB. CO. LAW § 606 (McKinney 2002) (providing in part that a member may withdraw only at the time or upon the happening of events specified in the operating agreement and that notwithstanding anything to the contrary may not withdraw prior to the dissolution and winding up of the limited liability company).

101. PA. CONS. STAT. § 8933 (1995 & Supp. 2002) (providing that upon the occurrence of an event of dissociation that does not result in the dissolution of the limited liability company, a dissociating member is entitled to receive any distribution to which the member is entitled under the operating agreement on the terms provided in the operating agreement and, within a reasonable time after dissociation, the fair value of the interest of the member in the company as of the date of dissociation based upon the right of the member to share in distributions from the company).

102. PA. CONS. STAT. § 8948 (1995 & Supp. 2002) (indicating that notwithstanding anything to the contrary, an operating agreement may provide that a member may not voluntarily dissociate from the limited liability company or assign his membership interest prior to the dissolution and winding up of the company, and an attempt by a member to dissociate voluntarily from the company in violation of the operating agreement shall be ineffective).

The results of the responses to question 7 appear in Table IV and Appendix A. The results show that a majority of respondents in California, Delaware, and New York correctly replied “No” when asked if they were to form an LLC tomorrow and the LLC agreement were silent, whether a member would have the right to a buy-out if he or she left the LLC prior to its winding up. Approximately 69% of California practitioners, 53% of Delaware practitioners, and 61% of New York practitioners correctly replied “No” when asked whether a member would have a right to a buy-out if the practitioner formed an LLC tomorrow and the agreement was silent. In contrast, approximately 56% of Pennsylvania practitioners *incorrectly* replied “No” when asked whether the LLC member would be entitled to a buy-out upon dissociation prior to the winding up of the company.

A variety of conclusions may be drawn from these survey results on familiarity with default LLC buy-out rights. It is possible that Pennsylvania practitioners are simply less familiar with LLC rules because adverse state tax treatment is resulting in less frequent use of the LLC in Pennsylvania. Because a corporate net income tax applied to Pennsylvania LLCs until 1998, it is possible that Pennsylvania practitioners have not yet had sufficient time to absorb the change in the law and have not yet gained sufficient exposure to Pennsylvania LLCs. Alternatively, one could argue that most practitioners rationally would expect that a member *would not* be entitled to a buy-out upon dissociation prior to the dissolution of the firm. Under this line of reasoning, if the best statutory default rule is the one that most closely conforms to practitioner and/or investor expectations, one could argue that the statutory granting of a default buy-out right makes for a *very poor* default position because it is not the position most practitioners would anticipate. In fact, one of the comments made by a practitioner described Pennsylvania’s default buy-out rule as a “trap.”¹⁰³ One could also argue that the best default rule is the one that tends to bring the parties to the negotiating table, and that a default rule that locks investors into an entity is a rule that will most effectively compel the parties to approach the table to negotiate an express buy-out provision.¹⁰⁴

There are, of course, many arguments in favor of retaining default buy-out rights, not the least of which is that the LLC has been intended as a vehicle for the informal conduct of private business, and that locking in

103. See *infra* Appendix C.

104. See Coffee, Jr., *supra* note 8, at 1623 (indicating that “the optimal default rule is not the rule that either maximizes wealth or reflects what rational parties would have intended, but rather the rule that best compels each party to reveal to the other its intended use of discretionary powers”).

investors creates rich grounds for oppressive majority misconduct. The inherent weakness of the minority's negotiating position, the absence of statutory remedies for oppressive conduct in LLC legislation, and procedural and substantive uncertainties surrounding the duty of loyalty and/or the standard of care in the LLC context have all been cited as factors that favor the retention of default buy-out rights.¹⁰⁵ Inequalities in the extent of legal representation of minority owners could be added to the list of arguments favoring default buy-out rights.

Although reasonable minds may differ on the relative merit of default buy-out rights, all would probably agree that regardless of which statutory position is taken, the legal community should become thoroughly familiar with the default law. As discussed in Part IV below, at a minimum, the results of the survey suggest a need for increased professional education of the legal community with regard to default LLC rules.

E. LLC DISPUTES AND LITIGATION

Overall, a total of 199 practitioners, roughly 26% of respondents, replied "Yes" when asked whether they had ever handled a majority/minority dispute. The fact that over a quarter of practitioners reported having handled majority/minority disputes is not a surprising result in light of the long history of majority/minority disputes involving close corporations.¹⁰⁶ This finding lends support to the recommendation that further research be conducted regarding the LLC majority/minority relationship. The results to Question 8 appear in Table IV and Appendix A.

105. See Miller, *supra* note 1 at 417–18 (critiquing the elimination of default buy-out rights to accomplish estate tax objectives).

106. See JAMES D. COX, THOMAS LEE HAZEN & F. HODGE O'NEAL, CORPORATIONS § 14.11–14.16 (2001) (discussing the prevalence of shareholder disputes and the role of shareholder agreements in preventing litigation); F.H. O'NEAL & R. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 7.21 (2d ed. Supp. 2002) (referring to a number of litigated shareholder disputes that have centered around valuation issues and the concept of fair value); WILLIAM H. PAINTER, 1 PAINTER ON CLOSE CORPORATIONS: CORPORATE, SECURITIES, AND TAX ASPECTS § 7:2 (1999) (analyzing the significant risks assumed by investors in private business entities). See also Sandra K. Miller, *How Should U.K. and U.S. Minority Shareholder Remedies for Unfairly Prejudicial or Oppressive Conduct be Reformed?*, 36 AM. BUS. L.J. 579, 580 (1999) [hereinafter *U.K. and U.S. Minority Shareholder Remedies*] (indicating that existing studies suggest that U.S. dissolution cases present a broad range of factual settings); Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 30 CORNELL INT'L L.J. 381, 383–93 (1997) (discussing the universal nature of interpersonal disputes in the private enterprise).

On a state-by-state basis, the percentage of practitioners replying that they had handled majority/minority disputes was highest in California and Delaware, at 37% and 36% respectively, and lowest in New York and Pennsylvania, at 27% and 13% respectively. In other words, practitioners in the two states with the higher frequency of LLC usage (and the states with the more flexible and arguably less onerous regulatory environment) appeared to report a greater experience with disputes than their more restrictive counterparts. These state-by-state differences in the rate of experience with majority/minority disputes were found to be statistically significant at the .01 level. Once again, this means that we can be 99% confident that the observed differences were not due to just random sampling differences.¹⁰⁷

Of the 199 respondents who reported handling minority disputes, approximately 29% went on to indicate in question 9 that a lawsuit had been filed. In California and Delaware, the percentages of practitioners reporting that suits had been filed were 21% and 50%, respectively. In New York and Pennsylvania, 9% and 25% of practitioners indicated suits had been filed. The differences in percentages among the four states were found to be statistically significant, as were the differences in rates shown between Delaware as compared to California, New York, and Pennsylvania.¹⁰⁸

On the surface, the data suggest that about two-thirds of majority/minority LLC disputes handled by respondents are being resolved without resort to litigation. The rate of litigation once a dispute emerges appears to vary considerably depending on each state and the LLC statute. With regard to dispute resolution, it is difficult to compare the LLC's relative effectiveness with that of the partnership or private corporation, since so little empirical research has been done on litigation experience in the context of partnerships and corporations.¹⁰⁹ The two studies that have been done on shareholder disputes involved *litigated* disputes and the use

107. See *infra* Appendix B.

108. See *infra* Appendix B.

109. See Harry J. Haynsworth, *The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25, 51-53 (1986-87) (analyzing forty-seven published 1984 and 1985 dissolution cases and finding that a buy-out occurred in fifty-four percent of the cases, and that dissolution was granted in twenty-seven percent of the cases); 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, 30-31 (1977) (analyzing fifty-four reported cases involving suits for dissolution and finding that buyouts occurred in the majority of cases). See also Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 471-73 (1990) (discussing valuation of minority discounts in business buy-outs).

of the judicial remedy of shareholder buy-out as compared with the remedy of a judicial dissolution of the corporations.¹¹⁰

Perhaps one of the most interesting findings of the present study is the comparatively high rate of dispute and litigation experience reported by Delaware practitioners. The Delaware rate of experience with majority/minority disputes, reported at 36%, topped comparable rates reported by practitioners in all other states except California. Further, of the practitioners who had handled disputes, the percentage of those indicating a lawsuit had been filed was quite a bit higher for Delaware practitioners than for practitioners with dispute experience in California, New York, and Pennsylvania. Prior to this study, it had been suggested that “hands-off” LLC statutes that employ a contractual rather than mandatory approach to LLC governance would result in less, rather than more, litigation.¹¹¹ In fact, the desire to avoid “officious (although admittedly well-intentioned) meddling” with the internal affairs of small business has been cited as a driving force in the development of the contractual approach taken by the Delaware LLC statute.¹¹² If it were true that contractually-driven LLC statutes deter disputes, one would expect Delaware practitioners to report the lowest rate of experience with LLC majority/minority disputes and litigation. Interestingly, greater contractual flexibility in business-entity law may create an environment that fosters an increase rather than a decrease in disputes among LLC participants. Of course, there may be other explanations as to why the dispute experience and litigation rates are comparatively high in Delaware. Perhaps a more sophisticated and well-represented pool of clients gravitate toward Delaware. Such a trend could also explain why Delaware practitioners reported the highest representation of minority LLC owners.

It would be helpful for further research to be done comparing practitioners’ experiences in dispute resolution and litigation in an expanded pool of states with different types of LLC statutes over the course of several years. It would be useful to conduct a similar analysis of disputes in partnerships and privately owned corporations. A

110. See Haynsworth, *supra* note 109, at 51–53. See also Hetherington & Dooley, *supra* note 109, at 30–31.

111. See Oesterle, *supra* note 4, at 917 (analyzing hands-off LLC statutes and reporting that the California division of the American Trial Lawyers Association noticed that “hands-off LLC statutes . . . But see John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 939–41 (1988) (observing that “the corollary of the need for greater flexibility is also the need for closer judicial monitoring”).

112. *Id.* at 883.

comprehensive study of dispute resolution across business entities and LLC statutes would assist in an overall evaluation of business entity forms and could expose strengths and weaknesses of alternative statutory regimes.

F. MINORITY CONTRACTUAL PROTECTIONS

Question 10 asked practitioners whether in their usual LLC agreement the company dissolves by court order upon a showing of illegal, fraudulent, or oppressive conduct by majority owners. Comparable provisions protecting against deadlock and majority squeeze-outs are contained in Ribstein and Keatinge's Model Operating Agreement.¹¹³ The results appear in Table IV and Appendix A.

Overall, only 14% of respondents replied "Yes" when asked whether in their usual LLC agreement, the company dissolves by court order upon a showing of illegal, fraudulent, or oppressive conduct by majority owners. It is interesting that in Delaware, only 4% of practitioners included such contractual protection, and yet, in question 4, 26% of Delaware practitioners reported frequent representation of minority owners. In contrast, 25% of California practitioners reported including such contractual protection. Approximately 14% and 16% of practitioners in Pennsylvania and New York, respectively, replied that under their usual LLC agreement the entity would dissolve by court order upon a showing of illegal, fraudulent, or oppressive majority conduct. These state-by-state differences were found to be statistically significant at the .01 confidence level. The difference in the rates reported by California and Delaware were also found to be statistically significant at the .01 confidence level.¹¹⁴ Ironically, it may be argued that Delaware minority owners require greater express contractual protections against majority misconduct than their

113. See RIBSTEIN & KEATINGE, *supra* note 12, at app. A-1 p. 55, providing:

Dissolution:

(a) The Company shall be dissolved only upon the occurrence of any of the following events:

(1) by [the unanimous written agreement of the Members] [the written agreement of Members holding Two-Thirds Interest];

(2) by an order of a court of competent jurisdiction in an action commenced by any Member in which the Member can show that:

The Members are deadlocked in the management of the Company's affairs, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted, because of the deadlock;

The Managers or other Members in control of the Company have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

There have been repeated, material breaches of the Agreement by the Company or by other Members or Managers; or

The corporate assets are being misapplied or wasted;

[upon the expiration of the term, if any, specified in Section 2.5 of the Agreement.]

114. See *infra* Appendix B.

counterparts in many other states because the Delaware LLC statute fails to contain an express statutory remedy for deadlock, fraud, mismanagement, or abuse of authority, as does the California LLC statute.¹¹⁵ While other jurisdictions have applied a “heightened” duty of loyalty in the close corporation arena, Delaware Courts have failed to do so.¹¹⁶ Without express contractual or statutory protection against oppressive majority tactics, Delaware LLC participants apparently must look to the developing law utilizing “fundamental fairness” as a basis for challenging self-interested and exploitive conduct in the LLC context.¹¹⁷

The low overall rate of usage of contractual minority protections tends to paint a portrait of a not-so-level playing field for majority and minority participants. Legal counsel for minority investors may be unaware of the value of enacting express contractual protections against majority misconduct, or may otherwise be unable to effectively negotiate for the inclusion of such protections in the operating agreement. In either event, it

115. See CAL. CORP. CODE § 17351 (West 2001) (providing for dissolution if 1) it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement, 2) dissolution is reasonably necessary for the protection of the rights or interests of the complaining members, 3) the business has been abandoned, 4) there is deadlock or internal dissension, or 5) those in control have been guilty of, or have knowingly countenanced, persistent and pervasive fraud, mismanagement, or abuse of authority).

116. See *Ueltzhoffer v. Fox Fire Dev. Co.*, No. 9871, 1991 Del. Ch. LEXIS 204, at *22, (Dec. 19, 1991) *aff'd*, 618 A.2d 90 (Del. 1992) (observing the absence of Delaware authority following *Wiles v. Springside Nursing Home, Inc.*, and refusing to rule that there had been a violation of fiduciary duty where the plaintiff was fired but where the plaintiff's competence was not entirely free from doubt). See also *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 33–40 (Del. 1996) (involving a lawsuit by a fifteen percent minority shareholder/employee who claimed that the majority had breached its fiduciary duty by dismissing him as an employee and indicating that the company's status as a closely held company did not alter the duties of stockholders *inter se*); *Nixon v. Blackwell*, 626 A.2d 1366, 1377 (Del. 1993) (refusing to hold that the board of directors breached their fiduciary duties to nonemployee minority shareholders by failing to offer them the same liquidity offered to employee-shareholders who were covered by an ESOP plan and key life insurance); *Olsen v. Seifert*, No. 97-6456, 1998 Mass. Super. LEXIS 592, at *11 (Mass. Super. Ct. Aug. 28, 1998) (explaining that Delaware law does not impose broad fiduciary duties on stockholders of a closely held corporation).

117. See *VGS, Inc. v. Castiel*, No. 17995 LEXIS 122, 11 (Del. Ch. Aug. 31, 2000) *aff'd*, 781 A.2d 696 (Del. 2001) (rescinding a merger which was clandestinely approved by a meeting in the absence of the majority owner, indicating that the General Assembly never intended to enable two managers to deprive, clandestinely and surreptitiously, a third manager of an opportunity to protect his interest, an interpretation grounded in a classic maxim of equity: Equity looks to intent rather than form). See also *Cole v. Kershaw*, No. 13904 LEXIS 117, *25–*30 (Del. Ch. Aug. 5, 2000) (indicating that all parties agree that entire fairness is the applicable standard of review and awarding damages where there was neither a fair procedure nor a fair price). See generally Theresa L. Kelly, *Nixon v. Blackwell: Fairness But Not Equality For Minority Shareholders*, 19 DEL. J. CORP. L. 533 (1994) (analyzing the implications of *Nixon v. Blackwell*). See also Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099 (1999) (highlighting the failure of Delaware to embrace heightened fiduciary duties but stressing that the doctrine of fundamental fairness may be usefully extended to protect against majority misconduct).

may be appropriate for the legislative community to reconsider the appropriateness of default statutory protections against oppressive majority tactics, such as those contained in the Uniform Limited Liability Company Act (which was discussed in detail in Part IV).¹¹⁸

G. PRACTITIONERS' VIEWS REGARDING THE EXTENT OF NEGOTIATION INVOLVED IN THE FORMATION OF THE LLC OPERATING AGREEMENT

Question 11 of the Questionnaire asked practitioners whether they believe that many LLC agreements are based on form agreements that are not extensively negotiated. Over two-thirds of all practitioners replied "Yes" when asked whether they believe that many in-state or out-of-state LLC agreements are based on form agreements that are not extensively negotiated. The perception that many LLCs are being formed with a minimum of paperwork at a minimal cost is not surprising in light of the growing array of "self-help" books that guide readers on how to form an LLC.¹¹⁹ Approximately 81% and 59% of practitioners in California and Delaware, respectively, agreed that many LLC agreements are based on form agreements that are not extensively negotiated. Approximately 59% and 68% of practitioners in New York and Pennsylvania also indicated that they believed that LLC agreements are based on form agreements that are not extensively negotiated. The differences in these responses were statistically significant at the .01 confidence level.¹²⁰

IV. HIGHLIGHTS AND RECOMMENDATIONS

One of the most interesting findings of the study concerns differences in the dispute and litigation experience observed under the different LLC statutes sampled. Other noteworthy observations include differences in LLC usage in states with different regulatory and statutory regimes, the low rate of usage of contractual minority protections, and the lack of familiarity with default buy-out rules, particularly in Pennsylvania. Because of both the inherent flaws in survey research, and the potential for nonresponse bias, care should be taken to avoid sweeping generalizations going beyond the pool of practitioners who actually responded to the questionnaire. Notwithstanding the limitations of survey research of this type, several

118. See UNIF. LTD. LIAB. CO. ACT § 801 cmt. (1996).

119. See W. DEAN BROWN, HOW TO FORM A CORPORATION LLC OR PARTNERSHIP (2000); SCOTT E. FRIEDMAN, HOW TO PROFIT BY FORMING YOUR OWN LIMITED LIABILITY COMPANY (1996); ANTHONY MANCUSO, FORM YOUR OWN LIMITED LIABILITY COMPANY (2d ed. 2000); MARTIN M. SHENKMAN & SAMUEL WEINER & IVAN TABACK, STARTING A LIMITED LIABILITY COMPANY (1996).

120. See *infra* Appendix B.

fascinating trends may be emerging that provide rich grounds for further research.

In light of the observations made by the study, the following suggestions warrant discussion: 1) the need for continued judicial monitoring based on the facts and circumstances of each case to enforce LLC agreements and combat opportunistic and fundamentally unfair conduct, 2) the importance of future business entity legal education, 3) the need for educational initiatives targeted to the business community, 4) the desirability of expanded comparative study of dispute and litigation experience under different statutory regimes, and 5) the reevaluation of the Uniform Limited Liability Company Act after several more years of experimentation and study of different styles of LLC statutes.

A. THE IMPORTANCE OF JUDICIAL MONITORING

Approximately 26% of respondents replied that they had handled majority/minority disputes. As few as 15% of respondents indicated that they had employed express contractual protection against oppressive majority conduct. Further, as many as 50% of Delaware practitioners who had handled majority/minority disputes indicated that a lawsuit was filed.

Active judicial monitoring of the LLC majority/minority relationship appears to be inevitable in a contractarian business-entity environment, and active judicial monitoring to enforce LLC agreements, as well as to prevent opportunistic conduct, will undoubtedly be necessary. The judicial commitment to enforce contractual expectations does not conflict with active judicial monitoring of investor conduct. Rather, active judicial oversight is the necessary underpinning of the entire contractual process. It is precisely the threat of judicial intervention that enables the parties to rely on each others' promises and to come to expect good faith and fundamental fairness on the part of fellow LLC investors.¹²¹

An operating agreement cannot be expected to resolve all of the conflicts that may arise in a swiftly changing competitive economy. Some participants may never enter an operating agreement,¹²² or others may have an inadequate agreement that fails to anticipate a potentially impending

121. See Coffee Jr., *supra* note 8, at 1621 (discussing the judicial role in a contractarian environment).

122. *New Horizons Supply Coop. v. Haack*, 590 N.W.2d 282 (Wis. Ct. App. 1999) (unpublished opinion) (indicating that an LLC agreement was never entered into evidence).

deadlock.¹²³ A lawsuit may be required where the grievance is not addressed in the operating agreement,¹²⁴ or where the understanding between the parties was primarily oral, or not fully articulated in the operating agreement.¹²⁵

A contractual solution to disputes may be particularly difficult in family-owned LLCs. In second-generation businesses, for example, children may join parents or relatives in a business enterprise. Minority interests may be inherited and the business may be operated by a variety of relatives or acquaintances over a considerable period of time. The original LLC operating agreement may indeed be personal to those parties who initially formed the limited liability company and negotiated and drafted the LLC agreement. Members who inherit an LLC interest or who join an LLC years after its formation may either lack the foresight or the leverage to renegotiate the fundamental workings of an existing LLC agreement. Those minority owners who inherit an LLC interest as assignees and are inactive may lack the sophistication or the bargaining power to modify the fundamental terms of the inherited LLC operating agreement.¹²⁶ Thus,

123. *Meiselman v. Meiselman*, 307 S.E.2d 551, 558 (N.C. 1983) (explaining that close corporations are formed by friends or family members who simply may not believe that disagreements could ever arise).

124. *See generally* *McCauley v. McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986) (involving a lawsuit by a divorced wife against her former husband, parental in-laws, and two sons alleging improper expulsion from management, failure to pay dividends, and conversion of corporate assets to personal use, where nothing in the company by-laws or contractual agreements addressed the grievances at issue); *Fox v. 7L Bar Ranch Co.*, 645 P.2d 929 (Mont. 1982) (involving an action for dissolution of a family corporation where neither the articles of incorporation nor any other contractual documents were cited); *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973) (involving exclusion of the plaintiff as an employee of the corporation but not citing articles of incorporation or other contractual documents); *Masinter v. Webco Co.*, 262 S.E.2d 433 (W. Va. 1980) (involving a squeeze-out of the minority shareholder from the Board of Directors but not referring to shareholder documents). *But see* *Capitol Toyota, Inc. v. Gervin*, 381 So. 2d 1038 (Miss. 1980) (including a formal written contract with the minority shareholder providing that his twenty-five percent stock interest was subject to the condition that he be employed at retirement).

125. *See* F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873, 884 (1978) (discussing the array of difficulties encountered by the minority shareholders). O'Neal, the leading authority on close corporations explains:

[M]any participants in closely-held corporations are "little people," unsophisticated in business and financial matters. Not uncommonly a participant in a closely held enterprise invests all his assets in the business with an expectation, often reasonable under the circumstances even in the absence of an express contract, that he will be a key employee in the company and will have a voice in business decisions.

Id. *See also* *Balvik v. Sylvester* 411 N.W.2d 383, 384 (N.D. 1987) (observing that the articles of incorporation had provided that a separate buy-sell agreement would be entered into, but that the parties never executed the buy-sell agreement).

126. This issue is discussed at length in connection with whether reasonable expectations can be imputed to minority shareholders who have obtained their rights in a close corporation without bargaining for them. *See* Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the*

experience tells us that continued judicial monitoring will be important. In fact, future research may reveal that lawsuits are more prevalent in an innovative contractarian environment than in a traditional legal setting.

B. A CASE-BY-CASE APPROACH TO LLC DISPUTES

The findings suggest that continued majority/minority disputes can be expected in the LLC arena, and that courts will assume an important role in interpreting the LLC members' fiduciary duties in light of the LLC statute and the contractual terms presented. It is suggested that courts avoid broad generic formulations of investors' rights and responsibilities, and instead provide a careful and rigorous scrutiny of the particular facts and circumstances of each case. Sweeping statements deferring to the operating agreement may unduly diminish the courts' correct role of actively monitoring opportunistic and exploitive conduct on a case-by-case basis.

A number of recent decisions have begun to lay a foundation for active judicial monitoring in a less-than-perfect contractarian environment. Courts are beginning to guide plaintiffs as to whether to institute a direct or derivative lawsuit in a dispute involving LLC members.¹²⁷ They are

Appropriate Remedy, 15 J. CORP. LAW 285, 326 (1990) (indicating that minority owners frequently obtain their shares without bargaining with the majority shareholders and that courts have refused to attribute the reasonable expectations of the transferor to the transferee). Additionally, O'Neal noted:

A person taking a minority position in a close corporation often leaves himself vulnerable to squeeze-out or oppression He may be unaware of the risks involved, or his bargaining position maybe so weak that he is unable to negotiate for protection. Further, he may have been given or may have inherited his minority interest.

O'Neal, *supra* note 125, at 883.

127. See Paclink Communications Int'l, Inc., v. Yeung, 109 Cal. Rptr. 2d 436, 440 (Ct. App. 2001) (holding that an alleged fraudulent transfer of assets without the receipt of consideration is an injury to the LLC and should be the subject of a derivative suit); Carson v. Lynch Multimedia Corp., 123 F. Supp. 1254, 1259 (Kan. 2000) (refusing to dismiss a derivative claim asserted by a majority LLC owner against the minority where plaintiff's complaint alleging the usurpation of a business opportunity revealed that it would have been futile to specifically demand that the LLC itself take the requisite legal action); Walker v. Virtual Packaging, LLC., 493 S.E.2d 551, 552 (Ga. Ct. App. 1997) (indicating the trial court erred by granting a motion for summary judgment where it had failed to give the parties an opportunity to be heard regarding whether an action was properly brought as a direct or as a derivative suit); Daniel S. Kleinberger & Imant Bergmanis, *Direct or Derivative, or What's a Lawsuit Between Friends in an Incorporated Partnership*, 22 WM. MITCHELL L. REV. 1203, 1207-17 (1996) (discussing the difference between direct and derivative suits); Bert S. Prunty, Jr., *The Shareholders' Derivative Suit: Notes on its Derivation*, 32 N.Y.U. L. REV. 980, 985-87 (1957) (discussing the development of the shareholders' derivative suit in America and the emergence of a theory upon which minority shareholders could sue a recalcitrant management).

fashioning immediate remedies for fraudulent transfers of LLC assets¹²⁸ and have invalidated at least one clandestine merger that had been planned to divest control of an unsuspecting, absent LLC investor.¹²⁹

In a largely contractarian state such as Delaware, the Delaware Chancery Court has held that the entire fairness test is the applicable standard of review of a merger of a partnership into an LLC, and after carefully scrutinizing the transactions, awarded damages where the plaintiff had been given no advance notice of the proposed merger.¹³⁰ Recovery of legal fees has been permitted where a secretive merger was approved and where in subsequent LLC litigation there had been improper conduct.¹³¹ Further, the Delaware Chancery Court has held that officers of a corporation could not circumvent their fiduciary duties to a target corporation and its shareholders by creating an LLC.¹³²

Outside of Delaware, other courts have found grounds for punishing opportunistic and exploitive conduct in the maturing LLC arena. Compensatory and punitive damages have been awarded where LLC managers divested the LLC of its principal assets in order to maintain control and achieve self-interested goals.¹³³ Also, at least one court has ruled that the statutory LLC shield from personal liability does not insulate

128. *Chaline Estates, Inc. v. Furcraft Assocs.*, 719 N.Y.S.2d 53, 54 (N.Y. App. Div. 2000) (permitting a motion for a temporary receiver where the managing partners of a real estate partnership attempted to transfer real property to a new LLC without giving notice to the twenty percent minority).

129. *VGS, Inc. v. Castiel*, No. 17995, 2000 Del. Ch. LEXIS 122, at *15 (Del. Ch. Aug. 31, 2000) (rescinding a merger and holding that there was a failure to discharge the duty of loyalty and good faith where a merger was authorized secretly by two of three LLC members without notice to the third member and where the merger had the effect of divesting the third member of his majority control).

130. *Cole v. Kershaw*, No. 13904, 2000 Del. Ch. LEXIS 117, at *10 (Del. Ch. Aug. 15, 2000) (awarding damages where plaintiff was never told that his partnership interest would be or had been eliminated by a merger).

131. *VGS, Inc. v. Castiel*, No. 17995, 2001 Del. Ch. LEXIS 117, at *2 (Del. Ch. Sept., 25 2001) (permitting plaintiff to recover a portion of legal fees that was caused by improper and oppressive conduct in litigation where the defendant had failed to appear at three depositions in an attempt to disrupt the orderly progression of the lawsuit).

132. *Barbieri v. Swing-N-Slide Corp.*, 22 DE. J. CORP. L. 1148, 1154-55 (Del. Ch. 1997) (holding that an LLC assumed the same fiduciary duties as the officers and directors who formed the LLC for the purpose of serving as a partner in a partnership to acquire a corporation, but refusing to impute fiduciary duties to the partnership that acquired the target under the facts).

133. *See Flippo v. CSC Assoc. III*, 547 S.E.2d 216, 222-23, 228 (Va. 2001) (awarding compensatory and punitive damages where two managers divested an LLC of its principal assets by transferring them to a new entity in order to maintain control over the assets and achieve personal estate planning goals).

LLC participants from liability for breach of fiduciary duties or minority oppression.¹³⁴

Such active judicial oversight is particularly welcome and appropriate for minority owners who lack the bargaining power or wherewithal to expressly negotiate contractual minority protections. In fact, it may be argued that increased flexibility in the enabling LLC statute implicitly invites and indeed requires increased judicial monitoring of the corporate contract in each particular case.

In the emerging contractarian landscape of business entities, human characteristics of greed and self-interest¹³⁵ have the opportunity to flourish, particularly where business participants have entered into the corporate contract from inherently unequal bargaining positions.¹³⁶ Although the contractarian movement of corporate governance was begun in an effort to reduce unwarranted judicial intermeddling, flexible statutes have increased the importance of even-handed judicial review of the particular facts of each case, as courts are left to interpret the corporate contract and to balance the interest in contractual freedom with the competing state interests in the accountability of management, the fulfillment of fiduciary obligations, and the compliance with fundamental notions of fair play.¹³⁷

134. See *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 1254, 1264 (D. Kan. 2000) (alleging that defendants usurped a business opportunity belonging to the LLC, denying motions for dismissal, and rejecting defendants' argument that the Kansas LLC statute's shield from personal liability immunizes them from a suit for breach of fiduciary duty or oppression). *But see* *Lynch Multimedia Corp. v. Carson Comm., LLC*, 102 F. Supp. 2d 1261, 1265 (Kan. 2000) (granting defendants' motion for summary judgment as to the general claims of breach of fiduciary duty).

135. See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (indicating that a public policy, existing through the years and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty).

136. See Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273, 301–02 (1991) (observing that the deficiency in the contractarian model of corporate governance is the role of promissory estoppel where the reliance interest is recognized to avoid injustice and where restitution is necessary to prevent unjust enrichment); Miller, *supra* note 1, at 461–63 (discussing the reasonable expectation standard that has evolved to provide relief to minority shareholders for oppressive majority conduct that has violated the minority's "reasonable interest of sorts).

137. See Hazen, *The Corporate Persona*, *supra* note 136, at 297–98 (discussing the role of the court in enforcing fiduciary obligations). See also Thomas C. Lee, *Limiting Directors' Liability: Delaware's Section 102(b)(7) and the Erosion of the Directors' Duty of Care*, 136 U.P.A. L. REV. 239, 266 (1987) (discussing the educational and socializing effect of the law).

C. IMPLICATIONS FOR THE DIRECTION OF LLC EDUCATION AND RESEARCH

Both the survey results and a review of LLC case law reveal several areas that are of interest to educators, scholars, and legislators. Clearly, the findings of the present study reveal that many respondents were unfamiliar with default LLC buy-out rights. It is suggested that default buy-out rights should be emphasized by legal educators and should also be the subject of further study by legislators before default buy-out rights are changed. In addition, a review of recent LLC case law reveals several other areas that warrant increased educational emphasis and, perhaps, further study, including 1) anti-compete issues, 2) arbitration clauses, and 3) powers of removing LLC members and managers.

Plaintiffs' attorneys undoubtedly regretted the inclusion of a broadly phrased clause in the LLC operating agreement that allowed LLC members to compete with the LLC in *McConnell v. Hunt Sports Enterprises*.¹³⁸ Under the facts of the case, three of six LLC members rejected the terms of a proposed lease for an arena in connection with their bid for a National Hockey League franchise. Thereafter, three of the six original LLC members, led by McConnell, formed a new entity that ultimately accepted the lease terms, and the three members were awarded the hockey franchise. The other investors sued the McConnell group for a breach of fiduciary duty. The appellate court affirmed the lower court's motion for summary judgment, holding in part that the LLC agreement permitted participants to compete with the LLC.¹³⁹ The decision underscores the significance of contractual provisions regarding competition.

LLC arbitration clauses have been yet another source of LLC litigation, and perhaps have not been fully understood by the lawyers who draft them and the clients who use them. Several attorneys have come to regret the use of arbitration clauses that have stripped their clients of their right to a day in court because of provisions in the LLC agreement calling

138. 725 N.E.2d 1193, 1206-07 (Ohio Ct. App. 1999) (holding that the obtaining of a hockey franchise by an LLC was not prohibited where the LLC members had been members of a previously formed LLC that had rejected the offer of the Hockey Franchise, since the previously formed LLC was governed by an LLC agreement that expressly stated that members would not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including a competitive venture).

139. *See id.*

for arbitration, even where tortious conduct has been the foundation of the complaint.¹⁴⁰

Another stumbling block giving rise to conflicts involves powers of removal (or lack thereof) where the member's or manager's conduct amounts to a breach of fiduciary duty. In at least one case, which involved a highly negotiated LLC agreement, defendants undoubtedly regretted their failure to include a clause granting them the power to remove an LLC member for misconduct—a protection defendants should have sought in light of the plaintiff's history of alcoholic abuse.¹⁴¹

Additional problematic areas that should be monitored by legal educators, legislators, and scholars alike include choice of forum clauses, clauses that provide for methods of appraisal in connection with the determination of a buy-out price for the dissociating member, and powers to appoint a receiver in the event of dissolution.¹⁴²

140. *Elf Atochem N. Am., Inc., v. Jaffari*, 727 A.2d 286, 287 (Del. 1999) (denying the court special jurisdiction to adjudicate claims for a breach of fiduciary duty and removal of the manager because the parties had entered into an arbitration agreement on claims arising out of, under, or in connection with the LLC agreement); *Mid-America Surgery Ctr., LLC, v. Schooler*, 719 N.E.2d 1267, 1269–71 (Ind. Ct. App. 1999) (requiring arbitration for an alleged breach of contract where the LLC agreement provided that any dispute or breach shall be submitted to arbitration); *Albertson v. Magnetmakers LLC*, No. 99-4931C, 2000 Mass. Super. LEXIS 34 (Mass. Super. 2000) (holding that claims based on tort as well as contract were subject to arbitration, and that arbitration was required pursuant to an arbitration clause even though there were allegations of fraud, deceit, and intentional misrepresentation).

141. *See Walker v. REDCO, LLC*, No. 1843-S, 2000 Del. Ch. 127, at *41 (Del. Ch. 2000) (indicating that the defendants could easily have included, but did not, a right to remove the plaintiff even though they knew that he had embarrassed the company, experienced bouts of drunkenness and alcohol abuse, misrepresented his sophistication in financing transactions, and borrowed money from the party with whom he was supposedly negotiating).

142. *See RIBSTEIN & KEATINGE*, *supra* note 12, at app. A-3 Article XIII (containing a model professional LLC agreement providing that if the dissociated member and the company cannot agree on the fair market value within 30 days, each one will be entitled to choose one appraiser, and the two appraisers will choose a third appraiser); W. DEAN BROWN, *HOW TO FORM A CORPORATION LLC OR PARTNERSHIP* 93 (2000) (providing a form LLC agreement that excludes buy-out provisions); SCOTT E. FRIEDMAN, *HOW TO PROFIT BY FORMING YOUR OWN LIMITED LIABILITY COMPANY* 169–70 (1996) (containing an LLC form agreement containing dissolution and withdrawal provisions but not mentioning appraisal); ANTHONY MANUSCO, *FORM YOUR OWN LIMITED LIABILITY COMPANY* App. D (2d ed. 2000) (including an LLC form agreement containing withdrawal and dissolution clauses but no clauses on valuation or appraisal); MARTIN M. SHENKMAN, SAMUEL WEINER & IVAN TABACK, *STARTING A LIMITED LIABILITY COMPANY* 75 (1996) (containing an LLC form agreement with dissolution and winding up clauses but no valuation provisions). *See also Investcorp, v. Simpson Inv. Co.*, 983 P.2d 265, 272–74 (Kan. 1999) (rejecting plaintiff's argument that the remaining family LLC members of a deadlocked LLC were not qualified to wind up the LLC whose sole asset was 104 acres of commercial property, thus highlighting the importance of drafting contractual provisions that address details concerning control of the dissolution process should a dissolution be required).

D. TARGETING EDUCATION TO THE BUSINESS COMMUNITY: AVOIDING THE DO-IT-YOURSELF DISASTER IN A CONTRACTARIAN ENVIRONMENT

Many members of the business community may be unaware of the emphasis some courts place on the role of the operating agreement in delineating the rights and responsibilities of the LLC member and/or manager. Even moderately sophisticated businesspeople may head to the “do-it-yourself” books or web sites for forming business LLCs without fully comprehending the deference courts show to the LLC operating agreement.

The LLC member without counsel is unlikely to comprehend the significance of an arbitration clause or a right to remove an LLC member or manager. He or she may not have the foresight to include a provision regarding the method of valuation and the terms and conditions of an appraisal. The LLC member without counsel may pay little attention to profit-sharing ratios, rights to compete, or choice-of-law clauses. Such an investor may understand little about the significance of omitting a buy-out clause upon voluntary or involuntary dissociation. The benefits of favorable tax treatment and a simplified managerial structure may well pale in comparison to the serious financial losses that can result from an unfavorable LLC agreement signed hastily and without the benefit of legal counsel.

Thus, it is important to inform the business community of the central role played by the LLC operating agreement and the judicial deference shown by some courts to the contract between the parties. Minority participants should be informed of the importance of retaining legal counsel at the inception of the business rather than later on, and of drafting buy-out provisions and other protections necessary in the event of a future disagreement.

E. FURTHER STUDY OF DIFFERENT STATUTORY REGIMES AND AN EVALUATION OF THE NEED FOR STATUTORY REMEDIES

The findings of the present study suggest that practitioners’ choice of business entities may be driven by the inherent advantages of the entities and may be sensitive to adverse tax and regulatory rules. Further study of practitioners’ experience working with different LLC statutes should be analyzed to evaluate alternative statutory approaches.

The low rate of express contractual protection against oppressive majority conduct reported by the respondents is consistent with what

academics and practitioners have long concluded based on actual experience, anecdotal discussions, and a casual review of case law—that minority investors frequently lack the bargaining power and/or the wherewithal to obtain effective express contractual protection from illegal, fraudulent, or fundamentally unfair majority conduct.

The typical statutory structure of LLC legislation does little to protect the minority LLC owner, and contains several features that may in fact place him or her at a distinct disadvantage. LLC statutes were drafted to avoid formalities in the conduct of business,¹⁴³ and as a result, may lack some of the statutory rules and requirements that protect minority owners in corporations.¹⁴⁴ Not all LLC statutes provide for dissenters' rights in the case of certain mergers or acquisitions,¹⁴⁵ and as previously mentioned, relatively few LLC statutes provide an equitable remedy to sue for a dissolution or buy-out in the event of certain illegal, fraudulent, or other misconduct.¹⁴⁶ LLC statutes frequently do not contain corporate-style

143. See CAL. CORP. CODE § 17059 (1999) (indicating that members have the power to adopt an operating agreement, but avoiding a mandatory requirement that an operating agreement be executed); D.C. CODE ANN. § 29-1302 (1998) (indicating that the LLC is formed by filing articles of organization) and D.C. CODE ANN. § 29-1318 (1998) (indicating that entering into an operating agreement is optional); FLA. STAT. ANN. § 608.423 (1999) (indicating that members may enter into an operating agreement which need not be in writing). *But see* FLA. STAT. ANN. § 608.4101 (1999) (setting minimum standards for keeping records, including records of the amount of cash and property contributed).

144. See generally Ribstein, *supra* note 2, at 417–38 (providing insight into the history of the LLC and its goal of combining the limited liability offered by the corporation with the flexibility available to the partnership).

145. See CAL. CORP. CODE §§ 17600–13 (1999) (providing for dissenters rights with regard to certain reorganizations or mergers of LLCs); FLA. STAT. ANN. § 608.4384 (1999); N.Y. BUS. CORP. LAW § 1005 (McKinney 1986 & Supp. 2002) (providing for payments to dissenting members in the case of certain mergers or consolidations); OHIO REV. CODE ANN. § 1705.40 (Anderson 1998). *But see* DEL. CODE ANN. tit. 6 § 18-210 (1998) (providing that the LLC agreement or agreement of merger may provide appraisal rights, but failing to provide appraisal rights in the absence of such contractual rights bestowed).

146. See ARIZ. REV. STAT. ANN. § 29-785 (2000) (providing for involuntary dissolution in certain cases involving deadlock, illegal or fraudulent conduct, or the wasting, misapplication, or diversion of substantial assets); COLO. REV. STAT. ANN. § 7-80-808 (1999) (providing for involuntary dissolution if LLC exceeds or abuses authority); CAL. CODE § 17351 (1999) (permitting dissolution in a number of circumstances including where it is necessary for the protection of the rights and interests of the complaining members, in the event of deadlock or internal dissension, or where those in control have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority); FLA. STAT. ANN. § 608.441 (1999) (authorizing a Circuit Court to dissolve the LLC if the manager or members are deadlocked, the members are unable to break the deadlock, and irreparable injury will result or the LLC's assets are being misappropriated or wasted).

notice provisions and other protections commonly contained in corporate statutes.¹⁴⁷

On the judicial side, instances of fundamentally unfair or oppressive conduct by majority owners may be, and have been, combated through a purely judicial approach. Some courts have recognized a heightened fiduciary duty owed to minority owners of a close corporation, and can build upon this foundation to combat oppressive conduct in the setting of the LLC.¹⁴⁸ In contrast, the Delaware Court has rejected this notion of “special” fiduciary duties in the private corporation and has extended the doctrine of fundamental fairness to rein in fundamentally unfair conduct in private as well as public companies, and in the LLC as well.¹⁴⁹ The Delaware Chancery Court has also permitted complaints to proceed on grounds that the majority has engaged in “oppressive conduct” by failing to declare dividends and by intending to cause financial hardship that would lead to a forced sale at a reduced price, thus defeating the minority’s “rights.”¹⁵⁰ As of yet, however, the Delaware Supreme

147. See DEL. CODE ANN. tit. 6 § 18-302 (1998) (indicating that unless otherwise provided in the operating agreement, on any matter that is to be voted upon the members may take action without a meeting, without prior notice, and without a vote if consent in writing setting forth the action taken is signed by members having not less than the minimum number of votes that would be necessary to authorize the action).

148. See *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505, 516 (Mass. 1975).

149. See *Olsen v. Seifer*, No. 97-6456, 1998 Mass. Super. LEXIS 592, at *15 (Mass. Super. Ct. Aug. 28, 1998) (applying Delaware law and refusing to provide relief to a minority shareholder when the defendant sought to repurchase the minority shareholder’s shares at the original purchase price rather than at the fair market value price on the eve of a favorable merger, emphasizing that Delaware would review a particular transaction for overall fairness but would not impose broad fiduciary duties on close corporations). See also *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 38–40 (Del. 1996) (involving a lawsuit by a 15% minority shareholder/employee of the corporation who claimed that the majority breached its duty by dismissing him as an employee and holding that company’s status as a closely held company did not alter the duties of stockholders); *Nixon v. Blackwell*, 626 A.2d 1366, 1377–81 (Del. 1993) (refusing to develop any judicially created rules in the absence of an election to be treated as a statutory close corporation where plaintiffs had alleged that the board of directors breached their fiduciary duties to nonemployee minority shareholders by failing to offer the minority the same liquidity offered to employee-shareholders who were covered by an ESOP plan and key man life insurance); Theresa L. Kelly, *Nixon v. Blackwell: Fairness But Not Equality For Minority Shareholders*, 19 DEL. J. CORP. L. 533, 535–45 (1994) (analyzing the implications of *Nixon v. Blackwell*); Robert A. Ragas, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH U. L.Q. 1099, 1134 (1999) (analyzing Delaware’s refusal to carve out special fiduciary duties for management of closely held corporations).

150. See *Litle v. Waters*, No. 12155, 1992 Del. Ch. LEXIS 25, at *23 (Del. Ch. 1992) (holding that the majority’s firing of the defendant and refusal to pay dividends constituted oppressive conduct, and borrowing from the definition of oppressive conduct from cases in other jurisdictions that defined the term in connection with the interpretation of dissolution statutes). See also *Minor v. Albright*, No. 01 C 4493, 2001 U.S. Dist. LEXIS 19436 (D. Ill. 2001) (stating that Delaware recognizes two

Court has not endorsed an open-ended judicial remedy for oppressive conduct, and if it were, it might well attract considerable criticism particularly if applied in the context the limited liability company.¹⁵¹ An open-ended judicial remedy for “oppressive conduct” arguably creates a vague and uncertain legal standard that could “undo” negotiated business deals through the development of expansive judicial constructions.¹⁵²

One of the many issues that should be monitored over the next several years is the need for an express statutory remedy for oppressive majority conduct. Section 801 of the Uniform Limited Liability Company Act currently provides that the LLC can be dissolved if “the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner.”¹⁵³ This type of remedy may or may not be useful. There are many different strategies that could be developed to reduce the vagueness of the oppression remedy to provide increased practical guidance to the legal and business communities. LLC statutes could couple the oppression remedy with either a nonexhaustive list of factors that typically signal a minority squeeze-out,¹⁵⁴ or alternatively, a rebuttable presumption that oppression occurs where certain patterns of conduct have occurred in the absence of a business purpose. Such factors or patterns of conduct could

alternative definitions of oppressive conduct by majority stockholders: a reasonable expectations standard and a standard based on burdensome, harsh, and wrongful conduct, lack of fair dealing, etc).

151. See Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 340–41 (referring to open-ended oppression remedies as “problematic”).

152. See *Litle*, No. 12155, 1992 Del. Ch. LEXIS 25, at *23 (De. Ch. 1992). See also Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 340–41 (1997) (discussing the need to ward-off open-ended oppression remedies in the LLC context); Weidner, *Three Policy Decisions*, *supra* note 9, at 462.

153. UNIF. LTD. LIAB. CO. ACT § 801(5)(v).

154. The author has previously suggested that a list of statutory factors could be developed as being indicative of unfairly prejudicial conduct:

- (a) the enactment of amendments to the operating agreement that unfairly alter or abolish the complainant’s rights to receive a distribution;
- (b) the enactment of amendments to the operating agreement that unfairly alter or abolish the complainant’s rights to voluntarily withdraw or resign;
- (c) the enactment of amendments to the operating agreement that unfairly alter or abolish the complainant’s rights to vote;
- (d) the enactment of amendments to the operating agreement that establish or change the conditions for or consequences of expulsion;
- (e) the unreasonable withholding of distributions;
- (f) the alteration or elimination of the complainant’s role in management and/or as an employee;
- (g) the payment of excessive salary or distributions to the majority;
- (h) the structuring of transactions between the LLC and the controlling members on a non-arms-length basis;
- (i) the appropriation or wasting of the LLC’s assets.

Miller, *What Buy-Out Rights*, *supra* note 1, at 464.

include the exclusion of the minority from management, the withholding of distributions, the payment of excessive salaries, the personal use or wasting of business assets, or the structuring of non-arms length transactions.¹⁵⁵

For example, the Supreme Court of South Carolina has utilized a reference to factors indicative of oppressive conduct as a way to provide guidance on the definition of “oppressive conduct.”¹⁵⁶

CONCLUSION

The present survey challenges several assumptions underlying LLC legislation. Although broad generalizations should be avoided, the findings with respect to the respondents’ dispute and litigation experience call into question the proposition that greater contractual flexibility in business entity statutes will necessarily lead to fewer disputes and/or less litigation. LLC statutes, like all legislation with substantive rules, presuppose that attorneys will know and understand their substantive provisions. At least with respect to statutory default buy-out rights, this assumption does not hold true for a number of respondents, particularly in Pennsylvania. Future empirical study of different LLC regimes is suggested, along with an eventual reevaluation of the Uniform Limited Liability Company Act. If it becomes apparent that disputes are indeed more prevalent under the less structured LLC statutes, it may be desirable to develop improved statutory default rules or more defined and/or mandatory rules for specific problem areas to increase certainty and guidance.

155. See *Kiriakides v. Atlas Food Sys.*, No. 25244, 2001 S.C. LEXIS 22, at *27–*28 (S.C. Jan. 29, 2001) (applying a case-by-case analysis of oppressive conduct with reference to factors that reflect typical patterns of oppression).

156. See *id.* (taking a case-by-case approach to the definition of oppressive conduct, but referring to factors that reflect typical patterns of oppressive behavior).

APPENDIX A: STATE BY STATE ANALYSIS OF RESULTS

Q1) Do you frequently use a [CA, DE, NY, PA] LLC instead of a corporation or other business entity?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	90	66	1	157
AVERAGE FOR CA	57.5%	42.0%	.6%	
DE				
NUMBER OF RESPONSES	96	56	30	182
AVERAGE FOR DE	52.7%	30.8%	16.5%	
NY				
NUMBER OF RESPONSES	52	68	12	132
AVERAGE FOR NY	39.4%	51.5%	9.1%	
PA				
NUMBER OF RESPONSES	119	141	39	299
AVERAGE FOR PA	39.8%	47.2%	13%	
ALL STATES				
TOTAL RESPONSES	357	331	82	770
Average All States	46.4%	43%	10.6%	

Q2) Do you frequently use a non-[CA, DE, NY, PA] LLC instead of a corporation or other business entity?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	51	104	2	157
AVERAGE FOR CA	32.5%	66.2%	1.3%	
DE				
NUMBER	11	142	29	182
AVERAGE FOR DE	6%	78%	15.9%	
NY				
NUMBER OF RESPONSES	52	67	13	132
AVERAGE FOR NY	39.4%	50.8%	9.9%	
PA				
NUMBER OF RESPONSES	75	186	38	299
AVERAGE FOR PA	25.1%	62.2%	12.7%	
ALL STATES				
TOTAL RESPONSES	189	499	82	770
AVERAGE ALL STATES	24.5%	64.8%	10.6%	

Q3) Do you frequently represent majority owners of [CA, DE, NY, PA] or non-[CA, DE, NY, PA] LLCs?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	113	43	1	157
AVERAGE FOR CA	72%	27.4%	.6%	
DE				
NUMBER	94	64	24	182
AVERAGE FOR DE	51.6%	35.2%	13.2%	
NY				
NUMBER OF RESPONSES	76	43	13	132
AVERAGE FOR NY	57.6%	32.6%	9.9%	
PA				
NUMBER OF RESPONSES	151	109	39	299
AVERAGE FOR PA	50.5%	36.5%	13%	
ALL STATES				
TOTAL RESPONSES	434	259	77	770
AVERAGE ALL STATES	56.4%	33.6%	10%	

Q4) Do you frequently represent minority owners of [CA, DE, NY, PA] LLCs and/or non [CA, DE, NY, PA] LLCs?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	40	116	1	157
AVERAGE FOR CA	25.5%	73.9%	.6%	
DE				
NUMBER	47	110	25	182
AVERAGE FOR DE	25.8%	60.4%	13.7%	
NY				
NUMBER OF RESPONSES	28	91	13	132
AVERAGE FOR NY	21.2%	68.9%	9.9%	
PA				
NUMBER OF RESPONSES	41	216	42	299
AVERAGE FOR PA	13.7%	72.2%	14%	
ALL STATES				
TOTAL RESPONSES	156	533	81	770
AVERAGE ALL STATES	20.3%	69.2%	10.5%	

Q5) In your usual LLC agreement for [CA, DE, NY, PA] or non- [CA, DE, NY, PA] LLCs, do you give the minority owners the absolute right to force the LLC to buy them out at the fair market value of their interests in the event of a dispute?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	12	134	11	157
AVERAGE FOR CA	7.6%	85.4%	7%	
DE				
NUMBER	14	114	54	182
AVERAGE FOR DE	7.7%	62.6%	29.7%	
NY				
NUMBER OF RESPONSES	5	106	21	132
AVERAGE FOR NY	3.8%	80.3%	15.9%	
PA				
NUMBER OF RESPONSES	29	206	64	299
AVERAGE FOR PA	9.7%	68.9%	21.4%	
ALL STATES				
TOTAL RESPONSES	60	560	150	770
AVERAGE ALL STATES	7.8%	72.7%	19.4%	

Q6) In your usual LLC agreement for [CA, DE, NY, PA] or non- [CA, DE, NY, PA] LLCs, do you give the majority owners the absolute right to force the LLC to buy them out at the fair market value of their interests in the event of a dispute?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	40	105	12	157
AVERAGE FOR CA	25.5%	66.9%	7.6%	
DE				
NUMBER	31	96	55	182
AVERAGE FOR DE	17%	52.7%	30.2%	
NY				
NUMBER OF RESPONSES	22	89	21	132
AVERAGE FOR NY	16.7%	67.4%	15.9%	
PA				
NUMBER OF RESPONSES	63	171	65	299
AVERAGE FOR PA	13.7%	72.2%	14%	
ALL STATES				
TOTAL RESPONSES	156	461	153	770
AVERAGE ALL STATES	20.3%	59.9%	19.9%	

Q7) If you were to form a [CA, DE, NY, PA] LLC tomorrow and the LLC agreement were silent, does a member have the right to a buy-out if he or she leaves the LLC prior to its winding up?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	23	109	25	157
AVERAGE FOR CA	14.6%	69.4%	15.9%	
DE				
NUMBER	26	95	61	182
AVERAGE FOR DE	14.3%	52.2%	33.5%	
NY				
NUMBER OF RESPONSES	18	80	34	132
AVERAGE FOR NY	13.6%	60.6%	25.7%	
PA				
NUMBER OF RESPONSES	43	167	89	299
AVERAGE FOR PA	14.4%	55.9%	29.7%	
ALL STATES				
TOTAL RESPONSES	110	451	209	770
AVERAGE ALL STATES	14.3%	58.6%	27.1%	

Q8) Have you ever handled LLC majority/minority disputes involving [CA, DE, NY, PA] LLCs?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	58	97	2	157
AVERAGE FOR CA	36.9%	61.8%	1.2%	
DE				
NUMBER	66	89	27	182
AVERAGE FOR DE	36.3%	48.9%	14.8%	
NY				
NUMBER OF RESPONSES	35	84	13	132
AVERAGE FOR NY	26.5%	63.6%	9.9%	
PA				
NUMBER OF RESPONSES	40	219	40	299
AVERAGE FOR PA	13.4%	73.2%	13.4%	
ALL STATES				
TOTAL RESPONSES	199	489	82	770
AVERAGE ALL STATES	25.8%	63.5%	10.6%	

**Q9) If you answered “yes” to question 8, was a lawsuit ever filed?
(Counting only those respondents who really did answer “Yes” to
Question 8 and disregarding N/A or Blank Responses)**

	YES	NO	TOTAL Y OR N
CA			
NUMBER OF RESPONSES	12	46	58
AVERAGE FOR CA	21%	79%	
DE			
NUMBER	33	33	66
AVERAGE FOR DE	50%	50%	
NY			
NUMBER OF RESPONSES	3	32	35
AVERAGE FOR NY	8.6%	91.4%	
PA			
NUMBER OF RESPONSES	10	30	40
AVERAGE FOR PA	25%	75%	
ALL STATES			
TOTAL RESPONSES	58	141	199
AVERAGE ALL STATES	29%	71%	

Q10) In your usual [CA, DE, NY, PA] LLC agreement, does the company dissolve by court order upon a showing of illegal, fraudulent, or oppressive conduct by majority owners?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	39	104	14	157
AVERAGE FOR CA	24.8%	66.2%	8.9%	
DE				
NUMBER	7	112	63	182
AVERAGE FOR DE	3.8%	61.5%	34.6%	
NY				
NUMBER OF RESPONSES	21	87	24	132
AVERAGE FOR NY	15.9%	65.9%	18.2%	
PA				
NUMBER OF RESPONSES	42	173	84	299
AVERAGE FOR PA	14%	57.9%	28.1%	
ALL STATES				
TOTAL RESPONSES	109	476	185	770
AVERAGE ALL STATES	14.2%	61.8%	24%	

Q11) Do you believe that many LLC agreements formed under [CA, DE, NY, PA] law or elsewhere are based on form agreements that are not extensively negotiated?

	YES	NO	N/A OR BLANK	TOTAL
CA				
NUMBER OF RESPONSES	127	20	10	157
AVERAGE FOR CA	80.9%	12.7%	6.4%	
DE				
NUMBER	106	34	42	182
AVERAGE FOR DE	58.2%	18.7%	23.1%	
NY				
NUMBER OF RESPONSES	78	37	17	132
AVERAGE FOR NY	59.1%	28%	12.8%	
PA				
NUMBER OF RESPONSES	209	26	64	299
AVERAGE FOR PA	69.9%	8.7%	21.4%	
ALL STATES				
TOTAL RESPONSES	520	117	133	770
AVERAGE ALL STATES	67.5%	15.2%	17.3%	

APPENDIX B: STATISTICAL ANALYSIS OF DIFFERENCES IN
RESPONSES AMONG STATES¹⁵⁷

**ARE DIFFERENCES OBSERVED
STATISTICALLY SIGNIFICANT?**¹⁵⁸

**Q1: Do you frequently use a [CA, DE, NY, PA] LLC instead of a
corporation?**

Differences Among all four states	Yes
Differences between of CA+DE vs. NY+PA	Yes

**Q2: Do you frequently use a non-[CA, DE, NY, PA] LLC instead of a
corporation?**

Differences among all Four states	Yes
Differences between DE vs. CA+NY+PA	Yes

157. See WILLIAM G. ZIKMUND, *EXPLORING MARKETING RESEARCH*, 624–27 and 778, tbl. A.4 Chi-Square Distribution (2000) (discussing the Chi-Square test for goodness of fit and its application to test for statistical significance); Armstrong & Overton, *supra* note 74, at 396–97 (citing methods including comparing known values of the population such as age or income, or making subjective estimates of bias). Also, the author gratefully acknowledges the assistance of Ralph Greenberg, Professor of Accounting at Temple University for conducting this statistical test.

158. Ralph Greenberg, Associate Professor of Accounting at the Fox School of Business at Temple University used the Chi-square test in the statistical analysis of the results. The calculation of the Chi-square statistic assisted in the determination of whether the difference in the observed frequency distributions in each state were attributable simply to sampling variation, or were large enough to be statistically significant.

A null hypothesis was formulated for each question to test the proposition that the percentages of responses to each question would be equal among all four states. For several questions a second null hypothesis was formulated stating that the percentages would be equal as between various combinations of states. For example, equality was posited as between California and Delaware, on one hand, (arguably the two states with the more favorable regulatory and tax environment), and New York and Pennsylvania, (the two states with the more restrictive environment) for Questions 1, 3, 4, 8, 9, and 11. For Questions 2 and 9, equality was posited as between Delaware on one hand, and California, New York, and Pennsylvania on the other. See Appendix B above for a detailed statement of the null hypotheses and the Chi-square analysis.

STATISTICAL DIFFERENCES AMONG STATES

**ARE DIFFERENCES OBSERVED
STATISTICALLY SIGNIFICANT?¹⁵⁹**

**Q3: Do you frequently represent majority owners of [CA,DE,NY,PA]
and/or non-[CA, DE, NY, PA]LLCs?**

Differences Among all four states	Yes
Differences between of CA+DE vs. NY+PA	No

**Q4: Do you frequently represent minority owners of [CA, DE, NY, PA]
and/or non[CA, DE, NY, PA] LLCs?**

Differences among all Four states	Yes
Differences between DE vs. CA+NY+PA	Yes

159. Once the null hypotheses were formulated, an appropriate significance level was selected and the Chi-square statistic was calculated. The statistical decision was made by comparing the calculated Chi-square statistic with the critical Chi-square value found in the Chi-Square Distribution Table. If the calculated Chi-square value was less than the critical value, the null hypothesis of equality could not be rejected, and hence the differences were judged to be statistically insignificant. If the calculated Chi-square value was greater than the critical value, the null hypothesis was rejected, and the differences observed were judged to be statistically significant.

STATISTICAL DIFFERENCES AMONG STATES

**ARE DIFFERENCES OBSERVED
STATISTICALLY SIGNIFICANT?**

Q5: In your usual LLC agreement . . . do you give the minority . . . the absolute right to force the LLC to buy out the minority . . . ?

No

Q6: In your usual LLC agreement . . . do you give the majority . . . the absolute right to buy out the minority . . . ?

No

Q7: If you were to form a [CA, DE, NY, PA]LLC tomorrow and the LLC agreement were silent, does a member have the right to a buy-out . . . ?

Differences among all No

Four states

Differences between No

DE vs. CA+NY+PA

Q8: Have you ever handled a majority/minority dispute . . . ?

Differences among all Yes

Four states

Differences between Yes

DE vs. CA+NY+PA

STATISTICAL DIFFERENCES AMONG STATES

ARE DIFFERENCES OBSERVED
STATISTICALLY SIGNIFICANT?**Q9: If you answered “yes” to question 8, was a lawsuit ever filed?**

Differences among all Four states	Yes
Differences between CA+DE vs. NY+PA	No
Differences between DE vs. CA+NY+PA	Yes

**Q10: In your usual . . . LLC agreement, does the company dissolve
by court order upon a showing of illegal, fraudulent, or oppressive
conduct by majority owners?**

Differences among all Four states	Yes
Differences between CA vs. DE	Yes

**Q11: Do you believe that many LLC agreements formed . . . are
based on form agreements that are not extensively negotiated?**

Differences among all Four states	Yes
Differences between CA+DE vs. NY +PA	Yes

APPENDIX C: COMMENTS

The following is a sampling of the more relevant comments received. The statements below are direct quotes.

CALIFORNIA

“Frequently” is vague

LLC agreements tend to be unfair to the minority owners.

Note that my usual LLC agreement does not include an absolute buy-back right; I usually have some buy-sell or other provision.

My views are toward LLCs established in other jurisdictions for my company and another party to use in jointly pursuing business. We do negotiate the LLC terms.

Because operating agreements are optional, I have already encountered situations where the LLC has been formed and operated without benefit of an agreement creating an even larger problem of uncertainty of interest and rights. Personally I steer my clients away from LLCs unless it is a real estate venture with more sophisticated ownership. I am not convinced that LLCs are what they were promoted to be by the legal profession so far as ease and simplicity in place of corporations for traditional business ventures.

Usually minority owners do not have negotiating power to give them rights to be bought out. In an LLC with many members, that could be very disruptive to the business. If a minority owner does have negotiating power, there aren't too many members, I do frequently add buy-sell provisions (and also in the context of a family-owned LLC).

Many of our LLCs are wholly-owned entities so disputes are not an issue.

California law is lacking in very important protections to minority members, which should be addressed.

I have come across LLCs which have no operating agreement “governed by Code.”

I'd be most interested in your findings and conclusions.

Most of my LLCs are single member or family member LLCs. Buy-out provision is negotiated if there is a minority member. Dissolution provision is generally not negotiated.

Give the Co. and/or other members a right of first refusal & allow withdrawal of members.

Re: "5" and "6," these may vary, depending on how corporation-like or how partnership like the LLC is to be.

Re: "10": dissolution by court order is viewed by me as one of several remedies available upon showing of illegal, fraudulent or oppressive conduct by majority owners, but should not be viewed as automatic or the sole remedy. Alternatives might include having malfeasors assessed damages, "tossed-out," or otherwise sanctioned.

DELAWARE

LLCS ARE CREATURES OF CONTRACT BY DESIGN-WITH THE STATUTE OVER-RIDING DEFAULT PROVISIONS FOR ISSUES NOT ADDRESSED IN THE LLC AGREEMENT. TOO MANY PEOPLE USE FORM AGREEMENTS THAT DO NOT ADEQUATELY ADDRESS THE ISSUES PECULIAR TO THE DEAL, AND IT RESULTS IN A MESS LATER WHEN DISAGREEMENTS ARISE. THIS IS REFLECTED IN THE FEW LLC DECISIONS THAT HAVE REACHED THE COURT.

#11 IS A STRONG YES.

I don't think you can refer to the "usual" LLC agreement. There's really no such thing if it's a negotiated agreement, rather than the "boiler" between friendly, affiliated parties.

My answer to question #1 varies. I have formed many Delaware and non-Delaware LLC's. For the most part, however, the corporation makes more sense. In most instances, the capital markets undervalue LLC's.

Aside from tax driven deals, the LLC is the most flexible & effective entity to do a business deal.

If a statute allowed a minority partner to dictate to the majority or required a put, people would simply select a jurisdiction which did not place onerous restrictions on their operations. Similar to the migration from NJ to DE in about 1890.

LLC's vary widely depending on members' interests. Sometimes heavily negotiated, sometimes not at all.

I generally use a form LLC then adjust depending on need circumstances and whom I represent. Obviously if I represent a majority, majority rules. If I represent the minority I try to obtain protections; e.g. Super majority of FMV buyout.

With respect to # 5 & 6, I would suspect that a specific formula, such as a multiple of revenues or profits, is more common than “fair market value.” Also, I have seen agreements where owners having substantially the same amount of equity agree that one will move a price and the others will decide whether to buy or sell at the price.

In my practice, LLCs are often used as either vehicles for a joint venture between two or more very sophisticated parties or as wholly owned vehicles in financing transactions for tax or rating agency purposes. People come to Delaware because of our flexibility in permitting parties to structure the deal to suit their purposes without extensive statutory constraints. LLCs are creatures of contract that reflect a negotiated deal. In every dispute I have been involved, the dispute arose because of either poor drafting (which is true for most contract disputes) or because a party negotiated a bad deal. They have not been because a majority owner imposed a bad deal on a minority owner. It is usually the other way with the majority owner damaged.

I do not feel comfortable answering questions 5-11. I feel this is confidential firm information.

NEW YORK

NY LLC’s not usually used because of extra organization formalities, etc.

I do not use NY LLC’s to avoid the publication requirements, which are bizarre.

Use of LLC in NY is often turned down by clients unwilling to incur publication costs and concerned about possible personal liability in bankruptcy.

It was difficult to answer what was “usual.” I often do have puts in LLC’s, sometimes at FMV but often below FMV and/or tied to a formula. Same with calls. However, it depends on the transaction. Also, I am not clear whether you are asking about transaction-related LLC’s or estate and succession planning vehicles. Obviously, the use affects the put and call features and what is “usual.”

I did not receive the earlier questionnaire. I have handled a few disputes involving LLC members as a neutral arbitrator. I find that the agreements, in general, have been extensively negotiated as to the relative duties of the parties. Rights of the parties due to a dispute seem to be an area where the agreements are more or less silent. That leaves the courts

(or arbitration panels) the task of applying equitable and legal principles as opposed to following contractual provisions of the agreements.

I would have to research NY LLC statute. Because of publication (notice of formation), I usually choose a NY corporation with a federal "S" electing over a NY LLC – sometimes I use general partnerships.

Items 5 & 6 There are no usual answers. Each deal has this issue discussed and addressed.

Item 7 The issue is never silent. It may not provide for a buyout but that issue is addressed.

The choice of entity is frequently dictated by the nature of the transaction, not by the nature of the entity. Similarly, the complexity of the LLC operating agreement is dictated by the transaction – is it to be wholly-owned by how many members, intended transaction purpose – single purpose or operating business, relationship of members, etc. As practitioners have more experience with LLCs, the LLC agreements are more tailored, and less off the shelf, except when the LLC has a specific purpose in facilitating a transaction or is a one member LLC.

PENNSYLVANIA

§ 8933 is a trap and should be changed. The default should be no buyout unless authorized by written operating agreement.

LLC's not generally preferred over S or C corps. Some advantages but owners may not want to work out details of LLC agreement.

Until PA gets its act together from a taxation perspective, use of LLC's in PA will be limited.

Because of the many unanswered issues related to LLC governance, I advise against use in PA.

LLC operating agreements are rarely negotiated. Almost always form agreements. LLC legislations should have more extensive default provisions to cover issues not addressed in operating agreement. Banks occasionally struggle with the authority a customer has to open an account. Often a "form" agreement is presented which is very short and unclear. On the other hand, some long detailed operating agreements are difficult for a "new account" clerk to understand, plus this increases the paper load a bank might retain.

There should be more continuing education programs regarding LLC agreements in PA.

The answers to 6, 7, and 8 are dependent on factors that are so numerous that they cannot be discussed here. The single no or yes answers will be deceiving for your survey.

We don't use PA LLCs because of the PA capital stock tax.

You should really define "frequently", or use a different word, such as "usually." It could significantly affect the answers.

All other things being equal, I would choose an S corp. over an LLC. I have formed about twenty LLCs, and the negotiation of the operating agreement can be a lengthy expensive process. If a business doesn't need the LLC "flexibility", then there is no need to complicate matters with its use. Sometimes flexibility can mean complexity and therefore greater costs. I think, however, that the LLC is a very helpful tool under the right circumstances.

I'm still not comfortable that the nature of the LLC is properly defined in law. I'm certain that the average client knows no more than he read in Forbes or Medical economics.

In my business practice, I find the use of LLC's to be most appropriate in real estate-related transactions and sometimes use them in conjunction with other entities in business planning. In my advice, if a corporate structure is equally useful for a "typical" business, I avoid LLCs although I don't hesitate to use them when corporate or limited partnership entities don't adequately work. I don't know if my attitude is typical but because LLC's don't have a case law "history" I don't think they are appropriate for a "typical" small business entity, which form the bulk of my practice.

My opinion – LLC's are overrated. I generally prefer to use a corporate form of entity unless there are strong reasons not to. Corporate law provides greater certainty. The situations where the supposed flexibility of the LLC provided an alternative is not otherwise available under either the corporate, partnership or limited partnership form are rare.

I have represented minority members of PA LLC's but not frequently. I encourage active negotiation of buy-out triggers and clients have almost always responded. The results vary far too widely to be accurately summarized in the above answers or in these comments.

Typically, I include a right of first refusal to other members and the company if a member wants to sell to a 3rd party. Also, I often include mandatory buy-out provisions upon a member's death, disability, bankruptcy, etc.

LLCs give you great flexibility and thus are viable vehicles. Unfortunately, they often deal extensively with business issues on which all focus is placed and special dissolution arrangements are overlooked.