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California's New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambiguous

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California's New Limited Liability Company Act: A Look at the Good, the Bad, and the Ambiguous

Franklin A. Gevurtz*

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California has now joined almost all the other states in enacting legislation that authorizes a new business entity—the limited liability company (LLC).¹ The object of this new form is to obtain classification for federal income tax purposes as a partnership, while at the same time allow the firm's owners to achieve insulation from personal responsibility for the debts of the firm.² The purpose of this article is neither to praise nor criticize this overall development.³ I leave to

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1. CAL. CORP. CODE §§ 17000-17705 (West Supp. 1996). Even more recently, California enacted a limited liability partnership (or LLP) statute. See Julia A. Butcher, *Review of Selected 1995 California Legislation*, 27 PAC. L.J. 349, 440-47 (1996) (discussing the enactment of S.B. 513, dealing with LLPs, available at 1995 Cal. Legis. Serv. ch. 679, sec. 1-20, at 4079-98). This statute provides limited liability to law and accounting firms in exchange for minimum insurance coverage. Beyond this, California LLPs generally are governed by the State's version of the Uniform Partnership Act. Hence, the LLP act raises few of the issues addressed in this article which occur in the far broader LLC act.

2. See FRANKLIN A. GEVURTZ, *BUSINESS PLANNING* 53-109 (2d ed. 1995) (discussing in detail why this combination is desirable).

3. See, e.g., Timothy M. Harris, *Review of Selected 1994 California Legislation*, 26 PAC. L.J. 202, 305, 309-11 (1995) (explaining the purpose and concerns underlying California's LLC enactment).

others, as well, the task of providing an overview of the act.⁴ Instead, this article will critique a select number of specific provisions of California's new LLC act. Some I single out for kudos, in the hope that jurisdictions which lack such terms in their LLC acts will be convinced to follow California's lead on these issues. Other portions of California's act, however, raise points for our own legislature to reconsider. These either reflect questionable policy or ambiguous drafting.

This article will address two broad areas. Part I considers various provisions impacting the rights of LLC members with respect to each other. First, this will entail an overview and critique of the rules governing members' financial and management rights in the absence of contrary agreement. By and large these provisions are unexceptional, and, accordingly, this overview will be brief. Next, this part explores the provisions relevant to the always controversial subject of fiduciary duty. Finally, this part will take an extended look at the coherence and wisdom of the most complex provisions in the LLC act—those dealing with fundamental changes.

Part II of this article looks at provisions in the LLC act which bear upon the protection accorded to third parties dealing with the firm. The focus is narrower here. This part will look at the rules limiting distributions from an LLC to its members, as well as the provision applying corporate "piercing-the-veil" doctrine to LLCs.

I. RIGHTS OF THE MEMBERS *INTER SE*

A. *Basic Operating Rules*

California's LLC act is generally similar to most states' with respect to the rules governing members' relations to each other. As with other states, California's LLC statute, by and large, allows the parties to make whatever agreement they wish concerning management, contributions and sharing of profit and loss.⁵ The act contains non-waivable provisions concerning certain aspects of fundamental transactions. This includes the right of members to vote on a merger or dissolution,⁶ the right of members to challenge expulsion clauses as unreasonable,⁷ the right of a member obligated to provide services to withdraw,⁸ and a requirement that there be no less than a majority vote required to amend the articles.⁹ Also, members cannot waive rights to receive financial information and

4. See, e.g., RICHARD BURT ET AL., FORMING AND OPERATING CALIFORNIA LIMITED LIABILITY COMPANIES (1995) [hereinafter CALIFORNIA LLCs].

5. CAL. CORP. CODE § 17005 (West Supp. 1996).

6. *Id.* §§ 17005(b)(3), 17103(c) (West Supp. 1996).

7. *Id.* § 17005(b)(2) (West Supp. 1996).

8. *Id.* § 17005(b)(5) (West Supp. 1996).

9. *Id.* §§ 17005(b)(3), 17103(b) (West Supp. 1996).

to inspect books and records.¹⁰ These provisions are rather narrow and should rarely interfere with parties structuring an LLC in the manner they desire.

Recognizing that parties may often overlook issues in forming a venture, California's act, like all others, provides various "default" rules to govern in the absence of agreement on matters likely to arise. Like most LLC acts, California's calls for direct management by members, barring other agreement.¹¹ It also joins most states in calling for voting in proportion to profit interest, rather than per capita, absent other agreement.¹² Direct management seems a reasonable default rule for the sort of closely held business likely to operate as an LLC (as well as more likely to neglect to cover the issue in a well drafted agreement).¹³ It is difficult to say whether proportional or per capita voting is likely to be more

10. *Id.* § 17005(b)(4) (West Supp. 1996).

11. CAL. CORP. CODE § 17150 (West Supp. 1996); *cf.* ALA. CODE § 10-12-22(a) (1994); ALASKA STAT. § 10.50.110 (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-681 (Supp. 1995); ARK. CODE ANN. § 4-32-401 (Michie Supp. 1995); COLO. REV. STAT. § 7-80-401 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-140 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1995); FLA. STAT. ANN. § 608.422 (West Supp. 1995); GA. CODE ANN. § 14-11-304 (Michie 1994); IDAHO CODE § 53-621 (1994); ILL. ANN. STAT. ch. 805, para. 180/15-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-4-1(a) (West Supp. 1994); IOWA CODE ANN. § 490A.702(1) (West Supp. 1995); KAN. STAT. ANN. § 17-7612 (1996); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 33 (Baldwin); LA. REV. STAT. ANN. § 12:1311 (West 1994); ME. REV. STAT. ANN. tit. 31, § 651(1) (West Supp. 1995); MD. CODE ANN., CORPS & ASS'NS § 4A-402 (1993); MICH. COMP. LAWS ANN. § 450.4401 (West Supp. 1995); MO. ANN. STAT. § 347.079(1) (Vernon Supp. 1994); MONT. CODE ANN. § 35-8-401(1) (1995); NEB. REV. STAT. § 21-2615 (Supp. 1994); NEV. REV. STAT. § 86.291 (1993); N.H. REV. STAT. ANN. § 304-C:31(II) (Supp. 1995); N.J. STAT. ANN. § 42:2B-27 (West Supp. 1995); N.M. STAT. ANN. § 53-19-15(A) (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 401 (McKinney 1996); N.C. GEN. STAT. § 57C-3-20(a) (Supp. 1993); OR. REV. STAT. § 63.130 (1995); R.I. GEN. LAWS § 7-16-14 (1992); S.D. CODIFIED LAWS ANN. § 47-34-16 (Supp. 1995); UTAH CODE ANN. § 48-2b-125 (1994); VA. CODE ANN. § 13.1-1022A (Michie 1993); WASH. REV. CODE ANN. § 25.15.150 (West Supp. 1996); W. VA. CODE § 31-1A-18(a) (Supp. 1995); WIS. STAT. ANN. § 183.0401(1) (West Supp. 1995); WYO. STAT. § 17-15-116 (Supp. 1995). *But see* MINN. STAT. ANN. § 322B.606 (West 1995) (requiring use of managers); N.D. CENT. CODE § 10-32-69 (1995) (same); OKLA. STAT. ANN. tit. 18, § 2015 (West Supp. 1996) (providing for the use of managers unless otherwise provided); TENN. CODE ANN. § 48-238-101 (1995) (containing no default provision for member or management control); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1996) (providing for the use of managers unless otherwise provided).

12. CAL. CORP. CODE § 17103(a)(1) (West Supp. 1996); *cf.* ALA. CODE § 10-12-28 (1994); COLO. REV. STAT. § 7-80-503 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-142 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1994); FLA. STAT. ANN. § 608.422 (West Supp. 1995); IOWA CODE ANN. § 490A.701 (West Supp. 1995); MD. CODE ANN., CORPS & ASS'NS § 4A-403(1) (1993); MICH. COMP. LAWS ANN. § 450.4502 (West Supp. 1995); MINN. STAT. ANN. § 322B.356 (West 1995); MO. ANN. STAT. § 347.079(1) (Vernon Supp. 1994); NEB. REV. STAT. § 21-2615 (1994); N.J. STAT. ANN. § 42:2B-27 (West Supp. 1995); N.M. STAT. ANN. § 53-19-17(A) (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 402 (McKinney 1996); OKLA. STAT. ANN. tit. 18, § 2020 (West Supp. 1996); R.I. GEN. LAWS § 7-16-21 (1992); S.D. CODIFIED LAWS ANN. § 47-34-16 (Supp. 1995); VA. CODE ANN. § 13.1-1022B (Michie 1993); WASH. REV. CODE ANN. § 25.15.120 (West Supp. 1996); W. VA. CODE § 31-1A-18(b) (Supp. 1995); WIS. STAT. ANN. § 183.0404(1)(a) (West Supp. 1995); WYO. STAT. § 17-15-116 (Supp. 1995). *But see* KAN. STAT. ANN. § 17-7612 (1995) (per capita); LA. REV. STAT. ANN. § 12:1318(A) (West 1994) (same); ME. REV. STAT. ANN. tit. 31, § 653 (West Supp. 1995) (same); N.H. REV. STAT. ANN. § 304-C:24 (Supp. 1995) (same); OR. REV. STAT. § 63.150(2) (1995) (same); TENN. CODE ANN. § 48-224-101 (1995) (same).

13. Direct management is the default rule for partnerships. U.P.A. § 18(e) (1914).

consistent with the participants' expectations;¹⁴ hence, California's choice of proportional voting is not unreasonable. On the other hand, changing this voting rule in California requires a written agreement,¹⁵ which seems unnecessarily restrictive for a closely held business.¹⁶

As is generally true in LLC acts, participants in a California LLC may agree to governance by managers, rather than directly by members.¹⁷ As in many other states, this requires a provision in the articles of organization, rather than just the operating agreement.¹⁸ Since the effect of providing for managers in the articles

14. Compare Larry Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 419-20 (1995) (arguing for a per capita default rule) with GEVURTZ, *supra* note 2, at 197 (questioning whether this is realistic for a firm with unequal contributions).

15. CAL. CORP. CODE § 17103(a) (West Supp. 1996).

16. See Dennis Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 461-63 (1995).

17. CAL. CORP. CODE § 17151(a) (West Supp. 1996); cf. ALA. CODE § 10-12-22(b) (1994); ALASKA STAT. § 10.50.110(b) (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-681(b) (Supp. 1995); ARK. CODE ANN. § 4-32-401 (Michie Supp. 1995); COLO. REV. STAT. § 7-80-401 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-140(b) (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1995); FLA. STAT. ANN. § 608.422 (West Supp. 1996); GA. CODE ANN. § 14-11-204 (Michie 1994); IDAHO CODE § 53-621(2) (1994); ILL. ANN. STAT. ch. 805, para. 180/15-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-4-1(b) (West Supp. 1994); IOWA CODE ANN. § 490A.705 (West Supp. 1995); KAN. STAT. ANN. § 17-7612 (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 33 (Baldwin); LA. REV. STAT. ANN. § 12:1312 (West 1994); ME. REV. STAT. ANN. tit. 31, § 651(3) (West Supp. 1995); MD. CODE ANN., CORPS. & ASS'NS § 4A-402(a)(1) (1993); MICH. COMP. LAWS ANN. § 450.4402 (West Supp. 1995); MO. ANN. STAT. § 347.079(2) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-402(2) (1995); NEB. REV. STAT. § 21-2615 (Supp. 1994); NEV. REV. STAT. § 86.291 (1993); N.H. REV. STAT. ANN. § 304-C:31(I) (1994); N.J. STAT. ANN. § 42:2B-27 (West Supp. 1995); N.M. STAT. ANN. § 53-19-15(B) (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 408 (McKinney 1996); N.C. GEN. STAT. § 57C-3-24 (Supp. 1993); OR. REV. STAT. § 63.135 (1995); R.I. GEN. LAWS § 7-16-15 (1992); S.D. CODIFIED LAWS ANN. § 47-34-16 (Supp. 1995); UTAH CODE ANN. § 48-2b-125 (1994); VA. CODE ANN. § 13.1-1024 (Michie 1993); WASH. REV. CODE ANN. § 25.15.150(2) (West Supp. 1996); W. VA. CODE § 31-1A-20 (Supp. 1995); WIS. STAT. ANN. § 183.0401(2) (West Supp. 1995); WYO. STAT. § 17-15-116 (Supp. 1995).

18. CAL. CORP. CODE § 17151(b) (West Supp. 1996); cf. ALA. CODE § 10-12-10(8) (1994); ALASKA STAT. §§ 10.50.075(5), 10.50.110 (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-632(5)(a) (Supp. 1995); ARK. CODE ANN. § 4-32-202(d) (Michie Supp. 1995); COLO. REV. STAT. § 7-80-204(1)(d) (Supp. 1995); CONN. GEN. STAT. ANN. § 34-121 (West Supp. 1995); FLA. STAT. ANN. § 608.407(g)(1) (West Supp. 1996); GA. CODE ANN. § 14-11-204(b)(1) (Michie 1994); IDAHO CODE § 53-608(4) (1994); ILL. ANN. STAT. ch. 805, para. 180/5-5(a)(4) (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-2-4(b)(4) (West 1994); KAN. STAT. ANN. §§ 17-7607(7)(A), 17-7612 (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 5(1)(e) (Baldwin); LA. REV. STAT. ANN. § 12:1305(C)(2) (West 1994); ME. REV. STAT. ANN. tit. 31, § 622(1)(C) (West Supp. 1995); MICH. COMP. LAWS ANN. § 450.4203(1)(d) (West Supp. 1995); MO. ANN. STAT. §§ 347.015(10), 347.039(1)(4) (Vernon Supp. 1995); MONT. CODE ANN. §§ 35-8-102(14), 35-8-202(1)(d) (1995); NEB. REV. STAT. § 21-2606(i) (Supp. 1994); NEV. REV. STAT. § 86.161(2) (1994); N.H. REV. STAT. ANN. § 304-C:12(II)(e) (1994); N.M. STAT. ANN. § 53-19-8(D) (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 401(a) (McKinney 1996); N.C. GEN. STAT. §§ 57C-1-03(13), 57C-2-21(a)(5) (Supp. 1993); OR. REV. STAT. § 63.047(1)(d) (1995); 15 PA. CONS. STAT. ANN. § 8913(5) (1995); R.I. GEN. LAWS § 7-16-6(a)(7) (1992); S.C. CODE ANN. § 33-43-202(A)(4) (Law. Co-op. Supp. 1995); S.D. CODIFIED LAWS ANN. § 47-34-12(9) (Supp. 1995); TENN. CODE ANN. § 48-205-101(5) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 3.02(A)(5) (West Supp. 1996); UTAH CODE ANN. § 48-2b-116(1)(f) (1994); WASH. REV. CODE ANN. § 25.15.070(1)(e) (West Supp. 1996); WIS. STAT. ANN. § 183.0202(4) (West Supp. 1995); WYO. STAT. § 17-15-117 (1989).

is to cut off the apparent authority of members to bind the firm,¹⁹ the requirement for such a provision to be in a public document is understandable. California's act provides default rules which answer some,²⁰ but by no means all,²¹ of the questions which can arise in a manager governed LLC. Still, if parties are going to depart from the primary default rule of member management, it is not too much to ask that they then draft the details of their own agreement.

California's LLC act, like most others, allows contributions of any nature.²² In what appears to be something of an overkill, it goes into great detail to authorize a wide variety of contractually established sanctions for failure to make an agreed contribution.²³ Like the majority of states, California's LLC act follows the limited partnership default rule²⁴ of profit sharing in proportion to contributions, rather than the partnership law approach²⁵ of equal sharing.²⁶ This creates

19. CAL. CORP. CODE § 17157(a), (b) (West Supp. 1996).

20. See *id.* § 17152(a)-(d) (West Supp. 1996) (dealing with election, removal, resignation, and term of managers); *id.* § 17156 (West Supp. 1996) (addressing the required majority vote for LLCs with more than one manager).

21. For example, the statute does not specify the frequency of required elections.

22. CAL. CORP. CODE § 17200(a) (West Supp. 1996); *cf.* ALA. CODE § 10-12-26 (1994); ALASKA STAT. § 10.50.275 (Supp. 1995); ARIZ. REV. STAT. ANN. §§ 29-601(2), 29-701 (Supp. 1995); ARK. CODE ANN. § 4-32-501 (Michie Supp. 1995); COLO. REV. STAT. §§ 7-80-102(4), 7-80-501 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-150 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101(3), 18-501 (1993); FLA. STAT. ANN. § 608.4211(1) (West Supp. 1996); GA. CODE ANN. § 14-11-401 (Michie 1994); IDAHO CODE § 53-626 (1994); ILL. ANN. STAT. ch. 805, para. 180/20-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-1-5 (West 1994); IOWA CODE ANN. §§ 490A.102(3), 490A.801(1) (West Supp. 1995); KAN. STAT. ANN. § 17-7602(i) (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 39 (Baldwin); LA. REV. STAT. ANN. §§ 12:1301(3), 12:1321 (West 1994); ME. REV. STAT. ANN. tit. 31, § 661 (West Supp. 1995); MD. CODE ANN., CORPS. & ASS'NS § 4A-501 (1993); MICH. COMP. LAWS ANN. § 450.4301(1) (West Supp. 1995); MINN. STAT. ANN. § 322B.40(2)(1) (West 1995); MO. ANN. STAT. § 347.015(5) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-501 (1995); NEB. REV. STAT. § 21-2614 (1994); NEV. REV. STAT. § 86.321 (1994); N.H. REV. STAT. ANN. §§ 304-C:1(III), 304-C:36(I) (1994); N.J. STAT. ANN. § 42:2B-2 (West Supp. 1995); N.M. STAT. ANN. § 53-19-20 (Michie Supp. 1995); N.Y. LTD. LIAB. CO. LAW §§ 102(f), 501 (McKinney 1996); N.C. GEN. STAT. § 57C-4-01 (Supp. 1993); N.D. CENT. CODE § 10-32-56(2) (1995); OHIO REV. CODE ANN. §§ 1705.01(B), 1705.09(A) (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2001(4), 2023 (West Supp. 1996); OR. REV. STAT. § 63.175 (1995); 15 PA. CONS. STAT. ANN. § 8931(a) (1995); R.I. GEN. LAWS §§ 7-16-2(e), 7-16-24, (1992); S.C. CODE ANN. § 33-43-501 (Law. Co-op. Supp. 1995); S.D. CODIFIED LAWS ANN. § 47-34-19 (Supp. 1995); TENN. CODE ANN. § 48-232-101(a) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 5.01(A) (West Supp. 1996); UTAH CODE ANN. § 48-2b-124 (1994); VA. CODE ANN. §§ 13.1-1002, 13.1-1027(A) (Michie 1993); WASH. REV. CODE ANN. § 25.15.190 (West Supp. 1996); W. VA. CODE §§ 31-1A-1(4), 31-1A-23(a) (Supp. 1995); WIS. STAT. ANN. § 183.0501(1) (West Supp. 1996); WYO. STAT. § 17-15-115 (1989).

23. CAL. CORP. CODE § 17201(a)(3) (West Supp. 1996).

24. UNIF. LTD. PARTNERSHIP ACT § 503 (1985) [hereinafter U.L.P.A.].

25. U.P.A. § 18(a) (1914).

26. CAL. CORP. CODE § 17202 (West Supp. 1996); *cf.* ALA. CODE § 10-12-28 (1994); COLO. REV. STAT. § 7-80-503 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-152 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-503 (1993); FLA. STAT. ANN. § 608.4261 (West Supp. 1996); ILL. ANN. STAT. ch. 805, para. 180/20-10 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-5-3 (West 1994); IOWA CODE ANN. § 490A.802 (West Supp. 1995); MD. CODE ANN., CORPS & ASS'NS § 4A-505(1) (1993); MICH. COMP. LAWS ANN. § 450.4303 (West Supp. 1995); MINN. STAT. ANN. § 322B.326 (West 1995); MO. ANN. STAT. § 347.111 (Vernon Supp. 1996); N.H. REV. STAT. ANN. § 304-C:38 (1995); N.J. STAT. ANN. § 42:2B-34 (West Supp. 1995); N.M. STAT. ANN. § 53-19-22 (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 503 (McKinney Supp. 1996); N.C. GEN. STAT.

the potential for controversy as to whether services, for example, are an agreed contribution, and, if so, the value of their worth.²⁷ Fortunately, it is extremely rare that the participants in a business venture will not make an explicit agreement about profit sharing (if nothing else) and so must rely upon a default rule for this subject.

On the other hand, overlooking the prospect of losses is a likely occurrence. Here, a proportional to contribution rule, rather than an equal sharing rule, makes sense—especially in a limited liability entity. The problem with equal loss sharing in the face of unequal contributions is that the loss sharing agreement can require the member(s) who made less contribution(s) to reimburse the member(s) who made more.²⁸ This creates a contradiction between the loss sharing arrangement and the notion of liability limited to the agreed contribution.

One of the most contentious situations in closely held businesses operated as a corporation occurs when the active participants attempt what is often referred to as a squeeze-out of the inactive minority.²⁹ Essentially, the active majority uses its power to obtain pretty much all of the economic benefit from the business through salaries and the like, while depriving the inactive minority of much of any return by declaring few or no dividends.³⁰ While California's LLC statute contains a default rule for allocating distributions once made,³¹ it provides no guidelines in the absence of agreement for when the LLC must make pre-withdrawal distributions.³² This gap, however, is common to LLC acts,³³ reflecting perhaps its inevitability. Given the numerous variables involved in deciding whether to distribute or reinvest a firm's earnings, it seems virtually impossible to construct a reasonable statutory formula for when and how much of earnings

§ 57C-4-03 (Supp. 1993); N.D. CENT. CODE § 10-32-36 (1995); OHIO REV. CODE ANN. § 1705.10 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, § 2025(1) (West Supp. 1996); R.I. GEN. LAWS § 7-16-26 (1992); TEX. REV. CIV. STAT. Ann. art. 1528n, art. 5.02-1(A) (West Supp. 1996); UTAH CODE ANN. § 48-2b-130 (1994); VA. CODE ANN. § 13.1-1029 (Michie Supp. 1995); WASH. REV. CODE ANN. § 25.15.200 (West Supp. 1996); W. VA. CODE § 31-1A-24 (Supp. 1995); WIS. STAT. ANN. § 183.0503 (West Supp. 1995). *But see* ALASKA STAT. § 10.50.290 (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-709 (Supp. 1995); ARK. CODE ANN. § 4-32-503 (Michie Supp. 1995); GA. CODE ANN. § 14-11-403 (Michie 1994); IDAHO CODE § 53-628 (1994); KAN. STAT. ANN. § 17-7615(b), (c) (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 41 (Baldwin); LA. REV. STAT. ANN. § 12:1323 (West 1994); ME. REV. STAT. ANN. tit. 31, § 663 (West Supp. 1995); MONT. CODE ANN. § 35-8-503 (1995); OR. REV. STAT. § 63.185(2) (1995); 15 PA. CONS. STAT. ANN. § 8932 (1995); S.C. CODE ANN. § 33-43-503 (Law. Co-op. Supp. 1995); TENN. CODE ANN. § 48-220-101 (1995).

27. *See, e.g.*, *Advanced Orthopedics, L.L.C. v. Moon*, 656 So. 2d 1103, 1106 (La. 1995) (rejecting the claim by a former LLC-member for reimbursement for contributed services).

28. *E.g.*, *Richert v. Handly*, 330 P.2d 1079 (Wash. 1958).

29. *See, e.g.*, Franklin A. Gevurtz, *Squeeze-outs and Freeze-outs in Limited Liability Companies*, 73 WASH. U. L.Q. 497, 498-501 (1995).

30. *See, e.g.*, *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

31. CAL. CORP. CODE § 17250 (West Supp. 1996).

32. *See id.* § 17251 (West Supp. 1996) (indicating that pre-withdrawal distributions occur at the times or upon the events specified in the operating agreement).

33. GEVURTZ, *supra* note 2, at 508-09.

every firm should pay out. Accordingly, the prevention of squeeze-outs in LLCs must come from provisions other than that governing distributions.

In this regard, California's statute contains an important rule which other states would do well to follow. California's act, apparently alone among the states, contains a provision preventing the payment of salaries to LLC members without the agreement of all members (with a narrow exception for winding up the business following dissolution).³⁴ By depriving a majority of the ability to obtain salaries without agreement, the California LLC act deters squeeze-outs in which the majority is content to cut-off distributions to all, while voting salaries to itself.

In rebuttal, one might ask whether California's rule does not give the passive owners too much power to veto salaries justified by the circumstances. If parties at the venture's inception contemplate unequal roles—some active, some passive—presumably they will take this into account, either through their profit shares or by agreeing to salaries at the start. The typical squeeze-out occurs after some ownership interests, which started as active, become passive—perhaps involuntarily at the behest of the majority (whether or not justified), or often because of changing life circumstances (retirement, inheritance of shares by those unable or unwilling to participate, or the like).³⁵ These cases, unless anticipated at the outset, seem to call for a renegotiation among the parties. The problem with the corporate law approach—which allows salaries without consent of all³⁶—is that it enables the active majority to dictate terms without such renegotiation. Such power seems excessive given the leverage parties providing needed services already have.

B. Fiduciary Duty

Few undertakings in the area of business associations law seem to generate quite as much controversy as does attempting to codify rules of fiduciary duty.³⁷ It is therefore not surprising that the drafters of California's LLC act, having decided to address the subject, seem to have left the job unfinished. The centerpiece of their effort is section 17153 of the California Corporations Code.

34. CAL. CORP. CODE § 17004(b) (West Supp. 1996). This is also the rule for partnerships under the Uniform Partnership Act. U.P.A. § 18(f) (1914). It is also part of the proposed Uniform Limited Liability Company Act. UNIF. LTD. LIAB. CO. ACT § 403(d) (1995).

35. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS § 2.03 (2d ed. 1985).

36. *See, e.g.*, DEL. CODE ANN. tit 8, § 141(h) (1991).

37. Witness the controversies surrounding the efforts to draft a duty of care provision for the Model Business Corporation Act, to create corporate loyalty and care rules in the American Law Institute's Principles of Corporate Governance and to draft rules of partnership fiduciary duty in the Revised Uniform Partnership Act.

Section 17153 states that managers of an LLC have the same fiduciary obligation toward the firm and its members as a partner has toward his or her partnership and partners.³⁸ One problem with this approach is that the question of what fiduciary duty a partner owes is not free from doubt. Once one gets past the “punctilio of an honor the most sensitive,”³⁹ and the duty under section 21 of the Uniform Partnership Act to “account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property,”⁴⁰ there are plenty of questions: Does a partner owe the firm or his or her fellow partners any duty of care? Or, put another way, must he or she pay the firm for losses resulting from his or her negligence?⁴¹ At the outset of the relationship, does a prospective partner have any duty to disclose all facts which other prospective partners would find important?⁴² At the termination of the relationship, are there any limits on dissolving an at-will partnership?⁴³ Despite such questions, the decision to incorporate partnership fiduciary duty brings to bear a substantial body of authority which addresses many issues,⁴⁴ even if not all. Moreover, it is probably too much to expect that one state’s LLC act should answer all the questions about fiduciary duty which have avoided definitive answer in other business forms with more history.

Another concern about section 17153 is whether it makes the correct choice in looking to partnership law as the source of fiduciary duty for LLC managers. Generally, the decision to incorporate partnership, rather than corporate, law rules of fiduciary duty seems sensible. LLCs are likely to be closely held,⁴⁵ have substantial member participation in management,⁴⁶ and have limited markets for

38. CAL. CORP. CODE § 17153 (West Supp. 1996).

39. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

40. U.P.A. § 21 (1914).

41. *Compare* *Ferguson v. Williams*, 670 S.W.2d 327 (Tex. Civ. App. 1984) (declaring that partners cannot be liable to fellow partners for negligent operation of the partnership) *with* REV. UNIF. PARTNERSHIP ACT § 404(c) (1985) [hereinafter R.U.P.A.] (imposing liability for gross negligence).

42. *Compare* *Herring v. Offutt*, 295 A.2d 876 (Md. 1972) (finding such a duty to disclose) *with* R.U.P.A. § 404(b)(1) (1985) (eliminating the portion of U.P.A. Section 21 relied upon in *Herring*).

43. *Compare* *Page v. Page*, 55 Cal. 2d 192, 359 P.2d 41, 10 Cal. Rptr. 643 (1961) (stating in dicta that there are limits in such a dissolution) *with* *Johnson v. Kennedy*, 214 N.E.2d 276 (Mass. 1966) (finding no such limits).

44. *See, e.g.*, *Shulkin v. Schulkin*, 16 N.E.2d 644, 650 (Mass. 1938) (barring contrary agreement one cannot compete the with partnership); *Meinhard v. Salmon*, 164 N.E. 545, 546-47 (N.Y. 1928) (discussing the duty to disclose opportunity); *Bassan v. Investment Exch. Corp.*, 524 P.2d 233, 238 (Wash. 1974) (concluding that a partner had a duty to turn over to the partnership all profits made in a transaction between the partnership and a partner without the consent of the other partners).

45. *See infra* note 126 and accompanying text.

46. *See* CAL. CORP. CODE § 17150 (West Supp. 1996) (barring a contrary provision in the articles, members manage the LLC).

their membership interests.⁴⁷ Under these circumstances, some courts have held that partnership fiduciary duty is appropriate even for shareholders in a closely held corporation.⁴⁸ Hence, if the question was what fiduciary duty should members in an LLC have, the answer of partnership law would seem obvious. Yet, this is not what section 17153 directly addresses. Rather, it considers the fiduciary duty of managers, who may not even be members.⁴⁹ Accordingly, perhaps corporate law fiduciary duty rules—which contemplate delegated management—might be more appropriate. Such distinctions, however, may be somewhat akin to an effort to count angels on the head of a pin. For many purposes, the difference between the fiduciary duties of partners and corporate managers may be more apparent than real.⁵⁰ Moreover, courts have made distinctions between the fiduciary duty of managing and non-managing partners,⁵¹ which section 17153 could import. Nevertheless, for some issues, the distinction may be important. For example, while some writers suggest partners owe each other no duty of care,⁵² such a duty seems appropriate for managers.⁵³

The final concern with section 17153 is what it does *not* cover: the fiduciary duty of members. Fortunately, section 17150 provides that if there is direct management by members, then the members have the same obligations (presumably including section 17153's fiduciary duty) as managers. Members, however, may retain substantial power in an LLC run by managers. For example, they might vote on mergers,⁵⁴ sales of assets,⁵⁵ expulsions,⁵⁶ dissolutions,⁵⁷ or a wide variety of other actions. Without any fiduciary duty, such transactions can certainly be subject to abuse.⁵⁸ Yet, the negative implication of specifying a

47. The desire to obtain partnership tax treatment often requires transfer restrictions. *E.g.*, Rev. Proc. 95-10, 1995-3 I.R.B. 20. Moreover, becoming publicly traded will lead to taxation as an association rather than a partnership. I.R.C. § 7704 (1988).

48. *E.g.*, *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505, 512 (Mass. 1975).

49. CAL. CORP. CODE § 17151(a) (West Supp. 1996).

50. *See, e.g.*, *Starr v. Fordham*, 648 N.E.2d 1261, 1265-66 (Mass. 1995) (applying a fairness test, rather than the business judgment rule, to a partner's conflict of interest transaction); *Wylar v. Feuer*, 85 Cal. App. 3d 392, 402, 149 Cal. Rptr. 626, 633 (1978) (applying business judgment rule to mismanagement claim against the general partner in a limited partnership); *Page v. Page*, 55 Cal. 2d 192, 196, 359 P.2d 41, 44, 10 Cal. Rptr. 643, 646 (1961) (citing a corporate dissolution case in support of the proposition that partners cannot dissolve in bad faith).

51. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545, 548 (N.Y. 1928).

52. *E.g.*, Larry Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 140 (1990).

53. Perhaps a group of co-owners who are all active in management—and who could all, therefore, harm the business through negligence—might be expected to agree (if they thought about the subject in advance) to simply share such losses as part of the costs of the business. Delegated management to only some participants suggests, however, a different expectation.

54. CAL. CORP. CODE § 17551(a) (West Supp. 1996).

55. *See infra* notes 97-98 and accompanying text.

56. *See infra* note 138 and accompanying text.

57. CAL. CORP. CODE § 17350(c), (d) (West Supp. 1996).

58. *See infra* notes 127-33, 144-61, and 216-22 and accompanying text.

fiduciary duty for managers, but not members, could form the basis for an argument that members have no duty. Section 17613(b) and (c) is helpful here. It imposes upon persons who control both sides in an LLC merger or other “reorganization” the burden of proving the transaction is just and reasonable.⁵⁹ Still, this leaves gaps for expulsions, dissolutions and other transactions which do not constitute a reorganization.⁶⁰

Two other provisions in the California act bear upon fiduciary duty. Section 17004 states that a member may transact business with the LLC.⁶¹ Does this abrogate the partnership law fiduciary duty rule requiring full disclosure and consent for such a transaction to be valid?⁶² Section 17005(d) states that modifying the fiduciary duty of a manager requires a provision in a written operating agreement with the informed consent of the members.⁶³ Is there any limit on how far members can go in modifying a manager’s fiduciary duty; for example, can they agree to abrogate such a duty entirely?⁶⁴

These questions suggest that the drafters of California’s LLC act have a way to go before they succeed in producing a completely coherent set of provisions dealing with fiduciary duty in an LLC. An alternate approach, given the fact that fiduciary duty historically has been an evolving judicial creation, would have been to leave the whole question alone. In the end, one suspects courts will do what they want in this area anyway.⁶⁵

C. Fundamental Changes

One of the most complex areas in drafting legislation for a new business entity involves transactions that change ownership or owner rights. This includes the sale or combination of businesses, the entry of new owners, the involuntary and voluntary exit of owners, and altering the contract between the owners. In handling these subjects, the legislative drafter confronts very different models in partnership versus corporate law—the former built around unanimous consent, the latter around majority rule. LLC legislation, including California’s statute, often attempts to split the difference—some actions require unanimity, while others simply a majority. One difficulty with this approach is that rules governing

59. CAL. CORP. CODE § 17613(b), (c) (West Supp. 1996).

60. *See id.* § 17600(a), (b) (West Supp. 1996) (defining “reorganization”).

61. *Id.* § 17004 (West Supp. 1996).

62. *See, e.g.,* Marsh v. Gentry, 642 S.W.2d 574, 575 (Ky. 1982) (explaining the duty for partnership transactions).

63. CAL. CORP. CODE § 17005(d) (West Supp. 1996).

64. The question of whether, or to what extent, fiduciary duties should be subject to agreement has been subject to considerable debate. *E.g., Symposium on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). Resolution of this debate, however, is well beyond the scope of this article.

65. *See, e.g.,* Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 417-24, 241 P.2d 66, 73-77 (1952) (imposing a fairness review despite the language of the corporate directors conflict of interest statute).

these transactions often generate strategic responses, in other words, the use of alternative statutory techniques to accomplish the same end, but with less restrictive (or less protective, depending upon one's viewpoint) requirements. Avoiding such strategic behavior requires shifting the focus of analysis from one that views statutory procedures (e.g., merger and amendment of the operating agreement) largely in isolation to an approach that examines the various ways to achieve transactional objectives (e.g., sale or combination of businesses and involuntary removal of owners). This is what the following discussion seeks to do.

1. Sale or Combination of Businesses

Owners of partnerships and corporations possess a number of alternate routes for structuring a sale or combination of businesses.⁶⁶ In either form of business, parties may structure the transaction as a sale by one entity of all its assets to another entity (presumably followed by dissolution of the selling firm) or a sale by the owners of one entity of their ownership interests. With corporations, a third choice—the statutory merger of two corporate entities into one surviving firm—is also available.⁶⁷

Barring other agreement, sale of substantially all the assets of a partnership generally requires unanimous approval of the selling firm's partners⁶⁸ and, if the buyer is a partnership, unanimity of the buyer's partners.⁶⁹ While, absent other agreement, partners may assign their interests in the firm,⁷⁰ the assignee cannot become a new partner with management rights without the consent of all the other partners.⁷¹ Hence, a sale or combination through the transfer of partnership interests would also require unanimous approval. There is one technique to force the sale of a partnership's business over objections. This is to dissolve the firm and demand liquidation.⁷² Still, this does not force a particular sale. Rather, it initiates an auction in which the objectors may end up buying the business.⁷³ Moreover, while this approach can force a cash sale, it cannot force a sale for equity interests in a combined firm.⁷⁴

66. See, e.g., GEVURTZ, *supra* note 2, at 305, 902-917.

67. E.g., CAL. CORP. CODE § 1100 (West 1990); DEL CODE ANN. tit. 8, § 251 (1991). The Revised Uniform Partnership Act contains provisions allowing partnership mergers. R.U.P.A. §§ 905-908 (1994).

68. See U.P.A. § 18(h) (1986).

69. This depends upon whether the purchase of another firm's assets would be an action outside the ordinary course of the buying partnership's business. *Id.*

70. See *id.* § 27(1) (1986).

71. *Id.* §§ 18(g), 27(1).

72. See *id.* §§ 31(1)(b), 38(1) (1986).

73. See, e.g., *Prentiss v. Sheffel*, 513 P.2d 949 (Ariz. Ct. App. 1973).

74. See U.P.A. § 38(1) (1986) (listing the right to demand one's share "in cash").

In contrast, corporate law follows a majority rule approach.⁷⁵ Even so, the votes required and other rights of the owners may be very different depending upon how the parties structure the transaction.⁷⁶ For example, the board of directors of both the buying and selling corporations must approve either a merger⁷⁷ or a sale of assets,⁷⁸ whereas the board of a target corporation often may oppose a sale by its stockholders of their stock—as in a hostile tender offer.⁷⁹ Both corporations' shareholders typically must approve a merger,⁸⁰ but the nominally buying corporation's shareholders often have no vote on its purchase of assets or stock.⁸¹ Corporate statutes commonly give shareholders dissenting from a merger the right to demand that the company cash them out at a price set by an appraisal.⁸² These rights may not be available in sales or combinations carried out through asset or stock sales.⁸³ As might be expected, these differences have produced considerable litigation in which dissenters have asked courts to re-characterize asset or stock sales as a "de facto" merger.⁸⁴ California's corporations statute seeks to avoid this problem through provisions that create a large degree of voting and appraisal rights parity between different types of "reorganizations," including mergers, asset sales and stock sales.⁸⁵

California's LLC act, like those in most other states, contains provisions allowing for LLC mergers.⁸⁶ A California LLC may merge with either another

75. See, e.g., DEL. CODE ANN. tit. 8, § 271(a) (1991) (instructing that a majority vote is necessary to approve the sale of substantially all assets); *id.* § 251(c) (1991) (providing that a majority vote is required to approve merger).

76. The structure of the transaction can also create numerous other legal impacts, affecting, for example, tax, securities laws, and succession to assets and liabilities. See, e.g., GEVURTZ, *supra* note 2, at 918-1029.

77. E.g., DEL. CODE ANN. tit. 8, § 251(b) (1991).

78. E.g., *id.* § 271 (1991).

79. E.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

80. E.g., DEL. CODE ANN. tit. 8, § 251(c) (1991).

81. E.g., GEVURTZ, *supra* note 2, at 907, 909.

82. E.g., DEL. CODE ANN. tit. 8, § 262 (1991).

83. E.g., *Hariton v. Arco Electronics, Inc.*, 188 A.2d 123 (Del. Ch. 1963).

84. E.g., *id.*; *Applestein v. United Bd. & Carton Corp.*, 159 A.2d 146 (N.J. Super. 1960), *aff'd*, 161 A.2d 474 (N.J. 1960).

85. CAL. CORP. CODE §§ 181, 1200, 1201, 1300 (West 1990).

86. *Id.* § 17550 (West Supp. 1996); *cf.* ALA. CODE § 10-12-54 (1994); ALASKA STAT. § 10.50.500 (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-752 (Supp. 1995); ARK. CODE ANN. § 4-32-1201 (Michie Supp. 1995); COLO. REV. STAT. § 7-80-1003 (Supp. 1995); CONN. GEN. STAT. ANN. § 34-193 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 6, 18-209 (Supp. 1994); GA. CODE ANN. § 14-11-901 (Michie Supp. 1995); IDAHO CODE § 53-661 (1994); IND. CODE ANN. § 23-18-7-1 (West 1994); IOWA CODE ANN. § 490A.1201 (West Supp. 1995); KAN. STAT. ANN. § 17-7650 (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 69(1) (Baldwin); LA. REV. STAT. ANN. § 12:1357 (West Supp. 1996); ME. REV. STAT. ANN. tit. 31, § 741(1) (West Supp. 1995); MD. CODE ANN., CORPS. & ASSN'S § 4A-701 (1993); MICH. COMP. LAWS ANN. § 450.4701 (West Supp. 1995); MINN. STAT. ANN. § 322B.70(1) (West 1995); MO. ANN. STAT. § 347.127 (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-1201 (1995); N.H. REV. STAT. ANN. § 304-C:18 (1994); N.J. STAT. ANN. § 42:2B-20 (West Supp. 1995); N.M. STAT. ANN. § 53-19-59 (Michie Supp. 1995); N.Y. LTD. LIAB. CO. LAW § 1001 (McKinney 1996); N.C. GEN. STAT. § 57C-9-01 (Supp. 1993); N.D. CENT. CODE § 10-32-100 (1995); OKLA. STAT. ANN. tit. 18, § 2054 (West Supp. 1996); OR. REV. STAT. § 63.481 (1995); R.I. GEN. LAWS § 7-16-59 (1992); S.D. CODIFIED

domestic or with a foreign LLC, or even with another business entity, such as a corporation.⁸⁷ The general rule in the absence of a greater vote requirement in the articles of organization or operating agreement is that members holding a majority interest of each LLC may approve the merger.⁸⁸ Exceptions to the majority rule approach exist if members will have any personal liability as a result of the merger,⁸⁹ or if the merger affects any amendment to the operating agreement of a merging LLC.⁹⁰ As discussed later, this second exception could largely eclipse the general rule.⁹¹

California's decision to allow sales or combinations of LLCs based upon majority vote through mergers raises a couple of questions. To begin with, to what extent has California's act avoided strategic behavior? With respect to appraisal rights, California's LLC act borrows from the state's corporations statute. It grants appraisal rights in a "reorganization"—defined to include mergers, certain sales of assets and certain sales of membership interests.⁹² One difference in this portion of the LLC act from its corporate counterpart is in the concept of control, which is important in covering triangular transactions and acquisitions of membership interests.⁹³ Instead of the California corporate law's numerical test (ownership of stock with more than fifty percent of the voting power),⁹⁴ there is a situation-specific one—the power to direct the management or policies of the business.⁹⁵ This facts-and-circumstances approach creates uncertainties avoided by numerical tests, which could make planning difficult for these transactions. Still, given the variations available for governing an LLC,⁹⁶ it is probably impossible to set out a sensible numerical definition of control. Moreover, it does not seem unreasonable to ask parties who wish to avoid any doubt to provide appraisal rights.

LAWS ANN. § 47-34-38 (Supp. 1995); TENN. CODE ANN. § 48-244-101 (Supp. 1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 10.01 (West Supp. 1996); UTAH CODE ANN. § 48-2b-149 (1994); VA. CODE ANN. § 13.1-1070 (Michie Supp. 1995); WASH. REV. CODE ANN. § 21.15.115(2)(a) (West Supp. 1996); W. VA. CODE § 31-1A-41 (Supp. 1995); WIS. STAT. ANN. § 183.1201 (West Supp. 1995); WYO. STAT. § 17-15-139 (Supp. 1994).

87. CAL. CORP. CODE § 17550 (West Supp. 1996).

88. *Id.* § 17551(a) (West Supp. 1996). Interestingly enough, the statute requires no vote of managers in LLCs that choose governance by managers, in contrast to the gatekeeping role played by directors in a corporate merger.

89. *Id.*

90. *Id.* § 17551(e) (West Supp. 1996).

91. See *infra* notes 217-18 and accompanying text.

92. CAL. CORP. CODE §§ 17600, 17601 (West Supp. 1996).

93. Specifically, the definition of a reorganization in section 17600 covers situations in which the consideration for the purchase of assets or interests is an interest either in the acquiring firm or in another firm that controls the acquiring firm (a triangular transaction). Also, this definition only picks up acquisitions of interests if immediately after the acquisition the buyer will be in control of the target firm. *Id.* § 17600 (West Supp. 1996).

94. *Id.* §§ 160(b), 181 (West 1990).

95. *Id.* § 17600 (West Supp. 1996).

96. As explained earlier, parties might govern their LLC by members or managers. They might vote proportionate to profits or per capita. See *supra* notes 11-20 and accompanying text.

Beyond the requirement that the transaction constitute a “reorganization,” appraisal rights are only available to LLC members entitled to vote on the transaction.⁹⁷ In addition, the questions of who votes and what vote is needed for approval of an LLC sale or combination are obviously critical in their own right. Here, in contrast to the care shown in attempting to reach all types of “reorganizations” for purposes of appraisal rights generally, California’s LLC act contains gaps.

To begin with, what vote is required for an LLC to sell substantially all of its assets? In the absence of any more specific guidance in the act, presumably Section 17103(a)(3) governs. Since this provides for decision by members holding a majority interest,⁹⁸ the result comes out the same as the merger statute and so generally achieves appropriate parity. One problem, however, arises if an LLC chooses governance by managers, but the articles of organization or operating agreement neglect to address the sale of substantially all of the assets. If this happened with respect to mergers, the statutory requirement of at least a majority vote of the members would control. The failure of the LLC act to similarly address a sale of substantially all assets creates the question of whether managers might undertake such a transaction without member approval.

In order to purchase control of an LLC through the acquisition of members’ interests, the LLC must admit the buyer as a new member.⁹⁹ Also, purchasing assets or equity interests in exchange for membership interests in an LLC entails the entry of new members into the buying LLC. Parity with the merger provision might suggest these transactions should, absent contrary agreement, take place upon a majority vote. Yet, it takes (barring agreement otherwise) unanimous consent to admit new members into a California LLC.¹⁰⁰ Given the clear legislative intent to allow mergers based upon a majority vote (unless otherwise agreed), the lack of this other route for sales or combinations may be of little practical concern. Moreover, the requirement of unanimity might be justified for an acquisition by the purchase of members’ interests, since this structure otherwise would allow for creeping acquisitions. Such creeping acquisitions can prejudice those selling out last.¹⁰¹ One problem here, however, is that section 17301(a)(4) gives the selling member, absent other agreement, the right to continue voting his or her former interest.¹⁰² As a result, a buyer of a majority of interests might take indirect control by contractually directing the votes of the

97. CAL. CORP. CODE § 17601(a) (West Supp. 1996).

98. *Id.* § 17103(a) (West Supp. 1996).

99. *See id.* § 17301(a)(3), (4) (West Supp. 1996) (providing that an assignee who is not admitted as a member does not have voting rights).

100. *Id.* § 17303(a) (West Supp. 1996).

101. *See, e.g.,* *Brown v. Halbert*, 271 Cal. App. 2d 252, 257, 76 Cal. Rptr. 781, 784 (1969) (discussing the case where, after purchasing control of a corporation, the buyer acquired the minority interests more cheaply by threatening to cut off dividends).

102. CAL. CORP. CODE § 17301(a)(4) (West Supp. 1996).

selling members—at least to the point of pushing through a merger or sale of assets. This suggests that section 17301(a)(4) is a poor idea; members who sell out do not still need to vote.¹⁰³

Beyond the problem of avoiding strategic responses, the second issue raised by California's decision to allow LLC mergers upon majority vote is whether this represents a sound legislative choice for parties who have not made their own express choice. Put differently, would most such parties, if they initially considered the issue themselves, have agreed to this corporate law approach or would they have preferred to follow the partnership model requiring unanimity? One way to answer this question empirically would be to survey partnership agreements and corporate articles and shareholders' agreements to see how many attempt to alter the respective statutory norms. Practicality, though, suggests another approach. One could examine the circumstances in which the partnership and corporate law norms arose.

Historically, partnership rules arose in the context of closely held businesses.¹⁰⁴ In that context, unanimous consent to combine or sell the business makes some sense. After all, as stated above, the minority cannot block any sale, since, barring other agreement, the majority could force a sale by dissolving the partnership. In this event, however, those opposed to a sale may attempt to acquire the business for themselves by being the high bidder in the liquidation—which seems a fair way to resolve the disagreement. Corporate law rules, by comparison, historically reflect the needs of a widely held business with passive owners.¹⁰⁵ With large numbers of owners, unanimity becomes impractical. Passive, scattered ownership suggests that minority shareholders would rarely be in a position to attempt to acquire the business for themselves in a liquidation sale. Since LLCs (particularly those not having their own comprehensive agreement) are likely to be more closely than widely held, perhaps the partnership unanimity norm would have been better.¹⁰⁶

2. Admission of New Members

Under the Uniform Partnership Act, admission of a new partner requires—barring other agreement—unanimous approval of the existing partners.¹⁰⁷ By contrast, the board of directors or even individual shareholders of a corporation

103. *Cf.* U.L.P.A. § 702 (1985) (stating that unless something to the contrary is provided for in the partnership agreement, a partner in a limited partnership withdraws if he or she sells all of his or her interest).

104. CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES & MATERIALS* 58-59 (1992).

105. *Id.* at 152-53.

106. Under California's LLC act, the majority has the power to dissolve, barring contrary agreement. CAL. CORP. CODE § 17350(c) (West Supp. 1996). Hence, the partnership solution would be available in case of a dispute regarding whether to sell.

107. U.P.A. § 18(g) (1986).

generally can bring new shareholders into the company. Specifically, absent restriction in the articles or in a valid shareholders agreement,¹⁰⁸ and subject to the existence of unissued authorized shares,¹⁰⁹ the board of directors of a corporation has the power to issue shares,¹¹⁰ thereby potentially bringing in new stockholders. Barring a valid share transfer restriction, individual shareholders can bring in new owners by selling their stock.¹¹¹ In contrast, partners may assign their interests, but the assignee does not, absent agreement of the other partners, become a new partner.¹¹²

California's LLC act, like most, presently follows the partnership model: It takes unanimous consent of the existing members (unless otherwise agreed) for a new member to enter the firm.¹¹³ Like a partner, a member of a California LLC can transfer his or her economic interest, but the transferee does not become a member of the LLC (with the management rights of a member) without consent of the other members.¹¹⁴

Until recently, the reason for this rule lay in tax concerns. A unanimous consent requirement ensured that the LLC avoided the corporate tax classification factor of free transferability.¹¹⁵ Hence, it was important to the goal of achieving partnership tax treatment.¹¹⁶ At the end of 1994, however, the Internal Revenue

108. *See, e.g.*, CAL. CORP. CODE § 300(b) (West 1990); DEL. CODE ANN. tit. 8, § 350 (1991).

109. *E.g.*, CAL. CORP. CODE § 202(d), (e)(1) (West 1990); DEL. CODE ANN. tit. 8, § 102(a)(4) (1991).

110. *See, e.g.*, CAL. CORP. CODE § 409 (West 1990); DEL. CODE ANN. tit. 8, § 161 (1991).

111. *See, e.g.*, *Rafe v. Hindin*, 288 N.Y.S.2d 662 (App. Div. 1968).

112. U.P.A. §§ 18(g), 27(1) (1986).

113. CAL. CORP. CODE §§ 17100(a)(1), 17303(a) (West Supp. 1996); *cf.* ALA. CODE § 10-12-31(a)(1) (1994); ALASKA STAT. § 0.50.155(1)(B) (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-731(B)(Supp. 1995); ARK. CODE ANN. § 4-32-801(a)(1) (Michie Supp. 1995); COLO. REV. STAT. § 7-80-701 (Supp. 1995); DEL. CODE ANN. tit. 6, § 18-301(b)(1) (Supp. 1995); FLA. STAT. ANN. § 608.423 (West Supp. 1996); GA. CODE ANN. § 14-11-505(b) (Michie 1994); IDAHO CODE § 53-640(a) (1994); ILL. ANN. STAT. ch. 805, para. 180/10-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-6-1(1) (West 1994); IOWA CODE ANN. § 490A.903(1) (West Supp. 1995); KAN. STAT. ANN. § 17-7618 (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 53(1) (Baldwin); LA. REV. STAT. ANN. § 12:1332(A)(1) (West 1994); ME. REV. STAT. ANN. tit. 31, § 691(1)(A) (West Supp. 1995); MD. CODE ANN., CORPS. & ASSN'S § 4A-601(b)(1) (1993); MICH. COMP. LAWS ANN. § 450.4506(1) (West Supp. 1995); MO. ANN. STAT. § 347.079(3)(2) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-801(1)(a) (1995); N.H. REV. STAT. ANN. § 304-C:23(II)(a) (1994); N.J. STAT. ANN. § 42:2B-21(b)(1) (West Supp. 1995); N.M. STAT. ANN. § 53-19-36(A)(1) (Michie Supp. 1995); N.C. GEN. STAT. § 57C-3-01(b)(1) (Supp. 1993); OKLA. STAT. ANN. tit. 18, § 2035(A)(2) (West Supp. 1996); OR. REV. STAT. § 63.245(2)(a) (1995); R.I. GEN. LAWS § 7-16-36(a) (1992); TENN. CODE ANN. § 48-232-102 (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 4.01(B)(1) (West Supp. 1996); UTAH CODE ANN. § 48-2b-122 (1994); VA. CODE ANN. § 13.1-1038.1(1) (Michie 1993); WASH. REV. CODE ANN. § 25.15.115 (West Supp. 1996); W. VA. CODE § 31-1A-34(c)(1) (Supp. 1994); WIS. STAT. ANN. § 183.0404(2)(b) (West Supp. 1995); WYO. STAT. § 17-15-122 (1989). *But see* CONN. GEN. STAT. ANN. § 34-179(a) (West Supp. 1995) (majority); N.Y. LTD. LIAB. CO. LAW § 602(b)(1) (McKinney 1996) (majority).

114. CAL. CORP. CODE §§ 17301(a), 17303(a) (West Supp. 1996).

115. *See, e.g.*, Rev. Rul. 88-76, 1988-2 C.B. 360.

116. In order to obtain taxation as a partnership, an LLC can have no more than two of the following four corporate characteristics: (1) limited liability; (2) central management; (3) free transferability of interests; and (4) continuity of life. *See, e.g.*, Rev. Rul. 93-6, 1993-1 C.B. 229. By definition, an LLC's members have limited liability and, if run by managers rather than members, an LLC likely has central management. *Id.*; Rev.

Service issued Revenue Procedure 95-10,¹¹⁷ which clarified and liberalized the requirements for an LLC to receive a ruling that it successfully avoided corporate characteristics. With respect to avoiding free transferability, Revenue Procedure 95-10 stated that requiring unanimous consent for entry of an assignee as a new member was not necessary; a majority vote requirement would be sufficient.¹¹⁸ This change has produced a predictable reaction: A bill was introduced in 1995 in the California Legislature that would amend the LLC act to reduce the requirement for admission of new members to a majority (absent other agreement).¹¹⁹

Such a knee-jerk reaction to tax law developments is potentially unfortunate. The question should not be what rule constitutes the absolute minimum useful for obtaining partnership tax status. Rather, the issue should be what is the best default rule; in other words, given that this is a rule only for parties who have not made their own agreement as to admission of new members, what rule best matches the one such persons would most likely have agreed to had they thought about the issue in advance?

In this regard, recall that partnership and corporate law have opposite default rules, which arose out of concerns divorced from tax. The partnership law rule presumably reflects the historical experience that parties usually want veto power over new entrants in a business that is normally closely held,¹²⁰ managed directly by all its owners,¹²¹ and where each owner can create potentially unlimited personal liability for the other owners.¹²² By comparison, the corporate law norm reflects a business with traditionally more widely held passive ownership (whose primary role is the election of directors to manage the firm) with no personal liability. Seen in this light, the unanimity rule makes sense for LLCs, independent of tax concerns. True, the LLC is unlike the partnership in that members enjoy limited liability. Nevertheless, LLCs normally will be more closely held (since publicly traded firms are taxed as a corporation regardless of other factors¹²³). Also, the LLCs in which owners are most likely not to have thought of the issue, and so need default rules, would be those which are closely held. Moreover, the default rule for California LLCs calls for direct governance by members,¹²⁴ and

Proc. 95-10, 1995-3 I.R.B. 20. Hence, it is important to avoid the corporate characteristic of free transferability of interests.

117. 1995-3 I.R.B. 20.

118. *Id.* § 5.02. Often overlooked regarding this issue is that the tax criterion is unconcerned with the requirements for admission of parties who purchase their interest from the firm itself, rather than from existing members. *Id.*

119. S.B. 141, 1995-96 Cal. Reg. Sess. §§ 9, 19, 20 (introduced by Senator Beverly, Jan. 24, 1995, amended Aug. 1, 1995); *see id.* (proposing to amend CAL. CORP. CODE §§ 17100, 17301, 17303).

120. *See supra* note 104 and accompanying text.

121. *See* U.P.A. § 18(e) (1914).

122. *Id.* §§ 9(1), 13, 14, 15 (1914).

123. I.R.C. § 7704 (1995).

124. CAL. CORP. CODE § 17150 (West Supp. 1996).

gives each member authority to create liability for the firm,¹²⁵ much like a partnership. Under these circumstances, it is likely that most parties will wish a veto over entry despite the absence of personal liability—witness the prevalence in closely held corporations of restrictions on the owners' ability to transfer their shares.¹²⁶

Beyond the question of whether to retain the current unanimity rule, the California LLC act raises one other issue regarding entry of new members. Is it possible to circumvent the rule through the use of LLC mergers? Recall that the default rule for approval of an LLC merger is a majority vote.¹²⁷ Unless the merger entails non-equity consideration for one side, the surviving LLC is inevitably going to end up with new members. Indeed, what is to prevent a majority in an LLC—who want to allow in new members, but face opposition from a minority—from having the prospective new members form an LLC simply for the purpose of undertaking a merger? If there is only one prospective new member, there could be a problem forming a California LLC, since California requires that LLCs have two members.¹²⁸ This problem is easily overcome either by forming the temporary new LLC in a jurisdiction which allows one member LLCs,¹²⁹ followed by a merger of the foreign into the California LLC,¹³⁰ or by creating a corporation solely owned by the individual desiring entry to merge with the existing LLC.¹³¹ Of course, the dissenting minority can cash out after the merger,¹³² but this seems a poor substitute for the veto seemingly given by the rule of unanimous consent to new entry. It is difficult to see that such a tactic, in and of itself, breaches whatever might be the majority's fiduciary duty, since the statute allows the end run.¹³³ Perhaps the minority's best bet would be to argue that the merger effects an amendment to the operating agreement and so requires a unanimous vote under section 17551(e). This seems true if the operating agreement specifies who the members are, but may be questionable

125. *Id.* § 17157(a) (West Supp. 1996).

126. *See, e.g.,* ROBERT CLARK, *CORPORATE LAW* 763 (1986) ("Shareholders who look ahead . . . will usually want to restrict the transferability of their shares [in a closely held corporation].").

127. *See supra* note 88 and accompanying text.

128. CAL. CORP. CODE §§ 17001(t), 17050(b) (West Supp. 1996).

129. *See* ARK. CODE ANN. § 4-32-201 (Michie Supp. 1995); COLO. REV. STAT. Ann. § 7-80-203 (West Supp. 1995); GA. CODE ANN. § 14-11-203 (1994); IDAHO CODE § 53-607 (1994); IND. CODE ANN. § 23-18-2-4 (West 1994); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 4 (Baldwin); ME. REV. STAT. ANN. tit. 31, § 621 (West Supp. 1994); MO. ANN. STAT. § 347.037(1) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-201 (1994); N.M. STAT. ANN. § 53-19-7 (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 102(m) (McKinney Supp. 1996); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 4.01 (West Supp. 1996).

130. *See* CAL. CORP. CODE § 17555 (West Supp. 1996) (permitting merger of foreign and California LLCs).

131. *Id.* § 17550(a)(3) (West Supp. 1996) (allowing merger of an LLC with a corporation).

132. *Id.* § 17601(a) (West Supp. 1996).

133. *See, e.g.,* *Kirschner Bros. Oil, Inc. v. Natomas Co.*, 185 Cal. App. 3d 784, 791, 229 Cal. Rptr. 899, 903 (1986) (structuring a merger in such a way as to deprive preferred shareholders of any statutory right to vote did not breach any fiduciary duty).

otherwise. Accordingly, this may be another reason to reconsider the majority rule merger provision. In addition, a sale of substantially all assets to a new LLC with new prospective members—in exchange for membership interests in the new LLC to be distributed to old LLC members upon dissolution—could serve to circumvent the unanimity requirement for admitting new members. This suggests the need to consider sales of substantially all assets, as well.

3. *Involuntary Exit: Expulsion of Members*

Efforts by some owners of a business to expel (or “freeze-out,” to use the pejorative term) other owners have provided fertile fields for litigation.¹³⁴ Expulsions have occurred pursuant to an advance arrangement of the owners granting this power—such as an expulsion clause in a partnership agreement¹³⁵ or a provision in the articles of incorporation which gave the company the option to redeem certain classes of stock.¹³⁶ Alternately, expulsions have occurred through the use of statutory procedures (such as mergers and dissolutions) whose purposes seem directed toward ends other than the involuntary removal of some owners by others.¹³⁷ California's LLC act raises issues with respect to both categories of expulsions.

Section 17100(c) of California's LLC statute authorizes LLC operating agreements containing expulsion clauses.¹³⁸ While the overall thrust of section 17100(c) is unexceptional, two aspects of this section raise questions. To begin with, if the operating agreement sets the conditions for expulsion, but fails to specify the consequences, to what is the expelled member entitled? Section 17350 states that expulsion will cause dissolution and, therefore, presumably liquidation, unless all the remaining members vote to continue¹³⁹—which is what one expects

134. See, e.g., O'NEAL & THOMPSON, *supra* note 35, §§ 5.02 *et. seq.*; Franklin A. Gevurtz, *Preventing Partnership Freeze-outs*, 40 MERCER L. REV. 535, 536 (1989).

135. See, e.g., Gelder Medical Group v. Webber, 363 N.E.2d 573 (N.Y. 1977).

136. See, e.g., Zahn v. Transamerica Corp. 162 F.2d 36 (3d Cir. 1947).

137. See, e.g., Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942) (dissolution); Teschner v. Chicago Title & Trust Co., 322 N.E.2d 54 (Ill. 1974) (reverse stock split); Coggins v. New England Patriots Football Club, Inc., 492 N.E.2d 1112 (Mass. 1986) (merger).

138. CAL. CORP. CODE § 17100(c) (West Supp. 1996); see *id.* (providing as follows:

The operating agreement may provide for the termination in whole or in part of the membership interest or economic interest of a member in the limited liability company. If a member's economic interest in the limited liability company is terminated pursuant to the operating agreement, the member may demand and shall be entitled to receive a return of that member's contribution. Any provision in an operating agreement governing the termination of a member's interest and the return of a member's contribution shall be enforceable in accordance with its terms unless the member seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the agreement was made. Upon any termination of a membership interest, the list required by paragraph (1) of subdivision (a) of Section 17058 shall be amended accordingly).

139. *Id.* § 17350(d) (West Supp. 1996).

the members normally will vote to do. After all, why bother to expel a member if one plans only to dissolve and liquidate the business?¹⁴⁰ Section 17100(c) gives expelled members the right to the return of their contribution (presumably, if there is no dissolution and no other agreement). By comparison, section 17252(c) grants members upon a "permitted withdrawal," which does not cause dissolution, the right to receive the fair market value of their interest.¹⁴¹ This does not cover expulsions, since section 17350 lists "withdrawal" as a separate cause of dissolution from "expulsion."¹⁴² The decision to give expelled members their contribution back (rather than the fair market value of their interest) seems curious. This could provide a windfall for the expelled member if the business has sustained losses. Worse, if the business has done well, this would deprive the expelled member of the benefit of retained profits and appreciation in the firm's assets.

Next, what limits exist upon the power of expulsion? Section 17100(c) allows an expelled member to challenge the expulsion agreement as unreasonable at the time it was entered.¹⁴³ Yet, what about challenges to the exercise of the power under a provision, which in itself was not unreasonable? Specifically, is there any good faith limit upon expulsion? This has been a contentious issue in partnership law.¹⁴⁴ Hence, section 17153's imposing upon managers of California LLCs the fiduciary duties of a partner is not entirely helpful to resolve this question. Moreover, as was discussed earlier, the California LLC act is silent regarding the fiduciary duties of members acting as members when it comes to expulsion.¹⁴⁵ This can be a problem if an operating agreement grants the power of expulsion to members rather than managers in an LLC otherwise run by managers. In any event, having created a financial incentive for expulsions if the LLC need only return the expelled member's contribution, it would be useful to impose some good faith requirement.

Of course, it is difficult to be overly sympathetic to parties who explicitly agreed to be subject to expulsion but then complain when they get expelled. More serious are the complaints of those expelled when the governing agreement never explicitly provided this power, but, instead, majority interests use various provisions of the statute to freeze-out the minority. California's LLC act makes a valiant effort to deal with this problem. This might serve as a model for other

140. *But see* Zahn v. Transamerica Corp. 162 F.2d 36, 39-40 (3d Cir. 1947) (describing the circumstances where a corporation liquidated following a redemption which was motivated by the desire to prevent the minority stockholders from sharing in the appreciation of the corporation's assets).

141. CAL. CORP. CODE § 17252(c) (West Supp. 1996).

142. *See id.* § 17350(d) (West Supp. 1996).

143. *Id.* § 17100(c) (West Supp. 1996).

144. *See, e.g.,* Gill v. Mallory, 80 N.Y.S.2d 155, 158 (App. Div. 1948) ("It does not appear that defendants acted in bad faith [by expelling partners] (*if that were to be the test*) . . ." [emphasis added]).

145. *See supra* notes 54-60 and accompanying text.

jurisdictions which have been less thoughtful. Unfortunately, California's effort is somewhat incomplete.

Probably the most common tool used by majorities in corporations to expel minorities is the freeze-out merger.¹⁴⁶ The majority sets up a new shell corporation which it then merges with the preexisting company under a plan of merger which gives the minority cash (or other non-equity consideration) for the minority's shares. In an apparently unthinking effort to mimic features of corporate law that are handy in combining or acquiring businesses, LLC statutes in many jurisdictions allow mergers of LLCs based upon majority approval and with non-equity consideration—thereby creating the tools for freeze-out LLC mergers.¹⁴⁷ Allowing such freeze-out mergers represents poor policy for two reasons.

To begin with, it is questionable whether granting the majority the power to expel the minority at will—subject only to the vagaries of fiduciary duty litigation—represents a sound default rule. Is this really the rule most parties who enter LLCs would have agreed to if they thought about the subject in advance?¹⁴⁸ Even if the legislature wished to give majorities the freeze-out power, merger provisions are a poor tool to do it. The problem is that many parties forming an LLC will not realize the hidden potential of the merger provisions in time to reach another agreement if that is what they wish.¹⁴⁹

Seen in this light, California's merger provision represents a step in the right direction—assuming one concludes it is really useful to have provisions allowing LLC mergers based upon majority vote and with non-equity consideration. Section 17551(b) of California's LLC act prevents the use of consideration other than non-redeemable equity interests in the surviving LLC (or its parent)—unless all the recipient members consent—when an LLC merges with another entity in which it or its "parent" owns the majority of voting interests.¹⁵⁰ By limiting consideration in this manner, the provision generally prevents freeze-out LLC mergers over the opposition of the frozen out parties.

Still, there are gaps in this protection. Some are intentional. Section 17551(b) creates exceptions if the minority frozen out is smaller than 10 percent or if the State's Corporations Commissioner approves the fairness of the transaction.¹⁵¹ These provisions track California's corporations statute.¹⁵² Except for this origin, the rationale for these two exceptions is unclear. For example, why—other than

146. See, e.g., *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112 (Mass. 1986).

147. See *Gevurtz*, *supra* note 29, at 530-32.

148. See Alan R. Bromberg, *Partnership Dissolution—Causes, Consequences and Cures*, 43 TEX. L. REV. 631, 653 (1965) (explaining that partnership agreement expulsion clauses are "quite rare" in the author's experience).

149. See *Gevurtz*, *supra* note 29, at 533-34.

150. CAL. CORP. CODE § 17551(b) (West Supp. 1996).

151. *Id.*

152. *Id.* §§ 1101, 1101.1 (West 1990 & Supp. 1996).

perhaps as some historic tie to short form merger provisions¹⁵³—should less than ten percent ownership interests exist at the suffrage of the majority? Also, what standards will the Commissioner apply to determine if a freeze-out merger is “fair”: A fair price? A business purpose? These questions have plagued courts in fiduciary duty litigation over freeze-out mergers.¹⁵⁴ At the very least, it might be helpful to have some statutory guidelines on these questions—perhaps giving the majority the right of expulsion only when it can establish wrongful conduct by the minority along lines similar to the minority’s rights to dissolution in section 17351.¹⁵⁵

Other gaps in California’s protection against freeze-outs are inadvertent. To begin with, section 17551(b)’s limitation on non-ownership consideration only applies if either the merging LLC or its “parent” owns a majority in the other merging firm.¹⁵⁶ Section 17001(ad) defines “parent” as a “person” who owns over 50 percent of the voting power in an LLC,¹⁵⁷ while section 17001(ae) defines “person” to include an individual, partnership, limited partnership, trust, estate, association, corporation, LLC or other entity.¹⁵⁸ This will cover the situation in which the majority attempting the freeze-out merger constitutes one individual or entity. Yet, what if a group of persons, who together but not individually have a majority interest, attempt to freeze out a minority? This is not an unlikely scenario in a closely held business,¹⁵⁹ especially if families are involved.

Beyond this question, note that California’s corporations statute contains provisions addressing freeze-outs through mergers,¹⁶⁰ reverse stock splits,¹⁶¹ and sales of substantially all assets.¹⁶² Reverse stock splits are not relevant to LLCs.¹⁶³ Sale of substantially all assets to a new LLC owned only by the prior firm’s majority can be a viable freeze-out technique, however, for LLCs. As discussed earlier, it is very possible that the majority interest in a California LLC has the power to approve a sale of substantially all assets.¹⁶⁴ At the very least, therefore,

153. *Id.* § 1110 (West Supp. 1996).

154. Compare *Alpert v. 28 Williams St. Corp.*, 473 N.E.2d 19, 28 (N.Y. 1984) (requiring a corporate purpose for a freeze-out merger) with *Tanzer v. International Gen. Indus.*, 379 A.2d 1121, 1124-25 (Del. 1977) (finding the majority’s business purpose adequate to meet the business purpose requirement) and with *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711, 715 (Del. 1983) (stating that proof of a business purpose was no longer required, as only a “fair price” and “fair dealing” were necessary).

155. See CAL. CORP. CODE § 17351(a)(5) (West Supp. 1996).

156. *Id.* § 17551(b) (West Supp. 1996).

157. *Id.* § 17001(ad) (West Supp. 1996).

158. *Id.* § 17001(ac) (West Supp. 1996).

159. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 660-61 (Mass. 1976) (discussing the case where three of four equal shareholders joined to squeeze-out fourth).

160. CAL. CORP. CODE §§ 1101, 1101.1 (West 1990 & Supp. 1996).

161. *Id.* § 407 (West 1990).

162. *Id.* § 1001(d), (e) (West 1990).

163. Nothing in the LLC act authorizes the cash-out of fractional shares after an article amendment—presumably because LLCs normally do not issue shares.

164. See *supra* note 98 and accompanying text.

it would be worthwhile to amend the California LLC act to clarify that such power does not extend to asset sales for non-equity consideration to entities owned by those in control of the selling LLC.

Dissolution can also lead to freeze-outs in partnerships and corporations.¹⁶⁵ Partners or majority shareholders might dissolve the firm with the plan of acquiring the business in the ensuing liquidation. California's LLC statute, unlike most, allows dissolution by majority vote (barring agreement otherwise).¹⁶⁶ However, in the liquidation following dissolution, members who are the target of the freeze-out may be able to turn the tables by outbidding their rivals for the business.¹⁶⁷ Hence, California may have dealt with this as well as can be done.¹⁶⁸

4. Voluntary Exit: Cash-out Rights

Partnership law follows what one might label a buy-out approach to dealing with the departure of partners: If a partner wants to leave the firm, his or her fellow partners must buy out his or her interest if the other partners wish to continue the business. Specifically, under the Uniform Partnership Act, including as adopted in California, each partner (barring other agreement) has the right to dissolve the partnership at any time and demand liquidation.¹⁶⁹ In that instance, the other partners, if they want to continue the venture, must either attempt to purchase the business in the liquidation sale or else reach an agreement with the departing partner to buy out his or her interest. Partners can change this by agreeing to a partnership for a term. Even in this case, however, a partner can

165. See, e.g., *Page v. Page*, 55 Cal. 2d 192, 359 P.2d 41, 10 Cal. Rptr. 642 (1961); *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941).

166. CAL. CORP. CODE § 17350(c) (West Supp. 1996); cf. ALA. CODE § 10-12-37(2) (1994); ALASKA STAT. § 10.50.400(2) (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-781(A)(2)(Supp. 1995); ARK. CODE ANN. § 4-32-901(b) (Michie Supp. 1995); COLO. REV. STAT. § 7-80-801(b) (Supp. 1995); DEL. CODE ANN. tit. 6, § 18-801(3) (1993); FLA. STAT. ANN. § 608.441(1)(b) (West Supp. 1995); GA. CODE ANN. §§ 14-11-308(b)(1), 14-11-602(3) (Michie Supp. 1995); IDAHO CODE § 53-642(2) (1994); ILL. ANN. STAT. ch. 805, para. 180/35-1 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-9-1(2) (West 1994); IOWA CODE ANN. § 490A.1301(2) (West Supp. 1995); KAN. STAT. ANN. § 17-7622(2) (1995); 1994 Ky. Rev. Stat. & R. Serv. ch. 275, § 57(2) (Baldwin); MD. CODE ANN., CORPS. & ASS'NS § 4A-902(2) (1993); ME. REV. STAT. ANN. tit. 31, § 701(2) (West Supp. 1995); MICH. COMP. LAWS ANN. § 450.480(c) (West Supp. 1996); MO. ANN. STAT. § 347.137(2) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-901(2) (1995); NEB. REV. STAT. § 21-2622(2) (Supp. 1994); NEV. REV. STAT. § 86-491(1)(b) (1993); N.H. REV. STAT. ANN. § 304-C:50(III) (1994); N.J. STAT. ANN. § 42:2B-48(c) (West Supp. 1995); N.C. GEN. STAT. § 57C-6-01(3) (Supp. 1993); OKLA. STAT. ANN. tit. 18, § 2037(A)(2) (West Supp. 1996); OR. REV. STAT. § 63.621(3) (1995); S.D. CODIFIED LAWS ANN. § 47-34-29(2) (Supp. 1995); TENN. CODE ANN. § 245-101(b)(2) (1995); VA. CODE ANN. § 13.1-1046(2) (Michie Supp. 1995); WASH. REV. CODE ANN. § 25.15.270(3) (West Supp. 1996); W. VA. CODE § 31-1A-35(2) (Supp. 1995); WIS. STAT. ANN. § 183.0901(2) (West Supp. 1995); WYO. STAT. § 17-15-123(a)(ii) (1989).

167. See *Gevurtz*, *supra* note 29, at 527-28.

168. After all, if the parties do not get along, determining who gets the business through competitive bidding may be at least as reasonable as a contest over who withdraws from the firm last.

169. U.P.A. §§ 31(1)(b), 38(1) (1914); CAL. CORP. CODE §§ 15031(1)(b), 15038(a) (West 1990).

depart at any time and force a buy-out—but at a much less favorable price and with the possibility of no payment until expiration of the term.¹⁷⁰

Under the Uniform Limited Partnership Act (ULPA), limited partnerships also follow a buy-out model, albeit under a somewhat different scheme. A general partner's departure triggers dissolution and liquidation barring other agreement or consent of the partners.¹⁷¹ A limited partner's departure, however, does not.¹⁷² In lieu of liquidation rights, the ULPA gives general partners the right to get the fair value of their interest when their departure does not result in dissolution and gives limited partners the right to withdraw and cash out at fair value upon six months' notice.¹⁷³ This, of course, is subject to other agreement, which might provide departing partners more or less favorable price and terms.¹⁷⁴

By contrast, corporations follow what one might call a free transfer model. If a stockholder wants out, the corporation and other stockholders may continue unaffected. Instead, in the absence of other agreement, it is up to the departing shareholder to sell his or her stock to whomever he or she desires or can find to buy the stock.¹⁷⁵

California's LLC act, like most of the other LLC acts,¹⁷⁶ follows a limited partnership style buy-out scheme. As with the withdrawal of a general partner from a limited partnership, departure of a member from a California LLC will trigger dissolution unless otherwise agreed or all the remaining members consent to continue the company without dissolution.¹⁷⁷ Avoiding dissolution and liquidation, however, does not render a member's interest illiquid. Instead, the California LLC act follows the limited partnership model by allowing LLC members, in the absence of contrary agreement, to withdraw and cash out at fair value on six months' notice (or without notice if the member is under an obligation to render services to the firm).¹⁷⁸

The principal motivating factor for following a limited partnership rather than a corporate departure model in LLC statutes has been tax. The drafters were trying to avoid the corporate characteristic of continuity of existence in order to obtain taxation as a partnership.¹⁷⁹ In fact, however, tax concerns do not compel the cash-out right, since continuity of existence involves maintaining the

170. U.P.A. §§ 31(2), 38(2) (1914); CAL. CORP. CODE §§ 15031(2), 15038(b) (West 1990).

171. U.L.P.A. § 801(4) (1976).

172. *See id.* § 801.

173. *See id.* §§ 603, 604 (1976).

174. *See id.* § 604.

175. *See* GEVURTZ, *supra* note 2, at 58.

176. *See* Gevurtz, *supra* note 29, at 513-14 n.94 (listing comparable provisions in various state statutes).

177. CAL. CORP. CODE § 17350(d) (West Supp. 1996).

178. *Id.* § 17252(a)(1), (b), (c) (West Supp. 1996).

179. *See supra* note 116.

possibility of entity dissolution, not individual owner departure.¹⁸⁰ Hence, the cash-out right must find its justification in non-tax concerns.

Recent legislative developments compel a reexamination of the justification for a cash-out right. By virtue of a 1994 amendment, California's limited partnership statute departed from the ULPA to no longer give limited partners the right to withdraw and cash out (barring other agreement) on six months' notice.¹⁸¹ Paralleling this development, a sponsor of California's LLC act introduced a bill to amend the act, which, among other things, would change the cash-out right for LLC members as well. As originally drafted, this bill sought to replace the right to cash out at fair market value, to be paid a reasonable time after withdrawal, with an entitlement only to "the share of profits and distributions to which the member would have been entitled if the member had not withdrawn."¹⁸² This language appeared to leave the withdrawing member, unless otherwise agreed, waiting around for the same distributions he or she would have received without withdrawing, instead of receiving a reasonably prompt payment upon withdrawal based upon the discounted present value of the right to future profits and distributions. In other words, it would have pretty well destroyed the cash-out right. Subsequent amendments to this bill have narrowed the scope of this change. As presently drafted, the change only applies to a family controlled limited liability company. Instead of eliminating the cash-out right for such companies, the bill reduces the price due the withdrawing member. He or she will only be entitled to the lesser of liquidation value or his or her right to share in reasonably anticipated future distributions based upon a 25 year remaining business life.¹⁸³ Whether this will be the final shape of the bill remains to be seen.

The impetus for this change lies in a concern with estate taxes. Under Internal Revenue Code section 2704 and the regulations issued pursuant thereto, state law default rules may establish a minimum value for computing estate tax on interests in a family controlled business held in a decedent's estate.¹⁸⁴ In other words, if state law provides, barring other agreement, limited partners or members in an LLC with the right to cash out at fair market value, then the minimum value of an interest in a family controlled business for estate tax purposes is the fair market value that the decedent's estate hypothetically would have received if it exercised this cash-out right, even though the actual limited partnership or LLC operating agreement denied or otherwise limited such a cash-out right. Such a denial, of course, means that the estate could not, in fact, cash out at the statutory fair

180. See Rev. Proc. 95-10, 1995-3 I.R.B. 20.

181. CAL. CORP. CODE § 15663 (West Supp. 1996).

182. S.B. 141, 1995-96 Cal. Reg. Sess. §§ 9, 10 (introduced by Senator Beverly, Jan. 24, 1995, amended Aug. 1, 1995).

183. *Id.* As amended through August 1995. While the language of the bill is not entirely clear, it appears to intend immediate payment of the present value of the future distributions.

184. See Jerald August, *Planning for Lapsing Rights and Restrictions—The Impact of Section 2704 on Valuation*, 82 J. TAX'N 342, 345, 347 (1995).

market value and this, in turn, presumably lowers the real value of the interest. Hence, by lowering the price payable under the LLC act, the proposed amendment can lower the estate tax.

In reacting to these estate tax rules, however, it is important to ask what is the “tail” and what is the “dog.” True, the impetus for LLC legislation lies in the search for tax advantages. Yet, that does not mean the statute was designed to milk every conceivable tax savings, no matter what the non-tax consequences. On the contrary, the purpose of LLC legislation was to allow persons to obtain partnership tax classification for income tax purposes *without incurring non-tax disadvantages* (such as personal liability) in order to get the desired tax treatment.¹⁸⁵ Hence, it is important not to trade marginal tax advantages for serious non-tax disadvantages.

Given this perspective, it is important to examine the purpose of the cash-out provision. This provision is a default rule—in other words, a right which exists only if not otherwise agreed.¹⁸⁶ Default rules exist because of the reality that parties enter business dealings with less than perfect sophistication and forethought. Inevitably, many parties will neglect to make their own agreement upon various issues that arise and then will look to the law for a rule. A number of approaches exist for setting default rules.¹⁸⁷ A common one is to determine what most parties would have agreed to had they thought about the issue at the start.¹⁸⁸

Applying this criterion, the fair market value cash-out right appears to be an appropriate default rule for the sort of closely held businesses likely to become LLCs. To understand why, it is useful to look at the two models that deal with departure problems outlined at the beginning of this discussion. The buy-out model, of which the cash-out right is a variant, is hardly a perfect solution. The put option for any member on six months’ notice creates a continuing liquidity danger for the firm with limited access to ready cash.¹⁸⁹ Worse, a member might opportunistically choose to exploit a lack of liquidity by threatening withdrawal unless there is a renegotiation of terms.¹⁹⁰ Yet, what are the alternatives? The corporate free-transfer model is not viable. This is not only because owners in a closely held business normally want to control who their associates are,¹⁹¹ but also because free transfer often does not provide a very happy solution when there is

185. See *supra* note 2 and accompanying text.

186. CAL. CORP. CODE § 17252(c) (West Supp. 1996).

187. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

188. See O’KELLEY & THOMPSON, *supra* note 104, at 48.

189. See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 289 (1986).

190. *Id.* at 287.

191. See *supra* notes 120-27 and accompanying text.

no outsider interested in buying into a closely held firm.¹⁹² Tax considerations compound this conclusion for an LLC. As noted earlier, restricting free transfer may be necessary in order to obtain partnership tax treatment.¹⁹³ What one ends up with then is a third model: that of no exit. The history of closely held corporations—in which this model often exists as the practical result of a lack of market, if not as a legal result of share transfer restrictions—has been a gloomy one. Indeed, many writers attribute the frequent oppression of minority shareholders in closely held corporations in large part to this model.¹⁹⁴

Yet, the notion of no exit is not an entirely accurate description. A party can almost always sell out to the firm's other owners if he or she sells cheaply enough.¹⁹⁵ Moreover, partnership law and many jurisdictions' corporate law provide a judicially imposed escape for the party who can show sufficient wrongful conduct by the other owners.¹⁹⁶ (LLC statutes, including California's, commonly contain similar provisions¹⁹⁷). The end result is to create a regime analogous to the old family law rules requiring fault for divorce. Here, in order to avoid selling at a sacrifice, parties run to court seeking an out. Unfortunately, this regime in the business context is subject to much the same criticism that led to no-fault divorce. If two or more parties in a close working relationship, be it business or family (or often both), cannot get along, attempting to determine who, if anyone, is at fault is likely to be both an expensive and ultimately unsatisfactory undertaking. The expense of litigating highly involved questions of fault imposes costs both for the

192. See O'NEAL & THOMPSON, *supra* note 35, § 2.15.

193. See *supra* note 118 and accompanying text.

194. E.g., 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 (1977).

195. See *id.*

196. U.P.A. § 32(1)(b)-(d) (1914); see, e.g., CAL. CORP. CODE § 1800(b)(4) (West 1990); N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986 & Supp. 1995).

197. CAL. CORP. CODE § 17351 (West Supp. 1996); cf. ALA. CODE § 10-12-38 (1994); ALASKA STAT. § 10.50.405 (Supp. 1995); ARIZ. REV. STAT. ANN. § 29-785 (Supp. 1995); ARK. CODE ANN. § 4-32-902 (Michie Supp. 1995); COLO. REV. STAT. § 7-80-802 (Supp. 1995); CON. GEN. STAT. ANN. § 34-207 (West Supp. 1995); DEL. CODE ANN. tit. 6, § 18-802(a) (Supp. 1994); FLA. STAT. ANN. § 608.441(2) (West Supp. 1995); GA. CODE ANN. § 14-11-603(a) (Michie 1994); IDAHO CODE § 53-643 (1994); ILL. ANN. STAT. ch. 805, para. 180/35-5 (Smith-Hurd Supp. 1995); IND. CODE ANN. § 23-18-9-2 (West 1994); IOWA CODE ANN. § 490A.1302 (West Supp. 1996); KAN. STAT. ANN. § 17-7629 (1995); Ky. Rev. Stat. & R. Serv. ch. 275, § 58 (Baldwin); LA. REV. STAT. ANN. § 12:1335 (West 1994); ME. REV. STAT. ANN. tit. 31, § 702 (West Supp. 1995); MD. CODE ANN., CORPS. & ASS'NS § 4A-903 (1993); MICH. COMP. LAWS ANN. § 450.4802 (West Supp. 1995); MINN. STAT. ANN. § 322B.833(1) (West 1995); MO. ANN. STAT. § 347.143(2) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-902 (1995); NEB. REV. STAT. § 21-2622 (Supp. 1994); NEV. REV. STAT. § 86.331(4) (1993); N.H. REV. STAT. ANN. § 304-C:51 (1995); N.J. STAT. ANN. § 42:2B-49 (West Supp. 1995); N.M. STAT. ANN. § 53-19-40 (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 702 (McKinney 1996); N.C. GEN. STAT. § 57C-6-02(5) (Supp. 1993); N.D. CENT. CODE § 10-32-119 (1995); OKLA. STAT. ANN. tit. 18, § 2038 (West Supp. 1996); OR. REV. STAT. § 63.661 (1995); R.I. GEN. LAWS § 7-16-40 (1992); S.D. CODIFIED LAWS ANN. § 47-34-30 (Supp. 1995); TENN. CODE ANN. § 48-245-902(a) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 6.02 (West Supp. 1996); UTAH CODE ANN. § 48-2b-142 (1994); VA. CODE ANN. § 13.1-1047 (Michie 1993); WASH. REV. CODE ANN. § 25.15.275 (West Supp. 1996); W. VA. CODE § 31-1A-36 (Supp. 1995); WIS. STAT. ANN. § 183.0902 (West Supp. 1995); WYO. STAT. § 17-15-120(c) (Supp. 1994).

parties and also for society (which maintains the courts). The result is ultimately unsatisfactory because the resolution of fault in such contests—in which one may be dealing as much with emotionally charged perceptions as with reality—is likely to be no more accurate than flipping a coin.¹⁹⁸ In the end, this seems a poor way to assure a fair price.

This suggests that a default rule allowing parties a no-fault buy-out at fair market value—as currently part of California’s LLC act—represents the rule closest to what most parties would agree to if they consider the issue in advance. While this may create some added estate taxes for parties in a family controlled business who choose a different agreement, that seems outweighed by non-tax factors in this situation. Certainly, as the proposed amendment now recognizes, this balance holds for all LLCs which are not family controlled. Yet, given the potential for conflict even (or perhaps especially) in a family controlled enterprise,¹⁹⁹ the balance favors the no-fault cash-out at fair market value there as well. Indeed, the transfer of an interest upon death is precisely when there may be the most need for a cash-out right. Under California’s LLC act, the surviving members can avoid dissolution and liquidation following a member’s death.²⁰⁰ At the same time, they can veto entry of the heirs as new members.²⁰¹ Under these circumstances, it seems only fair that the heirs have a right to cash out at fair market value. Moreover, while the remaining members might dissolve the LLC upon a member’s death or withdrawal with the hope of buying the business in the liquidation,²⁰² the need to deal with the firm’s debts²⁰³ and the risks of other bids²⁰⁴ makes this a chancy route to follow. Hence, one cannot argue the proposed lower liquidation or distribution value necessarily reflects a realistic price.

198. See, e.g., *Schymanski v. Conventz*, 674 P.2d 281, 287 (Alaska 1983) (“in many instances, the evidence in this case consisted of the word of one partner against that of the other”); *Saballus v. Timke*, 460 N.E.2d 755, 761 (Ill. 1983) (“it would be difficult to decide which of the parties is most in the wrong”); *Nupetco Assocs. v. Jenkins*, 669 P.2d 877, 882-83 (Utah 1983) (finding that “voluminous trial transcript” showed that the partners’ contentions “were widely conflicting and were accompanied by extravagant accusations of breach by the other party,” and that neither party proved by a preponderance of the evidence that the other breached the agreement); *Susman v. Venture*, 449 N.E.2d 143, 148 (Ill. 1982) (reviewing conflicting evidence as to which party breached the agreement); *Lunn v. Kaiser*, 72 N.W.2d 312, 314 (S.D. 1955) (declaring that the court was unable to determine whether one partner was more responsible for the discord than the other); *Drashner v. Sorenson*, 63 N.W.2d 255, 258-59 (S.D. 1954) (stating that evidence on fault was sharply in conflict).

199. My father—who had considerable experience in this regard—once remarked to me that one could not devise, if one tried, a more effective mechanism to sew discord than a family business.

200. CAL. CORP. CODE § 17350(d) (West Supp. 1996).

201. *Id.* § 17303(a) (West Supp. 1996). While some family members will already have voting interests in their own right (say, a favored son brought in to take over the business), other family members (say, a daughter) may only receive their interests as heirs.

202. *Id.* § 17350(d) (West Supp. 1996).

203. *Id.* § 17353 (West Supp. 1996).

204. See *supra* note 167.

5. Alteration of the Contract Between the Members

Under California's LLC act, as is typical of LLC acts generally, the operating agreement normally sets out most of the rights of the members vis-à-vis each other.²⁰⁵ The major exception to this is that if the parties desire governance by managers, rather than directly by members, they must place a provision to that effect in the company's articles of organization.²⁰⁶ Hence, the operating agreement generally dictates the most critical aspects of the members' relationship, including the allocation of profit and loss,²⁰⁷ rights to distributions²⁰⁸ and rights to other compensation.²⁰⁹ This, in turn, raises the question of whether these rights are subject to alteration by amendment of the operating agreement over the objection of any member.

205. See CAL. CORP. CODE §§ 17001(ab), 17005(a) (West Supp. 1996); cf. ALA. CODE §§ 10-12-2(j), 10-12-24 (1994); ALASKA STAT. §§ 10.50.110, 10.50.150, 10.50.990(15) (Supp. 1995); ARIZ. REV. STAT. ANN. §§ 29-601(11), 29-681, 29-682 (Supp. 1995); ARK. CODE ANN. §§ 4-32-102(k), 4-32-401 to 4-32-404 (Michie Supp. 1995); COLO. REV. STAT. §§ 7-80-102(11), 7-80-108(1) (Supp. 1995); CONN. GEN. STAT. ANN. §§ 34-101(14), 34-140 to 34-143 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101(7), 18-301(b)(1), 18-302 (1993 & Supp. 1995); FLA. STAT. ANN. §§ 608.402(13), 608.423 (West Supp. 1995); GA. CODE ANN. §§ 14-11-101(18), 14-11-204, 14-11-301 (Michie 1994); IDAHO CODE §§ 53-601(11), 53-616 to -618, -621 to -625 (1994); ILL. ANN. STAT. ch. 805, para. 180/1-5, 180/10-1 to 180/10-5, 180/15-5 (Smith-Hurd Supp. 1995); IND. CODE ANN. §§ 23-18-1-16, 23-18-4-5 (West 1994); IOWA CODE ANN. §§ 490A.703, 490A.705 (West Supp. 1995); KAN. STAT. ANN. § 17-7613 (1995); Ky. Rev. Stat. & R. Serv. ch. 275, § 3(13), 33-37 (Baldwin); LA. REV. STAT. ANN. §§ 12:1305(c), 12:1315-1316, 12:1318 (West 1994); ME. REV. STAT. ANN. tit. 31, §§ 651, 653, 654 (West Supp. 1995); MD. CODE ANN., CORPS & ASSN'S § 4A-402 (1993); MINN. STAT. ANN. §§ 322B.03(33), 322B.603 (West 1995); MICH. COMP. LAWS ANN. §§ 450.4102(n), 450.4501 to .4502, 450.4505 (West Supp. 1995); MO. ANN. STAT. §§ 347.015(13), 347.079, 347.081 (Vernon Supp. 1996); MONT. CODE ANN. §§ 35-8-102(16), 403-404, 502, 704, (1995); NEB. REV. STAT. §§ 21-2603(10), 21-2618, (Supp. 1994); NEV. REV. STAT. §§ 86.101, 86.281(10), 86.291, 86.341, 86.351 (1994); N.H. REV. STAT. ANN. §§ 304-C:1(VI), 304-C:24 (1995); N.J. STAT. ANN. § 42:2B-22 (West Supp. 1995); N.M. STAT. ANN. §§ 53-19-2(O), 15-18, 21-25 (Michie Supp. 1995); N.Y. LTD. LIAB. CO. LAW § 417 (McKinney 1996); N.C. GEN. STAT. §§ 57C-1-03(16), 57C-3-01 to -05, -20 to -21, -32 (Supp. 1993); N.D. CENT. CODE §§ 10-32-68, 10-32-50 (1995); OHIO REV. CODE ANN. §§ 1705.01(J), 1705.09, 1705.12, 1705.14, 1705.15, 1705.18 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2001(17), 2003(11), 2020, 2024, 2033, 2035 (West Supp. 1996); OR. REV. STAT. §§ 63.057, 63.130, 63.150, 63.180 (1995); 15 PA. CONS. STAT. ANN. § 8903 (1995); R.I. GEN. LAWS §§ 7-16-15, 7-16-19, 7-16-21, 7-16-25, (1992); S.C. CODE ANN. §§ 33-43-102(L), 33-43-202, 33-43-401(B), 33-43-402 to 404 (Law. Co-op. Supp. 1995); S.D. CODIFIED LAWS ANN. §§ 47-34-1(6), 47-34-22, 47-34-25 (Supp. 1995); TENN. CODE ANN. §§ 48-206-101, 48-216-101, 48-218-101, 48-218-102, 48-224-101 (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.09, art. 2.23, art. 4.02, 4.05 (West Supp. 1996); UTAH CODE ANN. §§ 48-2b-126, 48-2b-122, 48-2b-131 (1994); VA. CODE ANN. §§ 13.1-1023, 13.1-1022, 13.1-1038.1, 13.1-1039, 13.1-1040, (Michie 1993 & Supp. 1995); WASH. REV. CODE ANN. §§ 25.15.005(5), 25.15.040, 25.15.115, 25.15.120, 25.15.140, 25.15.150, 25.15.155, 25.15.250 (West Supp. 1996); W. VA. CODE §§ 31-1A-19, 31-1A-18, 31-1A-20, 31-1A-32, 31-1A-34, (Supp. 1995); WIS. STAT. ANN. §§ 183.0102(16), 183.401 to 404, 704, 706, 801 (West Supp. 1995); WYO. STAT. §§ 17-15-116, 17-15-122 (1989).

206. CAL. CORP. CODE § 17151(b) (West Supp. 1996).

207. *Id.* § 17202 (West Supp. 1996).

208. *Id.* §§ 17250, 17251 (West Supp. 1996).

209. *Id.* § 17004(b) (West Supp. 1996).

LLC acts vary in answering this question. Some follow a corporate law model²¹⁰ allowing, at least in the absence of contrary agreement by the parties, a majority of members to amend the operating agreement.²¹¹ California, however, like most LLC acts, follows an approach consistent with partnership law²¹² and requires (barring other agreement) unanimity to amend the operating agreement.²¹³ In so doing, California made the correct choice.

The obvious problem with sanctioning amendment of the operating agreement by majority vote is that it enables the majority to alter the fundamental division of power and profit in ways the parties would never have agreed to allow. For example, the abuse is evident if a party with 51 percent of the profits and voting power could simply amend the agreement to increase his or her profit share to 99 percent (particularly if he or she made no added contributions). To deal with this problem, statutes allowing amendment with less than unanimity might exclude certain subjects from the majority's reach.²¹⁴ Yet, this poses extraordinarily difficult challenges for drafting. For example, if the statute allowed the majority to amend anything but the profit allocation, what about the payment of salaries or other compensation to some members? What if some members make additional contributions? More fundamentally, California's unanimity requirement is consistent with the generally held notion that a contract is not subject to unilateral alteration unless specifically so provided,²¹⁵ and, thus, poses less danger of unfair surprise for members of an LLC.

210. See, e.g., DEL. CODE ANN. tit. 8, § 242(b) (1991) (requiring a majority vote to amend articles).

211. See, e.g., ALASKA STAT. § 10.50.150(c) (Supp. 1995); CONN. GEN. STAT. ANN. § 34-142(b) (West Supp. 1995); LA. REV. STAT. ANN. § 12:1318(B)(6) (West 1994); N.M. STAT. ANN. § 53-19-17(B)(1) (Michie Supp. 1993); N.Y. LTD. LIAB. CO. LAW § 402(c)(3) (McKinney 1996); OKLA. STAT. ANN. tit. 18, § 2020(B)(4) (West Supp. 1996); OR. REV. STAT. § 63.150(3)(c) (1995); R.I. GEN. LAWS § 7-16-21(b)(5) (1992); TENN. CODE ANN. §§ 48-206-102, 48-209-103(e) (1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.23(D)(1) (West Supp. 1996); see also DEL. CODE ANN. tit. 6, § 18-209(f) (1993) (allowing amendment by majority vote through merger); N.J. STAT. ANN. § 42:2B-27 (West Supp. 1995) (same); MINN. STAT. ANN. §§ 322.B.603, 605 (West 1995) (permitting amendment by majority of board members); ILL. ANN. STAT. ch. 805, para. 180/5-20(c) (Smith-Hurd Supp. 1995) (requiring two-thirds vote to amend articles, which can trump operating agreement).

212. U.P.A. § 18(h) (1914).

213. CAL. CORP. CODE § 17103(a)(2)(C) (West Supp. 1996); see *id.* (requiring unanimity to amend the articles of organization, as well); cf. ALA. CODE § 10-12-24(b) (1994); ARIZ. REV. STAT. ANN. § 29-681(c)(1) (Supp. 1995); ARK. CODE ANN. § 4-32-403(b)(1) (Michie Supp. 1995); GA. CODE ANN. § 14-11-308(b)(5) (Michie 1994); IDAHO CODE § 53-623(2)(a) (1994); IND. CODE ANN. § 23-18-4-3(c)(1) (West 1994); IOWA CODE ANN. § 490A.701(3) (West Supp. 1995); ME. REV. STAT. ANN. tit. 31, § 653(2)(A) (West Supp. 1995); MD. CODE ANN., CORPS. & ASSN'S § 4A-402(b)(2) (1993); MO. ANN. STAT. § 347.079(3)(1) (Vernon Supp. 1996); MONT. CODE ANN. § 35-8-403(2)(a) (1995); N.H. REV. STAT. ANN. § 304-C:24(VI)(a) (1994); N.C. GEN. STAT. § 57C-3-03(1) (Supp. 1993); VA. CODE ANN. § 13.1-1023(B)(1) (Michie 1993); WASH. REV. CODE ANN. § 25.15.120(2)(a) (West Supp. 1996); W. VA. CODE § 31-1A-19(b)(2) (Supp. 1995); WIS. STAT. ANN. § 183.0404(2)(a) (West Supp. 1995).

214. See, e.g., N.Y. LTD. LIAB. CO. LAW §§ 402(e), 417(b) (McKinney Supp. 1995).

215. See, e.g., *Angel v. Murray*, 322 A.2d 630, 634-36 (R.I. 1974).

Given this requirement of unanimity to amend the operating agreement, the question becomes can a majority in a California LLC circumvent this rule? One common technique for altering the financial interests of shareholders in a corporation (including amending the organic documents of the company) is through a merger with a shell company, the impact of which is not really to combine different firms, but, rather, to alter the rights within one corporation.²¹⁶ Could a voting majority in an LLC use this technique? In some jurisdictions, most notably Delaware,²¹⁷ the answer is yes. To their credit, the drafters of California's LLC statute recognized this danger and attempted to deal with it. Unfortunately, ambiguity mars the attempt.

The pertinent language is in section 17551(e) of the California Corporations Code:

An agreement of merger approved in accordance with subdivision (a) may effect any amendment to the operating agreement of any constituent limited liability company or effect the adoption of a new operating agreement for a constituent limited liability company if it is the surviving limited liability company in the merger Notwithstanding the above provisions of this subdivision, if a greater number of members is required to approve an amendment to the operating agreement of the constituent limited liability company than is required to approve the agreement of merger pursuant to subdivision (a), and the number of members that approve the agreement of merger is less than the number of members required to approve an amendment to the operating agreement of the constituent limited liability company, any amendment to the operating agreement or adoption of a new operating agreement of the surviving limited liability company made pursuant to the first sentence of this subdivision shall be effective only if the agreement of merger is approved by the number of members required to approve an amendment to the operating agreement of the constituent limited liability company.²¹⁸

At first glance, the meaning of this provision, despite its rather convoluted language, seems simple enough: Mergers receiving less than unanimous approval cannot effect an amendment of the operating agreement of a constituent LLC (unless the agreement expressly allowed amendment on less than unanimous vote). Yet, this leaves questions unanswered. To begin with, what is the impact

216. See, e.g., *Bove v. Community Hotel Corp.*, 249 A.2d 89, 93 (R.I. 1969) (holding that a merger between a parent corporation and its subsidiary is permissible even where the merger device is used for the sole purpose of avoiding the unanimous vote requirement which would otherwise be necessary to cancel the priorities of preferred shareholders).

217. See DEL. CODE ANN. tit. 6, § 18-209(b), (f) (Supp. 1994).

218. CAL. CORP. CODE § 17551(e) (West Supp. 1996).

of this provision on the validity of the merger itself; specifically, is a merger which receives a majority, but not a unanimous, vote invalid or is just the amendment ineffective? If the merger is valid, but the amendment ineffective, then how can one decide what provisions govern the surviving firm on the points on which the agreements of the two constituent firms disagreed? Will the mere labeling of one LLC as the “surviving” firm mean that its agreement controls? If, on the other hand, the merger is invalid, then could the end result be to trump the general rule that a majority can approve an LLC merger, for all but the few cases in which the operating agreements of the merging LLCs are mirror images of each other?

This, in turn, highlights the question of when a merger effects any amendment of an operating agreement. A simple hypothetical illustrates the problem. Suppose there are two LLCs, each of which has three members. The operating agreement of each calls for all members to receive an equal one-third share of the firm’s profits. Would a merger between the two firms under an agreement which calls for each member to receive an equal one-sixth profit share effect any amendment of the operating agreements? If one focuses on the equal sharing aspect of the original agreements, then there appears to be no alteration. If, however, one focuses on the one-third share aspect of the original agreements, then the conclusion is to the contrary. In deciding which interpretation to adopt, a court naturally may be inclined to look to language differences: Did the agreements refer to “equal shares” or “one-third shares?” The problem is that from the standpoint of the drafters of the original agreements, this language was substantially equivalent and, therefore, the words chosen could have been largely accidental. The same ambiguity can exist if the agreement follows the statutory default rule of profit sharing in proportion to contributions, since it may be quite common in drafting such an agreement to specify the actual percentage of profit interests in order to avoid disputes later as to what was the ratio of contributions and, hence, profits.²¹⁹

Faced with this problem, one temptation may be to read section 17551(e) narrowly so as to avoid eclipsing the majority rule principle of section 17551(a). For example, a court might interpret the “effect any amendment” language not to encompass the alteration of profit shares virtually inevitable upon merging of two LLCs. More broadly, one might assert that the merger of one LLC into another, under a plan which leaves the surviving LLC’s operating agreement unchanged, does not effect any amendment despite whatever changes this means for the rights of members of the disappearing LLC. The basis for this construction lies in section 17551(e)’s references to the “surviving limited liability company.” Yet, the impact of the latter construction is to create a huge disparity in the voting

219. See, e.g., CALIFORNIA CONTINUING EDUCATION OF THE BAR, CALIFORNIA LIMITED LIABILITY COMPANIES: BEYOND THE BASICS 173, 182, 202, 228 (1995) (form operating agreement specifying each member’s percentage profits interest).

rights of the members of two merging LLCs, depending upon the artificial distinction of which firm receives the label of survivor. This is contrary to the repeated efforts in the California corporations statute to prevent form trumping substance in reorganizations.²²⁰ Moreover, reading section 17551(e) narrowly opens dangerous prospects for abuse. A hypothetical illustrates why. Suppose A, B and C are equal members of an LLC. A and B feel they should receive an increase in their profit shares. C demurs. A and B cannot amend the operating agreement (barring a contrary provision in the document) to increase their shares over C's objection. Yet, if section 17551(e) does not apply, what would stop A and B from forming a new LLC owned by themselves, which they then merge with the existing LLC, thereby increasing their profit shares?

One further ambiguity in section 17551(e) may prove even more telling. Suppose a California LLC merges into a foreign LLC so the foreign LLC is the survivor; does this "effect any amendment" of the California LLC's operating agreement? After all, changing the law governing the LLC could significantly change the rights of the parties. For example, the majority voting interest in a Delaware LLC may amend the operating agreement by merger—something the majority could not do (barring other agreement) in California. Hence, unless one interprets section 17551(e) to apply to a merger which changes the governing law for a California LLC, majorities can circumvent the statute by merging into a shell Delaware LLC, which then merges again with another shell LLC in order to effect an amendment.

One might respond to these concerns about amendments through mergers by pointing to the objecting minority's possible ability to challenge the action as a breach of the majority's fiduciary duty²²¹ or to demand a cash-out of the minority's interest pursuant to section 17601.²²² The problem with relying on the protection of fiduciary duty is that with its vague legal contours and need to resolve what are often highly contested issues of fact, it tends to promote costly litigation with questionable outcomes. Regarding appraisal rights, why should the majority be able to force the minority into a choice between exit from the firm or changing the contract when that is not what the parties originally agreed? By contrast, section 17252(a)(2) of California's LLC act grants cash-out rights to those dissenting from an amendment, but only when the members agreed to allow amendments over opposition.²²³ Of course, one might deem the parties' original

220. See *supra* note 85 and accompanying text.

221. As discussed earlier, it is not clear that members of an LLC have any fiduciary duty when voting as members. See *supra* notes 54-60 and accompanying text. Significantly, however, California Corporations Code § 17613(c) imposes upon a party controlling both sides in a reorganization (including a merger) the burden of proving that the transaction is just and reasonable to the minority. Still, it is uncertain if this provision will apply if no one "party," as opposed to a group of persons, are in control of the merging LLCs.

222. See CAL. CORP. CODE §§ 17601-17606 (West Supp. 1996) (providing appraisal rights for members dissenting from an LLC merger or other reorganization).

223. *Id.* § 17252(a)(2) (West Supp. 1996).

contract to include the provisions of California's LLC statute, but any ability to circumvent sections 17103(2)(C) and 17551(e) would not have been readily apparent to most individuals forming a California LLC. Finally, it is useful to note that under partnership law, partners who attempt to unilaterally alter the partnership agreement—even if constituting a majority—are the ones who may need to leave the firm.²²⁴

This discussion suggests the legislature should amend section 17551(e). One possibility is to broaden it. Recognizing that almost all LLC mergers entail alteration of the constituent firms' operating agreements in some sense, the rule under section 17551(a) could be that *all* mergers must receive approval by the same vote as necessary to amend the merging firms' operating agreements. This would avoid questions as to what mergers "effect any amendment" to the operating agreement. Alternately, the legislature might narrow section 17551(e). The primary abuse occurs with a merger undertaken to amend the operating agreement, rather than to combine different businesses. Hence, section 13551(e)'s high vote requirement could apply only to mergers with LLC's under common control (much as with the freeze-out merger rule in section 17551(b)).

Beyond mergers, a sale of substantially all assets to a new LLC in exchange for interests in the new firm, followed by a dissolution of the old firm and a distribution of the new interests, could serve as a tool to amend an operating agreement. This suggests again the need for California's LLC act to address sales of substantially all assets.

II. CREDITOR PROTECTION ISSUES

A. *Distributions*

In an ordinary partnership, creditors are presumably unconcerned about distributions of money from the firm to its owners, because the owners have unlimited personal liability.²²⁵ Once one introduces limited liability, this changes. If those with no personal liability could legally withdraw their original investment at any time, they could deprive creditors of the cushion provided by this invested capital, which the creditors may have relied upon in advancing money to the business. Worse, the unscrupulous might take advantage of such a regime by withdrawing money representing not only their investment, but also that obtained through borrowing by the firm. For this reason, corporate law has long restricted the payment of dividends by a corporation to its shareholders.

224. *See, e.g., Vangel v. Vangel*, 116 Cal. App. 2d 615, 623, 254 P.2d 919, 924 (1953) (finding a partner who violated partnership agreement and usurped management guilty of wrongfully causing dissolution, thereby enabling other partners to continue the business without him).

225. U.P.A. § 15 (1914).

Traditionally, corporate statutes attempted to protect creditors by limiting dividends to the amount of the company's "surplus."²²⁶ Surplus, in turn, commonly refers to the amount by which the total worth of the corporation's assets exceeds the sum of its debts and its "capital."²²⁷ If one assumes (incorrectly, as it turns out) that capital is what the shareholders paid the company for their stock, then it is evident how this approach is supposed to protect creditors from both of the dangers outlined above.

Two factors, however, have undermined the protection of this traditional approach. To begin with, capital need not, under typical corporate statutes following the traditional approach, equal at least the amount paid by shareholders to the corporation for their stock. Instead, directors possess substantial discretion, subject to limits based upon par value, to make only some of the purchase price of stock represent capital.²²⁸ More significantly, directors and shareholders can take steps which will reduce capital, if not eliminate it altogether.²²⁹ The end result is that the traditional statute generally does not prevent shareholders from receiving dividends which effectively withdraw the equity cushion provided to creditors by the stockholders' original investment.

More recent corporation statutes have responded to this phenomenon in different ways. The Revised Model Business Corporation Act (RMBCA) reacts by giving up. Since the end result of the traditional statutes generally was not to prevent dividends which reflected a return of the shareholders' original investment, the MBCA simply eliminates the concept of capital as a limit on corporate distributions. Instead, subject to an equitable solvency limit, and limits for the protection of liquidation preferences, a corporation can declare a dividend up to the amount by which its assets exceed its liabilities.²³⁰ This, of course, will leave no equity to cushion the company's creditors.

California takes another approach. Its corporations statute attempts to retain an equity cushion for creditors by the use of a numerical test. California Corporations Code section 500 allows a dividend under either of two conditions: (1) the company may distribute a sum not in excess of the amount of the corporation's retained earnings (the accumulation of net income for each year of business, which the company neither subsequently lost nor distributed); or (2) if there are insufficient retained earnings, the company can distribute a sum which

226. *E.g.*, DEL. CODE ANN. tit. 8, § 170(a) (Supp. 1994); N.Y. BUS. CORP. LAW § 510(b) (McKinney 1986). *See generally* BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 68-84 (3d ed. 1990).

227. *See, e.g.*, DEL. CODE ANN. tit. 8, § 154 (1991); N.Y. BUS. CORP. LAW § 102(a)(13) (McKinney 1986).

228. *E.g.*, DEL. CODE ANN. tit. 8, § 154 (1991); N.Y. BUS. CORP. LAW § 506 (McKinney 1986).

229. Such reductions can occur through the repurchase and cancellation of shares or through board resolution (if necessary, coupled with amendment to the articles reducing par). *See* GEVURTZ, *supra* note 2, at 643-44, 646. Some jurisdictions, however, attempt to limit dividends to "earned surplus," which requires subtracting everything paid for stock. *E.g.*, ARIZ. GEN. CORP. LAW §§ 10-045, 10-046 (1990).

230. REVISED MODEL BUS. CORP. ACT § 6.40(c) (1984) [hereinafter R.M.B.C.A.].

leaves it with total assets in excess of 1¼ times its total liabilities and current assets greater than its current liabilities (or greater than 1¼ times its current liabilities if the company did not manage to earn more than its interest expense in the prior two years).²³¹

A second difficulty presented by both the traditional and the more recent statutory tests is the need to put a dollar amount on the corporation's total assets. Conventional accounting practice generally uses the cost of an asset, less depreciation, as the amount placed on the books for the value of each asset.²³² Suppose, however, a corporation's directors wish to declare a larger dividend than this practice would allow: Can they argue that some assets have, in fact, appreciated in value since their purchase? Decisions under the traditional statutes were divided,²³³ a split reflected in the recent statutes. The RMBCA is permissive, allowing directors to base their determination upon financial statements prepared on the basis of accounting practices which are "reasonable in the circumstances" or on a "fair valuation" or other method that is "reasonable."²³⁴ California, in contrast, mandates the corporation follow generally accepted accounting principles in determining the dollar amount of its assets.²³⁵ This generally will preclude revaluing assets at greater than their initial cost so as to declare more dividends.²³⁶

Given how California's corporations statute addresses these two issues, one might have expected California's new LLC Act to contain the same rules with respect to distributions by an LLC to its members. The LLC Act, however, does not meet this expectation. Instead, the drafters of California's LLC Act chose to use the RMBCA as a model. Hence, subject to an equitable solvency test, and limits to protect any liquidation preferences, a California LLC can make a distribution up to the amount by which its assets exceed its liabilities (rather than 1¼ times its liabilities).²³⁷ Moreover, in determining the value of its assets for this purpose, the LLC need not use generally accepted accounting principles, but instead can look to "a fair valuation" or accounting practices or any other method that is "reasonable in the circumstances."²³⁸ This, of course, could allow upward revisions in asset values.

231. CAL. CORP. CODE § 500(a), (b) (West Supp. 1996).

232. See TED FIFLIS ET AL., ACCOUNTING FOR BUSINESS LAWYERS; TEACHING MATERIALS 79 (3d ed. 1984).

233. Compare *Randall v. Bailey*, 43 N.E.2d 43, 49 (N.Y. 1942) with *Kingston v. Home Life Ins. Co.*, 101 A. 898, 903-04 (Del. Ch. 1917).

234. R.M.B.C.A. § 6.40(d) (1984).

235. CAL. CORP. CODE § 114 (West 1990).

236. See Accounting Principles Board Opinion No. 6 ¶ 17 (1965).

237. CAL. CORP. CODE § 17254(a) (West Supp. 1996). This point is also true of the new LLP Act. *Id.* § 15053 (West Supp. 1996).

238. *Id.* § 17254(b) (West Supp. 1996).

These provisions in California's LLC Act represent poor policy. To understand why, it is useful to begin by considering the role which shareholder equity plays in protecting creditors. One aspect is to provide a cushion against downturns in the business. Far more significant, however, is the impact on incentives. If individuals with no personal liability have no money of their own invested in the business, they have an incentive to engage in what may be unreasonably risky undertakings.²³⁹

California, like most states, does not attempt to address this problem by requiring any minimum capital for a corporation—presumably because of the difficulty of setting a minimum capital which could sensibly apply to corporations engaged in a multitude of differing businesses. The problem becomes potentially both more dangerous and more subject to remedy, however, if one focuses solely on withdrawal of money which shareholders invested in the corporation. This situation is more dangerous because it is changing the incentive structure, after creditors decided to deal with the company, to one which may have been unacceptable had it been in place before. This situation is also more subject to remedy because it does not require figuring out what should be the minimum capital, but rather involves simply limiting the withdrawal of money once put in. Of course, one could respond that creditors might create such protections for themselves by contractually limiting dividends. Yet, the logical extension of this argument is to eliminate all restrictions on distributions. The fact that the legislature has chosen to make any restrictions presumably reflects a notion that creditors should not be put to the added transaction costs of always needing to specify limits on dividends. Seen in this light, California Corporations Code section 500 is a reasonable attempt to craft a compromise between allowing shareholders to withdraw funds no longer needed in the business, and protecting creditors against excessive removal of equity.

Having made the judgment to limit the removal of equity in the corporate context, there seems no rational reason to create a different rule for LLCs. In both instances, every owner enjoys limited liability.²⁴⁰ The differing tax treatment of LLCs is irrelevant to this question. Similarly, while the normally more closely held status of LLCs may militate against following corporate law norms with respect to internal management issues,²⁴¹ this has little to do with justifying different rules for creditor protection (indeed, creditor concerns with excessive distributions may be greater in a closely held firm, where the owners likely are

239. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 113 (1985). Imagine the incentives if one could gamble with another person's money, where one would be out nothing if one lost, but could keep all winnings beyond a fixed interest rate if one won.

240. By way of comparison, in a limited partnership, the personal liability of the general partner(s) might be expected to play the same role as owner's equity in curbing incentives toward excessively risky undertakings. Hence, it is not inconsistent for the California limited partnership act to allow distributions which effectively return the limited partners' contributions. See CAL. CORP. CODE § 15666 (West Supp. 1996).

241. See *supra* notes 5-222 and accompanying text (Part I).

in direct control²⁴²). Hence, the LLC act should follow the same numerical limits on distributions as imposed by the corporate statute.

A more complex question is whether California's LLC act should have required adherence to generally accepted accounting principles (GAAP) in determining if the value of the company's assets allows a distribution. The practical issue here involves upward revisions in the value of the firm's assets—something not generally allowed by GAAP. While it may be argued that some requirements of GAAP—such as accrual accounting—could be unrealistic for a closely held business,²⁴³ the corporations statute applies to closely held corporations and so faces the same objection.²⁴⁴ At any event, curing this does not require allowing the LLC to use a "fair valuation."

Reasonable views differ on the subject of asset revaluations. Historic costs often have limited relation to the present value of a firm's assets.²⁴⁵ Hence, it may seem unrealistic to limit the ability to make a distribution to a calculation based upon historic cost. On the other hand, prior to realizing a profit upon actual disposition of an asset, any upward revision is inherently speculative.²⁴⁶ Moreover, there is always a temptation for those desiring a distribution to err on the side of more rather than less in any upward revaluation.

Without resolving this debate, what is important for present purposes is that California decided this question in its corporations statute in favor of following GAAP. Hence, the issue is whether there are grounds for having a different answer in the LLC act. Generally, for the same reasons outlined in considering the withdrawal of owner equity above, the answer is no. There is, however, one exception. California's LLC act gives members (barring contrary agreement) the right to withdraw upon six months' notice (or immediately if they are obligated to provide services).²⁴⁷ Upon withdrawal, the member is entitled to payment of the fair value of his or her interest.²⁴⁸ Determining such fair value requires going beyond GAAP and looking to see what the business' assets are really worth.²⁴⁹ It would be anomalous if the withdrawing member then could not obtain payment of this value because of a prohibition upon distributions by the firm which is based upon historic cost. Moreover, not only is there an important business reason for departing from historic cost in this context, but there is less danger to creditors

242. Closely held corporations often declare few dividends in order to avoid double taxation. See GEVURTZ, *supra* note 2, at 384. This would not apply to LLCs taxed as partnerships.

243. See CALIFORNIA LLCs, *supra* note 4, § 6.46.

244. See, e.g., R.M.B.C.A. § 6.40 cmt. ¶ 4.a.

245. See, e.g., *In re Valuation of Common Stock of Libby, McNeill & Libby*, 406 A.2d 54, 66-67 (Me. 1979).

246. See ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 8.7, at 181 (1989).

247. CAL. CORP. CODE § 17252(a)(1), (b) (West Supp. 1996).

248. *Id.* § 17252(c) (West Supp. 1996).

249. See, e.g., *Curtis v. Campbell*, 336 S.W.2d 355, 360 (Ky. 1960) (finding that figures on a balance sheet did not reflect the "true and correct financial condition" of a deceased partner's interest in a partnership).

from doing so. At this point, the members stand in opposition to each other, with the non-withdrawing members normally seeking the lowest possible valuation on the firm's assets so as to pay the least to the withdrawing member.²⁵⁰ This should serve as a check on inflated upward revisions in asset values for purposes of making a distribution.

This suggests that the LLC act went too far in following the RMBCA, rather than the California corporations statute, with respect to valuing assets for purposes of distribution limits. The general rule should be to follow GAAP. An exception, however, should exist for withdrawing distributions to members who exercise their right to cash out at fair value.

B. Piercing the LLC

One of the most significant protections of creditors from the possible abuse of limited liability in the corporate context comes from the doctrine of piercing the corporate veil. Under this doctrine, courts will disregard the existence of the corporate entity and hold shareholders personally liable for its debt when those shareholders have controlled the corporation and used that control in such a manner as to perpetrate some fraud or injustice upon a corporation's creditor.²⁵¹ Such fraud or injustice may come from a number of actions. These include: (1) undercapitalization;²⁵² (2) commingling of corporate and personal funds;²⁵³ (3) transactions between the company and its shareholder(s) which do not bear the indications of an arms length deal;²⁵⁴ (4) misrepresentations to creditors;²⁵⁵ (5) assurances and other conduct which might lead a creditor to believe the shareholder(s) stand behind the corporate debt;²⁵⁶ and (6) using the corporation to enter contracts which there is no intent to perform.²⁵⁷

Section 17101(b) of California's new LLC act imports the doctrine of piercing into the LLC context. It states that an LLC member shall be personally liable generally to the same extent as a shareholder may be liable for the debt of a corporation.²⁵⁸ This makes sense, since the potential for abuse of limited liability is the same in both entities. One problem with piercing in the corporate context lies in its uncertain criteria and resulting unpredictable application.²⁵⁹ Yet,

250. See, e.g., *id.*

251. See, e.g., *Automotriz del Golfo de Cal. v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957).

252. See, e.g., *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

253. See, e.g., *Riddle v. Leuschner*, 51 Cal. 2d 574, 335 P.2d 107 (1959).

254. *Id.*

255. *Id.*

256. See, e.g., *Talbot v. Fresno-Pacific Corp.*, 181 Cal. App. 2d 425, 5 Cal. Rptr. 361 (1960).

257. See, e.g., *Associated Vendors, Inc. v. Oakland Meat Co.*, 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962).

258. CAL. CORP. CODE § 17101(b) (West Supp. 1996).

259. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

even if this problem is susceptible to a legislative solution, the LLC statute would not be the place to start—since this is a problem which would need addressing in the corporations statute as well.

Section 17101(b) contains one special direction. It states that:

[T]he failure to hold meetings of members or managers or the failure to observe formalities pertaining to the calling or conduct of meetings shall not be considered a factor tending to establish that the members have personal liability for any debt, obligation, or liability of the limited liability company where the articles of organization or operating agreement do not expressly require the holding of meetings of members or managers.²⁶⁰

At first glance, this provision appears eminently sensible. The failure to hold, or the informal handling of, meetings for which there is no legal requirement in the first place should hardly be a factor for piercing. A difficulty, however, lies in the possible negative implication of this provision. Will the failure to hold meetings called for in the articles or operating agreement be a ground for piercing? Concern that this could be the case has already led some writers to suggest that members not include in their articles or operating agreements any specific requirement for member or manager meetings.²⁶¹

This is an unfortunate development. In LLCs with more than several members, and especially those choosing governance by managers, specifying in a written agreement when there will be meetings (for example, to elect managers) might be handy to avoid later disputes among the membership.²⁶² Why then should the failure to observe meeting requirements intended for the benefit of the owners in their relationship with each other be a factor against them when it comes to liability to outsiders?

This raises the question of whether this caveat was really necessary. Section 17101(b) appears to be based upon section 300(e) of California's Corporation Code. Section 300(e) provides that

The failure of a close corporation to observe corporate formalities relating to meetings of directors or shareholders in connection with the management of its affairs, pursuant to an agreement authorized by

260. CAL. CORP. CODE § 17101(b) (West Supp. 1996).

261. CALIFORNIA LLCs, *supra* note 4, § 6.24.

262. *See, e.g., Gidwitz v. Lanzit Corrugated Box Co.*, 170 N.E.2d 131, 136 (Ill. 1960) (concluding that failure to hold shareholders meetings to elect directors for ten years was oppressive to 50 percent shareholders); *see also O'NEAL & THOMPSON*, *supra* note 35, § 2.08 (describing how failure to follow corporate meeting formalities often leads to disputes among shareholders).

subdivision (b), shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations.²⁶³

The logic behind section 300(e) is not difficult to comprehend. Section 300(b) validates shareholders agreements respecting the management of a statutory close corporation in California²⁶⁴ against the claim that they are contrary to public policy because they interfere with the statutory power of the board of directors to manage the corporation.²⁶⁵ Ultra-cautious parties might not take advantage of this provision, however, for fear that the failure to follow management formalities pursuant to a shareholders agreement could be a factor leading to piercing. To allay this fear and ensure that the statutory close corporation provision did not become a trap leading to personal liability, the legislature included section 300(e).

Yet, is it really true that the failure to observe formalities respecting meetings of directors or shareholders is a factor leading to piercing? This belief is the critical assumption behind section 300(e) and, in turn, section 17101(b). While getting beyond the scope of this article, a careful examination of corporate piercing cases suggests that this may be the legal equivalent of an "old wives' tale." Admittedly, numerous court opinions²⁶⁶ and writers²⁶⁷ list lack of management formalities as a factor for piercing. It is a challenge to find a decision, however, in which the absence of *meeting* formalities actually yielded a decision to pierce, which the observance of such formalities would have changed. Instead, this "factor" seems at most to be a make-weight used to justify further a result already reached on other grounds.²⁶⁸ In fact, there is no reason for formalities regarding meetings to be a factor in piercing. Their presence is hardly likely to benefit creditors, nor their absence to harm them. (In this regard, it is important to distinguish informalities regarding meetings from informalities regarding finances; i.e. failure to issue stock, commingling funds, and typically unfair as well as poorly documented self-dealing transactions.)

263. CAL. CORP. CODE § 300(e) (West 1990).

264. See *id.* § 300(b) (West 1990); see also *id.* § 158(a) (West 1990) (defining a close corporation for purposes of later sections of the statute as a corporation whose articles limit ownership to not more than 35 shareholders and state that the corporation is a close corporation).

265. For a successful example of such a challenge, see *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953).

266. See, e.g., *Associated Vendors, Inc. v. Oakland Meat Co.*, 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962).

267. See, e.g., Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 990 (1971).

268. See Thompson, *supra* note 259, at 1067-68 (providing a statistical survey of piercing cases which did not confirm the view that the absence of formalities substantially increases the probability of piercing). *Temple v. Bodega Bay Fisheries, Inc.*, 180 Cal. App. 2d 279, 4 Cal. Rptr. 300 (1960), is illustrative. While the court mentions the lack of meeting formalities, the real prejudice to the creditor came from inadequately capitalizing the corporation and then using what funds the company had on improvements to property owned by the stockholders. *Id.* at 282-83, 4 Cal. Rptr. at 303-04.

Accordingly, perhaps the meeting caveat in section 17101(b) was not necessary at all. If ultra-caution dictated some statement about meetings, however, it should extend to all meetings, whether or not required by the articles or operating agreement.

CONCLUSION

A review of LLC statutes generally, and California's in particular, brings to mind the advice sometimes heard about purchasing an automobile produced in the first few years after its introduction as a new model. While full of wonderful improvements over prior models, such a car often has a few bugs not yet worked out. California's LLC act has benefited from the efforts of earlier LLC acts and contains a number of improvements. These include, most notably, its prohibition upon salaries to members without the consent of all, as well as merger provisions which try valiantly to prevent mergers from becoming a tool to expel members or to alter the terms of the members' agreement, rather than a means of combining or selling businesses.

On the other hand, the act has some bugs requiring a recall. It contains unjustified differences in distribution limits from the rules for a California corporation. It has an unnecessary and potentially unfortunate caveat regarding piercing the LLC. Its fiduciary duty provisions raise almost as many questions as they answer. The act contains a number of glitches in its default rules regarding fundamental transactions: The provision allowing LLC mergers based upon majority vote may be contrary to the expectations of most parties entering the sort of closely held business likely to operate as an LLC; more significantly, it creates the prospect of majorities using LLC mergers to expel minorities or to circumvent the unanimity requirements for admission of new members or amendment of the operating agreement. The act attempts to prevent some of this, but without complete clarity or coverage. The failure of the act to address the sale of substantially all of an LLC's assets creates similar problems. The act creates potential difficulty by allowing members who sold their entire interest to continue to vote (barring other agreement). Its provision regarding expulsion agreements is incomplete, as well as poorly thought through in calling for the return of the expelled member's contribution.

Still, it is important not to change what is right about the act. The legislature should resist efforts to change the unanimous vote default rule for admission of new members or the default rule allowing a cash-out at fair market value on six month's notice.