

MINORITY OWNER OPPRESSION IN THE CLOSELY HELD CORPORATION AND THE LLC

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Good morning. Thank you all for inviting me back. I guess we're at Connecting the Threads Three. And I'm going to suggest maybe to Joan that, next year, we go to Connecting the Threads Four: Haven't We Connected These Already? Something along those lines. This is the third time I've been here, unfortunately, it's the first time that I missed dinner. And I was sad to miss dinner; I had to teach a late class. So, I want to let some of you students know that law professors do sacrifice for you.

The topic I want to talk to you about today is minority owner oppression in the closely held corporation and the LLC. And let me first start by saying that is a terrible title. It is not remotely catchy or interesting. It is certainly descriptive, but it sums up that this project has proceeded at this point in fits and starts. And I would tell you more fits than starts. So, what we're hoping to do this year is to make a bigger dent into this project, which has its genesis in a 2005 article that I wrote. In that 2005 article, I basically took the position that the shareholder oppression problem that is historically associated with the closely held corporation context is going to show up in the LLC setting as well.

And so, what I want to do today is explain the basis of that article to you in hopefully about 10 or 15-ish minutes, and then I want to segue into what we're trying to do with this next project. So, let me just start... I said last year, I always like using these PowerPoint transitions, so it'll probably annoy you by the end. Let's just start with some basics here. So, what in the world is a closely held corporation? I suspect that most of you in this room are already familiar with this, but basically, a closely held corporation, not surprisingly, is a business organization, right? It's a corporation. And it's a corporation that gets typified by a couple of different characteristics.

It's got a small number of shareholders, so don't think about Apple, which is sort of on one end of a spectrum. That's our publicly-held

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companies. Think much more of a small family company. It has a small number of shareholders, it has no market. It's not like you can just call your stock broker and buy stock in our small T-shirt company. And, usually, the shareholders have a pretty active role in participating in management. Now, again, if you contrast that, if you are a shareholder in a public corporation like Apple, you're investing money, but, largely, you're going to be a passive investor. When you invest in Apple, you don't expect that you're going to work for the company. You don't expect that you're going to have a management role in the company. You basically expect, "I'm going to hopefully get a financial return, either through dividends or through the stock appreciating in price."

But closely held corporations are very different. Most shareholders in closely held companies, they invest money, and they also expect a financial return. But they also are thinking, "I'm going to have an active, participatory role in this company. I'm going to, usually, work for this company." And, often, they also expect to have a management position. They're going to be on the board or, possibly, an officer. Okay, so what's the problem? The problem is that our conventional corporate law norms of majority rule and centralized control can lead to some serious problems if you're a minority investor in a closely held corporation. And the easiest way to think about this is that, traditionally, when we think about power in the corporation, it is centralized in the hands of a board of directors. The directors are statutorily charged with either managing the company or supervising its management. The statute locates management power with the board

Okay, well, who cares? Who elects the board? Well, the board is elected by shareholders. And so, if you own a majority of the company's stock, you are going to have the power to elect the entirety of the board. Since the board controls the company, you as the majority shareholder, indirectly, you control the company. Now, that's fine unless you decide to use your control for nefarious purposes. You might use that control to take unjustified actions that harm the minority shareholders' interests. And what do I mean by unjustified actions? Usually what I mean is you're going to do something to affects that minority shareholder's participatory rights in the business.

So we're going to get rid of your employment, we're going to get rid of your management position, as well as your financial rights in the business. We typically call that oppressive conduct. We're really talking about when those in control unjustifiably take some action that is going to

work against the minority's financial and/or participatory interests. In the case law, there's probably about half a century worth of solid case law on shareholder oppression. To give you some common examples from the case law: termination of a minority shareholder's employment, removing minority shareholders from positions of management, dividends not being paid, siphoning off profits to the majority shareholder. Those are some of the major categories of what we typically refer to as oppressive conduct.

How have states responded to the shareholder oppression problem? You typically see two types of responses. The first is that most states, the number is about 37 or 38 states in this country, have a dissolution statute, where if you're a shareholder, you can come into court, and you can ask the court to dissolve the company on the grounds of oppressive conduct. In most states, you don't even have to ask for dissolution, either the statute or the courts have empowered courts to grant less drastic remedies. Probably the most popular remedy for oppression these days is a buyout. You can go into court and say, "Just buy me out. I don't want dissolution."

Traditional fiduciary duties are owed to the entity, not to an individual shareholder. In some states—typically states without an oppression dissolution statute—there is common law that says, "In our state, we're going to say in a closely held business, that shareholders owe fiduciary duties to each other, individually." If you feel like you've been treated unfairly, that fiduciary duty runs to you, and you can bring an action based on whatever harm you believe has occurred to you.

So one of those two responses is generally present in most states. Delaware is a rather large exception, but in most states, you get one of those responses. Okay, so the point of the 2005 article was really to try and identify, really almost just to describe, what is it about the closely held corporation that gives rise to this oppression problem? If we can identify the seeds of oppression, we can see if those seeds transfer to the LLC setting. So, let me run through this somewhat swiftly. You have the 2005 article somewhere in the materials if, for whatever reason, you were wanting to read the 80-page version. The first seed of oppression is unquestionably the lack of exit rights in a closely held corporation.

Let's talk about the inability to sell for a moment. Assume that you're a shareholder in a public company, again, think Apple, and you're dissatisfied with management in some way. Either they're making decisions that you don't like, or they're making decisions that actually hurt you individually. You can sell, right? You can cash out, get whatever the market

price provides. And that ability to cash out does provide you with some substantial protection. By definition, however, in a closely held corporation, there is no market. And so, you don't have that easy ability to liquidate your interest.

Now, we might not care if you had the ability to just demand a buyout. And that's not as crazy as it may seem. In the general partnership context, if you say "I want out," you're either going to get bought out (although, admittedly, it might be at the end of the term of the partnership, but you're going to get bought out), or it's going to result in dissolution. So, it's not crazy to say in business organizations that an owner might have a right to demand a cash-out, but it is crazy in the corporation context. No state's corporation law provides a default right for a shareholder to just say, "I want out, pay me." Unless you have that right in a contractual agreement, in a shareholder's agreement, maybe in your bylaws, you're not going to get that as a default matter.

We might not care about that if you had the ability to dissolve the company, right? The way dissolution works is we're pretty much selling the company. And we're going to get whatever money we can for selling it, we're going to pay off our creditors. And whatever's left over, we're going to be distributing to the shareholders. So that would be a way of getting your money out of the company. But that doesn't work here because every state that I'm aware of, in order to voluntarily dissolve a corporation, that requires at least a majority of the voting shares, which, by definition, if you're a minority shareholder, you don't have. In most states, it also requires a board resolution as well, so that's not going to work for you.

Trust me. There's really no way out without some advanced planning that we'll talk about in a moment in the closely held corporation context. Now, what else contributes to the oppression problem? The norm of majority rule. The oppression problem, as well as the need for any sort of oppression doctrine, would be far less acute if the minority shareholder could block harmful majority decisions, right? You might not need a market exit if you just have the right to block these decisions. Well, of course, you don't because the way that business organizations law works, certainly corporate law works, is that there is a norm of majority rule, that's the norm that the statutes default to, and those norms are going to leave you as a minority investor unable to block most decisions that could affect your personal welfare. By the way, I'm not saying that's even a problem. Majority rule has a lot of obvious advantages in trying to run a system where multiple people are involved. I'm just trying to descriptively say that

the norm of majority rule is clearly something that also contributes to the oppression problem.

Now we might not even care about the fact that there's no exit rights and that there's a norm of majority rule if we thought that judicial oversight would offer adequate protection to the minority shareholder. After all, if you've taken Business Organizations, you've learned that directors, officers, and controlling shareholders owe fiduciary duties. They owe them to the company or to the shareholders collectively, but we'll talk more about that in a moment. If that fiduciary duty somehow provided the minority with protection, we might not care about the fact that there's no exit rights and a norm of majority rule.

The problem is that, not only do we have an issue about who that fiduciary duty runs to, which again we'll talk about in a minute, but judicial protection is really not there because of the business judgment rule. We could sit here and have an entire conference on the business judgment rule, but let me just say for the moment that, under the business judgment rule, the courts are going to review the substantive business decisions of managers in a very, very deferential manner and with a very minimal amount of scrutiny. As a consequence, all I need for you to understand on this point is that majority shareholder decisions involving internal matters, like employment, management, and dividends, even though such decisions form the core of many shareholder oppression disputes, those are largely going to be insulated from any sort of judicial review.

The business judgment rule and the deference of the business judgment rule, which again, I'm not necessarily criticizing, but that is clearly something that adds to the oppression problem. This dovetails nicely with Professor Edwards' presentation. We wouldn't care about the lack of exit rights, the norm of majority rule, and the deference of the business judgment rule if we could get minority investors to simply contract for protection before they invested. They could protect themselves through employment agreements, buy/sell agreements, all kinds of contractual tools. But that doesn't work either. Let me just sort of sum up a huge body of scholarship by saying that, despite the opportunity for some ex-ante bargaining, there's a wide body of literature that shows that small business investors just don't bargain for protection in advance. We could have an entire conference on that phenomena, but let me just hit some high points.

If you think about a lot of small businesses, they are family businesses or businesses with friends. There's often this atmosphere of mutual trust

where you think, “I don’t need contractual protection.” I like to, a little crass, but I like to call this the “Mom isn’t going to screw me” phenomenon. You don’t need any contractual protection because it’s your family. That leads you into an over-trust situation. In addition, some commentators have said that small business investors tend to be unsophisticated in legal matters. I’m a little dubious about that, but that’s often said.

A lot of people argue that even if you thought there was a need for contractual protection, it’s very difficult to foresee all of the different ways that you could be taken advantage of. Thus, your contracting efforts, if you engaged in them, would be inadequate. As a good example of that, in Texas where I’m from, and in a couple of other states, there are oppression cases where the majority shareholder simply pretends that the minority shareholder doesn’t exist. They’re not a shareholder. If you think about it, how would you have contracted for that in advance? “You will always acknowledge me as a shareholder.” I mean, it doesn’t even make sense, right? That’s sort of the idea that it might be difficult to foresee all of the problems.

Let me just add one other thought before we move on. A lot of these companies are starting on a shoestring budget and contracting for protection is expensive. If you’re the minority owner, then you’ve got to get a lawyer, presumably, who’s going to help you negotiate with the majority, and you’re going to work out whatever agreement you’re going to work out. If you’ve got multiple minority shareholders, maybe they’re all having to get their own lawyers. For a company like Apple, this is a drop in the bucket. But if you’re thinking about two or three of us starting a venture of some sort, spending several thousand dollars at the outset of a venture on what we hope will never come to pass—us getting cross-wise with one another—is quite a heavy burden to ask people to engage in.

I tried to explain in the 2005 article that these are what I think are the main seeds or causes of the oppression problem. Do these seeds appear in the LLC context? Just to cut through it, let me just say, yes. You can read the detail if you would like, but the answer is yes. The lack of exit rights in the LLC, even more so. The norm of free transferability of ownership interests which exists in the corporate context doesn’t even exist in the LLC, so it’s even harder to get out of an LLC. The norm of majority rule, we’ll talk about that, but, yes, it exists except for mergers. And that might be significant, which we’ll talk about in a minute. The business judgment rule applies in the LLC.

All of the factors that cause people not to contract for protection, they're not tied to the corporation setting. They're tied to small-business investors, regardless of what vehicle we put them in. The same problems of over-trusting your family, et cetera, et cetera, are going to exist no matter what organizational form you're putting your business in. Indeed, a decent number of states have extended their dissolution-for-oppression statutes to the LLC setting. Back in 2005, it was only like four or five states. So there's clearly been an uptick, and it's in the model acts as well so I expect that to continue.

For the new project, there are really two goals. The first is: what is going on out there with the LLC oppression cases? What's happening? We expect to see very similar patterns that have developed in the corporate context, but that's what we want to do. The second thing is there are some factors that we hypothesize might make a difference in how the oppression case law in the LLC setting is going to shake out. Those factors might cut one way or the other.

The first is freedom of contract in the LLC. All business organizations today allow you to use contract and typically enforce contracts. It wasn't always like that. In the corporation, it used to be much more difficult to contract around statutory norms, but today, you can contract for the way you want to run things. With that said, the LLC is held up today as, really, the most contract-oriented business organization. In fact, it's so contract oriented that Delaware has a statute that says it is the policy of the courts to give maximum effect to the principle of freedom of contract when it comes to the LLC.

That makes us wonder, "Will the courts be more reluctant to provide a judicial safety net?" Because a safety net is really what the oppression doctrine is. A court might think, "Look, you could have contracted for protection. Contract is front-and-center in the LLC. And if you didn't, that's sort of the bed that you have made." I'm going to be less willing, as a court, to extend some sort of protection.

Perhaps another way of making the same point is that there are a lot of oppression cases that are about contractual ambiguities. We wrote a bylaw provision; we wrote a shareholder provision, but the meaning of the provision is not clear. The minority will make some sort of argument like, "This isn't what we meant. We never meant that I could be fired the day before my proverbial pension vests." Something like that. Now I'm not saying that's always a winner in the corporate context, but I wonder if there will be even less sympathy for that sort of argument. Perhaps we're

going to cut any lack of clarity against the minority because, after all, the LLC is a contractually based organization. If there's any ambiguity, any generality, we're going to enforce those contracts, maximum effect, et cetera. It's hard to know. But we predict that there's going to be some discussion in the case law about the strength of freedom of contract and the protection that you could have contracted for. And that may very well affect what kinds of cases are out there.

The second bullet point: the explicitness of fiduciary duty. I mentioned a couple of times that, traditionally, fiduciary duties in the corporate context run to the corporation or to the shareholders collectively, but not to an individual shareholder. The problem you had under traditional corporate law is that for you to bring a fiduciary duty action, you'd have to say that the company was harmed. But in these shareholder oppression disputes, it's usually you who are harmed. The corporation might not be harmed at all. In the corporate context, that explains why an oppression doctrine developed. There wasn't a way for a minority shareholder to sue and say, "This has harmed me directly." LLCs are very different. In many LLCs statutes, it is explicit that a fiduciary duty runs from managers directly to an individual member. In that context, you now have a route where you can say, "Oh, I've been injured. I'm going to bring a breach of fiduciary duty action based on my own injuries." Perhaps you wouldn't even need an oppression action.

We're curious if we're going to find fewer cases involving the oppression statutes—possibly because there's no need to bring an action under the oppression statutes. You'll simply bring your action using fiduciary duty law. If that's true, though, there's going to be confusion in the courts over how does the business judgment rule apply to fiduciary duty lawsuits that are brought on behalf of individuals? Normally you think of the business judgment rule as protecting deference to act for the company. But when the fiduciary duty lawsuit is individually focused, you're going to see the courts having to struggle with whether the rule protects decisions that target individual shareholders. Your state, by the way, has some interesting case law about whether you owe a duty to an individual member in an LLC. There's definitely a case that says you only owe a fiduciary duty to the entity, and then there's some later cases that – I think – conclude a little differently. At any rate, in states that follow the model act, it's usually much clearer that a fiduciary duty is owed to the LLC and to an individual member.

Unanimity for mergers... Since I'm running out of time, let me just run through a couple of these very quickly. There are a number of cases in the corporate context where the oppression lawsuit takes the form of a merger. In the corporate context, we can effectuate a merger with a majority vote, and I can freeze you out of the company if I want to. Interestingly, here, the LLC actually provides more protection. Under the model LLC acts, unanimity is the default rule for mergers because they didn't want to have to come up with an appraisal and a dissenter's rights framework in the LLC statute. So we expect few freeze-out merger cases in the LLC setting because the majority can't effectuate them on its own.

Transferees is a big one. Transferees is not a concept, really, in the corporate context. A transferee is a concept, or a status, I should say, that arises in the partnership and LLC settings. Basically, a transferee has all of the financial rights of being an owner in the business, but that's it. A transferee does not have any management rights, and a transferee is not an owner of the business.

Let me just give you an example. There is a very famous corporate law shareholder oppression case called *Donahue versus Rodd Electrottype*. All you need to know about the case is that the plaintiff is Euphemia Donahue. Euphemia is the widow of a former shareholder. Now in the corporate context, if you're a shareholder and you die, your heirs inherit your stock and become full-fledged shareholders. They have all the rights that you had as a shareholder. If a shareholder could bring an oppression action, well, your heirs who are also shareholders can bring an oppression action. Not in the LLC setting. If you transport that case to the LLC setting, when Joseph Donahue died, Euphemia, his surviving spouse, became a transferee and only a transferee. She did not become a member of the LLC.

What's interesting about this is that none of the oppression statutes that have extended the oppression action to the LLC allow you to bring an action if you are a transferee. Either we're going to see no cases about this because they're all getting poured out on the ground that you don't have standing to bring an oppression action; you're just a transferee. Or we are going to find some cases where courts are having to engage in legal gymnastics to figure out how to get protection to these people that the statutes don't otherwise cover.

There are some statutes that say that members in a manager-managed LLC do not owe any duties. And that's right. Fiduciary duties tend to follow control. If you're in a manager-managed LLC and you're just a

plain-old member, you shouldn't owe any duties. But, analogously, under traditional corporate law, shareholders don't owe fiduciary duties unless they're controlling shareholders. The status doesn't create the fiduciary duty; it's when you have control. We suspect that a lot of courts are going to read the statute too broadly and are going to say that controlling members don't owe any duties because the statute says members don't owe any duties. That's clearly not what those statutes were designed to cover. They were designed to cover the status, but not if you overlay control on top of that status.

At any rate, I've gone a little past my time, but thank you all, and I look forward to questions after we finish the discussion.