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Commentary to Professor Moll's Presentation

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COMMENTARY TO PROFESSOR MOLL'S PRESENTATION

*George Kuney**

Good morning. I am George Kuney. I teach a variety of business courses here at the College of Law. Before I joined the faculty of College of Law in 2000, I was primarily a Chapter 11 corporate attorney working in large California law firms in San Francisco and San Diego, handling matters all over the country.

The development of the Limited Liability Company has been one of the biggest changes that I've seen since I started in law school in 1986 up to now. I don't think it was even a subject covered in my Business Associations course at Hastings at the time. It's not often that one gets to see the birthing of a new body of law and watch it grow up and reach maturity in real time. It has been very interesting to me to see that happen with limited liability companies.

I respectfully disagree with a lot of what Doug [Moll] has said about the need for importing corporate law principles into LLC law wholesale. It's funny how the LLC sort of caught on at different speeds in different jurisdictions. I remember when Professor Joan Heminway and I first arrived here on the faculty at the University of Tennessee in 2000, she from Boston, I from San Diego. We were having some discussion about what kind of entity should be chosen for an acquisition transaction. And I said something like, "Well, there's not really anything to analyze. That's not much of a problem, you just form an off-the-shelf LLC, and we put the asset into that." And she looked at me like I was stark raving mad because I hadn't put up a pro and con sheet on each type of possible entity like you would in Business Associations class. To me, the answer is: it's an LLC, unless we're talking about taking it public. That is the most flexible form of entity as a practical matter. And even if we are thinking about

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taking it public as the harvest strategy for the founders, we can easily convert our LLC into a C corporation and then go talk to the underwriters.

The LLC developed because people were unhappy with corporate and partnership law. And they sought to bring over some of the benefits of that law into a new structure without the attendant burdens. Tennessee's experiment with the first LLC Act was kind of a nod towards Doug's position. In that we, here, our first act, spoke of governor-governed LLCs, and that was the default method, and it drew heavily on corporate law principles, basically a board of directors model. At which point, I think if that law had remained on the books, it would've been natural to just import all of Tennessee corporate law to LLCs and have no effective change. But after a while, Tennessee practitioners and legislators came around and said, "No, no, we're going to go towards more of the national norm – LLCs are different, they are a creature of contract." The IRS went and acceded to the notion of "check the box" status for taxation as a partnership or as a corporation, which was quite an acquiescence for that entity given the glacial pace at which it radically revises regulations. Instead of having to do the "What does it look like the most?" test to decide whether or not it will be taxed as a corporation or a partnership, we now just check a box and select that type. Similarly, we have a number of legislative and judicial statements recognizing the primacy of contract over corporate ideals in LLC law that have been made over the intervening almost 20 years.¹

I think I'm firmly in the camp that says LLCs are not corporations. They came from a different place. Corporations developed over a very, very long period of time, starting with royal charter corporations and leading to the abuses of the British West India Company, and the Dutch East India Company, entities that actually supported private armies and were quasi-nation states.² These developed, some would say devolved, into

¹ According to an ABA report published in 2017, "[b]oth the Court of Chancery and the Delaware Supreme Court accept and adhere to the policy of the Delaware Act 'to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements' under section 18-1101(b) [of the Act; and . . . even under a Delaware operating agreement that successfully waives all fiduciary duties, the implied contractual covenant of good faith and fair dealing remains in place to constrain unduly opportunistic behavior." Daniel S. Kleinberger, *From the Uniform Law Commission: Don't Dabble In Delaware*, 2017 A.B.A. BUS. L. TODAY. See also RCW 25.15.038(6)(b) (good faith and fair dealing implied in contract and uniquely non-waivable); American Bar Association, *Fiduciary Duties of Managers of LLCs: The Status of the Debate in Delaware*, 2012 A.B.A BUS. L. TODAY.

² ROY FRANKLIN NICHOLS & JOHN ALLEN KROUT, A SYLLABUS FOR THE GENERAL COURSE IN AMERICAN HISTORY, (New York Columbia University 1923); New

the modern corporate form. And over time, a lot of baggage developed around those entities, which was appropriate. Professor Hess quoted Justice Cardozo in his “punctilio of an honor most sensitive” language, which, as she noted, still has no definite meaning, but we pull it out every time we want to litigate regarding a fiduciary duty.

That sort of high-minded but vague and undefined standard tends to lead to less certainty for all involved as to what is permitted and what is prohibited. And where there's uncertainty, it brings litigation. For litigators in the room, I know that's grist for your mill. But from my perspective, not making my money litigating anymore, or at least not principally, I tend to favor certainty and efficiency. And I do really embrace the “you made your bed, you lie in it” personal responsibility.³ If you're going to go into a transaction, you should take some time to evaluate the potential “seeds of oppression,” which we all can recognize, and I think Professor Moll has correctly identified them.

To address the lack-of-an-easy-exit problem, the parties should provide for a buyout provision in the operating agreement. I think just about any LLC, a form that I can find on the internet or that I've seen when people have come to talk to me about their problems, has a buyout provision of one sort or another.⁴ And some of the ones on the internet have alternate ones. Often one uses rolling averages of net profits or revenues for a period of time that get used. That's simple and easy to handle. The no-dissolution-of-the-LLC-by-statute problem can be solved

Internationalist, *A Short History of Corporations*, NEW INTERNATIONALIST, JULY 5, 2002 (discussing the East India Company as the first company used by imperial powers, set up by British merchants, and granted a royal charter, and mentioning prior royal charters or constitutions “detailing [corporate] duties overseen by the government [or crown]”).

³ Absent a basis in the operating agreement, courts avoid imposing fiduciary duties on an LLC but, instead, uphold the entity's contractual nature and the parties' intent. See Keith Paul Bishop, *The Fiduciary Duties of a Nevada LLC Manager May be Limited Indeed*, NAT'L L. REV. (2019) (explaining that Delaware decisions may “now clarify that the implied contractual covenant of good faith and fair dealing is [an LLC manager's] only statutorily-prescribed fiduciary duty”).

⁴ See generally Joan MacLeod Heminway, *Pitfalls and Problems in State Limited Liability Company Statutes: Underlying Conflicts and Teambuilding... and the Resulting Statutory Frameworks*, A.B.A. (2005) (citing Howard M. Friedman, *The Silent LLC Revolution – The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 81 (2004)) (discussing default buy-out rights as a default concept in LLCs and further suggesting applying some form of a buy-out provision in every LLC); Nolo, *Plan Changes in LLC Ownership with Buy-Sell Provisions*, BPLANS (2019), <https://articles.bplans.com/plan-for-changes-in-llc-ownership-with-buy-sell-provisions/>; Joan MacLeod Heminway, *The Death of an LLC: What's Trending in LLC Dissolution Law?*, 2016 A.B.A. BUS. L. TODAY (member dissolution typically triggers buyout under ULLCA, Art. 7).

by providing for dissolution by majority or supermajority consent in the document. The norm-of-majority-rule problem can be addressed by including a supermajority provision for key terms and actions such as salaries, benefits, decisions to merge or sell substantially all the assets of the business. All of that is addressable by contract.

As to the lack of judicial oversight, I tend to think that narrowing the grounds by which the parties can jump into court is a good idea. I think that means what we will be doing is limiting the shareholder oppression or other breach of fiduciary duty-style claims to those that are the most serious and that are the most easily provable. Other than in egregious cases, a would-be plaintiff won't be able to get somebody to take the case on contingency, and that acts as a filter to lower the amount of vexatious litigation that's brought.

There is no need to resort to wholesale adoption of corporate law principles of fiduciary duty and the like. The LLC solution is provided by the very doctrinal body of law that is at the heart of the LLC: contract law.⁵ We can use the duty of good faith and fair dealing to address oppression concerns that have merit. The duty of good faith and fair dealing is a direct contractual relationship between the parties to the LLC agreement.⁶ It is still a fairly young doctrine, still waiting to be fleshed out, as opposed to the doctrines of corporate law, which developed again in the corporate context over hundreds of years. Good faith and fair dealing can be developed in the LLC context to address oppression and many, many, many other ills that are out there.⁷

⁵ Unlike a corporation, an LLC is a creature of contract, nothing more. As the sole provision for LLC manager obligations, the operating agreement implies the covenant of good faith and fair dealing. *See, e.g.*, REVISED UNIFORM LIMITED LIABILITY ACT § 17704.09(d). LLC members are free, however, to craft an operating agreement imposing additional manager-duties owed to the LLC and those bound by the agreement, such as the duties of loyalty, care, or candor; *see* Gale Weinstein et al., *The Power of the Fiduciary Duty Contractual Waiver in LLCs*, LAW 360 (2019), https://www.law360.com/securities/articles/1011659?utm_source=rss&utm_medium=rss&utm_campaign=section (“[u]nlike in the corporate context, where boards have [non-waivable] fiduciary duties to the stockholders by common law, relationships within an LLC [are] solely contractual in nature”).

⁶ *See* Kleinberger *supra*, note 1.

⁷ Good faith and fair dealing can, when fully enforced and broadly construed, replace and improve the corporate structure of fiduciary obligations. “[I]f contract law is understood to include a strong obligation of good faith and fair dealing, and if courts can use that obligation to fill gaps in the parties’ contract consistent with the parties’ reasonable expectations, then fiduciary duties can be confined for the mostly part to the traditional duty of loyalty owed by directors and controlling shareholders in all corporations. [In sum], taken seriously, the duty of good faith vies courts ample ability to regulate shareholder relationships.” Benjamin Means, *A Contractual Approach to*

Good faith and fair dealing, is a doctrine that's enunciated in different ways in different places:

→ We know that there's a general obligation of good faith and fair dealing that applies to all contracts.⁸

→ A party to the contract has a duty to avoid doing anything that will injure the ability of the other party to receive the contemplated benefits of the deal.⁹ That sounds like shareholder oppression. It fits within that area, at least if it's egregious enough.¹⁰

→ We know it's impossible to say what good faith is, but it consists of avoiding conduct that does not conform to accepted norms of decency, fairness, and reasonableness. The standard of decency, fairness, and reasonableness seems to be a flexible one that we can apply to LLC member disputes.¹¹

→ Good faith means avoiding opportunistic behavior, which in turn is defined as using a contract term to get an un-bargained-for advantage, usually because of circumstances not contemplated when the contract was made.¹² This addresses the freeze-out situation where

Shareholder Oppression Law, 79 *FORDHAM L. REV.* 1203–04 (2010). In fact, “[b]ecause of the primacy of contract over fiduciary law in Delaware, fiduciary duty claims arising from the same facts that underlie contractual duties are superfluous, and thus, foreclosed.” Albert Manwaring IV, *Self-Dealing Conduct Supporting Fiduciary-Duty Claims Was Covered by Contractual Duties Imposed in the LLC Agreement*, *DEL. BUS. CT. INSIDER* (May 23, 2018). Simply put, the duty of good faith and fair dealing supplies the exhaustive components of an efficient recourse against overreaching LLC managers.

⁸ A duty of good faith and fair dealing embodies the extent to which LLC managers must consider the interests of the LLC, its members, and any others bound by its operating agreement. In Delaware, good faith and fair dealing has alone proven to be sufficient protection for the rights of LLC members and, especially, minority shareholders. See *Miller v. HCP & Co.*, No. 2017–0291–SG, 2018 WL 656378 (Del. Ch., Feb. 1, 2018) (not reported in A.3d); Dina B. Legal & Robert G. Copeland, *Business and Corporate: Ready or Not the RULLCA is Now the Law in California* (2019) (first published in the CAL. REAL PROPERTY J.).

⁹ *Schoolcraft v. Ross*, 81 Cal. App. 3d 75, 81 (1978).

¹⁰ “Any bad acting will be ferreted out by the parties’ bargain and the implied covenant of good faith and fair dealing.” See Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 *AM. BUS. L.J.* 221, 232 (2009).

¹¹ See *supra* note 4 and accompanying citations.

¹² See *Nemec v. Shrader*, 991 A.2d 1120 (2010) (providing that duties beyond that of good faith and fair dealing would only be imposed, despite absence in the operating agreement, when the circumstances were unanticipated and would have been outside the

one party is financially vulnerable. I'm reminded of the case involving the Dodge Brothers and Henry Ford,¹³ who's remembered by some as being a father of modern industry and by others, not so fondly, as being a man of sharp business practices. I think we can address that sort of thing with the duty of good faith and fair dealing.

→ There's a nice limit on the obligation of good faith and fair dealing. We say that it does not override the express terms of the contract.¹⁴ That is giving full effect to the Delaware thesis that we want to promote freedom of contract and creativity and the responsibility of parties to structure their own relationships between themselves.¹⁵

→ The final statement that I'll give you from case law is that the obligation of good faith should not be used to protect parties from things that they should have protected themselves from when they negotiated and documented the deal.¹⁶ Forcing folks to get a lawyer at the beginning of the representation if they can't do that thinking and drafting for themselves doesn't seem too high of a price to me.

So, I know mine is a contrary position to that of Professor Moll, and it's not to say that he doesn't have good points and valid concerns. He

contemplation of the parties at the time the agreement was created); *Don King Productions Prod.'s v. Douglas*, 742 F. Supp. 741, 758, 761–62, 772 (1990).

¹³ *Dodge Bros., Inc. v. United States*, 118 F.2d 95 (4th Cir. 1941) (prohibiting infringement of minority rights on the basis of finding an irrefutable corporate obligation of goodwill).

¹⁴ *Allison v. Ericsson*, 479 Mass. 626, 98 NE.3d 143 (2018) (finding a breach of good faith in conduct patently inconsistent with the operating agreement's explicit preclusion of the conduct's consequences); *Market Street Accocs. Ltd v. Frey*, 941 F.2d 588, 595 (1991) ("Good faith is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties."); see Kleinberger, *supra* note 1.

¹⁵ Good faith and fair dealing preserve contractual intent and better protect minority rights than do fiduciary duties. Benjamin Means, *A Contractual Approach to Shareholder Oppression Law*, 79 *FORDHAM L. REV.* 1161, 1165 (2010) ("By enforcing [only] the implicit contractual obligations of good faith and fair dealing, courts protect minority shareholders from oppression and, at the same time, advance the values of private ordering").

¹⁶ Courts often apply broad fiduciary norms, which seek to uphold selfless dealings but more often impede basic self-ownership inherent in the contractual nature of the LLC context. See Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 *AM. BUS. L.J.* 221, 236 (2009). "Fiduciary standards, if interpreted too broadly, may stand in the way of the parties' actual bargain [and, further,] equitable contract theory provides surer footing for shareholder oppression law." Means, *supra* note 15, at 1207.

does. I just think that all of those points can be better addressed in the limited fashion of the covenant of good faith and fair dealing without importing all the law from the corporate field. Good faith and fair dealing provides maximum flexibility to the parties while still providing a check and an avenue for judicial review with regard to this still-young body of law.

