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Rebalancing conflicts of interests in hybrid business forms

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REBALANCING CONFLICTS OF INTERESTS IN HYBRID BUSINESS FORMS

MANDATORY LAW VERSUS CONTRACTUAL ARRANGEMENTS

REBALANCING CONFLICTS OF INTERESTS IN HYBRID BUSINESS FORMS: MANDATORY LAW VERSUS CONTRACTUAL ARRANGEMENTS

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aan Tilburg University
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in het openbaar te verdedigen ten overstaan
van een door het college voor promoties
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geboren op 2 november 1984 te Yerevan, Armenië.

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INTRODUCTION

According to the most recent data available for active business forms in the United States, about one-third of firms are limited liability companies—a hybrid business form combining the flexible governance structure of partnerships with the limited liability of corporations.[1] This is a remarkable statistic if one considers the fact that the majority of the states enacted limited liability company statutes only in early 1990s.[2] The widespread use of limited liability companies is not a unique US phenomenon. Many countries worldwide have introduced similar hybrid business forms recently—either by adding a new firm type to the list of the existing business forms or by revising one of the existing business forms with limited liability and strengthening contractual freedom in determining internal governance within that form.[3] The rise of hybrid business forms suggests that by focusing corporate law studies on "traditional" corporations we miss a significant part of the real picture.

Although statutes play an important role in regulating the relations of the members of hybrid business forms, the primary source of governance, given the strong contractual freedom, is the operating agreement of the firm. Statutory provisions cover basic and a number of specific conditions of organizing businesses. Further, with very few exceptions, statutory rules are cast as default rules that apply only if the founders of the firm have not excluded their application by explicitly contracting for alternative rules. The operating agreement typically defines the internal governance structure of the firm and the rights and obligations of its members. Similar to the founding documents of traditional corporations, all founding and subsequent members of a firm are bound by the terms of the firm's operating agreement.

Under some circumstances, the enabling nature of the statutory rules governing hybrid business forms and less burdensome regulations offer important advantages to their users. First, flexible statutes allow the firm's members to determine rules that meet their individual needs

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[1]*See infra* Part II of Chapter 1.

[2]*See infra* Part II of Chapter 1.

[3]*See* Joseph A. McCahery, Erik P.M. Vermeulen, & Priyanka Priydershini, *A Primer on the Uncorporation*, 14 EUR. BUS. ORG. L. REV. 305, 314 (2013) (listing hybrid business forms that have been introduced recently as a separate organizational form of business in Colombia, France, India, Japan, Singapore, and the United Kingdom); Ulrich Seibert, *Close Corporations—Reforming Private Company Law: European and International Perspectives*, 8 EUR. BUS. ORG. L. REV. 83, 86–92 (2007) (describing the reform of the German private limited company, the GmbH); Harm-Jan de Kluiver, *Towards a Simpler and More Flexible Law of Private Companies: A New Approach and the Dutch Experience*, 8 EUR. COMPANY & FIN. L. REV. 45, 56–63 (2006) (reviewing the modernization of the Dutch private (close) limited liability company, the BV, directed towards strengthening the freedom of shareholders in determining internal governance structures); Christoph Van der Elst & Erik P.M. Vermeulen, *The Dutch Private Company: Successfully Relaunched?*, *in* SIMPLIFICATION OF PRIVATE COMPANY LAW AMONG THE EU MEMBER STATES, 159, 167–80 (Yves De Cordt & Edouard-Jean Navez, eds., 2014).

and requirements and to make timely alterations along with the changing circumstances.[4] Second, enabling statutes give better informed constituencies of hybrid business forms an opportunity to engage in an efficiency-driven choice between rules and standards rather than delegate this decision to a remote legislature.[5] Third, decentralized private provision of the rules may also foster innovations in legal drafting that better meet the needs of the users of hybrid business forms or reduce their costs.[6]

New opportunities, however, bring new challenges as well. Freedom of contract may lead to four types of costs. First, the need to draft contractual arrangements in every single case creates transaction costs for the constituencies of hybrid business forms. Second, the need to understand the actual content of specific contractual arrangements—in contrast to unified mandatory rules—requires courts to invest additional resources in resolving governance disputes within hybrid business forms. Third, disparity in the bargaining power of the members of hybrid business forms may create situations where privately drafted internal governance structures tip the balance in favor of the stronger party. And fourth, strong private autonomy may also create negative externalities for third parties because the contract parties maximize their joint efficiency, rather than social welfare.

Supply of detailed default rules by statutes on hybrid business forms and the standardization of the practice of drafting operating agreements reduce the transaction costs of the parties and the learning costs of courts. But neither can address the problems of opportunistic behavior between the members of hybrid business forms and of negative externalities for third parties affected by the activities of hybrid business forms. Therefore, the possible partial modification or complete waiver of the standard mechanisms of balancing the conflicting interests within the firm and in relations of the firm with third parties creates risks for the interests of weak parties. The question then is how do the members of hybrid business forms rebalance the arising conflicts of interests under the flexible statutory framework?

This question can be answered in several steps. To start with, it is necessary to establish the demand for altering statutory default rules by private contracts of the members of hybrid business forms. If default rules are the governing rules, then the conflicting interests are balanced in the same way as they are addressed in the setting of corporations. But if the members of hybrid business forms contract around statutory default

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[4] *See*, *e.g.*, ERIK P.M. VERMEULEN, THE EVOLUTION OF LEGAL BUSINESS FORMS IN EUROPE AND THE UNITED STATES: VENTURE CAPITAL, JOINT VENTURE AND PARTNERSHIP STRUCTURES 264 (2003)

[5] *Cf.* Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 608–11 (1992).

[6] *See* Gillian K. Hadfield, *Privatizing Commercial Law*, 24 REGULATION 40, 41 (2001).

rules, then the inquiry must focus on the preferred contractual alternatives. It is necessary to understand whether these alternatives can offer equivalent protection to weak parties. If they do not, then obviously the introduction of hybrid business forms creates wide avenues for abusive behavior. But if they do, then we need a theory explaining the preference of alternative contractual mechanisms over the traditional mechanisms of addressing conflicts of interests within the firm.

Freedom to alter traditional investor protection mechanisms is the most pronounced in the setting of publicly traded firms. Listed firms are traditionally subject to prescriptive governance regimes and have to comply with numerous mandatory provisions. Allowing the use of hybrid business forms by firms that intend to offer their equity securities to a wide public changes dramatically the usual mechanisms of investor protection on stock markets. The limited liability company (LLC) is no longer the exclusive domain of non-listed firms. Listed firms in the US can be organized as an LLC or a similar hybrid business form—typically a limited partnership or a real estate investment trust. Publicly traded alternative business forms, unlike their non-listed peers, are not the majority in the total number of listed firms nor in new listings. But their use has reached a level where they cannot be ignored.

The contrast between hybrid business forms and their non-listed corporate peers is less acute. The stockholders of a close corporation have traditionally enjoyed wide flexibility in shaping the corporation's internal governance structure. Nevertheless, the rise of US LLCs is changing the traditional governance structures and investor protection mechanisms used in non-listed firms. State LLC statutes, as a rule, are based on the principle of contractual freedom and are thus flexible statutes, permitting company founders to engage in private ordering to govern their internal relations. Given the default nature of almost all provisions of the LLC statutes, the founders can use LLC operating agreements to form LLCs that either replicate traditional governance structures of corporations or modify and waive any or all long-established investor protection rights, including fiduciary duties of members and managers. This flexibility permits users of the LLC form to employ contracts to draft customized rules governing their business relationships. Yet, it can also be abused by the party to an agreement that has stronger bargaining power. The controversy focuses on the question of imposing some mandatory rules that will protect the interests of LLC members. Although studying the actual contractual practices in LLCs can shed some light on the reality and provide insights for LLC members, courts, and legislators, the usual confidential nature of the private agreements complicates matters.

A typical governance framework of firms includes three elements—voice, liability, and exit. The exit option, due to the absence of a readily-available market in which stock can be traded, is limited in

non-listed firms. This has important implications. Limited exit increases the reliance of the firm's members on the two other elements—namely, voice and liability. As a result, locked investments in non-listed firms strengthen the dependence of the firm's members upon each other's actions. Individual personalities of the members and trust between them become important. Legislators have reacted to this reality in two ways. First, they offer rules that smoothen exit in non-listed firms and thus bring investors in non-listed firms closer to the position of stockholders of listed firms. In particular, in partnership law, each partner has a right to dissolve the partnership. When applied universally, this solution increases the uncertainty risk and hold-up problems, since every partner can threaten to dissolve the partnership. The second solution is the reverse of the first—further weakening of exit with the aim of preventing disruptions of the balance of power within the firm by arrival of third parties. In particular, default statutory rules in partnerships and limited liability companies allow partner (member) substitution only by the consent of all other partners (members). Similar to the first case, a universal solution applied to all non-listed firms increases the hold-up problem, because every partner can strategically veto interest transfers by others. This analysis demonstrates that statutory default rules can be inadequate or insufficient. The pool of available contractual instruments, which can be tailored to the specific circumstances of investing in each firm, is much larger. Whereas strengthening exit can be achieved by employing various forms of put and call options, including tag-along and drag-along rights, first purchase rights can be used to preserve the established balance of power within the firm.

This thesis develops around these three topics. Chapter 1 starts with the descriptive view on the use of the LLC form by publicly traded firms. Afterwards, it explores different mechanisms that address member conflicts in publicly traded LLCs. There were twenty publicly traded Delaware LLCs in September 2013. The study analyzed the governance agreements and structures of these twenty LLCs to establish the demand for contractual freedom in LLC governance and examine the practice of investor rights in listed LLCs. The chapter shows that governance in listed LLCs differs from the traditional governance structure of corporations. Particularly, the founders of publicly traded LLCs extensively contracted around the default statutory rules to strengthen their decision-making rights, entrench control, and limit the role of fiduciary duties of care and loyalty. But they included alternative provisions in the operating agreements that balance the rights of controlling and minority members. Nevertheless, these provisions were not always identical in terms of the strength of the offered protection. Hence, other factors—such as ownership structure, dividend policies, board composition and board practices, market forces, and the standardization of the governance structures of listed LLCs—fill the gaps

as substitutes for legal rights. Publicly traded LLCs combine different contractual rights and non-legal factors to make their IPOs attractive for investors.

Chapter 2 focuses on the governance of non-listed LLCs. In the absence of minimum corporate governance requirements of disclosure and monitoring, strong market disciplining, and liquid markets for LLC units, contractual mechanisms of investor protection play stronger role in non-listed LLCs. This chapter is based on a study of the operating agreements of almost 300 non-listed LLCs with two and more members formed in Delaware. All agreements in the sample were coded based on a scorecard containing 84 questions affecting investor rights. The results support the main hypothesis that in the case of changing default statutory rules the parties used other contractual substitutes which ensured equivalent protection and, in many cases, increased clarity and reduced incentives for ex post speculative litigation. Furthermore, the choices of governance structures and investor rights were strategic as they tended to differ depending on the underlying conflicts of interests. Thus, strong contractual freedom of LLC statutes, at least in large companies, brings more benefits than risks for the firm members. The results of the study provide drafting reference points for the members of smaller firms and can be informative for courts and legislators in the ongoing debate on the nature of fiduciary duties in non-corporate business organizations.

Chapter 3 studies privately designed exit options in non-listed LLCs. This study compares the characteristics of real-world contracting to the theories of interest (share) transfer restrictions. The evidence from the hand-collected database of operating agreements of 289 non-listed LLCs formed in Delaware shows the positive effect of most of these contractual provisions on encouraging efficient investments in closely-held firms. First purchase rights, such as a right of first refusal and a right of first offer, and tag-along rights stipulate efficient investments by discouraging value-decreasing transfers of interests to third parties and reducing incentives for opportunistic renegotiation. Similar problems arising during the ordinary course of business are solved by different forms of put and call options, including their special buy/sell-out modifications—Russian roulette and Texas shoot-out clauses. The findings assist in understanding circumstances where a particular interest transfer restriction is preferable. Along with informing the theory, the results can be used in the practice of drafting shareholders' agreements and joint venture agreements and in interpreting and enforcing these agreements.

Finally, chapter 4 offers an analysis of the scope of freedom of contract in the governance of a hybrid business form available in another jurisdiction—the United Kingdom's limited liability partnership (LLP). This comparative study offers a different perspective on the topic and aims to tackle a potential bias resulting from the US approach towards

the regulation of hybrid business forms. The results demonstrate that although the UK LLP and the Delaware LLC may differ in the way the statutory defaults are cast, both business forms offer their members almost identical flexibility in determining the internal governance structure of the firm. Where the two business forms differ is the external aspect of governance. The UK legislation imposes additional information disclosure requirements on LLP members, including regular updates of the identities of the LLP's members and of its financial results. Enhanced disclosure requirement for LLPs, however, is a direct result of rules promulgated by the institutions of the European Union. The difference between the two hybrid business forms thus is a result of a policy choice rather than a necessary feature dictated by a need to address conflicts of interests unique for the UK LLP.

These findings make several important contributions to the literature and practice. First, they fill the gap in mostly theoretical literature on hybrid business forms by offering evidence from contracting practices of the members of non-listed firms. Since contracts rather than statutes are the main source of governance in these firms, the results have important implications for the ongoing debates on the scope of freedom of contract. Second, the study informs theoretical discussions of the structure of corporate law. And third, the results show circumstances where different contractual provisions are preferable. This can help users of hybrid business forms in choosing particular governance structures and courts in interpreting these provisions.

1. THE GOVERNANCE OF PUBLICLY TRADED LIMITED LIABILITY COMPANIES*

I. INTRODUCTION

According to the most recent data available for active business forms in the United States, more than one-third of all firms are limited liability companies ("LLCs").[7] This is a remarkable statistic if one considers the fact that the majority of the states enacted their LLC statutes in the early 1990s.[8] LLCs combine the limited liability of their members with strong contractual freedom in relations of the members and in internal governance matters.[9] Hence, LLCs are positioned between corporations and partnerships as a hybrid business form that borrows limited liability from the former and contractual flexibility and pass-through taxation from the latter.[10] The widespread use of LLCs by American private business has given rise to the term "uncorporations,"[11] which emphasizes their difference from corporations. However, the LLC form is no longer the exclusive domain of non-listed companies. A new term that has been introduced recently by the *Economist* is "distorporation," which includes LLCs and similar hybrid business forms that are publicly listed.[12] Such publicly traded business forms, due to specific taxation and strong contractual freedom, employ different governance structures and, according to the *Economist*, are changing the "face of American capitalism."[13] Publicly traded alternative business forms, unlike their non-listed peers, are not the majority in the total number of listed firms nor in new listings,[14] but their use has reached a level where they cannot be ignored.

In light of statutory enabling rules, LLC operating agreements ("LLC agreements") play a special role in LLC corporate governance.[15] LLC members are free to choose a governance structure that best fits

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*This chapter is based on an article published earlier in the *Delaware Journal of Corporate Law*. *See* Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207 (2015).

[7]*See infra* Figure 1–II.

[8]*See infra* note 53 and accompanying text.

[9]*See* Larry E. Ribstein, *Uncorporating the Large Firm* 4 (Univ. Ill. Law & Econ. Research Paper Series, Paper No. LE08-016, 2008), *available at* http://perma.cc/VXF4-7G82 (discussing characteristics of LLCs).

[10]*See id.*

[11]*Id.* at 3 n.4.

[12]*The New American Capitalism: Rise of the Distorporation*, ECONOMIST (Oct. 26, 2013), *archived at* http://perma.cc/WUG9-AHDL.

[13]*Finance in America: Subterranean Capitalist Blues*, ECONOMIST (Oct. 26, 2013), *archived at* https://perma.cc/CE9E-5V5E.

[14]*Id.*

[15]*See, e.g.*, Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 561 (2012) (discussing treatment of fiduciary duties in Delaware LLC operating agreements).

their needs.[16] This is in stark contrast to listed corporations that have to comply with mandatory governance structures offered by the law.[17] The question is whether, in publicly traded LLCs, the founding and controlling members use the statutory default rules to create governance structures that entrench their control, limit their accountability, or are potentially oppressive towards outside investors in any other way. To the extent that LLCs are subject to less regulation, do they really "distort" long-established corporate governance practices and investor protection mechanisms of corporations?

Early empirical evidence, though focusing not only on publicly traded LLCs—the studies cover either different publicly traded hybrid business forms or all LLCs, including non-listed companies—suggests that, perhaps the answer is yes. Professor Mohsen Manesh conducted a first-hand analysis of the operating agreements of publicly traded limited partnerships ("LPs") and LLCs.[18] This study looked into the operating agreements of 85 listed entities formed in Delaware, with the main focus on the fiduciary duties of the members and managers and on exculpation provisions.[19] There are two main findings of this study: (1) the majority of the sample either totally waived the fiduciary duties of the managers or eliminated the liability of the managers arising from the breach of fiduciary duties; and (2) the sample LPs and LLCs did not use commensurate substitute mechanisms to counterbalance the waiver or the elimination of liability arising from the breach of fiduciary duties.[20] A parallel study looked into the operating agreements of 129 mostly non-listed LLCs which were filed with the SEC by their listed members or by the LLCs themselves in cases of issuing debt securities.[21] This study pointed to the possible imbalances in the bargaining power of LLC members.[22] For instance, the modifications of the managers' duties and liabilities were not accompanied with the buy-out rights of the members,[23] and large LLC members were able to protect their fiduciary duty and liability modifications through special procedures for amending LLC agreements.[24] Two other empirical studies used questionnaires

[16]*See id*. (emphasizing freedom of contract in Delaware LLC law).

[17]*See id.* at 596; *see also* Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's* Price Discrimination in the Market for Corporate Law, 86 CORNELL L. REV. 1257, 1260 (2001) (discussing a more prescriptive and less flexible variety of corporate statute).

[18]*See* Manesh, *supra* note 15, at 567.

[19]*Id.*

[20]*Id.* at 575, 581–83.

[21]Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879, 898, 901 (2012).

[22]*Id.* at 883.

[23]*Id.* at 914.

[24]*See id.* at 923–24 (noting an association between modification of member duty of loyalty requirements in operating agreements and a requirement of unanimous consent to amend the agreements).

distributed among bar members in several U.S. states to document the experience of practicing lawyers with regard to LLCs.[25] Both articles point to low rates of using contractual minority protections and conclude that the minority members of LLCs tend to be vulnerable to majority expropriation.[26] The most recent study, and the one that presents separately the findings for publicly traded LLCs, was conducted by Professor Brent Horton. Professor Horton studied the application of fiduciary duties in 86 publicly traded non-corporate business associations—17 LLCs and 69 LPs—with the aim of defining the position of minority investors of these firms in going-private-freeze-out transactions.[27] The study found that in the majority of listed LLCs investors faced higher risks during freeze-outs than in corporations.[28]

Based on the predictions of financial contracting theories, this study starts from the presumption that to obtain financing from outside investors, publicly traded LLCs choose governance and financing structures that, at the end of the day, offer sufficient mechanisms to outside investors to deal with adverse selection, moral hazard, and agency problems or compensate investors for their absence. Given the contractual freedom and flexibility of LLCs,[29] the combinations of mechanisms within these structures can be myriad and particular mechanisms can act as substitutes for each other.[30] However, the end results are expected to be equivalent. This implies that the empirical study of publicly traded LLCs should be broad enough to cover all possible substitute mechanisms. In this sense, this study comes closer to Conrad Ciccotello and Chris Muscarella's 2001 study of the operating agreements of 119 publicly listed LPs, which showed that contracting and equity ownership act as substitutes in these entities.[31] This study, by widening the focus, shows that the governance structures of listed LLCs contain elements that address the risks of minority investors.

The objective of this study is to conduct an in-depth analysis of corporate governance in publicly traded U.S. LLCs by looking to the

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[25]Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 364 (2003) [hereinafter *A New Direction*]; Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609, 615 (2006) [hereinafter *An Empirical Glimpse*].

[26]*See* Miller, *A New Direction*, *supra* note 25, at 397–98; Miller et al., *An Empirical Glimpse*, *supra* note 25, at 628–29.

[27]Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53, 60–61 (2013).

[28]*Id.* at 93.

[29]*See* Ribstein, *supra* note 9, at 4 (discussing the flexibility of LLCs).

[30]*See generally* Manesh, *supra* note 15, at 557–66 (discussing the various governance devices available to LLCs and similar alternative entities).

[31]Conrad S. Ciccotello & Chris J. Muscarella, *Contracts Between Managers and Investors: A Study of Master Limited Partnership Agreements*, 7 J. CORP. FIN. 1, 2 (2001) (analyzing the substitution of organizational constraints for traditional ownership control in the context of master limited partnerships).

legal mechanisms used in the operating and other relevant agreements of the sample companies, their ownership structures, management incentives, actual board practices, dividend distributions, and other corporate governance mechanisms. The sample includes twenty listed LLCs that, to the best of this author's knowledge, were all listed U.S. LLCs at the end of September 2013.[32]

The analysis shows that publicly traded LLCs used contractual freedom to enhance the control of management by the founding members and to strengthen their decision-making rights, but these measures were accompanied by other legal mechanisms directed towards balancing the rights of the controlling and minority members.[33] The choice of ownership structures was used in the sample companies as a signal to outside investors about the quality of the investments.[34] Other factors that disciplined the controlling members and managers were the board structures and board practices, dividend policies, market forces, and the high level of standardization of governance structures.[35]

The rest of this chapter is organized as follows. The next part provides brief statistical information about LLCs and describes their origins. Then the chapter proceeds to describing the search and coding strategy, and the background data. Part IV presents the results of the analysis of the LLC agreements. Parts V and VI look to non-legal factors that affect the governance of publicly traded LLCs, such as ownership structure, board composition and board practices, dividend policies, market discipline, and the standardization of governance structures. It is argued that these factors can substitute or complement contractual mechanisms of protecting the rights of outside investors.

II. STATISTICAL DATA ON LLCS

Currently, LLCs are one of the most popular business forms in the United States.[36] In new business formations, LLCs and different types of partnerships outnumber corporations in many U.S. states.[37] Starting from 1993—the first year that the Internal Revenue Service of the U.S. Department of the Treasury ("IRS") provided data about partnership tax

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[32]*See infra* Part III of this Chapter.

[33]*See infra* Part IV of this Chapter.

[34]*See infra* Part V of this Chapter.

[35]*See infra* Part VI of this Chapter.

[36]Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–60 (2010).

[37]*See id.* at 460 (noting that in 2007, new Delaware LLCs outnumbered new Delaware corporations three to one); Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J.L. & ECON. 741 app. A (2012).

filings by LLCs and their members—the number of LLCs has been rising at a remarkable pace.[38]

Figure 1–I demonstrates the percentage changes in the numbers of several business forms in the United States since 2001—the starting year is considered as a basis.[39] During an eleven-year period, the number of LLCs more than tripled. In the same period, the number of LPs rose marginally, while the share of general partnerships ("GPs") dropped by approximately 30%. The number of corporations increased; but compared to LLCs this increase was not significant. The only other business form that could compete with the success of LLCs was the limited liability partnership ("LLP"). Yet, one should consider that the IRS only started to provide data on LLPs in 1998.[40] Hence, the low basis from which LLPs started could bias the results in favor of this business form. In contrast, 808,692 LLCs filed tax returns with the IRS in 2001.[41] This number is higher than the number of active GPs at that time, and is more than twice the number of the then-active LPs.[42] If the starting date in Figure 1–I had been 1996—the fourth year following the introduction of LLCs in the IRS data—then the number of LLCs would have increased more than 1,350%. Interestingly, the LLC is the only U.S. business form which continued to rise in number even in 2008 and 2009, when the number of all other business forms decreased, affected by the financial crisis and the following recession.[43]

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[38]*See* INTERNAL REVENUE SERVICE, SOI TAX STATS—PARTNERSHIP STATISTICS BY SECTOR OR INDUSTRY, *archived at* http://perma.cc/P7V4-NWAB (last visited July 25, 2015) (providing data from 1993); Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 36–37 (2004) ("[By 2003,] [i]n almost all the states, the percentage of businesses choosing the LLC form increased from the prior year.").

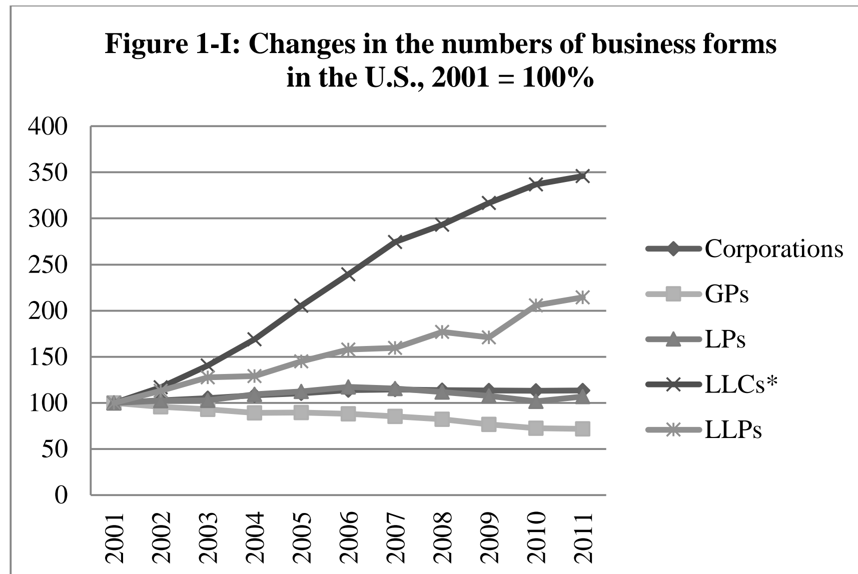
[39]*See infra* Figure 1–I. The data used in the calculations are available from the IRS Business Tax Statistics documents. *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, PARTNERSHIP RETURNS, 2011 (2013) [hereinafter PARTNERSHIP RETURNS], *archived at* http://perma.cc/Z65Q-M9KH; INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, CORPORATE INCOME TAX RETURNS, TAX YEAR 2011 [hereinafter CORPORATE INCOME TAX RETURNS], *archived at* http://perma.cc/R6PR-A2K9 (last visited July 25, 2015).

[40]Alan Zempel, *Partnership Returns, 1996*, STATISTICS OF INCOME BULLETIN, Fall 1998, at 49; *see also* Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice*, 50 ALA. L. REV. 813, 815–17 (1999) (explaining that LLPs rose to great prominence in the 1990s as states passed laws authorizing their formation and general partners sought to protect themselves from their partners' losses in the aftermath of the savings and loan financial crisis).

[41]*See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME, INTEGRATED BUSINESS DATA 1980-2008, *archived at* http://perma.cc/RNS8-JZYL (last visited July 25, 2015).

[42]*See* INTERNAL REVENUE SERVICE, *supra* note 41; *see also* Chrisman, *supra* note 36, at 462 ("[T]here is no other alternative entity on the horizon that shows the promise or potential to unseat the LLC . . . .").

[43]*See infra* Figure 1–I.



Source: U.S. Internal Revenue Service, the author's own calculations.
Notes: GP = general partnership; LP = limited partnership; LLC = limited liability company; LLP = limited liability partnership.
* LLCs taxed as a C corporation or S corporation are not included in the data.

Nowadays, LLCs along with partnerships constitute almost half of all tax-reporting business entities.[44] Indeed, recent data on the number of different business forms in the U.S. corporate landscape, based on the tax filings of business entities and their members with the IRS, demonstrate that corporations have been giving away part of their share of the corporate landscape to other business forms.[45]

The ratio of corporations to LLCs in 2011 was 1.80.[46] Almost 57% of all active business forms in 2011 were corporations and one-third were formed as LLCs.[47] The share of the remaining business forms, mainly GPs and LPs, did not exceed 11.5%.[48] Figure 1–II also shows

[44]*See infra* Figure 1–II.

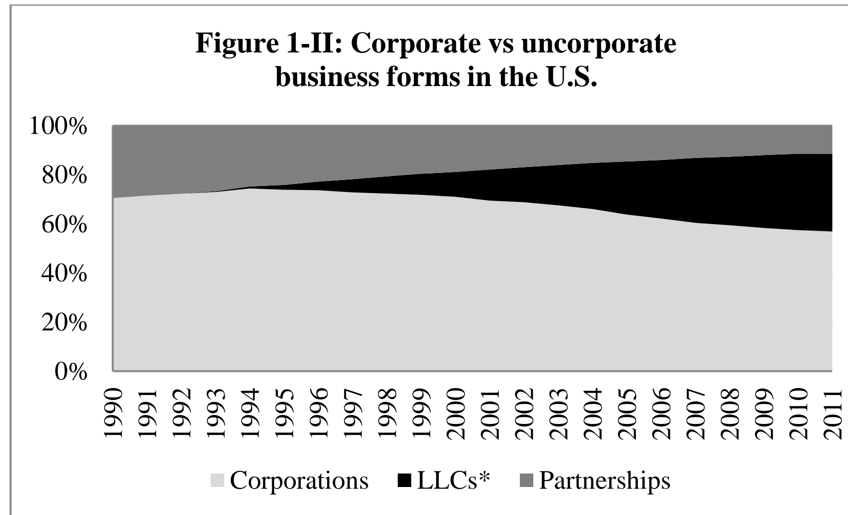
[45]*See infra* Figure 1–II.

[46]There were roughly 3.3 million tax returns filed by partnerships and 5.8 million tax returns filed by corporations in 2011. *Compare* Ron DeCarlo et al., *Partnership Returns, 2011*, STATISTICS OF INCOME BULLETIN, Fall 2013, at 83 fig.C, *archived at* http://perma.cc/XE9W-5VRD, *with* CORPORATE INCOME TAX RETURNS, *supra* note 38.

[47]*See infra* Figure 1–II.

[48]The data on partnerships include domestic GPs, domestic LPs, domestic LLPs, foreign partnerships, and other partnerships. *See* DeCarlo et al., *supra* note 46, at 85–87. Foreign partnerships must file tax returns in the United States if they have gross income effectively connected with the conduct of a trade or business within the United States or have gross income derived from sources in the United States. *Id.* at 91–92. The IRS classifies other partnerships as those that checked the "other" box in Form 1065, Schedule B, line 1, Type of Entity, or did not check a box. *Id.* at 86. Potentially this category may also include LLCs, meaning that the share of LLCs in Figure 1–II could be understated. *See id.* at 87. "In some cases, LLCs file as sole proprietorships on individual income tax returns or as corporations on

that the rise of LLCs came not only at the expense of corporations, but also of partnerships.[49] The share of GPs was declining before the LLC had become a popular business tool among entrepreneurs—if initially the rise in the number of corporations compensated this decline, later the LLC took up a significant share previously occupied by GPs.[50] Prior to 2002, GPs were the most common type of "uncorporations."[51] However, they have ranked second since that time.[52]



Source: U.S. Internal Revenue Service.
Notes: LLC = limited liability company.
* Data on single-member LLCs taxed as sole proprietorships are added starting from 2001. LLCs taxed as a C corporation or S corporation are not included in the data.

It is remarkable that LLCs have achieved this statistic in a period that is significantly shorter than the periods during which corporations and partnerships have existed. As recently as the early 1990s, not all states had even passed LLC statutes.[53]

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corporate income tax returns." *Id.* at 94. "LLC data reported on [corporate income tax] returns [are] not included in the IRS data," which further understates the real number of LLCs. *Id.*

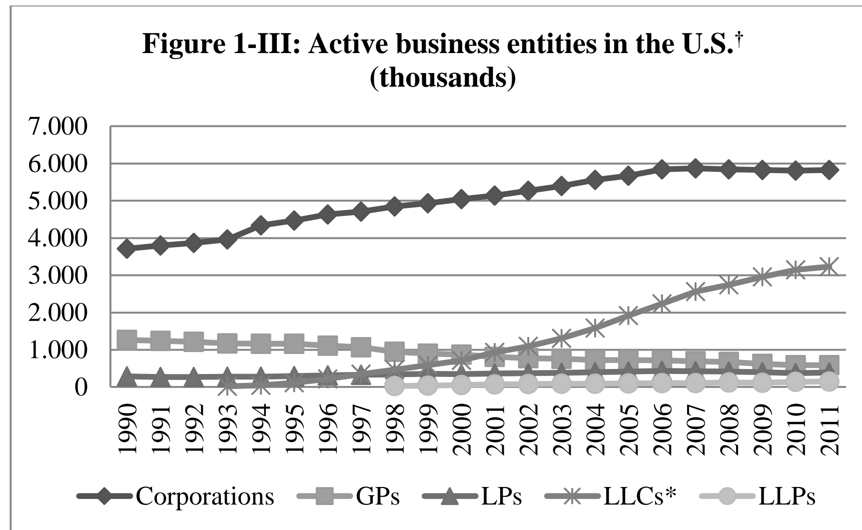
[49] *See infra* Figure 1–II. The number of GPs formed each year cannot be ascertained exactly because no filing is required. Chrisman, *supra* note 36, at 461. However, because all advantages of general partnerships can be achieved by using LLCs, it has been suggested that currently, most GPs arise from unlawyered transactions where entrepreneurs start business together informally. *See id.*; Friedman, *supra* note 38, at 59.

[50] *See infra* Figure 1–II.

[51] *See infra* Figure 1–II; *see also* Friedman, *supra* note 38, at 49 ("The once-elaborately drafted partnership agreement has gone the way of the buggy whip and slide rule.").

[52] *See infra* Figure 1–III.

[53] Friedman, *supra* note 38, at 45–46 (noting that after an IRS ruling allowed LLCs to be taxed as partnerships and Colorado enacted its LLC statute in 1990 all states followed in order to attract business and revenue to their state).



Source: U.S. Internal Revenue Service.
Notes: Number of business entities is in thousands. The numbers are rounded up to zero decimal places. GP = general partnership; LP = limited partnership; LLC = limited liability company; LLP = limited liability partnership.
† All business forms that filed tax forms with the IRS are considered as active, regardless of incurring profits or losses in the result of their activities.
* Includes single-member LLCs. Data on single-member LLCs taxed as sole proprietorships are added starting from 2001. LLCs taxed as C corporations or S corporations are not included in the data.

The process of enacting LLC statutes by all U.S. states, strongly influenced by regulatory competition, was quick.[54] The 1988 IRS ruling, according to which all Wyoming LLCs that lacked two out of the four main corporate characteristics—continuity of life, centralization of management, limited liability, and free transferability of interests—were eligible for partnership tax treatment, served as a catalyst for the development of the LLC legislation.[55] What followed was a surge in the number of state LLC statutes, resembling a race between the states.[56] It started in Colorado in 1990 and ended in Hawaii in 1997.[57] By the beginning of April 1997, all 50 states and the District of Columbia had enacted state LLC statutes.[58] The number of active LLCs in the United States by the end of 1997 was about 350,000.[59] This was a sharp contrast

[54] *See* Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1475 (1998) ("From 1992 through 1996, LLC legislation swept across the country."); Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, but Heading Where?*, 45 SYRACUSE L. REV. 1193, 1193–99 & n.1 (1995) (discussing the adoption of LLC statutes in the context of regulatory competition).

[55] *See* Rev. Rul. 88–76, 1988–2 C.B. 360; Hamill, *supra* note 54, at 1469–70, 1478.

[56] *See* Hamill, *supra* note 54, at 1475–78.

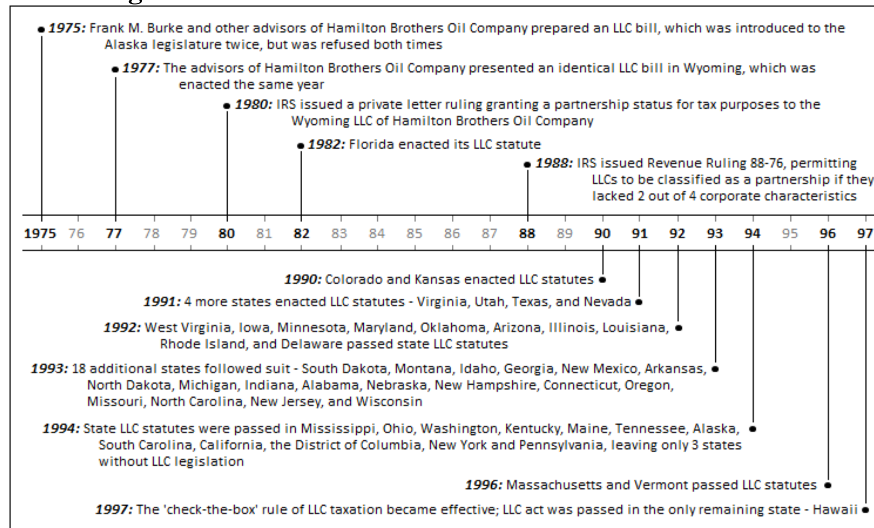
[57] *See id.* at 1470 & n.43, 1477 & n.75.

[58] *See id.* at 1476–77 & nn.74–75.

[59] *See supra* Figure 1–III.

to the earlier data on LLCs reported by Carol Goforth—one year after the enactment of the Florida LLC statute in 1982, only two LLCs had been formed in Florida; as of February 22, 1988, there were only 26 Wyoming LLCs.[60] The timeline in Figure 1–IV displays the chronology of the development of the state LLC legislation.

Figure 1–IV: The LLC Movement in the United States



Source: The author's own research.

III. DATA

A. Sources of Data and Search Strategy

The database of LLC agreements was created by using the operating agreements of LLCs filed with the SEC.[61] The full text search tool of the SEC's Electronic Data Gathering, Analysis, and Retrieval database ("EDGAR") provides access to the electronic texts of the documents filed with the SEC during the past four years.[62] The search was conducted in the annual reports—form 10–K—of all filing entities submitted to the SEC during 2012—search start date: January 1, 2012, search end date: December 31, 2012. Because state LLC statutes employ different terminology for referring to the operating agreements of

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[60]*See* Goforth, *supra* note 54, at 1202 n.50.

[61]*See, e.g.*, Nexeo Solutions Holdings, LLC, Third Amendment to Amended and Restated Limited Liability Company Agreement (Aug. 31, 2012), *archived at* http://perma.cc/DKJ2-FTGM.

[62]*Full-Text Search*, SEC. & EXCH. COMM'N, https://searchwww.sec.gov/EDGARFSClient/jsp/EDGAR_MainAccess.jsp (last visited Dec. 8, 2014).

LLCs,[63] a number of separate searches were conducted using different groups of keywords: (1) "LLC agreement," (2) "limited liability company agreement," and (3) "company operating agreement." The aim of conducting three separate searches using the LLC agreement names used in different states was to avoid creating a biased database populated with LLC agreements of companies formed in any particular state.

The searches yielded a total of 1,380 documents—mostly10–K annual reports.[64] This author identified references to LLC agreements in these documents and located the texts of the agreements in company filings.[65] An LLC agreement can be filed as an exhibit to the annual report of a company,[66] or it can be incorporated by reference to exhibits of previous filings—annual or quarterly reports (forms 10–K and 10–Q), current reports (form 8–K), or securities registration statements (forms S–1, S–4, and S–11).[67] In this way the LLC agreements of twenty publicly traded U.S. LLCs were identified. The LLC agreement of a publicly traded company formed in the Marshall Islands was not included in the sample. The last LLC IPO—data updated in November 2013—took place in October 2012.

The filings of the sample companies with the SEC were used to obtain other data. The ownership information was obtained from the prospectuses, annual reports, and definitive proxy statements of the companies.[68] The annual reports and definitive proxy statements were also the source of information on the board composition and practices and on profit distribution practices.[69] In addition to the LLC agreements and other data described above, where necessary, other company agreements, such as management agreements, exchange agreements, and shareholders agreements, were studied.

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[63]The Delaware Limited Liability Company Act uses the term "limited liability company agreement." DEL. CODE ANN. tit. 6, § 18–101(7) (2013). The drafters of the Revised Prototype Limited Liability Company Act decided to use this term as well. REV. PROTOTYPE LTD. LIAB. CO. ACT § 102(14) (2011). Unlike these two acts, the Revised Uniform Limited Liability Company Act uses the term "operating agreement." REV. UNIF. LTD. LIAB. CO. ACT § 102(13) (2006). Indeed, in practice an LLC agreement can take other names as well. For instance, LLC agreements can be named "company agreement" or "company by-laws." *See* Kennebrew v. Harris, 425 S.W.3d 588, 592 (Tex. App. 2014) (referencing "Company Agreement"); Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, from Sure Bet to Long Shot:* Gallinger v. North Star Hospital Mutual Assurance, Ltd., 22 J. CORP. L. 131, 143 (1996) (referencing "Company Bylaws").

[64]Original Research (on file with the author).

[65]*See, e.g.*, Nexeo Holdings Solutions, LLC, Annual Report 88 (Form 10–K) (Sept. 30, 2012); Nexeo, *supra* note 61.

[66]*See, e.g.*, Nexeo, *supra* note 61, at 129.

[67]*See, e.g.*, *id.*

[68]*See, e.g.*, Macquarie Infrastructure Company LLC, Annual Report (Form 10–K) (Feb. 19, 2014).

[69]*See, e.g.*, *id.* at 113, 165.

B. Research Design and Coding

One of the main differences between LLCs and corporate-type business forms is the enhanced role of enabling rules in regulating the internal governance matters of the company and the relations between members.[70] This feature allows LLC members to choose different governance structures and enhances the role of LLC agreements.[71] In many cases, the latter contain detailed regulations of relations between managers and members and between different groups of members.[72] The contractual freedom of LLC governance provides ample room for studying different privately chosen governance mechanisms, establishing whether there is a demand for this freedom in practice, and comparing the real-life contractual governance structures with the predictions of the financial contracting theories.[73] The coding criteria were defined based on: (1) the background information, (2) information about the ownership of voting and equity rights, and (3) the main differences of the legal regime of LLCs as opposed to corporate statutes. Within these three areas, eighty-four primary questions were identified.[74] This author read all twenty sample LLC agreements and coded all variables (except background information) as either zero (a negative answer) or one (a positive answer).

The research design of this study is outlined by the basic assumption that contractual techniques employed in LLC agreements should be assessed, keeping in mind the larger picture that stipulated the choice of one clause over the other. Publicly traded LLCs operate in an institutional environment where many factors interact with each other.[75] LLC agreements and their particular provisions are only a small number of elements that need to be examined in this system.[76] In particular, earlier research supports the argument that ownership structure acts as a substitute for contractual arrangements.[77] Following this assumption, one of the distinctive characteristics of this study is the consideration of a large number of corporate governance techniques that can act as a

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[70]*See* Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 390–91 (1992) (discussing the various governance mechanisms available to LLCs and their freedom to choose from among them).

[71]*See id.*

[72]*See, e.g.*, *id.* at 390 (discussing the functioning of LLC agreements and possible pitfalls of failing to understand particular provisions).

[73]*See* Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1610-14 (2004) (emphasizing contractual freedom as an important feature of LLC laws and examining contractual freedom to eliminate fiduciary duties in Delaware LLCs and the judicial response as of 2004).

[74]*See infra* Appendix 1–I (listing questions).

[75]*See infra* notes 406–409 and accompanying text.

[76]*See infra* notes 394–406 and accompanying text.

[77]*See, e.g.*, Ciccotello & Muscarella, *supra* note 31, at 15–19.

substitute for legal protection rules such as ownership structure, management incentives, reputation building, board composition and practices, profit distribution practices, and others.[78] Nevertheless, this study does not claim to cover all possible elements affecting LLC governance. The second innovation in the research design was the grouping of the sample companies based on their industry division or specialization. For example, publicly traded LLCs that were the managing partners of private equity and hedge funds tended to use different ownership structures than oil and gas LLCs.

As mentioned above, the total number of LLCs in the database is twenty.[79] All sample LLCs were formed in one state—Delaware.[80] This characteristic of the data eliminates the possible influence of state statutory differences on contractual choices that parties had made. On the other hand, the governance structures of publicly traded LLCs, indeed, are highly affected by the listing regulations of the national exchanges (*e.g.*, the requirement of having a board of directors).[81] But in many cases these LLCs qualify for exemptions from some of these requirements and, therefore, use different governance structures than a typical listed corporation is expected to use.[82] Usual exemptions are related to the role of independent directors, dual-class ownership structures, board committees, and the obligation to convene annual member meetings.[83]

Since the study focused on a specific group of LLCs—publicly traded LLCs—any extrapolation of the results of the study to all LLCs (including those used by small businesses) should be approached very carefully. Tax filings of LLC members with the IRS (excluding LLCs that elected corporate taxation) show that the average number of LLC members in 2011, including publicly traded LLCs, was only 3.04.[84] The mean of the average members in the period from 2001 to 2011 was 3.22.[85] Therefore, most LLCs have only a few members who face

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[78]*See infra* Appendix 1–I.

[79]*See infra* note 88 and accompanying text.

[80]*See infra* note 93 and accompanying text.

[81]Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1151–52 (2007) (discussing the role of exchange listing standards on corporate governance).

[82]*See infra* notes 399, 406–409 and accompanying text.

[83]*See, e.g.*, NYSE LISTED CO. MANUAL § 303A.00 (2009) (exempting companies of which more than 50% of voting power is held by an individual, group, or another company from the requirements in §§ 303A.01, 303A.04, or 303A.05).

[84]*See* DeCarlo et al., *supra* note 46, at 184; Adrian Dungan, *Sole Proprietorship Returns, 2011*, STATISTICS OF INCOME BULLETIN, Summer 2013, at 33, *archived at* http://perma.cc/J2EX-RQ73.

[85]Dungan, *supra* note 84, at 33; Tim Wheeler & Maureen Parsons, *Partnership Returns, 2002*, STATISTICS OF INCOME BULLETIN, Fall 2004, at 56–57; Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2004*, STATISTICS OF INCOME BULLETIN, Fall 2006, at 190–91; Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2006*, STATISTICS OF INCOME

completely different conflicts of interest than the controlling and minority members of publicly traded LLCs. Moreover, at least one-third of all LLCs have one member,[86] and in these cases LLC agreements contain only very basic information about the name, term, and location of the LLC or, perhaps, are not even written. The governance structure of publicly traded LLCs has more similarities with the governance structure of listed LPs.[87]

C. Descriptive Summary of the Background Information

As of September 2013, there were twenty publicly traded LLCs in the United States.[88] The sample LLCs represented three industrial groups. More than half of the LLCs operated in the oil and gas sector, including transportation and retail operations (Macquarie Infrastructure Company LLC, which was included in this group, was also famous for operating airport infrastructure such as parking).[89] The next group was composed of the managing companies of private equity and hedge funds and one relatively smaller investment company.[90] In this group, the listed companies were the managers of the funds, rather than the funds themselves; the principal sources of their income was: (1) management fees based upon a percentage of the committed or invested capital, (2) transaction and advisory fees received from private equity portfolio companies for consultations, (3) income based on the performance of the funds, and (4) investment income from direct investments.[91] The third group consisted of companies investing in mortgage securities.[92]

BULLETIN, Fall 2008, at 215–16; Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2008*, STATISTICS OF INCOME BULLETIN, Fall 2010, at 167–68; Nina Shumofsky et al., *Partnership Returns, 2010*, STATISTICS OF INCOME BULLETIN, Fall 2012, at 167–68; DeCarlo et al., *supra* note 46, at 184.

[86]There were 1,125,132 nonfarm sole proprietorships in 2011 that filed taxes as registered LLCs. Dungan, *supra* note 84, at 33. This is out of 3,236,191 total LLCs. *See id.*; DeCarlo et al., *supra* note 46, at 184.

[87]*Cf.* Manesh, *supra* note 15, at 559 (discussing the similarities in governance structure between larger LPs and LLCs).

[88]*See infra* Table 1–I. Seadrill Partners LLC was organized according to the laws of the Marshall Islands and was headquartered in London, and, hence, was not included in the data. BLOOMBERG LAW, COMPANY REPORT SEADRILL PARTNERS LLC (2015). At the end of September 2012, the shares of W.P. Carey & Co. LLC were delisted and cancelled and the common stock of its successor (W.P. Carey Inc., a Maryland corporation) was listed. BLOOMBERG LAW, COMPANY REPORT W.P. CAREY INC. (2015); *W.P. Carey Announces Shareholder Approval of REIT Conversion*, BLOOMBERG LAW, Sept. 14, 2012. Thus, at the end of 2013 there were nineteen listed U.S. LLCs.

[89]*See infra* Table 1–I.

[90]*See infra* Table 1–I.

[91]*See, e.g.*, Apollo Global Mgmt., LLC, Annual Report 230-33 (Form 10–K) (Mar. 1, 2013).

[92]*See infra* Table 1–I.

All LLCs in the database were formed in Delaware, though none of them had a principal place of business in Delaware.[93] Owing to the large number of oil and gas companies in the sample, Texas was the most common state where the headquarters of the listed LLCs were located (nine companies).[94] It was followed by New York (five LLCs); California, and Connecticut (two companies each).[95] The remaining two LLCs were headquartered in Maryland and Ohio.[96] The largest number of IPOs of LLCs took place in 2006 and 2007 (four and five, respectively).[97] The second largest concentration of LLC IPOs was during the last few years—five listings in the period from 2010 to 2012.[98] Partnership taxation was elected by fourteen sample LLCs, and six LLCs, all oil and gas companies, elected corporate taxation.[99] Table 1-I lists all publicly traded LLCs and presents data on their distribution according to the industry division, the date of listing, and the election of taxation.

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[93]*See* EDGAR Search Results for Apollo Global Mgmt., LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Compass Grp. Diversified Holdings LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Constellation Energy Partners LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Copano Energy, L.L.C., Sec. & Exch. Comm'n (2014); EDGAR Search Results for Ellington Fin. LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Enbridge Energy Mgmt., L.L.C., Sec. & Exch. Comm'n (2014); EDGAR Search Results for Fortress Inv. Grp. LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Kinder Morgan Mgmt, LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for KKR Fin. Holdings LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Linn Energy, LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for LinnCo, LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Macquarie Infrastructure Co. LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for MMA Capital Mgmt. LLC (formerly Municipal Mortgage & Equity, LLC), Sec. & Exch. Comm'n (2014); EDGAR Search Results for Niska Gas Storage Partners LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for NuStar GP Holdings, LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Oaktree Capital Grp., LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Och-Ziff Capital Mgmt. Grp. LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Travelcenters of Am. LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for Vanguard Natural Res., LLC, Sec. & Exch. Comm'n (2014); EDGAR Search Results for W.P. Carey, Inc. (Formerly W.P. Carey & Co. LLC), Sec. & Exch. Comm'n (2014).

[94]The nine LLCs headquartered in Texas are Constellation Energy Partners LLC; Copano Energy, L.L.C.; Enbridge Energy Mgmt., L.L.C.; Kinder Morgan Mgmt., LLC; Linn Energy, LLC; LinnCo, LLC; NuStar GP Holdings, LLC; Travelcenters of Am. LLC; and Vanguard Natural Res., LLC.

[95]The five LLCs headquartered in New York are Apollo Global Mgmt. LLC; Fortress Inv. Grp. LLC; Och-Ziff Capital Mgmt. Grp., LLC; Macquarie Infrastructure Co. LLC; and W.P. Carey & Co. LLC. The two LLCs headquartered in California are KKR Fin. Holdings LLC and Oaktree Capital Grp., LLC. The two LLCs headquartered in Connecticut are Compass Grp. Diversified Holdings LLC and Ellington Fin. LLC.

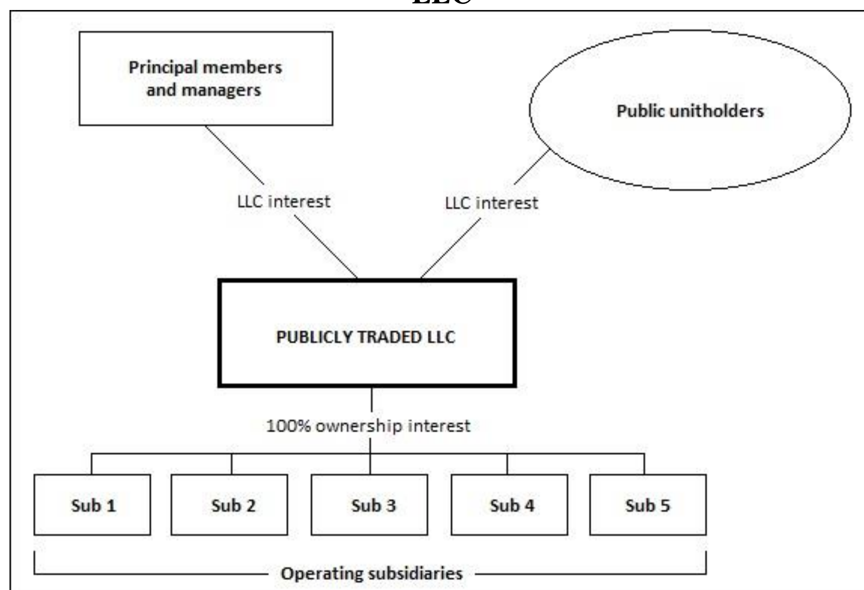
[96]The two other LLCs are MMA Capital Management, LLC and Niska Gas Storage Partners LLC.

[97]WILMERHALE, 2013 MID-YEAR IPO REPORT 2 (2013), *archived at* https://perma.cc/EZQ3-4CAX.

[98]*See id*.

[99]*See infra* Table 1–I.

Figure 1–V: Simplified ownership structure of a publicly traded LLC



Source: The author's own research.

Where available, the data show that publicly traded LLCs had a large number of members and were thus completely different from an average LLC that had just 3.22 members.[100] The approximate number of members in publicly traded LLCs ranged from a minimum of 2,000 to a maximum of 98,000. Twelve of the LLCs on the date of listing and nine LLCs in 2012 had a large member (group of affiliated members) controlling at least 20% of the voting rights.[101] This ownership structure, in which controlling members coexist with a large number of minority members, obviously makes publicly traded LLCs different from the rest, especially regarding the perspective of conflicts of interest arising during corporate governance.[102] The typical simplified (omitting intermediary holding companies) ownership structure of a publicly traded LLC is presented in Figure 1–V.

[100]*See infra* Table 1–I; *see also supra* text accompanying note 85.

[101]*See infra* Table 1–I.

[102]*See Delaware Court Refuses to Dismiss Breach of Fiduciary Duty Claims Against Controlling Unitholder of LLC*, CORPORATE GOVERNANCE GROUP CLIENT ALERT (Milbank, Tweed, Hadley & McCloy, LLP, New York, N.Y.), Dec. 22, 2010, at 4, *archived at* http://perma.cc/5ZK2-4B8Y ("'[C]ontrolling members in a manager-managed LLC owe minority members the traditional fiduciary duties that controlling shareholders owe minority shareholders' in the corporate context.") (quoting *In re* Atlas Energy Res., LLC, 2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823 (2011)).

IV. CONTRACTUAL RIGHTS

The sample LLCs actively used the default provisions of the Delaware LLC Act to design various governance structures.[103] In many ways these structures differed from the traditional governance models of listed corporations.[104] After describing the main provisions of the operating agreements of the publicly traded LLCs, this section goes on to find whether the waivers of the traditional investor protection rights were accompanied by offering substitute contractual protections to minority members.[105] The main idea is that to attract outside investors, along with tailoring the governance of publicly traded LLCs to the needs of their founders and managers, these companies should offer some additional legal protection to outside investors.[106]

Board entrenchment and the use of control-enhancing mechanisms were common practices in publicly traded LLCs.[107] In 40% of the LLCs, the operating agreements contained provisions that effectively entitled the founding members to appoint the majority or all of the members of the board of directors.[108] More than half of the companies also limited the right to remove directors and officers by employing different techniques, such as allowing removal only for cause, requiring the approval of certain members, or supermajority voting.[109] In 30% of the companies, dual class interests separated voting rights from economic interests.[110] Dual class membership interests were not the only means available for enhancing control in listed LLCs.[111]

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[103] *See* DEL. CODE ANN. tit. 6, § 18–402–07 (2013).

[104] *See* Martin Lipton & Paul K. Rowe, *The Inconvenient Truth About Corporate Governance: Some Thoughts on Vice-Chancellor Strine's Essay*, 33 J. CORP. L. 63, 64 (2007):

> The key elements of the existing corporate governance order have been (1) centralized professional management; (2) supervision of management by knowledgeable, largely independent groups of directors who help set long-term policy and deal with extraordinary events; (3) a federal regulatory system largely limited to disclosure and punishment for outright fraud; (4) a body of state law that recognizes the critical importance of the business judgment rule and therefore limits judicial intervention to egregious cases; and (5) a role for shareholders that is generally restricted to votes on rare events like mergers and proxy contests.

[105] *See infra* text accompanying notes 182–217.

[106] *See* Manesh, *supra* note 15, at 578–83 (discussing substitutes for fiduciary duties in the governance structures of alternative entities).

[107] *See infra* Table 1–I.

[108] *See infra* Table 1–I. Apollo Global Mgmt., LLC, Oaktree Capital Grp., LLC and Och-Ziff Capital Mgmt. Grp., LLC tied the appointment rights of the founding members with a particular threshold of the founding members' minimum voting rights. In the first two LLCs it was only 10%, while in the latter the threshold was 50%. Original Research (on file with author).

[109] *See infra* Appendix 1–I.

[110] *See infra* Table 1–I.

[111] *See infra* Table 1–I.

The detailed analysis of the ownership structures demonstrates that another mechanism was the pooling of membership interests.[112] In several cases, the founders of the company brought together their membership interests in one holding company.[113] In this situation, the founders were the beneficial owners of the membership interests in a listed LLC, but the immediate holder was an intermediate legal entity that combined the interests of several founders and voted as a single large member. This mechanism resembles that of the voting trust mechanism where the settlors of the trust transfer their interests to the trust and the trustee votes the interests according to the trust agreement.[114] Similarly, at the level of an intermediate holding entity, the beneficial owners of a public LLC can enter into an agreement guiding the voting by the holding entity. At least four LLCs included in the sample (20%) used intermediate holding structures to enhance the control and rights of the founding members and managers.[115]

Shareholder agreements among the large members of publicly traded LLCs were also used as a control-enhancing mechanism. The sample contains three companies, all from the finance sector, where the principal members entered into shareholders agreements with the aim of enhancing their voting rights.[116] These agreements provided for: (1) special approval rights (including the appointment of officers) as long as the principals held more than 40% of the total voting power (two companies), (2) special board representation rights (all three), and (3) transfer restrictions (all three), as a rule, during a certain period after the IPO.[117] Shareholders agreements were used only where a group of members held a large membership interest. In general, unlike U.S. listed corporations,[118] shareholders agreements seem to be practiced in publicly traded LLCs.

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[112]*See infra* Table 1–I.

[113]*See infra* Table 1–I.

[114]*See* 18 AM. JUR. 2D *Corporations* § 956 (2007) ("[A] voting trust is an agreement between stockholders on one side and a trustee on the other whereby rights to vote the stock are transferred to and vested in the trustee.").

[115]The four LLCs are Niska Gas Storage Partners LLC, Apollo Global Mgmt., LLC, Oaktree Capital Grp., LLC, and Ellington Fin. LLC. *See infra* Table 1–I.

[116]Apollo Global Mgmt., LLC, Shareholders Agreement (Form S–1/A Ex. 10.10) (July 13, 2007); Fortress Inv. Grp. LLC, Shareholders Agreement (Form S–1/A Ex. 4.2) (Dec. 31, 2013); Och-Ziff Capital Mgmt. Grp. LLC, Class B Shareholders Agreement (Form 10–K Ex. 4.2) (Dec. 31, 2013).

[117]*See* Och-Ziff Capital Mgmt. Grp. LLC, *supra* note 116, §§ 3.1–5.1; Fortress Inv. Grp. LLC, *supra* note 116, at §§ 2.1–4.1; Apollo Global Mgmt., LLC, *supra* note 116, §§ 2.1–3.2.

[118]*See* Steven N. Bulloch, *Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue?*, 59 TEMP. L.Q. 61, 62 (1986); Marco Ventoruzzo, *Why Shareholders' Agreements are not Used in U.S. Listed Corporations: A Conundrum in Search of an Explanation* 3 (Pa. State Univ. Dickinson Sch. of Law, Bocconi Legal Studies Research Paper No. 42–2013, 2013), *archived at* http://perma.cc/GVG9-V76B (noting that there is a strong belief among business law scholars and corporate law attorneys (probably wrong) that the use of shareholders' agreements is not common in listed corporations in the United States).

Table 1–I
Publicly traded LLCs, September 2013

LLC name	Stock exchange	Listing date	Election of taxation	Number of members	Share of the largest member, listing date, %*	Share of the mgmt.., listing date, %*	Share of the largest member, 2012, %*	Share of the mgmt.., 2012, %*
Panel A: Oil and gas exploration and production; pipelines and other midstream operations (including retail marketing)								
Constellation Energy Partners LLC	NYSE Amex	Nov 2006	Corporation	4,460	60[†, ‡]	0	26.4[†]	6.1
Copano Energy, L.L.C.	NASDAQ	Nov 2004	Partnership	n/a	19.71	21.36	14.07	2.49
Enbridge Energy Management, L.L.C.	NYSE	Oct 2002	Corporation	9,000	100 (10)[†]	<1	100 (16.8)[†]	<1
Kinder Morgan Management, LLC	NYSE	May 2001	Corporation	97,550	100 (10)[†, ‡]	0	100 (14.27)[†, ‡]	<1
Linn Energy, LLC	NASDAQ	Jan 2006	Partnership	n/a	39.2	56.7	<1	1.95
LinnCo, LLC	NASDAQ	Oct 2012	Corporation	n/a	<1[†]	0	<1[†]	0
Macquarie Infrastructure Company LLC	NYSE	Dec 2004	Corporation	18,500	7.8	8.1	9.7	10.3
Niska Gas Storage Partners LLC	NYSE	May 2010	Partnership	n/a	74.1[†]	0	74.1[†]	<1
NuStar GP Holdings, LLC	NYSE	Jul 2006	Partnership	n/a	59.4	0	17.74	18.85
Travelcenters of America LLC	NYSE Amex	Jul 2007	Corporation	19,900	8.2[‡]	<1	8.8[‡]	7.6
Vanguard Natural Resources, LLC	NYSE	Oct 2007	Partnership	n/a	29	3.7	1.3	1.3
Panel B: Investment and financial management								
Apollo Global Management, LLC	NYSE	Mar 2011	Partnership	n/a	80.7 (0)[†, ††]	80.7 (4)[†, ††]	78.4 (0)[†, ††]	78.4 (≈3)[†, ††]
Compass Group Diversified Holdings LLC	NYSE	May 2006	Partnership	> 20,000	28.67	1.49	16.4	1.9
Fortress Investment Group LLC	NYSE	Feb 2007	Partnership	n/a	77.7 (0)[‡‡]	77.7 (0)[‡‡]	59.5 (3.2)[‡‡]	59.5 (3.2)[‡‡]
Oaktree Capital Group, LLC	NYSE	Apr 2012	Partnership	n/a	97 (0.01)[†, †††]	97 (0.01) [†, †††]	97 (0.01) [†, †††]	97 (0.01) [†, †††]
Och-Ziff Capital Management Group LLC	NYSE	Nov 2007	Partnership	n/a	79.1 (0)[†, ‡‡‡]	79.1 (0)[†, ‡‡‡]	66.6 (1)[†, ‡‡‡]	66.7 (1.4)[†, ‡‡‡]

Table 1–I (*continued*)

LLC name	Stock exchange	Listing date	Election of taxation	Number of members	Share of the largest member, listing date, %*	Share of the mgmt.., listing date, %*	Share of the largest member, 2012, %*	Share of the mgmt.., 2012, %*
Panel C: Real estate—mortgage securities								
Ellington Financial LLC	NYSE	Oct 2010	Partnership	n/a	17.7‡	17.7	18.8‡	16.7
KKR Financial Holdings LLC	NYSE	Aug 2007	Partnership	n/a	9.8‡	5.3	15‡	1
Municipal Mortgage & Equity, LLC	OTC	Jul 1998	Partnership	1,955	6.33	8.54	2.56	12.85
W.P. Carey & Co. LLC	NYSE	Jan 1998	Partnership	39,893	2.79	2.90	28.93	32.07
		Average**		*26,407.25*	*44.91*	*23.11*	*36.87*	*20.89*

* For the purposes of defining the largest members/managers affiliated entities were considered as one member. The percentages of the holdings are based on the voting rights; the economic interests, if different, are indicated in the parentheses. The sources of data are the securities registration statements (Forms S-1, S-4, S-11), annual reports (Form 10-K) and proxy statements (Form 14A DEF) of the LLCs filed with the SEC and available through the SEC's EDGAR database. For the last two columns the percentages of the shares of the largest members and managers were defined based on the documents filed in 2012.

** For average calculations membership interests indicated as below 1% were equaled to 1; the numbers were rounded up to the hundredth decimal place.

† The member had special rights of appointing managers or the majority of the board members of the LLC (including the right to elect the board fully).

‡ The LLC agreement placed voting caps or maximum ownership restrictions on the beneficial ownership of the interests.

†† The group of the largest members (three managers) owned 58.9% effective economic interest in the operating subsidiaries at the date of the IPO.

‡‡ The largest member (a group of managers) separately owned 77.7% and approximately 60% economic interest in the operating subsidiaries in 2007 and 2012 respectively.

††† The largest member (a group of managers) separately owned 78% economic interest in the operating subsidiaries.

‡‡‡ The largest member separately owned 80.8% economic interest in 2007 and 68.1% economic interest in 2012 in the operating subsidiaries.

In total, 65% of the listed LLCs, by employing director appointment rights, dual-class interests, holding structures, and shareholders agreements, had strong management control rights. However, only 35% in 2012 had a large member with a voting share above 50% and just one LLC had a large member holding a majority economic interest.[119]

The founders of an LLC are free to make it more partnership-like by bestowing upon members day-to-day management tasks and responsibilities and agreeing to dissolve the LLC upon the withdrawal of members, or make it more corporate-like with centralized management structure and unlimited existence.[120] Notwithstanding this freedom, all publicly traded LLCs opted for the centralized management by the board of directors.[121] The LLCs also tended to apply the rules of the Delaware General Corporation Law ("DGCL") to divide the powers between the board and the member meetings, and between the board and the company officers.[122] In one case, the centralized management was vested in the founding member who then delegated the day-to-day decision making to the board and officers appointed by the board.[123] Accordingly, in publicly traded LLCs, the members did not have actual nor apparent authority to bind the company.[124] Similarly, although the board was a centralized management body, separate board members could not bind the company, as only officers were endowed with this power.[125]

All publicly traded LLCs opted out from the default rule of the Delaware LLC Act, which restricts interest transfers,[126] to allow free transferability of LLC interests.[127] Preemptive rights in cases of new equity issuances and share transfer restrictions were not common.[128] However, in three publicly traded LLCs, which capped a maximum ownership share in order to maintain preferential real estate investment trust ("REIT") taxation,[129] transfer restrictions were used to prevent

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[119]*See supra* Table 1–I; *infra* Appendix 1–I.

[120]*See* Carol R. Goforth, *Continuing Obstacles to Freedom of Choice for Management Structure in LLCs*, 1 J. SMALL & EMERGING BUS. L. 165, 173 (1997).

[121]*See infra* Appendix 1–I.

[122]*See infra* Appendix 1–I.

[123]*See infra* Appendix 1–I. Niska Gas Storage Partners LLC adopted this member management style.

[124]*See* Goforth, *supra* note 120, at 173 ("Manager management exists where management authority, both actual and apparent, is vested in designated managers.").

[125]*See*, *e.g.*, Apollo Global Mgmt., LLC, Annual Report 249-50 (Form 10–K) (Dec. 31, 2013), ("[O]ur board of directors will have no authority other than that which our manager chooses to delegate to it.").

[126]*See* DEL. CODE ANN. tit. 6, § 18–702(a) (2013).

[127]*See infra* Appendix 1–I.

[128]*See infra* Appendix 1–I. For the only company that had a centralized member-managed structure, only the managing member had a preemptive right. *See* Niska Gas Storage Partners LLC, Annual Report 27 (Form 10–K) (May 30, 2014).

[129]KKR Fin. Holdings LLC, Municipal Mortgage & Equity, LLC, and W.P. Carey & Co. LLC all have single-member ownership values under 10% to prevent an aggregate ownership of more than 50% by five individuals. *See supra* Table 1–I; *see also* I.R.C. §§

purchases above the maximum ownership limit, and two other companies used approval clauses for change-of-control transactions.[130]

Save for the three special cases discussed in detail below,[131] all publicly traded LLCs could engage in any lawful activity.[132] All companies had perpetual existence and were not subject to dissolution upon the death, retirement, or resignation of their members or any other special events.[133] None of the LLCs provided their members with resignation or appraisal rights in the events of opposing important corporate matters, such as LLC agreement amendment, mergers, consolidations, and capital decrease.[134] Publicly traded LLCs, similarly to Delaware corporations,[135] tended to allow dissolution by the affirmative vote of the majority of the members and the approval of the board of directors.[136] Only six LLCs could dissolve by member vote without obtaining the approval of the board.[137] The voting threshold in the latter case, however, was usually higher than a simple majority.[138]

None of the LLCs waived the judicial dissolution rule of the Delaware LLC Act,[139] according to which courts can dissolve an LLC if it is not reasonably practicable to carry on its business in conformity with the LLC agreement.[140] At the same time, none of them expanded it, which means that the judicial dissolution of publicly traded LLCs based on minority member oppression grounds, similar to Delaware corporations, was not possible.[141] The practice of the Delaware courts

856(a)(5)–(6), 857(a)(1) (providing that REITs are generally exempt from taxation at the trust level as long as they distribute at least 90% of their income to their unit holders, and that a company is classified as a REIT for tax purposes if it has more than 100 beneficial members); I.R.C. § 856(h)(1)(A) (providing that REITs must not be "closely held" with more than 50% value of its interest owned by more than five individuals as established in I.R.C. § 542(a)(2)). Typically, REITs tend to be more value than growth oriented. ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS § 16.7 (4th ed. 2006) ("[A modern REIT] usually functions as a conservative manager of completed income-producing properties.").

[130]Original Research (on file with author).

[131]*See infra* Part V of this Chapter.

[132]*See infra* Appendix 1–I.

[133]*See infra* Appendix 1–I.

[134]*See infra* Appendix 1–I.

[135]*See* DEL. CODE ANN. tit. 8, § 275(a)–(c) (2011).

[136]*See infra* Appendix 1–I.

[137]Original research (on file with author).

[138]*See infra* Appendix 1–I.

[139]*See infra* Appendix 1–I.

[140]*See* DEL. CODE ANN. tit. 6, § 18–802 (2013).

[141]*See infra* Appendix 1–I; *see also* Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1101 (1999) ("In 1993, in *Nixon v. Blackwell*, the Delaware Supreme Court considered '[w]hether there should be any special, judicially-created rules to "protect" minority shareholders of closely held Delaware corporations.' The court emphatically declined to create any such special rules.").

makes judicial dissolution of listed LLCs a very limited remedy.[142] Bearing in mind the broad definition of the purpose of publicly traded LLCs in the operating agreements, it is rather difficult to prove that it is no longer reasonably practicable for an LLC to operate in accordance with its broad purpose clause.[143] The second ground for judicial dissolution applied by the Delaware courts—deadlock in decision making—is not likely to be applied to listed LLCs due to their ownership structure.[144]

Delaware law differs significantly with regard to the legal formalities that corporations and LLCs must meet.[145] Legal formalities have much narrower scope in LLCs.[146] However, the operating agreements of listed LLCs contained many procedural rules, thus, making listed LLCs similar to their corporate peers.[147] In particular, almost all LLCs had strong procedural rules for the member and board meetings: minimum quorum requirement (100%), voting threshold rules (100%), notice period (90%),and record date for the member meetings (100%).[148] The LLC agreements of publicly traded LLCs allowed board action without a meeting, but they diverged with regard to the minimum-consent requirement. In 80% of the companies, such action was possible only by the unanimous consent, in one case by a super-majority vote, and in the remaining three cases by a simple majority.[149] Action without a

[142]*See* Huatuco v. Satellite Healthcare, 2013 WL 6460898, at *5 (Del. Ch. Dec. 9, 2013), *aff'd*, 93 A.3d 654 (Del. 2014) (showing the reluctance of Delaware courts to consider a right to judicial dissolution as a "default right" that cannot be waived by a contract).

[143]*See In re* Seneca Invs. LLC, 970 A.2d 259, 263 (Del. Ch. 2008) ("The role of this Court in ordering dissolution under § 18-802 is limited, and the Court of Chancery will not attempt to police violations of operating agreements by dissolving LLCs."); Wiggs v. Summit Midstream Partners, LLC, 2013 WL 1286180, at *13 (Del. Ch. Mar. 28, 2013) (holding, in light of a broad company purpose clause, that plaintiff failed to plead how it was no longer practicable for management to operate in accordance with the LLC agreement). *But see In re* Silver Leaf, L.L.C., 2005 WL 2045641, at *10–11 (Del. Ch. Aug. 18, 2005), *reprinted in* 31 DEL. J. CORP. L. 326 (2006) (looking to the actual purpose of the LLC based on past activities).

[144]*See* Phillips v. Hove, 2011 WL 4404034, at *26 (Del. Ch. Sep. 22, 2011); *Silver Leaf*, 2005 WL 2045641, at *11 (addressing situation where the vote of the members is deadlocked and the operating agreement provides no means around the deadlock); Haley v. Talcott, 864 A.2d 86, 95, 97-98 (Del. Ch. 2004) (holding that given deadlock between the parties and the absence of a reasonable exit mechanism in the LLC agreement, it was not reasonably practicable for the LLC to continue to carry on business in conformity with the LLC agreement).

[145]*Compare* DEL. CODE ANN. tit. 8, §§ 101-398 (2011) (establishing formalities that Delaware corporations must observe) *with* DEL. CODE ANN. tit. 6, §§ 18–101 to –1109 (2013) (establishing formalities that Delaware LLCs must observe).

[146]*See* Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 864 (2008) ("[E]ach of the mandatory terms of the DGCL identified above[—stockholders' right to elect directors, to inspect books and records, and the directors' duty of loyalty—]is absent from the LLC Act . . . .").

[147]*See infra* Appendix 1–I.

[148]*See infra* Appendix 1–I.

[149]*See infra* Appendix 1–I.

meeting by the members was less common.[150] Such action was not possible in six LLCs and in three LLCs unanimous consent of all members was required.[151] Those eleven LLCs where the members were entitled to act by written approval by a majority of members were mostly controlled by a large member.[152] All LLCs provided their members with broad information rights, though in three cases the extent of the disclosure had to be defined by the board.[153] LLC members also agreed about detailed rules for amending LLC agreements.[154] Only members were entitled to vote, though in most cases the prior board approval was necessary.[155]

The companies diverged significantly in annual member meetings and board elections. A mandatory requirement on holding an annual member meeting was absent in LLCs with a large controlling member.[156] Annual board election was not necessary in three LLCs.[157] In six LLCs, operating agreements provided for staggered three-year term boards.[158] Thus, only 55% of the boards of publicly traded LLCs had one-year terms.[159] This is lower than a similar measure at the S&P 500 boards, but is similar to the situation at the boards of the S&P SmallCap 600 and S&P MidCap 400 companies.[160] If one admits that the change in board formation rules that occurred in large listed corporations during the last decade was driven by investor pressure, then, perhaps, investor expectations with regard to governance standards in listed LLCs are more moderate.

The Delaware LLC Act contains flexible rules on LLC capital structure and capital contributions.[161] Yet, almost all publicly traded LLCs allowed member admission only on the basis of purchasing an LLC interest.[162] However, more than half of the sample LLCs had

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[150] *See infra* Appendix 1–I.
[151] *See infra* Appendix 1–I.
[152] *See infra* Appendix 1–I.
[153] *See infra* Appendix 1–I.
[154] *See infra* Appendix 1–I.
[155] *See infra* Appendix 1–I.
[156] *See infra* Appendix 1–I.
[157] *See infra* Appendix 1–I.
[158] *See infra* Appendix 1–I.
[159] *See infra* Appendix 1–I.
[160] *See* SPENCER STUART, SPENCER STUART BOARD INDEX 2014 15 (2014), *archived at* https://perma.cc/CBB6-UWH4 (reporting that 93% of the S&P 500 companies had annually elected boards in 2014); EQUILAR, S&P 1500 BOARD PROFILE: COMPOSITION & RECRUITING TRENDS (PART 3) 9 (2013), *archived at* http://perma.cc/R2XE-ZGNE (reporting that in 2012, the share of staggered boards was 17.8%, 44.8%, and about 46% in the S&P 500, mid-cap and small-cap companies, respectively).
[161] *See* DEL. CODE ANN. tit. 6, § 18–501 (2013); *see also* Michael D. Goldman & Eileen M. Filliben, *Corporate Governance: Current Trends and Likely Developments for the Twenty-First Century*, 25 DEL. J. CORP. L. 683, 708 (2000) ("LLCs also have significant non-tax advantages, including: flexible management choices, liberal member qualification requirements, and flexible capital structures.").
[162] *See infra* Appendix 1–I.

different classes of members (twelve out of the twenty).[163] In addition, some LLCs issued special classes of LLC interests that allowed member admission without contribution.[164] This was particularly popular among the finance LLCs, where the founding members and managers held controlling voting rights without making contributions to the capital of their respective companies.[165] In the majority of the LLCs (thirteen companies), the issuance of additional securities was the sole prerogative of the board of directors.[166] In seven other LLCs, members had limited issuance approval rights—in the case of the issuance of a new class of interests or for the definition of the maximum authorized number of LLC interests.[167] None of the classes of LLC interests was sidelined from voting on matters that affected the rights of the holders of such interests or created additional obligations for them.[168]

Less than half of the LLCs, all from oil and gas sector, had specific target distribution obligations included in the LLC agreements.[169] However, in most cases (six out of the nine), these provisions had very broad language and provided large discretion to the boards of directors in defining the share of the profits that should be distributed to the members.[170] In the remaining cases, the LLCs did not promise any distributions and left the question to the discretion of the board of directors.[171]

Finally, publicly traded LLCs used the default rules of the Delaware LLC Act to waive or restrict the fiduciary duties of the members and managers, or to limit or eliminate any and all liabilities for the breach of these duties.[172] The freedom to contract out of fiduciary duties is considered one of the principal advantages of a Delaware LLC as opposed to a corporation.[173] Delaware LLCs allow their members to (1) expand, restrict partially, or waive in full the fiduciary duties of members or managers (with the exemption of the implied contractual covenant of good faith and fair dealing),[174] or (2) limit or eliminate liability for breach of fiduciary duties and contractual obligations (with

[163] *See infra* Appendix 1–I.
[164] *See infra* Appendix 1–I.
[165] *See infra* Appendix 1–I. Namely, Ellington Fin. LLC, Och-Ziff Capital Mgmt. Grp. LLC, Oaktree Capital Grp., LLC, Fortress Inv. Grp. LLC, and Apollo Global Mgmt., LLC.
[166] *See infra* Appendix 1–I.
[167] *See infra* Appendix 1–I.
[168] *See infra* Appendix 1–I.
[169] *See infra* Appendix 1–I.
[170] *See infra* Appendix 1–I.
[171] *See infra* Appendix 1–I.
[172] *See infra* Appendix 1–I.
[173] Paul M. Altman et al., *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, BUS. L. TODAY, Feb. 2013, at 1–2.
[174] DEL. CODE ANN. tit. 6, § 18–1101(c) (2013).

the exception of acts violating the implied contractual covenant of good faith and fair dealing).[175]

The usual practice of publicly traded LLCs was not to waive or restrict any of the fiduciary duties of the members.[176] The only exception was the duty to avoid competition with the company itself.[177] Competition by members or managers with the company can include not only engaging in competing businesses, but also using private information obtained from the company to enter into individual contracts surpassing the company.[178] The agreements of the sample LLCs typically banned the latter but allowed investments and engagement in other competitive activities not related to the use of confidential information.[179] Such competition, including direct competition with the LLC, was allowed in 70% of the companies.[180] The LLC agreements also did not limit liability of members for breaching fiduciary duties. Only two firms had exculpation clauses for members which, however,

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[175]*Id.* § 18–1101(e).

[176]*See infra* Appendix 1–I (illustrating that, although fourteen LLCs restricted fiduciary duties of LLC members, those same LLCs also carved out the majority of duties from the restrictions). In six LLCs, however, the operating agreements contained special provisions resolving conflicts of interests between the controlling and all other minority members. *See* Ellington Fin. LLC, Second Amended and Restated Operating Agreement § 6.22 (Form S–11/A Ex. 3.1) (July 1, 2009); Fortress Inv. Grp. LLC, Fourth Amended and Restated Limited Liability Agreement § 5.20(a) (Form 10-Q Ex. 3.3) (Aug. 10, 2009); Niska Gas Storage Partners LLC, First Amended and Restated Operating Agreement § 7.11(a) (Form 8–K Ex. 3.1) (May 17, 2010); NuStar GP Holdings, LLC, Second Amended and Restated Limited Liability Company Agreement § 7.9(a) (Form 8–K Ex. 3.01) (July 19, 2006) (known as "Valero GP Holdings, LLC" in 2006); Oaktree Capital Grp., LLC, Third Amended and Restated Operating Agreement § 6.17(a) (Form S–1/A Ex. 3.2) (Aug. 31, 2011); Och-Ziff Capital Mgmt. Grp. LLC, Second Amended and Restated Limited Liability Company Agreement § 5.20(a) (Form 10–K Ex. 3.2) (Nov. 13, 2007). In light of the Delaware Court of Chancery's judgment in *In re Atlas Energy Resources, LLC*, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823 (2011), these conflict of interest rules are very likely to be interpreted as substituting the fiduciary duties of controlling members owed to minority members. Only one of these companies adopted its operating agreement after the Delaware Court of Chancery's judgment in *Atlas Energy*. Oaktree Capital Grp. LLC, *supra* (agreement dated Aug. 31, 2011). However, in all six companies the LLC agreements were entered into after the judgment of the Delaware Court of Chancery interpreting a similar provision of the partnership agreement of a listed LP. *See* Brickell Partners v. Wise, 794 A.2d 1, 4 (Del. Ch. 2001).

[177]*See infra* Appendix 1–I.

[178]*See* J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 8:7 (2014) ("[The] duty of loyalty includes . . . the duty *not to usurp LLC opportunities* for his or her personal benefit, and a duty *not to compete* with the LLC.") (emphasis in original).

[179]*See, e.g.*, Constellation Energy Partners LLC, Second Amended and Restated Operating Agreement § 7.5(a) (Form 8–K Ex. 3.1) (Nov. 28, 2006) ("It shall be deemed not to be a breach of any duty . . . of . . . any Manager . . . to engage in outside business interests and activities in preference to or to the exclusion of the Company or in direct competition with the Company; *provided* such Affiliate does not engage in such business or activity as a result of or using confidential or proprietary information . . . .").

[180]*See infra* Appendix 1–I.

did not cover duty of loyalty, actions in bad faith, and actions with the knowing violation of criminal law.[181]

The waivers and restrictions of the fiduciary duties of the managers were not common either.[182] Only three LLCs waived the duties completely and one more LLC waived all fiduciary duties except duties of care and loyalty.[183] However, the operating agreements of all sample LLCs included exculpation provisions for managers.[184] Only in one case was exculpation full, while the remaining LLC agreements carved out one or more duties from the exculpation provision, meaning that in the absence of other provisions clearly eliminating fiduciary duties, the managers were not protected and were liable for the breach of these carved-out duties.[185] In four LLCs, the exculpation clauses were applicable only to the directors or board members and only to the extent allowed by the DGCL; they did not apply to the officers, who were fully liable for the breach of their duties.[186] Hence, the sample LLCs did not

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[181]*See infra* Appendix 1–I.

[182]*See infra* Appendix 1–I.

[183]*See infra* Appendix 1–I; Oaktree Capital Grp., *supra* note 184, § 6.20(a).

[184]*See infra* Appendix 1–I.

[185]*See* Fortress Inv. Grp., *supra* note 176, § 5.19(a) (full exculpation). The position of the Delaware Court of Chancery is that exculpation carve-outs are not intended to establish any duties or assume their existence; rather they serve only the aim of limiting the liability. *See* Dawson v. Pittco Capital Partners, L.P., 2012 WL 1564805, at *28 (Del. Ch. Apr. 30, 2012); Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *9 (Del. Ch. May 7, 2008). In other words, if an operating agreement waives fiduciary duties, then the effect of an exculpatory provision and its carve-outs is that if in a case any fiduciary duty is ever found in any agreement of the members, then the fiduciaries are not liable except in the cases mentioned in the carve-outs. *See Dawson*, 2012 WL 1564805, at *28. Hence, if there are no duties, then any carve-outs are irrelevant. *See id.* The situation is different where duties are not modified—in addition to injunctive or other equitable relief, a breach of fiduciary duties can be remedied by potential monetary damages. *See* Manesh, *supra* note 15, at 569 (suggesting that to take advantage of these remedy options, the operating agreement must first include specific provisions expressing the adoption of the fiduciary duties). In the latter case, the carve-outs define the extent of availability of damages. *See id.* at 570 ("[A] fiduciary exculpation provision prevents unitholders from seeking monetary damages after the fact for harm caused by a manager's breach."). If a duty is carved out in full (for instance, the duty of loyalty), then damages are available for any breach of the duty. *See id.* at 577 (managers are only liable for breaches of duties explicitly carved out). But it is also possible to carve out a chunk of a duty and limit the liability of fiduciaries to specific cases of breaching the duty requiring a higher standard of proof. *See id.* ("Provided a manager's actions do not fit into [a] heightened categor[y] of culpable conduct, the manager will not be liable for any actions, even if such actions otherwise breach the manager's default fiduciary duties or express contractual duties."). For example, carving out only willful misconduct implies that fiduciaries are liable for self-dealing transactions that they entered with intent to harm the protected parties; but the mere fact that self-dealing caused damages is not sufficient to hold a fiduciary liable. *See, e.g.*, Venhill LP v. Hillman, 2008 WL 2270488, at *23 (Del. Ch. June 3, 2008), *reprinted in* 33 DEL. J. CORP. L. 982 (2008) (requiring bad faith, gross negligence, or some other form of culpable conduct that had been carved out in the exculpation provision in order to recover damages based on an "unfair, self-dealing transaction").

[186]*See infra* Appendix 1–I. The fiduciary duties in Delaware corporations are mandatory and cannot be eliminated or restricted by contract. *See* Manesh, *supra* note 15, at 557. However, the liability for breach of the fiduciary duties of directors (not officers)—excluding the duty of loyalty, acts not in good faith or involving intentional misconduct, or a

fully use the freedom of contract provided by the Delaware LLC Act to limit the liability of fiduciaries.[187]

Duty of care was the only fiduciary duty that was never carved out explicitly, but two companies excluded gross negligence—the standard for evaluating the breach of the duty of care by Delaware courts[188]—from the scope of the exculpation provisions.[189] Duty of loyalty was carved out in nine cases.[190] Apart from excluding duty of loyalty itself from exculpation clauses, the sample LLCs also carved out other standards for evaluating breaches of the duty of loyalty by fiduciaries.[191] In particular, actions in bad faith[192] were carved out from the exculpation clauses in fifteen cases, and duties not to engage in fraud or willful misconduct[193] in thirteen and twelve cases, respectively.[194] Exculpation carve-outs, considered together with non-modified fiduciary duties in many companies, imply that the directors and officers of the sample LLCs in the majority of the cases discharged their functions under some fiduciary duties protected by potential monetary-damage claims.

In addition to serving as standards for evaluating breaches of traditional fiduciary duties, exculpation carve-outs can cover contractually created substitutes of these duties, for example, special approval rules for large or related party transactions. The significance of ensuring the compliance with contractually created duties is obvious given the role LLC agreements play in the governance of listed LLCs.[195] The limitation of liability for breaching the contractual substitutes of traditional fiduciary duties places outside investors in a risky position where fiduciaries are liable neither for the breach of duties established by

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knowing violation of law—can be eliminated or limited by including an express indication in the certificate of incorporation of a corporation. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

[187]*Cf.* Manesh, *supra* note 15, at 560 ("Delaware alternative entity law has long allowed firms to contractually limit or even eliminate the fiduciary duties of managers through the terms of the firm's operating agreement.").

[188]*See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining gross negligence as the standard of care applicable to the business judgment rule), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000); Albert v. Alex. Brown Mgmt. Servs., Inc., 2005 WL 2130607, at *8 (Del. Ch. Aug. 26, 2005), *reprinted in* 31 DEL. J. CORP. L. 267 (2006).

[189]*See infra* Appendix 1–I.

[190]*See infra* Appendix 1–I.

[191]*See infra* Appendix 1–I.

[192]*See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[T]he requirement to act in good faith 'is a subsidiary element[,]' i.e., a condition, 'of the fundamental duty of loyalty.'") (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)); *Guttman*, 823 A.2d at 506 n.34 ("A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.").

[193]*See* Feeley v. NHAOCG, LLC, 62 A.3d 649, 664 (Del. Ch. 2012) ("Willful misconduct is one standard for evaluating whether a fiduciary breached the duty of loyalty by acting in bad faith."); Dawson v. Pittco Capital Partners, L.P., 2012 WL 1564805, at *28 n.303 (Del. Ch. Apr. 30, 2012).

[194]*See infra* Appendix 1–I.

[195]*See supra* notes 146–155 and accompanying text.

law, nor for their contractual equivalents.[196] At least seven companies expressly did not limit the liability of officers for breaching the provisions of the operating agreements.[197] Many others, although covering breaches of contract by exculpatory provisions, had carve-outs that probably can be invoked to hold managers liable for breaching the operating agreements.[198] For example, bad faith behavior may be shown where a director or officer fails to act in the face of a known duty to act;[199] willful misconduct occurs where a director or officer knows that she is committing a breach of duty or knowingly acts outside the scope of her authority intending to harm a protected party.[200] However, where a fiduciary believes that her action does not violate any contractual provision and it is an action about which reasonable minds may disagree as to whether it breaches the agreement, then willful misconduct cannot be established.[201]

Additionally, where the carve-outs from the exculpation provisions were limited, in exchange for contracting around the fiduciary duties of the members and managers, the majority of the LLC agreements in the sample contained conflict of interest rules for members and managers.[202] These conflict of interest rules allow self-dealing but establish standards of fair price (terms of the transaction shall be substantially equivalent to the terms of a comparable unaffiliated transaction) and fair dealing (certain procedures for approval).[203] Under these standards, the manager or member can either bear the burden "to perform a reliable market check

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[196]*See* Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295, 316–17 (2014) ("Fiduciary duties provide constraints that may help investors deter, rein in, or root out dishonest, irresponsible, or excessively careless management . . . . Eliminating business laws that help deter or combat dishonest and extremely careless management could result in increased fraud, theft, safety violations, injuries, etc.").

[197]*See infra* Appendix 1–I.

[198]*See infra* Appendix 1–I.

[199]*See* Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006) (citing *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 n.111 (Del. 2006)).

[200]*See* Dawson v. Pittco Capital Partners, L.P., 2012 WL 1564805, at *37 (Del. Ch. Apr. 30, 2012):

> [W]hen intentional misconduct or bad faith is the standard at issue, and not the general, broader loyalty standard, some showing of the requisite mental state is necessary for the defendant to be liable; mere participation in a self-dealing, unfair transaction is not enough, without a showing of the requisite mental state. . . . [I]t will often be "useful" for the Court to apply an entire fairness analysis in such a case, but it is not the test by which liability is established under an intentional misconduct standard.

In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 290 (Del. Ch. 2003) (quoting DEL. CODE ANN. tit. 8, § 102(b)(7)(ii)) ("Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either 'not in good faith' or 'involve intentional misconduct.'").

[201]*See Disney*, 825 A.2d at 290 (explaining when willful misconduct can be established).

[202]*See infra* Table 1–II.

[203]*See, e.g.*, Manesh, *supra* note 15, at 585–86.

or valuation analysis *ex ante* or bear the risk of any uncertainty that exists *ex post*."[204] Such rules create a contractual fiduciary duty of entire fairness that is a substitute for the traditional duty of loyalty.[205] However, as noted earlier in the literature, the wording of these contractual fiduciary standards shifts the burden of proof and puts it on outside investors, rather than on fiduciaries.[206] Nevertheless, these provisions were not less protective for outside investors than functionally similar provisions in listed corporations.[207] In the latter case, the compliance with statutory safe harbor provisions of special procedural rules and fairness standards also complicates fiduciary liability for the breach of the duties, because the transaction either becomes subject to review under the business judgment rule or the burden shifts to the plaintiffs to prove unfairness.[208]

The relations between several important contractual provisions and the ownership aspects of the publicly traded LLCs are presented in Table 1–II.[209] Significant positive correlation suggests that provisions tended to appear together. Two important results of the correlation analysis are: (1) in cases where some investor protection rights were waived, the operating agreements included substitute rights, and (2) the LLCs had ownership structures that mitigated the conflicts created by the waived rights.

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[204]Gotham Partners v. Hallwood Realty Partners, 795 A.2d 1, 27 (Del. Ch. 2001).

[205]*See* Gotham Partners v. Hallwood Partners, 817 A.2d 160, 171 (Del. 2002).

[206]*See* Manesh, *supra* note 15, at 587 (citing Blackstone Grp. L.P., Amended & Restated Agreement of Limited Partnership § 7.9(a) (Form 8–K Ex. 3.2) (June 27, 2007)). Yet, it is not obvious that putting the burden of proof on plaintiffs in this case is bad for the firm, as such a provision may deter speculative litigation by incentivizing members to bring fiduciary duty claims before the courts only if the likelihood of proving the breach is high.

[207]*See, e.g.*, *id.* ("Sections 7.05 and 7.10(a) 'operate together as a contractual statement of the traditional entire fairness standard [of fair price and fair dealing], with § 7.05 reflecting the substantive aspect of that standard and § 7.10 reflecting the procedural aspect of that standard.'") (citing *Gotham Partners*, 795 A.2d at 26).

[208]*See* Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663, 688-89; J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443, 1462 (2014).

[209]*See infra* Table 1–II.

Table 1–II

Correlation of the governance aspects of the publicly traded LLCs

The table shows whether the pairs of the provisions of the LLC agreements of the publicly traded LLCs and other aspects of their governance structures are positively correlated (likely to appear together), negatively correlated (likely that one appears without the other) or are not correlated. The calculations are based on phi coefficient of correlation for 2x2 tables of categorical variables of each pair. φ values range from 0 (no relation between the pairs) to 1 (perfect positive relation) or −1 (perfect negative relation). One asterisk indicates significance at the 10% level, two asterisks at the 5% level and three asterisks at the 1% level.

	Sell-out rights	Purpose limitations	Dissolution by member vote (not unanimous)	Waiver or exculpation of managers' self-dealing duty	Conflict of interest rules for managers	Debt limits	Specific target distribution	Right to call member meetings (min. 10%)	Right to make business and director nominations (min. 10%)	More than 30% economic interest[†, ‡]	More than 5% management interest or IDRs[†]
Strong control of management	0.245	0.308	0.015	0.179	– 0.105	0.308	– 0.179	– 0.105	0.319	0.424*	0.257
Sell-out rights		0.793***	0.793***	– 0.369*	0.167	0.793***	0.369*	– 0.111	– 0.245	– 0.192	– 0.408*
Purpose limitations			0.608***	– 0.183	0.210	1.000***	0.464**	– 0.140	– 0.308	– 0.243	– 0.514**
Dissolution by member vote (not unanimous)				– 0.183	0.210	0.608***	0.183	0.327	– 0.015	– 0.243	– 0.229
Waiver or exculpation of managers' self-dealing duty					0.302	– 0.183	0.010	0.302	– 0.032	0.522**	0.492**
Conflict of interest rules for managers						0.210	0.201	0.167	– 0.157	0.000	0.102
Debt limits							0.464**	– 0.140	– 0.308	– 0.243	– 0.514**
Specific target distribution								– 0.302	– 0.664***	– 0.290	– 0.492**
Right to call member meetings (min. 10%)									0.454**	– 0.192	0.272
Right to make business and director nominations (min. 10%)										0.061	0.385*
More than 30% economic interest[†, ‡]											0.471**

[†] Ownership data are for 2012 and are obtained from the annual reports (Form 10–K) and proxy statements (Form 14A DEF) of the LLCs filed with the SEC. IDRs are management incentive distribution rights. For details on IDRs *see infra* notes 247–49 and accompanying text.

[‡] For the calculation of the economic interest of the largest members in the publicly traded LLCs the adjusted data for private equity and hedge fund managing companies were taken into account (for the details see *infra* Part V of this Chapter).

In particular, strong control of management had a positive association with the ownership of a large economic interest in the company.[210] The larger the economic share of the largest member in the company is, the more likely it is that management decisions are made in the interests of the company.[211] The waiver or exculpation of the duty to avoid self-dealing was positively correlated with the existence of a large economic member and the management ownership of membership interests.[212] The main implication of this positive correlation is that the waiver and exculpation provisions were not likely to create strong agency problems, because the managers had strong incentives to increase shareholder value—in order to increase the price of their shareholdings and avoid removal by the decision of a large member.[213]

Table 1-II also shows strong positive association between such provisions as the company purpose limitation clauses, minority sell-out rights, specific target distribution obligations, and a right of the members to dissolve the company by majority vote without prior board approval.[214] All these four provisions are strong minority rights.[215] In addition, they tended to be used in the absence of membership interest ownership by managers.[216] As is shown below, these minority protection mechanisms are likely to be used as counterbalancing mechanisms in those listed LLCs where the governance structures create some potential minority risks.[217]

To conclude, the operating agreements of publicly traded LLCs often altered investor protection mechanisms typically used in listed corporations. In some instances, the operating agreements included contractual substitutes that ensured results equivalent to investor protections available in the corporate law setting. In a few cases, the substitute mechanisms were absent. However, contractual safeguards for outside investors were not the only means of protecting their rights and interests. The correlation analysis shows that ownership structure might have played some role as well. The next section discusses this factor in more detail.

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[210] *See supra* Table 1–II.

[211] *See In re* Oracle Corp., 867 A.2d 904, 930 (Del. Ch. 2004) ("[A]s Ross Perot would say, 'skin in the game' will tend to align their interests with those of the public stockholders.").

[212] *See supra* Table 1–II.

[213] *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 208 (2009) (suggesting the interests of the managers of LLCs are aligned with those of the businesses).

[214] *See supra* Table 1–II.

[215] *See* Sandra K. Miller, *Discounts and Buyouts in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce*, 13 U. PA. J. BUS. L. 607, 613 (2011) (listing rights affecting control).

[216] *See supra* Table 1–II.

[217] *See infra* Part V of this Chapter.

V. THE OWNERSHIP STRUCTURE OF PUBLICLY TRADED LLCS

Ownership structure can be important from the perspective of the protection of the rights and interests of minority investors by aligning the interests of insiders and outsiders and by creating unique relations that can explain the choices of contractual investor rights.[218] This section starts with the alignment argument and then proceeds to the description of several cases that demonstrate that the study of LLC agreements in publicly traded LLCs, detached from their unique ownership structures, may lead to incorrect conclusions with regard to the level of investor protection.

Given the possibility of modifying the enabling rules of the Delaware LLC statute to expropriate minority members,[219] the scholarly literature emphasizes the special role of the ownership structures of companies in aligning the interests of different groups of members.[220] In particular, Ribstein argued that the managers of an LLC are also the owners of the firm and thus bear the same risks as other outside investors.[221] This argument is in line with the predictions of the financial contracting theories where one of the important remedies for agency problems, in the classic principal-agent models, is granting shareholdings to managers.[222] This aligns the interests of managers with those of other shareholders and thus makes less probable actions of managers aimed at obtaining private benefits.[223] Similarly, even if managers do not hold significant membership interests, the presence of a large controlling member can be a guarantee for minority members that the managers will take actions in the interests of members.[224] Unlike cases where voting rights are held by numerous small members, concentrated control rights make action less costly.[225] Large investors have more incentives to monitor LLC managers, and perhaps more importantly, can appoint and remove them.[226] The downside of concentrated ownership and management holdings is that large members alone, or by combining their holdings with the units of managers, can expropriate minority members.[227]

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[218] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305, 308–09 (1976).

[219] *See* Miller, *A New Direction*, *supra* note 25, at 397–98.

[220] *See, e.g.*, RIBSTEIN, *supra* note 213, at 4–5.

[221] *See id*. at 208.

[222] *See* Jensen & Meckling, *supra* note 218, at 312 ("If a wholly owned firm is managed by the owner, he will make operating decisions which maximize his utility.").

[223] *See id.* at 316–17.

[224] *Cf. id*. at 348–49 (finding the reassurance minority shareholders enjoy from mangers having all of their wealth invested in the firm removes the risk of agency problems arising).

[225] *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006).

[226] *See id*.

[227] *See id*.

Table 1–I shows that at the date of listing not all publicly traded LLCs had significant management holdings.[228] In half of the companies, managers either did not have membership interests at all or their holdings did not exceed 5%. However, with the exception of a few cases where the membership interests of the management were small, most LLCs had a controlling member with more than 20% of votes. In 2012, a larger number of LLCs had insignificant management ownership (45%), and in more cases these small management holdings were not accompanied by the presence of a large controlling member (holding more than 20% of votes). Moreover, in half of the LLCs, the share of the largest member decreased over time along with the increasing share of LLC units held by outside investors. The average ownership of the largest member was 44.9% at the date of IPO and 36.9% in 2012. On both dates, the average ownership concentration level was high enough to conclude that public LLCs had a concentrated ownership structure.[229] A direct implication of this is the prevalence of conflicts between controlling and minority members, rather than manager versus member conflicts. In addition, these patterns also suggest that publicly traded LLCs have more concentrated ownership at the date of listing and increase the free float of shares representing LLC interests gradually—probably along with developing their reputation among public investors.[230]

Although listed LLCs gradually increased the share of free float at the expense of their largest members, a reverse trend can be observed for management holdings—in about half of the LLCs, the share of the management membership interests was higher in 2012 than at the date of listing.[231] This increase may correspond with the use of insider purchases and the option plans to incentivize management and align their interests with the interests of other unitholders.[232] A quote from a *Wall Street Journal* article is illustrative of the message that such ownership can send to outside investors according to a general belief among the public and investors:

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[228]*See supra* Table 1–I.

[229]A study of U.S. public corporations found that most of these corporations had blockholders and were not much different from public corporations elsewhere. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1405 (2009). The average ownership of the largest shareholder was 26%. *Id.* at 1384. However, unlike here, the reported data on listed corporations included only the firms that had a blockholder. *Id.* at 1382.

[230]Reputation based theories of financial contracting show that controlling shareholders and managers can implicitly commit not to expropriate minority investors and signal the market about their commitments in order to get higher share valuations and improved prospects for firm financing. *See* Armando Gomes, *Going Public Without Governance: Managerial Reputation Effects*, 55 J. FIN. 615, 629 (2000). The main prediction of these models is that firm insiders sell equity gradually as they develop reputation. *Id.* at 630.

[231]*See supra* Table 1–I.

[232]*See* Gomes, *supra* note 230, at 631 n.16 (suggesting that LLCs slowly increase the share of free float by divesting shares of the largest members).

> [I]nsider activity [in Kinder Morgan Management, LLC] is sending a strong "buy" signal. . . . Kinder Morgan is run by a highly respected insider—Chief Executive Richard Kinder. Mr. Kinder earns just $1 a year in salary; his fortune rises and falls with his ownership stake in the company. And he's increasing that stake.[233]

In addition to management holdings, listed LLCs occasionally used management incentive interests (two sample companies).[234] The incentive interests entitle management to receive a higher share of distributions from the surplus above the targeted distributions.[235] For instance, if quarterly distributions are below or equal to the targeted amount, all payments are made to the holders of common units; when quarterly distributions exceed the targeted amount, a certain percentage of the surplus is distributed among the holders of the incentive interests—which are evidenced by a separate class of LLC interests. Hence, these interests incentivize managers to deliver higher distributions even if they do not hold large equity interest in the company. In both cases where management incentive interests were used, the management did not have significant ownership interest in the LLC at the IPO date.[236] This suggests that share ownership by management and management incentive interests were used as substitute mechanisms for aligning the interests of managers and members.

As mentioned earlier, concentrated ownership and management holdings, along with mitigating conflicts of interest between insiders and outsiders, in fact, can work in the opposite direction and exacerbate these conflicts.[237] As long as the interests of the large and minority members overlap, managers are expected to act in the interest of the members.[238] This means that outside investors have no substantial reasons to worry

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[233]Beverly Goodman, *Getting the Inside Scoop*, WALL ST. J. (Apr. 17, 2005), http://www.wsj.com/articles/SB111368299538708824.

[234]*See infra* Appendix 1-I. Management incentive distribution rights (IDRs) are more popular in publicly traded master limited partnerships. *See* John Goodgame, *New Developments in Master Limited Partnership Governance*, 68 BUS. LAW. 81, 88 (2012). Some LLCs point to the absence of incentive distribution rights as an advantage compared to their competitors using the LP structure, because the absence of IDRs lowers the cost of equity capital for financing growth opportunities. *E.g.*, *id.*

[235]*See* John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 477–78 (2005).

[236]*See supra* Table 1–I (showing information for Constellation Energy Partners LLC and Niska Gas Storage Partners LLC).

[237]*See, e.g.*, James R. Booth et al., *Boards of Directors, Ownership, and Regulation*, 26 J. BANKING & FIN. 1973, 1974 (2002) ("[C]oncentration of power can exacerbate potential conflicts of interest . . . ."); Gilson, *supra* note 225, at 1652–53.

[238]*See* John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 403 & n.200 (1996) ("[S]ignificant shareholders reduce agency cost problems and enable shareholders to hold managers accountable, thus causing firm value to rise.").

about member versus manager conflicts.[239] But where these interests diverge, minority members can encounter problems. The divergence of the interests can be for legally justified reasons—such as different investment horizons[240]—or can come from a wish to benefit illegally from related party transactions—for example, in cases where managers own equity stakes in the parent of a listed LLC that dwarf their holdings in the latter.[241] In most of these cases, the potential conflict is between controlling and minority members.[242] Hence, it was important that the operating agreements of the listed LLCs did not waive the fiduciary duties of the members. In dealings with the companies, the controlling members owed the traditional fiduciary duties of corporations.[243] In six LLCs, controlling members were exempt from the application of fiduciary duties because the LLC agreements included special conflict of interest rules for resolving conflicts between controlling and minority members.[244] Whereas two of these LLCs had neither a large controlling member, nor provided to any of the members the right to appoint the majority of the board members, the remaining four firms had controlling members.[245] In the latter case, the alteration of the fiduciary duties of controlling members can be a serious concern for outside investors.[246]

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[239]*See id.* at 403.

[240]*See, e.g.*, F. HODGE O'NEAL & ROBERT B. THOMPSON, 1 OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 2:2 (2014) (discussing causes of "protracted policy disagreements").

[241]LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 9:3 (2014) ("Managers of an LLC are subject to a duty of loyalty . . . . When the courts speak of a duty of loyalty, they are really referring to the more specific duty to act without being subject to an obvious conflict of interest.").

[242]Maria Maher & Thomas Andersson, *Corporate Governance: Effects on Firm Performance and Economic Growth*, ORG. FOR ECON. CO-OPERATION & DEV. 24 (1999), *archived at* http://perma.cc/9VKX-TE2G (explaining that with concentrated ownership, the potential for conflict is usually between controlling and minority members); *see also* Dammann & Schündeln, *supra* note 37, at 748.

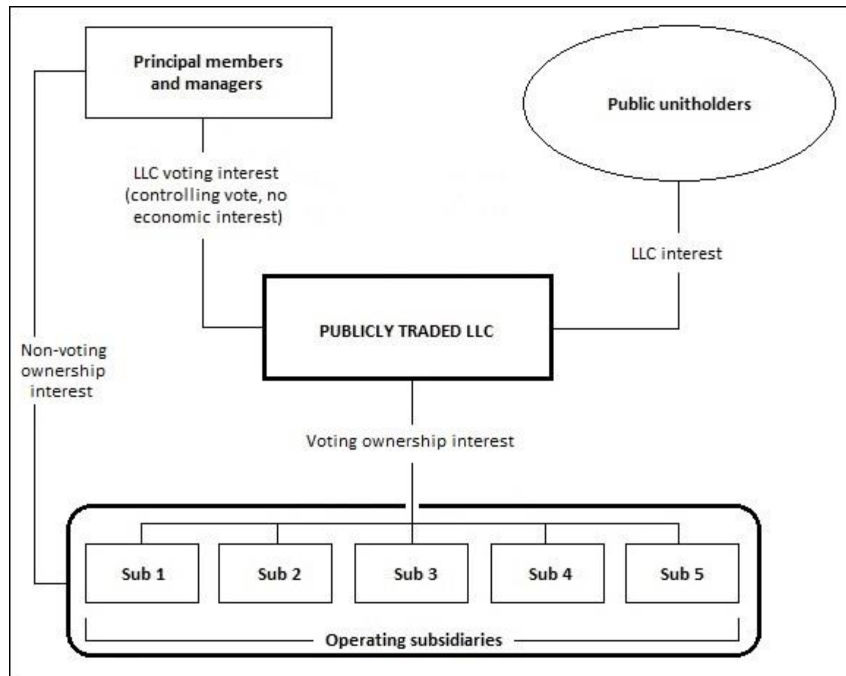
[243]*See* RIBSTEIN & KEATINGE, *supra* note 241, §§ 9:2–9:3 (discussing duties of care and loyalty); Winnifred A. Lewis, *Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 82 FORDHAM L. REV. 1017, 1028–30 (2013) (discussing the waiver of fiduciary duties in LPs and LLCs).

[244]*See supra* note 176.

[245]*See supra* Table 1–I.

[246]*See* Manesh, *supra* note 15, at 585 ("Operating agreements typically include various provisions that impose duties and obligations that act as contractual substitutes for default fiduciary standards. But these contractual duties and obligations rarely, if ever, match the exacting rigor of fiduciary duty law.").

Figure 1–VI: Simplified ownership structure of a publicly traded LLC from finance sector



Source: The author's own research.

Another distinctive characteristic of the ownership structure of publicly traded LLCs was the granting of economic interests in the listed entities only to outside investors.[247] This structure, practiced in the investment management and finance sector, in a simplified way can be described as follows: the founders and managers of an LLC obtain a controlling vote in the LLC after an IPO by holding voting units that do not entitle them to economic rights, while public investors purchase voting units of a different class entitling them to 100% of economic interest in the LLC. Separately, the founders and managers own economic (but non-voting) interests in the subsidiary operating entities (as a rule, in the size corresponding to their voting rights in the LLC). The remaining economic ownership in the operating entities is held by the listed LLC, implying that the public unit holders own an effective minority economic interest in the operating entities.[248]

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[247]*See supra* Figure 1–VI (illustrating how the ownership structure of publicly traded LLCs functions by affording the principal members and managers no economic interests, but rather having the economic interest held by outside investors).

[248]Company filings with the SEC show that similar corporate structures are also used in cases where the listed firm is a corporation. A few examples were Artio Global Investors Inc., an asset management company, Duff & Phelps Corporation, a provider of financial advisory and investment banking services, DynaVox Inc., a developer of speech generating devices, Manning & Napier, Inc., an investment management firm, and FXCM Inc., an online

The described ownership structure can send contradictory messages to outside investors. On the one hand, this structure can deepen majority versus minority conflicts, because it allows principal members and managers to participate in the distribution of profits at the level of the operating entities, but refrain from making dividend payment decisions at the level of the listed company.[249] Profit distribution practices of the sample LLCs suggest that this concern may be true—the majority of the LLCs that used the described ownership structure had lower than average dividend-price ratios.[250] On the other hand, under this ownership structure, public investors, as the sole holders of economic interest, receive all property of the LLC in the case of its bankruptcy or dissolution.[251] Therefore, this ownership structure sends a signal to investors about the successful prospects of the firm and the commitment of its managers, and aims to mitigate the adverse selection problems of investing in the shares of an unknown LLC.[252] Founders can signal that success is more likely by offering investors senior claims—such as debt instead of equity[253] or preferred stock instead of ordinary stock.[254]

Until a reputation is developed, the founders and managers have strong incentives to commit to this ownership structure. Along with

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provider of foreign exchange trading services. *See* Artio Global Investors Inc., Annual Report 26 (Form 10–K) (Mar. 4, 2013); Duff & Phelps Corp., Annual Report F–21 (Form 10–K) (Feb. 25, 2013); DynaVox Inc., Annual Report 17 (Form 10–K) (Nov. 22, 2013); Manning & Napier, Inc., Annual Report 1 (Form 10–K) (Mar. 3, 2014); FXCM Inc., Annual Report 31 (Form 10–K) (Mar. 17, 2014). The corporation holds controlling interests in a non-listed LLC, taxed as a partnership, which operates the business. Unlike public investors, the founders of the business have only voting rights in the listed corporation, but they own the same share of economic interests in the operating LLC. As a result, the founding members receive distributions from the LLC avoiding the additional layer of corporate taxation, while the cash distributions made to the outside investors before reaching them in the form of dividends are first taxed by the corporate income tax. This corporate structure is used for tax purposes. However, where the listed firm is another partnership taxed entity, rather than a corporation, the tax rationale is not obvious anymore, unless the structure gives the founders flexibility to change the election of taxation or the business form at the level of the listed firm (for instance, to attract more institutional investors) without increasing their effective tax obligations.

[249] *See generally* O'NEAL & THOMPSON, *supra* note 240, § 3:5 (discussing problems that can arise when authority to pay dividends is concentrated in majority shareholders).

[250] Original Research (on file with author).

[251] *See* Robert R. Keatinge, *Allocations and Distributions in Partnerships and LLCs*, GP SOLO & SMALL FIRM, Jan./Feb. 1999, at 23, 24, *archived at* http://perma.cc/H538-46GY ("Most . . . operating agreements provide that upon liquidation of the organization, each owner will receive an amount equal to the owner's capital account . . . .").

[252] *Cf.* Stuart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187, 209 (1984) (discussing how under circumstances of severe information asymmetries, outside investors undervalue equity and this may prevent current shareholders from offering equity to finance investments).

[253] *See id.* at 220.

[254] *See* Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 302–03 (2003).

reputation building, they can exchange their economic interests in the operating subsidiaries for the economic interests of the listed LLC. Correspondingly, voting interests in the listed LLC without economic interests will be cancelled. The signaling, however, can be misleading if the operating subsidiaries are liquidated prior to the liquidation of the listed LLC,[255] or where the founders and managers can, without any restrictions, convert their only-voting interests in publicly traded LLC to the interests entitling both to voting and cash flow rights. To make their initial commitments reliable, the founders and managers of publicly traded LLCs can use contractual mechanisms.[256] With the exception of Fortress Investment Group LLC,[257] the sample listed LLCs used some form of legal restriction on such conversions—establishing specific periods when the exchange can occur, empowering the board with veto rights on the exchange or with the right to define other equivalents in lieu of the economic interests, allowing the exchange only if the received economic interests will be sold subsequently, subjecting the exchange requests to vesting schedules, and setting transfer restriction periods on the economic interests of the operating entities.[258] Vesting and transfer restriction periods may be a signal to public investors that the managers believe in the success of the company after the sale of the interests to the public investors.[259]

Two LLCs from the oil and gas sector had a large discrepancy between the voting rights and economic interests of the largest members as well.[260] Yet, unlike the LLCs from the finance sector, in both cases

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[255]As a rule, the managing partners' direct ownership in the operating entities is only economic, thus, they cannot dissolve or bankrupt the entities directly. *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.04, at 52–53 (2015). However, through their controlling rights in the public LLC, which, in its turn, is the controlling member of the operating entities, the partners have a say over the future of these entities.

[256]*See generally* Manesh, *supra* note 15, at 596–97 (explaining how founders and managers of publicly traded LLCs can use contractual mechanisms to make their initial commitment more reliable via effective limitation and contractual restraints).

[257]*See* Fortress Inv. Grp. LLC, Annual Report 157 (Form 10–K) (Feb. 28, 2012).

[258]*See, e.g.*, Constellation Energy Partners LLC, *supra* note 179, § 4.6 (addressing "Restrictions on Transfers").

[259]*See* ALAN S. GUTTERMAN, BUSINESS TRANSACTIONS SOLUTIONS § 156:305 (2014):

> The primary purpose of vesting provisions and associated repurchase rights is to provide a mechanism for the founders to 'earn' their equity by continuing to work for the company. In most cases, the founders will have purchased their interest in the company for a nominal or relatively low purchase price, usually at a price per share much less than the current market value of the shares inherent in the price paid by the investors. The investors have an interest in ensuring that the founders continue to serve the company and help generate the returns anticipated by the investors before the founders are able to capitalize on the appreciation in their interest created by the financing.

[260]In Kinder Morgan Management, LLC and Enbridge Energy Management, L.L.C., the largest members held 100% voting rights against 10% and about 15% economic interests on the date of listing and in 2012, respectively. *See supra* Table 1–I.

the detachment of voting rights from economic interest did not come with a separate economic interest by the largest members in the capital of the operating entities.[261] In another case, the founding member of LinnCo, LLC (LinnCo)—Linn Energy, LLC (Linn Energy)—had a right to appoint all members of the board, though it held only 1% of the membership interests in LinnCo.[262] If considered independently, these structures, where controlling members hold voting power in excess of their cash flow rights, suggest an increased risk of minority oppression by extracting excessive private benefits—when the costs of private benefit extraction exceed the benefits of more focused monitoring of management.[263] In these situations, the market for corporate control does not work either—neither as an instrument for transferring control to more efficient managers, nor as an ex ante disciplining mechanism.[264]

Closer look, however, dispels this concern. In particular, publicly traded LLCs used ownership structures with separated voting and cash flow rights only in combination with counterbalancing contracting mechanisms that offer protections to outside investors—such as mandatory dividends and high standards of protecting the rights and interests of outside investors.[265]

[261] *See supra* Table 1–I.

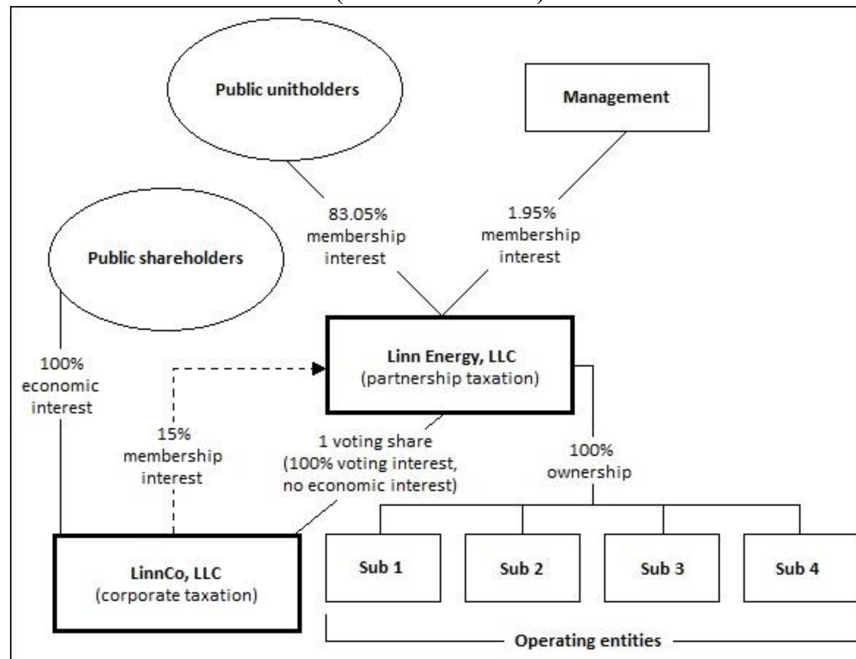
[262] *See* LinnCo, LLC, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 42 (Schedule 14A) (Mar. 12, 2014).

[263] *See* Sanford J. Grossman & Oliver D. Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. ECON. 175, 178–181 (1988).

[264] In general, in the majority of the sample publicly traded LLCs, the threat of unsolicited change of control was ruled out, with the exception of one due to the high level of ownership concentration. *See generally* Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103, 132–38 (2003) (discussing the function of the market for corporate control).

[265] *See supra* Table 1–II.

Figure 1–VII: Ownership structure of Linn Energy, LLC (December 2012)



Source: The author's own research.

The case of LinnCo is indicative.[266] The IPO of Linn Energy, a crude petroleum and natural gas company taxed as a partnership, took place in the beginning of 2006.[267] Based on the information contained in the annual report and proxy statements filed with the SEC in the beginning of 2012, the largest members of the company were a group of directors and officers holding less than 2% membership interest.[268] In April 2012, Linn Energy formed LinnCo, which was taxed as a corporation.[269] LinnCo's IPO took place in October 2012 and all proceeds from the offering were used to acquire the membership interests of Linn Energy—the number of the acquired interests was equal to the number of LinnCo shares sold in the IPO.[270] LinnCo's sole purpose was to own units in Linn Energy.[271] Linn Energy owned the only voting share of LinnCo and thus had 100% voting rights, including the right to

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[266]*See Year's First IPO, for Linn Energy, Posts Gain*, WALL ST. J., Jan. 14, 2006, at B4.

[267]*Id.*

[268]Linn Energy, LLC, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 38 (Schedule 14A) (Mar. 12, 2012).

[269]LinnCo, LLC, Quarterly Report 5–6 (Form 10–Q) (Oct. 26, 2012).

[270]*Id*. at 11.

[271]*Id*. at 5.

appoint all board members of LinnCo.[272] Common units of LinnCo were all held by the public.[273] At the end of 2012, LinnCo held approximately 15% of Linn Energy's outstanding units.[274] LinnCo had an obligation to submit to a vote of its shareholders any matter submitted by Linn Energy to a vote of its unitholders, including the annual election of the latter's board.[275] LinnCo would vote the units of Linn Energy based on the results of the vote of its own shareholders.[276]

According to the IPO prospectus of LinnCo, the company was created to enhance Linn Energy's ability to raise additional equity capital and widen the base of its investors.[277] Corporation taxation of LinnCo enabled its public shareholders to own indirectly membership interests in Linn Energy without creating any partnership tax-related obligations.[278] These obligations are related to: (1) onerous tax administration—the need to file individual income tax returns as partners; and (2) payment of taxes for unrelated business taxable income—if Linn Energy generates unrelated business income (income generated as a result of activities which fail to qualify for the criteria of the partnership taxation of LLCs),[279] then its members shall pay unrelated business income tax. Conversely, if the new investment structure is used, the unrelated business income tax is paid by LinnCo, rather than its shareholders.[280] This investment structure is attractive for several types of institutional investors that avoid partnership units for tax reasons, such as pension funds.[281]

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[272]*Id*. at 3.

[273]*See generally* LinnCo, LLC, Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Schedule 14A) (Mar. 12, 2014).

[274]*See supra* Figure 1–VII; Linn Energy, LLC, Units Representing Limited Liability Company Interests 2 (Schedule 13G) (Oct. 11, 2012).

[275]*Id.*

[276]*Id.*

[277]LinnCo, LLC, Final Prospectus 8 (Form 424B1) (Oct. 12, 2012).

[278]*See id.* at 6.

[279]*See* I.R.C. § 7704(d)(1) (2012) (listing qualifying incomes of publicly traded LLCs); HAMILTON & BOOTH, *supra* note 129, § 10.8 ("The [partnership] provisions of the IRC and the regulations issued thereunder are exceptionally complex.").

[280]*See supra* Figure 1–VII.

[281]Because partnership taxation implies pass-through taxation where the taxes are paid by the investors, tax-exempt institutional investors such as pension funds and mutual funds cannot invest in these entities. *See generally* Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225 (2012) (discussing the difficulties tax exempt entities can face investing in certain other entities). Therefore, most of the investors are individuals and non-institutional entities. In contrast to this, the election of corporate taxation by publicly traded LLCs makes the interests available for tax-exempt institutional investors as well. *See* Thomas J. Gallagher, III, *The Taxation of Investments by Pension Funds and Other Tax-Exempt Entities*, 67 TAXES 981, 981 (1989) ("Once an exempt organization moves beyond the more traditional investment vehicles, i.e., stocks, bonds, debentures and non-hybrid securities, and particularly where the organization assumes a more entrepreneurial role with respect to its investments, the tax consequences of these transactions to the exempt entity become less clear . . . .").

In fact, LinnCo imitated Linn Energy with the only difference being the election of taxation.[282] The shareholders of LinnCo had an indirect vote during the annual and special member meetings of Linn Energy and could participate in the election of Linn Energy's board.[283] Further, pursuant to LinnCo's LLC agreement, it had to distribute all dividends received from Linn Energy among its shareholders.[284] Under this governance structure, the conflicts of interests between the management and public investors within LinnCo were minimized, and actually were transferred to the level of Linn Energy. Thus, the fact that the managing member of LinnCo held full control rights in the company without corresponding economic rights does not *per se* imply higher risks of outside investor expropriation. Meanwhile, the capital structure of Linn Energy was based on full correspondence of voting and cash flow rights.[285]

Two other oil and gas publicly traded LLCs with wide discrepancies between voting and economic rights, mentioned earlier, were treated as corporations for federal income tax purposes as well, and served as an alternative way of investing in the partnership units of "sister" publicly traded master limited partnerships ("MLPs").[286] Once the company raises money in its IPO, it uses the proceeds to buy a new class of units in the MLP (*i-units*) in the same amount as the number of the LLC units offered to the outside investors.[287] Unlike the common units of the MLP, instead of cash distributions, the holder of the new class of units receives an equivalent number of *i-units*, while the MLP retains the cash and uses it in its business.[288] The corresponding number of the LLC interests is increased automatically as well.[289] Hence, the investment resembles an automatic dividend reinvestment, which does not generate any tax obligations for the investors unless they sell the interests.[290] Sale income on interests held more than one year is considered as a long-term capital gain, and is taxed at a favorable rate.[291] The right to receive regular cash distributions is actually traded off with reduced tax payments.[292]

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[282]*Compare* Linn Energy, LLC, Quarterly Report 16 (Form 10–Q) (Apr. 25, 2013), *with* LinnCo, LLC, Quarterly Report 8 (Form 10–Q) (Aug. 8, 2014).

[283]*See supra* note 276 and accompanying text.

[284]*See* LinnCo, LLC, Amended and Restated Limited Liability Company Agreement § 6.1 (Form 8–K Ex. 3.1) (Oct. 17, 2012).

[285]*See supra* Figure 1–VII (showing consolidated voting and economic interests).

[286]*See supra* note 260 and accompanying text.

[287]*See, e.g.*, Conrad S. Ciccotello & Chris J. Muscarella, *The Energy MLP Goes Institutional: Implications for Strategy and Governance*, 15 J. APPLIED CORP. FIN. 112, 114 (2003).

[288]*See id.* at 112.

[289]*See id.* at 114.

[290]*See id.* at 115.

[291]*See* Ciccotello & Muscarella, *supra* note 287, at 115; HAMILTON & BOOTH, *supra* note 129, § 8:13.

[292]*See* Ciccotello & Muscarella, *supra* note 287, at 115.

Under these governance structures, the full control of management by founding members and the high divergence between the voting and economic interests of founding members are counterbalanced by additional minority rights and guarantees.[293] First, the companies were established only for the purpose of buying *i-units* and could invest the IPO proceeds only in these units.[294] They were not entitled to sell or transfer these units in any other way; they could not raise any debt or engage in any other activity, including mergers and consolidations with other entities.[295] As a result, in the event of liquidation, the economic members would be the sole claimants of the LLCs and could receive *i-units* in the MLPs in the number equal to the number of their LLC interests.[296] Second, the companies voted the *i-units* in a manner that the outside investors voted their listed membership interests in the LLCs.[297] The outside investors had a right to dissolve the LLCs by a two-thirds vote.[298] Third, the controlling members were obliged to buyout the LLC interests held by the outside investors if (1) the market price of the listed MLP common units was less than double the targeted distributions made on those units, (2) the MLPs merged with other entities, or (3) the controlling members and their affiliates were no longer the controlling members of the MLP's general partners.[299]

The correlation analysis presented in Table 1–II demonstrates that the company purpose limitation clauses, sell-out rights, specific target distribution obligations, and the right of the members to dissolve the company by the majority vote without the prior board approval were likely to appear together, particularly in cases where the managers did not have interests aligned with outside investors via the ownership of economic interests.[300] In summary, although public investors had limited control rights in these LLCs, the governance rules of the LLCs offered additional protections to them and limited the options available to insiders for oppressing outside investors.

Finally, in some cases investments in the listed LLCs could be tied to the personality of their founders and managers.[301] This could be particularly true in the sample companies from the finance sector where the reputation of the founders and managers plays a crucial role during the regular rounds of raising money for private equity and hedge funds.[302] Where the personality of the firm insiders makes a difference,

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[293]*See id.* at 118.

[294]*See id.* at 119.

[295]*See, e.g.*, Kinder Morgan Mgmt., LLC, Annual Report 7 (Form 10–K) (Feb. 20, 2014).

[296]*See, e.g.*, *id.* at 11.

[297]*See* Ciccotello & Muscarella, *supra* note 287, at 117 fig.2.

[298]*See infra* Appendix 1–I.

[299]*See* Kinder Morgan Mgmt., LLC, *surpa* note 295, at 12.

[300]*See supra* Table 1–II.

[301]*See supra* text accompanying note 232–233.

[302]*See supra* text accompanying note 232–233.

outside investors can close their eyes to deviations from standard corporate governance mechanisms.[303]

VI. OTHER NON-CONTRACTUAL GOVERNANCE MECHANISMS IN PUBLICLY TRADED LLCS

In addition to trading and combining different contractual provisions and ownership structures to ensure a certain level of protection of the interests of outside investors, other mechanisms of balancing controlling member versus minority member rights and interests were important as well.[304] This Part focuses on four such mechanisms, which, to distinguish them from the contractual rights of investors, are conditionally grouped under the term "non-contractual/non-legal."

A. Dividends and Specific Target Distributions

Theoretical literature predicts that mandatory profit distribution clauses are used by the controlling members of LLCs to attract minority members in the absence of strong minority rights aimed to mitigate the agency problems between the majority and minority members.[305] This argument has two components. First, mandatory distribution clauses limit the amount of the retained cash and thus reduce the discretion of managers.[306] Second, the promise of paying higher dividends can make an investment in LLC interests attractive for outside investors even in the absence of strong corporate governance elements; higher dividends are actually the price that a company pays to its members for weaker legal protection.[307]

Several sample companies indicated explicitly in their IPO prospectuses a commitment to ensure a certain minimum level of profitability of their membership interests (defined as a percentage of the offering price).[308] The correlation analysis of the contractual clauses of the operating agreements of the publicly traded LLCs shows that specific target distribution clauses were negatively correlated with the right of minority members to make business and director nominations during the member meetings and with the management ownership of economic interest in the LLCs.[309] This negative correlation implies that mandatory profit distribution clauses, indeed, are used as a substitute for strong

[303]*See supra* text accompanying note 232–233.
[304]*See infra* Part VI.A–D of this Chapter.
[305]*E.g.*, RIBSTEIN, *supra* note 213, at 209–10.
[306]*See id.*
[307]*See id.*
[308]*See supra* Table 1–II (showing a correlation for specific target distributions).
[309]*See supra* Table 1–II.

minority rights and management ownership.[310] As predicted, weak minority rights are compensated by higher dividends.[311] However, the study also shows that only nine out of the twenty publicly traded LLCs made strong commitments in their LLC agreements to make mandatory quarterly distributions.[312] The rest of the sample provided full discretion to the board to make profit distribution decisions.[313] Moreover, except the three special cases of using LLCs taxed as corporations for enhancing investment bases in "sister" partnership taxed firms (special-purpose LLCs),[314] the LLCs with profit distribution commitments used broadly defined legal terminology and, in fact, allowed the management to retain a significant amount of the profits.[315] The question is whether in practice the management of publicly traded LLCs relies on these broad definitions to limit the amount of cash distributions to the members.

The data from the sample LLCs suggest that this is not the case. Publicly traded LLCs commonly declared and paid more dividends to their interest holders than they earned in net income.[316] In thirteen LLCs—excluding the three special-purpose LLCs—the amount of annual dividends per unit of ownership exceeded the earnings per unit of ownership.[317] These companies issued debt and used other sources to finance the dividend payments.[318] Only four listed LLCs practiced retaining earnings.[319]

As it was a common practice among the publicly traded LLCs to pay dividends from other sources than their net income and because the mandatory distribution clauses, as a rule, declared that the companies would distribute "all available cash" (with the term being defined broadly),[320] this study also looked at the share of annual distributions to members in the total amount of the sample companies' cash at the end of

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[310] *See supra* Table 1–II.

[311] *See supra* Table 1–II.

[312] *See infra* Appendix 1–I.

[313] Some of the companies that did not include mandatory distribution clauses in their LLC agreement nevertheless made non-binding promises to pay out a specific minimum quarterly distribution or to distribute substantially all net cash flow from operations in their IPO prospectuses. Original Research (on file with author).

[314] *See supra* Part V of this Chapter. LinnCo, LLC, Kinder Morgan Management, LLC, and Enbridge Energy Management, L.L.C. were taxed as corporations for the benefit of their associated business entities.

[315] Similarly, in an earlier study Manesh found that while the majority of publicly traded LPs and LLCs had provisions in their operating agreements that compelled the firms to make quarterly profit distributions, almost all used contractual language that provided the managers with broad discretion with regard to the definition of the amount of the distributions. Manesh, *supra* note 15, at 579–80.

[316] Original Research (on file with author).

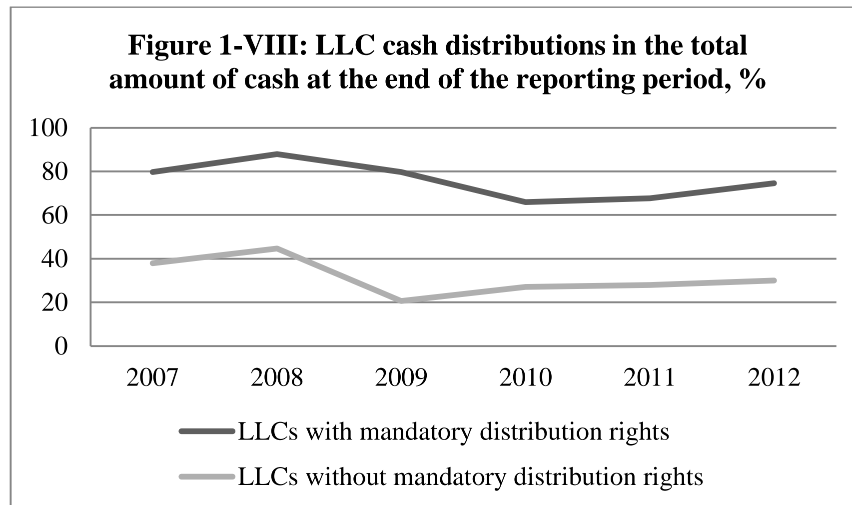
[317] Original Research (on file with author).

[318] *See, e.g.*, Copano Energy, L.L.C., Annual Report 85-86 (Form 10–K) (Mar. 1, 2013).

[319] *See, e.g.*, Travelcenters of Am. LLC, Annual Report 36 (Form 10–K) (Mar. 3, 2013).

[320] *See, e.g.*, Copano Energy, *supra* note 318, at 34.

the reporting periods. Figure 1–VIII compares the data on the percentage share of distributed cash in publicly traded LLCs with and without mandatory distribution clauses. On average, publicly traded LLCs with mandatory distribution rights used almost 76% of all cash to pay dividends to their members, whereas in the LLCs without legal obligations to pay dividends the share of the distributed cash was less than 31.5%. The figure does not cover the three special-purpose LLCs that owing to the specifics of their structure did not provide full data about the cash flows. These three companies automatically paid out all their earnings to the members[321] and, if added in the calculations, would further enhance the data for LLCs with mandatory distribution clauses. Yet, even in the absence of these three companies, it is clear that mandatory distribution clauses, notwithstanding the broad legal terminology used for their formulation, were not mere declarations.

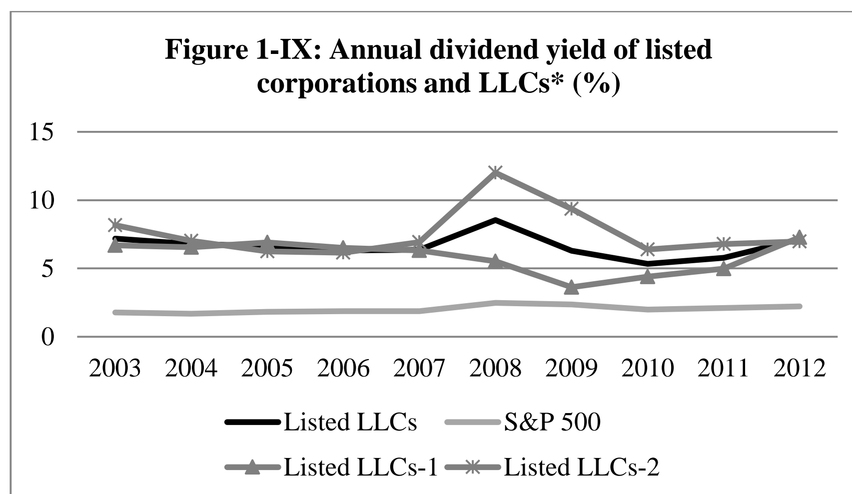


Source: The author's own calculations based on the data from the annual reports of the publicly traded LLCs filed with the SEC.

Figure 1–IX compares average annual dividend yield in publicly traded LLCs and corporations. The data demonstrate that publicly traded LLCs paid larger distributions than listed corporations. The average dividend yield of publicly traded LLCs in the ten-year period from 2003 till 2012 was 6.6%, while S&P 500 corporations had only 2% average dividend yield for the same period. The average annual dividend yield of the oil and gas companies was 6.9%; in finance and real estate sectors the average annual dividend yield was 7.1% and 7.8%, respectively.[322] Few companies had an average annual dividend income above 10%.[323]

[321] *See supra* notes 314–315 and accompanying text.
[322] Original Research (on file with author).
[323] Original Research (on file with author).

Another interesting observation is that before the crisis of 2008 the sample LLCs without mandatory distribution obligations ensured dividend yields at the level of the total sample.[324] During the crisis and the following few years, dividend yield in these companies fell more than the dividend yield of the total sample. However, in 2012 the dividend-price ratios in both cases again demonstrated similar patterns. The likely explanation for this is that during the crisis, cash-strapped listed LLCs made lower distributions, but the companies that included specific distribution obligations in their operating agreements were less flexible. Therefore, during normal circumstances all publicly traded LLCs are expected to have much higher dividend yields than listed corporations. They have, possibly, non-legal incentives to do this—like making the offered securities attractive for investors or meeting market expectations.[325] In times of crisis, however, specific target distribution clauses make a difference and ensure higher distributions for investors.



Sources: S&P Dow Jones Indices (for S&P 500 corporations); the author's own calculations based on the data from the annual reports of the publicly traded LLCs filed with the SEC.
Notes: Listed LLCs = all sample; Listed LLCs–1 = sample LLCs that did not include mandatory distribution rights in their LLC agreement; Listed LLCs–2 = sample LLCs with mandatory distribution obligations.
* The calculation of the annual dividend yield of the LLCs for the first year of the listing in cases where an LLC did not declare dividends for one or more quarters ended before the IPO is based on the annualized data taking into account the total dividend yield for the quarters of the same year when dividends were paid.

[324] *See infra* Figure 1–IX.

[325] *See* 11 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 5318 (2014) ("The purpose of modern business corporations is to earn money for their shareholders. When a corporation increases its wealth from profitable operations, the shareholders are entitled to a distribution of those corporate profits in proportion to their shares or interest in the corporation.").

The industrial division of the companies did not reveal strong differences in the annual dividend yields.[326] The average dividend yields in the three industries differed mainly during the period from 2007 to 2009.[327] Oil and gas companies, due to the fact that only companies from this sector had target distribution rights, had higher dividend-price ratios; firms in the finance sector had relatively stable annual dividend yield; the outlier was the real estate sector.[328]

Lastly, the study checked whether there is a correlation between higher dividend yields and specific target distribution clauses. Several approaches were used to divide the listed LLCs into groups based on their dividend-price ratios. First, all companies were ranked based on their average dividend yield for the full lifetime of each company. Then they were grouped as top and bottom half or above or below the average dividend yield for the total sample. Second, the companies were grouped on the basis of the number of the times they appeared above or below the average dividend yield of the total sample each year for the last five and ten years of the observations. Whereas the first grouping did not show any correlation between the dividend yield and specific target distribution clauses, for the second grouping the correlation is positive at the 10% level (φ values are equal to 0.414 and 0.382 for five and ten year periods, respectively).[329]

This evidence suggests that, indeed, dividend payment obligations and practices are an important element in the governance structure of publicly traded LLCs and are used to mitigate conflicts of interests between controlling members and outside investors. The large share of cash payments to LLC members limits the discretion of the managers and controlling members, while high dividend incomes compensate outside investors for poor corporate governance practices.[330] This compensation can also be upfront at the IPO stage through lower prices for the offered securities.[331] There are many cases where companies that are organized as LLCs convert to corporations immediately before the IPO, as this can attract more investors and raise firm valuation.[332]

This study did not find any evidence supporting the claim that partnership treatment of publicly traded LLCs for taxation purposes is a reinforcing incentive for maintaining high levels of profit distribution.[333] In none of the cases of grouping the sample LLCs based on their

[326]Original Research (on file with author).

[327]Original Research (on file with author).

[328]Original Research (on file with author).

[329]Original Research (on file with author).

[330]*See supra* Part VI.A of this Chapter.

[331]*See* Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 109–10 (2003) (finding correlation between shareholder rights and firm value).

[332]*See* MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK § 3:67 (2014) ("Typically, . . . owners will want to be operating as a C corporation at the time [a] public offering is made.").

[333]Original Research (on file with author).

dividend-price ratios is there any significant correlation with the election of partnership taxation.[334] This finding confirms the argument made earlier in the scholarly literature that the election of partnership taxation, at best, means that an entity has an incentive to distribute the amount necessary to offset the pass-through tax liability of its members.[335] While in REITs high dividend distributions are the result of the tax rules,[336] in listed LLCs high profit distributions are stipulated by their governance structure and market expectations.[337]

B. The Structure, Composition, and Practices of the Board of Directors

The analysis of the LLC agreements showed that all publicly traded LLCs had a board of directors and adopted procedural rules for the functioning of the boards, such as minimum quorum requirements, voting thresholds, and notice periods.[338] The majority of the agreements allowed the boards to create different committees, yet only six LLC operating agreements directly required the establishment of board committees.[339] In less than half of the sample (eight companies), the LLC agreements required that the board should be composed of the majority of independent directors.[340]

However, the listing requirements of stock exchanges impose similar rules in this field for all listed companies regardless of their organizational structure.[341] This means that although there are many differences between the governance structures of publicly traded LLCs and corporations because of the default rules of the LLC statutes,[342] one of the aspects of the governance structures where these two business forms are coming together is the characteristics of the boards of directors. Therefore, to define the true role of the boards in the governance of publicly traded LLCs, it is necessary to study the real-life practices of the boards. The summarized data are presented in Table 1–III.

The boards of directors of the listed LLCs had more than three board committees on average.[343] In the majority of the cases, these committees were fully composed of independent directors whose

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[334]Original Research (on file with author).

[335]*See* Manesh, *supra* note 15, at 592.

[336]*See supra* note 129.

[337]*See supra* note 308 and accompanying text.

[338]*See infra* Appendix 1–I.

[339]*See infra* Table 1–III.

[340]Original Research (on file with author).

[341]*See, e.g.*, NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.05(a) (2015) (requiring that compensation committees be composed entirely of independent directors).

[342]*See* RIBSTEIN & KEATINGE, *supra* note 241, § 2:1 ("[A wide variety of financial and managements] characteristics may be engrafted on an LLC.").

[343]*See infra* Table 1–III.

independence was defined based on the listing requirements of the stock exchanges.[344] The most frequent committees were audit, compensation, and nomination and corporate governance committees.[345] Some LLCs also established conflicts committees that reviewed transactions with affiliated and interested parties.[346] The average number of annual committee meetings was 16.8.[347]

Table 1–III
Board practices in the publicly traded LLCs (listing year-2012, incl.)

	Boards of directors in general		Composed of entirely independent directors	
	Number	%	Number	%
Audit committee	20	100	20	100
Compensation committee	17	85	16	80
Nomination & CG committee	16	80	16	80
Conflicts (affiliated transactions) committee	7	35	7	35
Executive committee	3	15	0	0
Average number of the board committees	3.15	n/a	2.95	n/a
Frequency of annual committee meetings*	16.77	n/a	n/a	n/a
Frequency of annual board meetings*	9.88	n/a	n/a	n/a
Majority independent directors	16	80	n/a	n/a

Source: The author's own calculations based on the annual reports and definitive proxy statements of the publicly traded LLCs filed with the SEC.
* The data are available only for fourteen sample companies.

The entire boards of directors were actively functioning with the average number of annual meetings close to ten.[348] In 2012, the boards of the publicly traded LLCs met 8.42 times.[349] Although many LLCs had a large controlling member or used other mechanisms to control their boards, 80% of listed LLCs had boards of directors composed of a majority of independent directors.[350] Parallels with the boards of S&P 500 corporations reveal many similarities. In 2012, the average number of board meetings of S&P 500 was eight, and 85% of all board members were independent directors.[351] The average number of standing board

[344]*See infra* Table 1–III.
[345]*See infra* Table 1–III.
[346]*See infra* Table 1–III.
[347]*See infra* Table 1–III.
[348]*See supra* Table 1–III.
[349]Original Research (on file with author).
[350]*See supra* Table 1–III.
[351]*See* SPENCER STUART, SPENCER STUART BOARD INDEX 2013 6 (2013), *available at* http://www.corpgov.deloitte.com.

committees in S&P 500 corporations was 4.3 in 2013.[352] All boards had audit and compensation committees.[353] With the exception of several controlled listed corporations, all S&P 500 boards also had nomination and corporate governance committees.[354] The mentioned board committees of S&P 500 corporations were fully composed of independent directors.[355]

These data suggest that the structure, composition, and practices of the boards of directors of the publicly traded LLCs did not differ significantly from the boards of listed corporations. Some of the publicly traded LLCs were eligible for exemptions from the listing requirements of the stock exchanges as controlled companies (*e.g.*, they could opt out from the requirements to have a majority of independent directors, to create board committees, or to hold annual member meetings).[356] Yet, even these LLCs voluntarily complied with all or several corporate governance requirements.[357] Thus, if in corporations, boards are considered active actors in dealing with governance problems, LLC boards should receive similar credit. Even with regard to fiduciary duties, the boards of listed LLCs did not seem to differ significantly from the boards of listed corporations.[358] Indeed, an empirical study of the articles of incorporation of Fortune 100 companies shows that it is a widespread practice for listed corporations to limit the liability of directors for the breach of duty of care.[359] Only in few listed LLCs, were the fiduciary duties of the directors less rigorous than they are in corporations.[360]

Nevertheless, the role of the boards of directors in publicly traded LLCs might be somewhat diminished by the fact that in several cases independent directors were appointed and could be removed by the controlling members of the publicly traded LLCs.[361] Second, although not widespread, in some listed LLCs fiduciary duties of directors were less rigorous than they are in corporations.[362] A further concern, that

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[352]*Id.* at 27.

[353]*Id.*

[354]*Id.*

[355]*See* SPENCER STUART, *supra* note 351, at 27.

[356]*E.g.*, Enbridge Energy Mgmt. LLC, Annual Report 42 (Form 10–K) (Feb. 18, 2015) ("Because we are a controlled company, the NYSE listing standards do not require that we or the General Partner have a majority of independent directors or a nominating or compensation committee of the General Partner's Board of Directors.").

[357]*See supra* Table 1–III.

[358]*See infra* Appendix 1–I. As mentioned earlier, the liability for breach of certain duties of board members of Delaware corporations can be exculpated by including an express indication in their charters. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

[359]*See* J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only in: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285, 310–11 (2009).

[360]*See infra* Appendix 1–I.

[361]*See infra* Appendix 1–I.

[362]*See infra* Appendix 1–I.

might be true for corporate boards as well, is low turnover of the board members—many times, directors of the publicly traded LLCs continued their terms from the date of becoming a director.

C. Market Discipline

The structure and practices of publicly traded LLCs force them to return regularly to the capital markets after an IPO to raise financing.[363] Thus, market discipline strongly affects the governance of these companies. The ownership information in Table 1–I shows that it was common among the sample LLCs to gradually reduce the share of the largest member by conducting secondary offerings of the shares after the initial offering.[364] To be able to attract outside investors in these follow-up interest offerings, LLCs have to establish an investor-friendly reputation.[365] Even in cases where LLC agreements provide wide discretion to controlling members to govern and make decisions, they have strong incentives to use their decision-making powers in the interests of the companies, rather than solely in their own interests.[366]

Similarly, publicly traded LLCs often issue debt to finance their current activities and pay promised distributions.[367] Listed LLCs distribute their net income and a significant part of cash flows among the members.[368] Among the sample LLCs, it was common to declare and pay dividends above the net income.[369] To make such payments possible and, at the same time, have some cash left to finance the current activities of companies, including future acquisitions and new business project developments, publicly traded LLCs often issue debt securities.[370] Therefore, market disciplining strongly—perhaps stronger than in listed corporations—and constantly influences the governance of publicly traded LLCs.[371] It incentivizes the controlling members to stick to their promises made in IPO prospectuses and ensure a certain minimum level of investor protection, even if there are no effective legal mechanisms to enforce the promises or oppose the actions of the controlling members and managers directed towards investor wealth appropriation.

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[363]*See* Manesh, *supra* note 15, at 565.

[364]*See supra* Table 1–I.

[365]*See* Ying Cao et al., *Company Reputation and the Cost of Equity Capital*, 20 REV. ACCT. STUD. 42, 44 (2015) ("We find that companies with better reputations enjoy a lower cost of equity . . . .").

[366]*See* Goodgame, *supra* note 234, at 501–02 (making similar arguments in the context of master limited partnerships).

[367]*See* Manesh, *supra* note 15, at 565.

[368]*See supra* Part VI.A of this Chapter.

[369]*See supra* Part VI.A of this Chapter.

[370]*See supra* note 318 and accompanying text.

[371]*Cf.* Goodgame, *supra* note 234, at 502 (making similar argument in the context of master limited partnerships).

Market disciplining is also a crucial element in the argument for aligning the interests of controlling and minority members by ownership structures.[372] Obviously, this argument is stronger in listed than in non-listed firms.[373] Where the securities are priced by the market, the holders of economic interests that can affect decision making see the effects of their actions on security prices.[374] Contrary to this, controlling members in non-listed firms are less constrained by market factors in expropriating minority investors.[375] Therefore, in publicly traded LLCs, market discipline combined with concentrated ownership structure helps to mitigate the conflicts between controlling and minority members. In cases where the ownership structure is the only factor aligning the conflicting interests—for instance, if the controlling members wish to delist the securities and the market reaction is no longer crucial—potential majority versus minority conflicts in publicly traded LLCs become more acute. In this situation, the role of contractual protections of minority investors is enhanced.[376]

D. The Practice of Using Standardized Governance Structures and Contractual Techniques

The analysis of the LLC agreements and governance structures of the publicly traded LLCs showed that they were highly standardized—in the sense that the companies opted into one or another governance structure that had been chosen earlier by other LLCs, but not in the sense of using the default statutory rules.[377] They used similar legal formulations and wording in the LLC agreements and other additional

[372]*See* Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO. L.J. 1207, 1218 (2009); Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 283 (1988) ("[A] great strength of investor-owned firms is the fact that the owners generally share a single, well-defined objective: to maximize the net present value of the firm's earnings per dollar invested").

[373]*See* Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465, 498 (2009).

[374]*See* Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131,136–37 (discussing how managers holding securities that are publicly traded will see the effects of their decisions quickly).

[375]*See* F. HODGE O'NEAL & ROBERT B. THOMPSON, 2 O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE § 9:34 (Rev. 3d ed. 2014) (discussing the features of the close corporation that make minority shareholders subject to oppression, including the lack of a marketability for their interests).

[376]Professor Horton shows that due to contractual alterations of fiduciary duties during freeze-outs, minority investors in listed LLCs face less risk than in listed limited partnerships but more risk than the minority shareholders of corporations. Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53, 85–93 (2013).

[377]*See* Miller, *supra* note 196, at 319 (discussing empirical data showing the vast majority of publicly traded LLCs deviated from statutory defaults concerning fiduciary duties and member competition).

governance agreements.[378] Notwithstanding the freedom of contracting the members of publicly traded LLCs enjoy under the Delaware LLC statute,[379] they tended to use standard governance structures.[380]

The governance agreements of listed LLCs contain provisions that might raise different expectations among outside investors. Specifically, broadly defined mandatory distribution clauses can be interpreted as giving managers too much discretion in retaining profits and cash.[381] The waiver of fiduciary duties or exculpation clauses might be treated as increasing the probability of opportunistic behavior by managers.[382] Strong control of management and decision making by founding members and entrenched control can be used to oppress the rights and interests of minority investors.[383] Standardized governance structures bolster the attractiveness of LLC IPOs for investors in several ways.[384] First, by using standardized governance structures, new issuers let potential investors clarify their expectations and reduce uncertainty by looking to the practices of other issuers that used similar structures before.[385] Second, investors familiar with these structures have to invest fewer resources into understanding and interpreting the governance structure of an offering company.[386]

On the supply side, the organizers of IPOs have strong incentives to offer structures around which they have developed knowledge and

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[378]Professor Manesh likewise found similar wording in LLC agreements. *See* Manesh, *supra* note 15, at 575 ("We found nearly identical language [eliminating fiduciary duties] in the operating agreements of all 42 firms [that chose to do so].").

[379]*See id.* at 561.

[380]*See id.* at 575.

[381]*See* RIBSTEIN & KEATINGE, *supra* note 241, § 6:2 ("[There can be] problems regarding excessive retention of earnings . . . in LLCs because they are likely to be closely held . . . ."); Manesh, *supra* note 15,at 579–80.

[382]*See* Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 178 (2006) ("[F]iduciary waivers raise concerns that unsophisticated investors will fail to realize what they are getting into. In light of the potential for opportunism, commentators have expressed fears that fiduciary waivers will harm unwitting parties. . . . [A]llowing a complete elimination of the fiduciary relationship looks suspect from this perspective."); *see also* Nicole M. Sciotto, Note, *Opt-In vs. Opt-Out: Settling the Debate Over Default Fiduciary Duties in Delaware LLCs*, 37 DEL. J. CORP. L. 531, 550 n.124 (2012).

[383]*Cf.* Robert C. Illig, *Minority Investor Protections as Default Norms: Using Price to Illuminate the Deal in Close Corporations*, 56 AM. U. L. REV. 275, 286–87 (2006) (discussing oppression of minority investors in the context of close corporations).

[384]*See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 916–17 (2007) (discussing advantages of standardized governance structures when evaluated by investors and advisers).

[385]*See* Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 241–42 (2006) (discussing the reduced investor cost and uncertainty accompanying standardized governance structures).

[386]*See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 723–24 (1997).

which have been successfully tested in practice.[387] They invest resources in developing governance structures, reviewing its risks, drafting agreements, and assessing its compliance—and they receive feedback from investors.[388] To reduce their own costs and increase the likelihood of a successful offering, instead of using unfamiliar provisions and completely new governance terms in a subsequent IPO, consultants are more likely to use their previous experience and adapt already tested structures to each new offering.[389] Practical evidence supports this argument. The underwriters of the IPOs of the sample LLCs were often led by the same investment banks. Particularly, Citigroup Global Markets and RBC Capital Markets jointly or separately participated in the IPOs of almost 65% of all oil and gas publicly traded LLCs; Goldman, Sachs & Co. was the lead underwriter of four (out of the total of five) equity and hedge fund managers.[390] Similarly structured IPOs were likely to have the same lead underwriters.[391]

To conclude, the practice has developed structures that have been tested and accepted by investors. Given the high level of standardization in LLC listings, any offering deviating from the standardized practices may raise concerns and be subject to a thorough study by investors before they decide to invest. Hence, the freedom of contract provided by the statute is actually limited.

VII. CONCLUSIONS

The analysis of the operating and other governance agreements of publicly traded LLCs showed that these companies tended to use the contractual freedom of the Delaware LLC statute to devise governance structures where the founding members had effective control over the boards of directors and officers and faced fewer formalities during decision making.[392] However, these companies used different contractual mechanisms to balance the rights of controlling and minority members.[393] In addition to the legal mechanisms of investor protection, other factors—such as ownership structures, board structures and board practices, dividend policies, market disciplining, and the standardization of the governance structures—affected the governance of the publicly

[387] *See id.* at 720–21 (discussing learning externalities related to drafting efficiency).

[388] *See id.* at 722–23 (explaining the benefits of using terms and provisions that have withstood judicial scrutiny and investor review).

[389] The corporate governance industry benefits from adopting familiar governance structures because there are fewer costs involved in formulation and litigation. *See id.* at 720–23.

[390] The data on the lead underwriters of the sample publicly traded LLCs were obtained from the *Wall Street Journal* and NASDAQ. The information was available for nineteen out of the twenty sample companies. Original Research (on file with author).

[391] Original Research (on file with author).

[392] *See supra* text accompanying notes 106–119.

[393] *See supra* text accompanying notes 214–217.

traded LLCs.[394] As a result, investors do not get identical levels of investor protection in listed LLCs as in corporations, but the contractual freedom to shape the governance of listed LLCs, contrary to expectations, has not led to an extensive lowering of the bar in the protection of investors' rights of financial markets.

The data on the ownership structure of publicly traded LLCs permits several observations. First, the evidence is clear that the choice of these structures was not accidental or a result of the preferences of the founders. Ownership and capital structures were actively used by listed LLCs to mitigate adverse selection, moral hazard and agency issues, and to make public offerings of shares representing LLC interests attractive for outside investors. These structures are dynamic—changing depending on where a company is in its life cycle, its capital needs, and other factors. Thus, the ownership and capital structures serve both as substitutes for and complements to the legal protection mechanisms of the operating agreements of listed LLCs. Second, outside investors in publicly traded LLCs, as a rule, had voting rights and could participate in the decision-making procedures.[395] In the majority of the publicly traded LLCs, the controlling members had to hold significant ownership interests to get control rights;[396] in cases where the controlling member's economic interest was small, outside investors received additional guarantees in the form of the limitation of the scope of the activities of the company and the discretion of the managers.[397] Finally, although the majority of publicly traded LLCs elected partnership taxation, several LLCs were taxed as corporations.[398] Innovative ownership structures combined these two taxation options and offered a choice to public investors with the aim of widening the investor base.

With regard to the structure, composition, and practices of the boards of directors, publicly traded LLCs did not differ significantly from listed corporations. Most of them had to comply with the corporate governance requirements of stock exchanges.[399] However, the companies that were considered controlled and were eligible for exemptions from these requirements opted for complying with one or several corporate governance requirements as well. The boards of the listed LLCs were mostly composed of the majority of independent directors, they established audit, compensation and other committees

[394]*See supra* Part VI of this Chapter.

[395]*See supra* Table 1–I; *see also* Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 214 (2011) (discussing shareholder voting rights in the context of publicly traded LLCs).

[396]*See supra* Part IV of this Chapter.

[397]*See supra* text accompanying notes 293–300.

[398]*See supra* Table 1–I.

[399]*See supra* text accompanying notes 341–357.

composed of independent directors, and they regularly held board and committee meetings.[400]

Publicly traded LLCs tended to distribute a significant part of their earnings and cash flows among the members.[401] This practice complies with the prediction of the theory that cash distributions limit the discretion of the managers and, hence, the agency problems within LLCs.[402] The annual dividend yield of the listed LLCs was usually more than triple the dividend yield of S&P 500 corporations. High level of cash payments compensated outside investors of listed LLCs for their limited investor rights, but limited their growth opportunities, particularly through acquisitions.

Finally, to keep going as a business, publicly traded LLCs had to turn to the markets regularly through SPOs and the issuance of debt notes.[403] The practice of paying high dividends did not allow them to retain earnings and accumulate cash similarly to corporations.[404] For this reason, market discipline could be stronger for listed LLCs than for corporations. Additionally, the public offerings of LLC interests were clustered around several standardized governance structures.[405] This standardization could establish confidence among outside investors and further discipline the founding members.

As listed businesses, publicly traded LLCs are subject to many rules that apply to listed corporations, including securities laws, stock exchange regulations, say-on-pay rules, and others.[406] However, they can elect partnership taxation,[407] they have more options for enhancing control by founding members and managers,[408] and they can opt out from several corporate law concepts in order to reduce formalities in decision-making and limit incentives of speculative litigation induced by some abstract standards applicable in the corporate law setting.[409] By using this freedom, publicly traded LLCs distort the traditional governance mechanisms of listed corporations, but they have alternatives to offer to investors. Therefore, this distortion does not swing the pendulum of investor protection strongly in the direction of insiders.

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[400]*See supra* Part VI.B of this Chapter.

[401]*See supra* Part VI.A of this Chapter.

[402]*See supra* text accompanying note 306.

[403]*See supra* Part VI.C of this Chapter.

[404]*See supra* Part VI.A of this Chapter.

[405]*See supra* Part VI.D of this Chapter.

[406]*See supra* text accompanying notes 341–357; Manesh, *supra* note 373, at 484 ("[L]ike all other public corporations, these noncorporations are subject to the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, and other regulations intended to protect public investors.").

[407]*See supra* Table 1–I; *see also* Heather M. Field, *Checking In on "Check-the-Box"*, 42 LOY. L.A. L. REV. 451, 471 n.113 (2009).

[408]*See supra* text accompanying notes 106–119.

[409]*See supra* text accompanying notes 15–17; *see also* Horton, *supra* note 27, at 57–58 (discussing how non-corporate entities can opt out of fiduciary duty requirements).

Certainly, this comes with a cost for public firms choosing the LLC form, because the cost of financing can be higher.[410] During a certain period after early IPOs, non-corporate business forms were and in some matters are still surrounded by a layer of uncertainty.[411] Additionally, many professional advisors, which have built their knowledge around IPOs by corporate business form, are perhaps reluctant to invest new resources in knowledge development for securities offerings by non-corporate business forms. However, more IPOs, the development of the case law, and academic and newspaper publications are gradually dispelling the dense layer of uncertainty and making such structures familiar among investors and professional investment advisors. In the end, the risk related to investments in publicly traded LLCs and LPs, if not mitigated by alternative rights, can be priced into their securities. Thus, investors can choose between strong legal protection and low investment returns or weak protection and higher returns. Where alternative protections offered by LLC governance structures are not equivalent to the rights of investors in listed corporations and the weaker protection is not compensated by higher cash distributions, the offered securities are expected to be priced lower.

[410] *See supra* Part VI.C of this Chapter.
[411] *See supra* Part VI.C of this Chapter.

Appendix 1–I

Summary scorecard: LLC agreement provisions of the publicly traded LLCs and their prevalence, N = 20
If the answer to the question was positive, then the coding variable took a value of 1; otherwise it took a value of 0. Numbers show how many sample LLCs had a respective provision in their LLC agreements. The percentage shows the share of companies with a respective provision in the total number of sample LLCs.

LLC agreement provision	**Number**	**Percentage**
Formalities		
Is there an annual member meeting?	15	75
Are there procedural rules of member meetings?		
a) quorum requirement	20	100
b) voting threshold	20	100
c) notice period	18	90
d) record date	20	100
Is there an appraisal right in cases of mergers and consolidations?	0	0
Does the agreement define a member's inspections rights of books and records?	17	85
Do members have audit rights?	0	0
Is there an annual board/management election?	11	55
Are there procedural rules of board meetings?		
a) quorum requirement	20	100
b) voting threshold	20	100
c) notice period	19	95
Is manager/board member:		
a) named in an LLC agreement?	9	45
b) designated pursuant to an LLC agreement?	20	100
Management structure		
Is there a centralized management with:		
a) one member?	1	5
b) non-member?	20	100
c) more than one member?	0	0
Can a board member/manager resign?	19	95
If a board member/manager resigns, can LLC recover damages (other remedies)?	0	0
Is there a board of directors?	20	100
Are board members the same as officers?	0	0
Are board members/managers compensated by members rather than the LLC?	0	0
Is the compensation of board members/managers defined by:		
a) managers?	20	100
b) members?	0	0
Can minority members (10% and more) call member meetings?	2	10
Can minority members (10% and more) make business and director nominations?	7	35
Is written board action without board meeting allowed?	20	100
Is unanimous consent required for written board action without board meeting?	16	80
Is written decision-making by members without member meetings allowed?	14	70
Is unanimous consent required for written decision-making by members?	3	15
Can members remove board members by the vote of:		

a) 50%?	11	55
b) 2/3 or other supermajority vote?	6	30
c) subject to the approval of a certain member?	3	15
d) only for cause?	4	20
Can the board of directors remove officers:		
a) at any time without any cause?	15	75
b) only for cause?	4	20
Interest transfer restrictions		
Is there a general default approval clause for becoming an LLC member?	0	0
Is there a right of first offer?	0	0
Is there a right of first refusal?	0	0
Is there a drag-along right/limited call option?	11	55
Is the minimum threshold for activating drag-along right/limited call option set at:		
a) 80%?	6	30
b) 90%?	5	25
c) other threshold?	0	0
Is there a mandatory purchase/sell-out right?	2	10
Is there other buy-sell option?	0	0
Do members have preemptive rights during the issuance of new interests?	1	5
Is the assignment of LLC interests fully banned?	0	0
Dissolution and member withdrawal		
Does an LLC have perpetual existence?	20	100
Are there special events when an LLC can be dissolved?	4	20
Is LLC dissolution by member vote not allowed?	0	0
Can members dissolve an LLC by the minimum vote of:		
a) 50%?	20	100
b) 2/3? (if only non-voting shares are voting for dissolution)	2	10
c) unanimous consent? (if the approval of the board of directors is not obtained)	3	15
Is judicial dissolution of an LLC:		
a) expanded as compared to § 18-802 of the Delaware LLC Act?	0	0
b) waived?	0	0
Does the death, retirement, resignation of any member lead to an LLC dissolution?	0	0
Does the death, retirement, resignation of a specific member lead to an LLC dissolution?	3	15
Can any member resign before an LLC dissolution:		
a) at will?	0	0
b) if a member votes against important company matters?	0	0
Are there substitutes for freedom of dissolution and member withdrawal?		
a) unanimous voting or minority veto rights	0	0
b) buy-sell options	0	0
c) drag-along/sell-out rights	0	0
d) resignation rights at will	0	0
e) resignation rights upon occurrence of specific events	0	0
Amending LLC agreement		
Is an LLC agreement amendment allowed by:		
a) unanimous vote?	0	0
b) supermajority vote? (only certain matters)	6	30
c) simple majority vote?	20	100

d) the prior approval of the board of directors/managers?	17	85
e) the approval of persons who are not signatories?	0	0
Capital structure & capital contributions		
Is it possible to make capital contributions by:		
a) promissory notes?	1	5
b) future services?	1	5
Can a member be admitted without a contribution?	5	25
Can a member be admitted without an interest?	1	5
Can non-members vote on LLC governance matters?	1	5
Does the issuance of additional LLC interests within the existing classes require member vote?	4	20
Does the issuance of new classes of LLC interests require member vote?	7	35
Are there different classes of members?		
a) non-voting	1	5
b) preferred	1	5
c) other	11	55
Are certain classes of LLC interests sidelined from voting on:		
a) important matters?	0	0
b) LLC agreement amendments and other matters adversely affecting their rights?	0	0
Fiduciary duties		
Are fiduciary duties of LLC members restricted?	14	70
If LLC members' fiduciary duties are restricted, are the following duties carved out from the restrictions?		
a) duty of care	14	70
b) duty of loyalty – avoiding self-dealing	14	70
c) duty of loyalty – avoiding competition with the LLC	0	0
d) not acting in bad faith	14	70
e) not engaging in fraud	14	70
f) not engaging in willful misconduct	14	70
g) not acting with knowing violation of law	14	70
Are fiduciary duties of LLC members fully eliminated?	0	0
Are fiduciary duties of LLC members fully eliminated and members exculpated?	0	0
Are LLC members exculpated?	2	10
If LLC members are exculpated, are the following duties not covered by the exculpation clauses?		
a) duty of care	0	0
b) duty of loyalty – avoiding self-dealing	2	10
c) duty of loyalty – avoiding competition with the LLC	0	0
d) not acting in bad faith	2	10
e) not engaging in fraud	0	0
f) not engaging in willful misconduct	0	0
g) not acting with knowing violation of criminal law	2	10
Are fiduciary duties of LLC managers restricted?	13	65
If LLC managers' fiduciary duties are restricted, are the following duties carved out from the restrictions?		
a) duty of care	12	60
b) duty of loyalty – avoiding self-dealing	12	60
c) duty of loyalty – avoiding competition with the LLC	2	10
d) not acting in bad faith	11	55
e) not engaging in fraud	11	55
f) not engaging in willful misconduct	11	55
g) not acting with knowing violation of criminal law	11	55
Are fiduciary duties of LLC managers fully eliminated?	3	15
Are fiduciary duties of LLC managers fully eliminated and	3	15

managers exculpated?		
Are LLC managers exculpated?	20	100
Do LLC manager exculpation clauses apply to officers as well?	16	80
If LLC managers are exculpated, are the following duties not covered by the exculpation clauses?		
a) duty of care	20	100
b) duty of loyalty – avoiding self-dealing	9	45
c) duty of loyalty – avoiding competition with the LLC	3	15
d) not acting in bad faith	15	75
e) not engaging in fraud	13	65
f) not engaging in willful misconduct	12	60
g) not acting with knowing violation of any law	7	35
h) not acting with knowing violation of criminal law	7	35
i) not acting with material violation of any law and committing a felony	1	5
j) not acting with gross negligence	2	10
Are there substitutes for fiduciary duties?		
a) conflict of interest rules for LLC managers	16	80
b) conflict of interest rules for LLC members	19	95
c) large transaction rules	10	50
d) large member holding 30% or more economic interest	5	25
e) unanimous voting/veto rights on important matters and large transactions	0	0
Limited liability & veil piercing		
Do members and managers have personal obligations for the debts of the LLC?	0	0
Ownership structure & control rights		
Is there a large member holding more than:		
a) 20% economic interest?	7	35
b) 30% economic interest?	5	25
c) 50% economic interest?	5	25
d) 20% voting rights?	9	45
e) 30% voting rights?	7	35
f) 50% voting rights?	7	35
Does management have 5% or more economic interest?	11	55
Is there a member with rights to:		
a) appoint majority of board members/officers?	8	40
b) appoint board members/officers?	4	20
c) make specific decisions?		
i) LLC agreement amendment	3	15
ii) LLC dissolution	3	15
iii) approve mergers	2	10
d) exert effective control over decision-making in other ways?	11	55
Can the board oppose mergers without taking into account fiduciary duties?	5	25
Can an LLC engage in any lawful activity?	17	85
Is there a proportional allocation of income and losses?	18	90
Is there a specific target distribution payment for members?	9	45
Are there management incentive distribution rights?	2	10
Are there specific debt limits for an LLC?	3	15

2. CONTRACTUAL MECHANISMS OF INVESTOR PROTECTION IN NON-LISTED LIMITED LIABILITY COMPANIES*

I. INTRODUCTION

Limited liability companies (LLCs) are the second most popular legal form of business in the United States. According to the most recent data available for active business forms, more than one-third of all firms are LLCs.[412] In the majority of the states, LLCs outnumber corporations in new business formations.[413] If new formations of LLCs keep increasing at the same pace, LLCs will very soon catch up with and perhaps pass corporations as the preferred form of business in the United States.

The rise of LLCs is changing the traditional governance structures and investor protection mechanisms used in firms. LLCs combine limited liability of their members with strong contractual freedom in relations of the members and internal governance matters.[414] State LLC statutes, as a rule, are based on the principle of contractual freedom and are thus flexible statutes permitting company founders to engage in private ordering to govern their internal relations. Given the default nature of almost all provisions of the LLC statutes, the founders can use LLC operating agreements to form LLCs that either replicate traditional governance structures of corporations or modify and waive any or all long-established investor protection rights, including fiduciary duties of members and managers. This flexibility permits users of the LLC form to employ contracts to draft customized rules governing their business relationships. Yet, it can also be abused by the party to an agreement that has stronger bargaining power. The controversy focuses on the question of imposing some mandatory rules that will protect the interests of LLC members. Although studying the actual contractual practices in LLCs can shed some light on the reality and provide insights for LLC members, courts, and legislators, the usual confidential nature of the private agreements complicates matters.

The study of the operating agreements of all publicly traded LLCs in the United States shows that though the founders of these firms extensively opted out from default statutory rules to strengthen their decision-making rights, entrench control, and limit the role of the fiduciary duties of care and loyalty, some contractual substitutes and

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*This chapter is based on an article published earlier in the *Villanova Law Review*. *See* Suren Gomtsian, *Contractual Mechanisms of Investor Protection in Non-Listed Limited Liability Companies*, 60 VILL. L. REV. 955 (2015).

[412]*See supra* Part II of Chapter 1 (presenting recent statistical data on LLCs).

[413]*See supra* Part II of Chapter 1.

[414]*See* RIBSTEIN, *supra* note 213, at 137, 143–47, 153–56.

non-legal factors played an important role in protecting the rights and interests of minority investors.[415] The situation is different in closely held LLCs for two reasons. First, non-listed LLCs are not subject to the federal securities laws and the listing requirements of stock exchanges; additionally, market disciplining plays a far weaker role. Second, investors in non-listed LLCs do not have the option of selling their interests in a liquid market. Hence, contractual mechanisms of investor protection are expected to play a larger role in non-listed LLCs, at least where members have access to the advice of professionals.

Delaware was the eighteenth state to introduce an LLC act and did so by enacting the Delaware Limited Liability Company Act (Delaware LLC Act) in 1992.[416] Delaware rules on LLCs are regarded as some of the most flexible among LLC statutes in the United States. In addition to the generally enabling nature of the statute itself, the supportive approach of Delaware courts towards contractual freedom in business organizations drafting and strong enforcement of contractual arrangements of parties of intercompany relations contributes to the high flexibility of Delaware's legislation on LLCs. The operating agreement is the primary source of governance for Delaware LLCs, and the statute applies if the agreement is silent. LLCs, in the words of a former Delaware judge, Chancellor William Chandler III, "*are creatures of contract*."[417] This flexibility, combined with the expertise of the Delaware courts, has attracted many businesses and led to the widespread use of Delaware LLCs. According to the most recent data, Delaware, a tiny state, has the third highest number of LLC formations after Florida and Texas. More than 150 LLCs are formed in Delaware annually per 1,000 state inhabitants aged eighteen and over; the runner-ups—Wyoming, Nevada, Colorado, Utah, Florida, and others—are far behind with less than thirty new LLC formations.[418]

This empirical study analyzes the operating agreements of almost 300 non-listed LLCs formed in Delaware to establish the demand for freedom of contract in LLC governance and to examine the practice of investor rights in non-listed LLCs. All agreements were coded based on a scorecard containing eighty-four questions on investor rights. The results support the main hypothesis that in cases of changing default statutory rules, the parties used other contractual substitutes that ensure

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[415] *See supra* Chapter 1.

[416] DEL. CODE ANN. tit. 6, §§ 18–101 to –1109 (2015).

[417] TravelCenters, LLC v. Brog, No. 3516–CC, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (emphasis added).

[418] *See infra* Appendix 2–I. Similar calculations for corporations show that in 2013 the number of newly-formed corporations per 1,000 people aged eighteen and over was 47.32 in Delaware. Other states had much lower indicators. For example, the numbers of newly incorporated corporations in Florida, California, and Texas were 6.59, 2.63, and 1.21, respectively; in New York, which along with Illinois and Washington was among the few states where more corporations were formed than LLCs, five corporations were incorporated per every 1,000 adult inhabitants.

equivalent protection and, in many cases, increased clarity and reduced incentives for ex post speculative litigation. Furthermore, the choices of governance structures and investor rights were strategic; they tended to differ depending on the number of company members and underlying conflicts of interests. Given the large size of the firms in the sample, any extrapolation of these results, particularly to small businesses, should be approached very carefully. Documenting choices of sophisticated actors, though, is an asset itself, as it can be informative for different stakeholders.

The analysis starts with stating the main features of the LLC. This leads to the development of two hypotheses. Part III describes data sources and research design. Then it proceeds to the presentation of detailed information on the sample companies, their ownership structure, industrial division, and the analyzed operating agreements. Part IV contains the results of the operating agreements study presented in several subsections that deal separately with procedural matters, company management, interest transfers, dissolution, amending LLC agreements, profit distribution practices, and fiduciary duties. Part V discusses these results and offers explanations for the chosen governance structures and contractual rights. The findings are briefly summarized in Part VI. The following appendices describe typical provisions of operating agreements often mentioned in the main text and present the results of the statistical analysis.

II. THE FEATURES OF THE LIMITED LIABILITY COMPANY AND HYPOTHESES

The introduction of the LLC to every jurisdiction in the United States has widened the pool of organizational structures available to entrepreneurs. This new business form combines many features of partnerships and corporations. In LLCs, partnership taxation rules come together with the limited member liability feature of corporations, but, different from corporate business forms, the LLC is subject to enhanced default rules that regulate its internal governance matters.[419] However, the LLC is not a rigid statutory hybrid placed stably between partnerships and corporations. The LLC, due to its flexibility, can replicate one of these two business forms and at the same time have characteristics of the other. The LLC thus has many frames around which its members build their relations.

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[419]*See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Robert W. Hillman & Mark J. Loewenstein eds., 2015). Greater contractual freedom of LLCs and partnerships is one of the frequently cited distinctions between non-corporate and corporate business organizations.

The corporate form is not always an optimal business structure. It was created primarily to facilitate the accumulation of capital by entrepreneurs from a large number of investors who did not necessarily need to actively participate in the business. Therefore, corporate law has developed mechanisms for retaining control by entrepreneurs, on one hand, and the protection of the interests of these numerous investors, on the other.[420] However, some of these mechanisms are not relevant for small businesses where the members do not face the same conflicts of interests that numerous stockholders in large corporations do. Because not all corporate rules are enabling, small businesses would have to comply with burdensome and costly formal legal requirements that would be of limited value if they had only the corporate form to choose from. It was this recognition of the need to differentiate large listed corporations from non-listed ones that led to changes—first, in close corporations court practice and later, in statutes.[421] New statutory rules on close corporations allowed their stockholders to depart from these rules by providing for special internal governance rules in stockholders' agreements.[422]

An alternative option for small businesses is to choose partnership-type business forms. The partnership offers rules such as informal decision-making, restrictions on interest transfers, permanent appointment of managers, and simplified exit rules as a default. Therefore, this choice, by cutting transaction costs, can facilitate the process of establishing a business. Yet, the partnership structure comes with unlimited liability for the general partners. In theory the partners can achieve limited liability by private contracting, but this "contractual limited liability" will not be effective in cases of the tort claims of the partnership's creditors and corporate criminal liability.[423] Alternatively, the partners, subject to the risk of corporate veil piercing by courts, can hold interests indirectly through intermediary corporate forms that offer limited liability. Both options, however, imply greater transaction costs.

One of the most important advantages of the LLC is the feature of limited liability, which allows its members to shield their personal assets from claims of the company's creditors. At the same time, unlike corporations, the limited liability company "*keeps the price of limited liability down by providing for flexible tax rules and the tax planner with the chance to opt for the most optimal taxation*."[424] However, the LLC

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[420]Friedman, *supra* note 38, at 43.

[421]Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 304, 312–14 (2008).

[422]*See id.* at 312–14.

[423]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 41 (1996); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 429 (2000).

[424]*See* JOSEPH A. MCCAHERY & ERIK P.M. VERMEULEN, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES 114 (2008) (emphasis added).

choice is affected by more than tax considerations. More than 6% (148,649 LLCs) and almost 2% (40,933 LLCs) of LLCs operated under S corporation and C corporation taxation regimes in 2006, respectively.[425] Apart from the several benefits of the S corporation taxation regime as compared to partnership taxation, this election suggests that the LLC as a business form does not offer only the combination of tax advantages and limited liability.[426] While the S corporation taxation regime is available to both corporations and LLCs, entrepreneurs who are driven by the demand for contractual flexibility and autonomy of firm members to structure their firm's internal affairs can form an LLC to take advantage of the structure of default rules offered by state LLC law.

Generally, the founders of an LLC are free to make it more partnership-like by entitling members to daily management functions and agreeing to dissolve the company upon the withdrawal of the members, or, alternatively, they can make it more like a corporation with centralized management structure and indefinite existence. After the introduction of the LLC, entrepreneurs choosing the optimal organizational structure are no longer constrained by the availability of member limited liability. The election of a partnership-like or corporation-like governance structure depends entirely on their needs.

By making default rules of partnerships automatically available to the members of an LLC, LLC statutes reduce the negotiation and contracting costs of the members. However, these default rules are not always detailed; state LLC statutes can be very general by leaving most of the work to be done by the founders of an LLC. In such situations, if the founders fail to anticipate their possible needs and do not include negotiated solutions in the operating agreement of the company, they may face governance issues in the future deriving from that legal vacuum. As a result, they have to rely either on renegotiation or ex post gap filling by courts. Both options can be problematic, as the first puts the party that requires renegotiation in a weaker bargaining position,[427] while the second is subject to uncertainty, time-consuming procedures, litigation costs, and the possibility of judicial error.[428]

The Delaware LLC Act is an example of a general statute that does not provide default solutions for many future contingencies. Do the members of Delaware LLCs, then, draft contractual rules that can supplement the general defaults of the statute? The second issue of default rules is the ability of the members to alter any, or all, traditional

[425]*See* Chrisman, *supra* note 36, at 486.

[426]*See id.* at 488.

[427]*See* Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2020–21 (1987).

[428]*See* VERMEULEN, *supra* note 4, at 243; *see also* MCCAHERY & VERMEULEN, *supra* note 424, at 247.

investor protection mechanisms. As compared to corporate stockholders, these alterations can put some members in a disadvantageous position and thus can create problems for members vis-à-vis other members or managers. Does this lead to situations where some members give up investor protection rights to protect them from opportunistic behavior by other members or managers? These are the questions addressed in this Article.

Following these raised questions are two main hypotheses. According to Hypothesis 1, the founders of LLCs include detailed rules in the operating agreements that fill the gaps of general default rules of the Delaware LLC Act. This hypothesis is mostly driven by the logic that the members of the sample companies covered by this study were large investors who have access to professional consultants and could afford to draft detailed contracts. This situation could be different in small firms where the founders' access to qualified legal advice is limited. Therefore, the choices made in the sample firms can be informative both for the legislatures that supply modified default rules for small firms and for the founders of small firms that draft LLC operating agreements. A negative alternative to Hypothesis 1 would be the ignorance of gaps by the contractual parties at the stage of ex ante contracting.

According to Hypothesis 2, LLC operating agreements often alter traditional investor protection mechanisms. There could be a number of reasons for this: to adapt the governance structures of firms to the specific needs of their members, depending on the circumstances of their relations, or the desire to limit the uncertainty that emanates from general standards—such as fiduciary duties—to name a few. In the latter case, if the number of members so allows, it is more reasonable to expect the operating agreement to substitute fiduciary duties with detailed decision-making rules that give veto rights to members in situations where the risks of opportunistic self-dealing are high.

Before analyzing the practice of contracting in non-listed LLCs, this Article describes the methodology of the study and the sample firms.

III. DATA, RESEARCH DESIGN, AND DESCRIPTIVE STATISTICS

The database of the LLC agreements used in this study was created compiling the operating agreements of LLCs filed with the Securities and Exchange Commission (SEC). The sample companies thus were not start-ups or small "mom and pop" businesses; rather, they were independent firms or joint ventures formed by large corporations. A search of the SEC's EDGAR database yielded LLC agreements of 887

U.S. companies.[429] Some of these LLCs had more than one agreement because the initial agreements were amended or restated. The general approach was to use the latest text of any duplicative agreement.

The analysis of the ownership structure provides important insights into the possible conflicts of interests in LLCs. For this purpose, all LLCs in the sample were divided into six groups: (1) LLCs with one member, (2) LLCs with two members, (3) LLCs with 3–10 members, (4) LLCs with more than ten members, (5) LLCs that offered LLC units to a wide group of investors, but did not create a public market of these units, and (6) publicly traded LLCs.

In several cases, the LLCs in the sample had affiliated members. For instance, an LLC could be formed by "sister companies" or by a company and its subsidiary. After identifying the cases where the actual number of independent members was lower, based on the information from annual and current reports filed with the SEC and from the LLC agreements, the ownership structures of the sample firms were coded in a way to reflect this information. The data on the ownership structure of the initial sample are in Table 2–I.

Table 2–I: Ownership structure of the sample LLCs

LLCs	Total	% of Total	Formed in Delaware	% of Total	Formed in Other States	% of Total
1 member	435	49.04	328	36.98	107	12.06
1 member*	481	54.23	366	41.26	115	12.97
2 members	197	22.21	164	18.49	33	3.72
2 members*	198	22.32	168	18.94	30	3.38
3–10 members	114	12.85	97	10.94	17	1.92
3–10 members*	74	8.34	62	6.99	12	1.35
> 10 members	70	7.89	66	7.44	4	0.45
> 10 members*	63	7.10	59	6.65	4	0.45
Widely held (no public market)	51	5.75	43	4.85	8	0.90
Publicly traded	20	2.25	20	2.25	0	0.00

Notes: The rows with * include data where all affiliated members were counted as one member. The maximum number of members in rows 8 and 9 is 79 and 71, respectively.

The database was further refined by removing all LLC agreements of one-member companies, which could not have potential conflicts of

[429]For a detailed description of the search strategy, see *supra* Part III.A of Chapter 1. Michelle Harner and Jamie Marincic, using a similar strategy of searching for references to LLC agreements in annual reports filed during different years, identified 129 LLC agreements. *See* Harner & Marincic, *supra* note 21, at 901. In this study, the search was limited to annual reports filed during 2012 only, yet the number of the obtained LLC agreements is larger.

interests between members, publicly traded LLCs and companies that were widely held by qualified investors but did not have a public market, and firms formed in states other than Delaware. The latter restriction on the data, which reduced the sample of non-listed firms with two or more independent members by less than 14%, aimed to eliminate the possible influence of state statutory differences on contractual choices that parties had made. The final database contains operating agreements of 289 LLCs formed according to the Delaware LLC Act. Of the total number, 168 firms had 2 non-affiliated members, 62 had 3 to 10 independent members, and the remaining 59 had more than 10 independent members.[430] A typical operating agreement in the sample is more than fifty pages long and contains detailed rules of conduct for the parties.

The sample company groupings based on ownership characteristics is one of the features that distinguishes this study from previous empirical studies of operating agreements in non-listed LLCs.[431] Obviously, the operating agreements of one-member LLCs cannot be analyzed in the same group with operating agreements of publicly traded LLCs. Such a grouping can distort the results of the analysis. Similarly, in two-member LLCs used for joint ventures, the members face different conflicts of interests as compared to LLCs with a larger number of members where one of the members holds controlling voting rights while others are minority investors.

In addition to introducing grouping samples based on number of members, this study differs from previous work by analyzing a large number of contractual provisions in the sample companies' operating agreements that could affect the rights and interests of their members. Company governance is affected by various legal and non-legal factors, which define the role of the company members in this system. The focus only on specific aspects of investor rights, such as fiduciary duties of members and managers or their ownership and voting rights, would certainly lead to incorrect conclusions about the overall level of available investor protection. For this reason, this study coded the sample LLC members' contractual rights based on a wide range of variables.

The coding criteria were defined based on (1) background information, (2) information about the ownership of voting and equity rights, and (3) the main differences of the legal regime of LLCs as

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[430]The study of these firms' operating agreements revealed several cases where the members, although not always formally affiliated, had special relationships that made detailed contracting unnecessary. These were cases where one (group) of members held top-management position(s) at the other members' board or all members were employees of a third firm. Given these special relationships, these firms were removed from the database at the stage that defined the role of different investor protection mechanisms by means of correlation analysis. Thus, for this purpose, the sample contains 158 firms with two members, 56 firms with the number of members from 3–10, and 29 firms with more than ten members, in total 243 LLCs.

[431]*See, e.g.*, Harner & Marincic, *supra* note 21.

opposed to corporate statutes. Within these three areas, eighty-four primary questions were identified.[432] The author read all 289 sample LLC agreements and coded all variables (except background information) as either 0 (a negative answer) or 1 (a positive answer).

Delaware is famous for attracting LLC formations from businesses domiciled in other states. Similar to its large number of corporate incorporations, Delaware leads the race of local LLC formations for large LLCs: more than 95% of LLCs with 5,000 or more employees that are formed outside the state of their principal place of business are formed in Delaware.[433] Only two LLCs in the sample had their executive offices in Delaware. New York (80 firms), Texas (28), California (25), Illinois (16), Colorado (15), Florida (13), and Massachusetts (10) were the main locations of the principal places of business of the LLCs included in the sample. The remaining companies were located in twenty-eight other states.[434]

Although all sample firms were formed in Delaware, five firms chose the law of other states to govern their operating agreements.[435] Many other companies, while still governing their operating agreements by Delaware law, choose other jurisdictions for dispute resolution.[436] These were not necessarily the courts of the state where a firm's principal place of business was located, though in the majority of cases, the choice of jurisdiction for dispute resolution and the place of business coincided. In more than 14.5% of the LLCs, the courts of other states were the exclusive venues of adjudication, and in another 2.7% of cases they were the preferred venue, though the LLC agreements did not ban bringing lawsuits in Delaware courts.[437] Arbitration, often as an exclusive dispute

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[432]The full scorecard appears as an appendix in Chapter 1. *See supra* Appendix 1–I.

[433]Dammann & Schündeln, *supra* note 37, at 745.

[434]These states were Pennsylvania (9), New Jersey (7), North Carolina (7), Ohio (7), Connecticut (6), Missouri (6), Oklahoma (6), Tennessee (6), Michigan (5), Arizona (4), Georgia (4), Maryland (4), Minnesota (4), Nevada (4), Indiana (3), Idaho (2), Oregon (2), Virginia (2), Washington (2), West Virginia (2), Arkansas (1), Hawaii (1), Iowa (1), Louisiana (1), Omaha (1), Rhode island (1), Utah (1), and Wyoming (1).

[435]Delaware law is clear that if parties of a Delaware LLC so choose, all provisions of the LLC agreement will be governed by and construed under Delaware law. DEL. CODE ANN. tit. 6, § 18–1101(i) (2015). Although the Section 29 of the 2010 bill specifically notes that the amendment is merely for the sake of clarification and is not intended "*to negate the application of the internal affairs doctrine*" to Delaware LLCs, it is not clear to what extent the courts of other states would apply non-Delaware law chosen by the members of a Delaware LLC to its operating agreement. *See* H.R. Bill No. 372, 145th Gen. Assemb., Reg. Sess. (Del. 2010), *available at* http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+372/$file/legis.html?open [http://perma.cc/J8TC-L53D] (emphasis added).

[436]New York courts were the most popular, followed by state and federal courts of Texas.

[437]The election of non-Delaware courts as an exclusive dispute resolution venue in the LLC agreements of many sample companies is difficult to explain, given the statutory ban on waiving the right of members to sue in Delaware courts. DEL. CODE ANN. tit. 6, § 18–109(d). Hence, with the exception of arbitration agreements, the disputes with respect to organizational

resolution mechanism, was chosen by 26.9% of the sample companies. Hence, the Delaware Court of Chancery was the desired venue for resolving disputes between the members of the sample companies in only 55.7% of cases.

Table 2–II: Number of the LLC agreements in the period from 1996 to 2013

Year	Delaware LLC Agreements	% of the Sample
1996	1	0.35
1997	0	0.00
1998	3	1.04
1999	6	2.08
2000	4	1.38
2001	4	1.38
2002	4	1.38
2003	9	3.11
2004	9	3.11
2005	18	6.23
2006	12	4.15
2007	43	14.88
2008	31	10.73
2009	46	15.92
2010	37	12.80
2011	49	16.96
2012	12	4.15
2013	1	0.35
Total	289	100.00

Table 2–II shows that most of the LLC agreements in the sample were entered after 2006. Low results for the years after 2011 are due to the strategy of populating the sample. Where the fiscal year coincides with the calendar year, annual reports are usually submitted in the first half of the following year. Hence, by searching for references in the annual reports filed with the SEC in 2012, it was possible to obtain mostly references to LLC agreements entered before the start of 2012. It was only possible to find LLC agreements entered during the year of 2012 in cases where the fiscal year also ended during 2012. In most cases, these agreements were filed with the SEC by the parent companies

matters on the organization or internal affairs of the sample LLCs were subject to Delaware state court jurisdiction.

of the sample firms. However, in thirteen cases, the sample companies disclosed their own operating agreements as the (co-)issuers of senior notes or (co-)guarantors of other issuers of debt.

Table 3–III: Industrial division of the sample

SIC Code	Industry Title	Number of Firms	% of the Sample	% of All LLCs*
01–09	Agriculture, forestry, and fishing	1	0.35	2.56
10–14	Mining (excl. oil and gas extraction)	8	2.77	0.84
13	Oil and gas extraction	28	9.69	n.a.†
15–17	Construction	1	0.35	5.28
20–39	Manufacturing	36	12.46	1.98
40–48	Transportation and communications	10	3.46	1.55
49	Electric, gas, and sanitary services	21	7.27	0.10
50–51	Wholesale trade	5	1.73	2.41
52–59	Retail trade	6	2.08	4.68
60–67	Finance and insurance (excl. real estate)	55	19.03	7.09
65	Real estate	78	26.99	50.11
70–89	Services	40	13.84	21.71

Notes: * Includes all LLCs that filed partnership tax returns for the tax year of 2011.
† The figure for oil and gas sector is included in the data for the mining industry.

The LLC form is used in various industries. The majority of all LLCs operate in the real estate sector. Other business industries where LLCs are popular are professional services, finance and insurance, construction, and trade. The sample contains companies from different industries as well. Table 3–III presents the industrial division of the sample based on the first two digits of the Standard Industrial Classification Codes (SIC Codes). More than 46% of the firms came from finance and real estate sectors. Services, manufacturing, oil and gas, and transportation services are strongly represented as well. Comparing the industrial representation of all LLCs taxed as partnerships reveals many similarities.[438] However, the sample is overrepresented in the manufacturing and oil and gas sectors and underrepresented in services and construction. The main explanation for these differences is the fact that the sample, as a rule, does not include small businesses. The different share of real estate firms can also be explained by the fact that many LLCs holding interests in real estate are formed locally.

More than 70% of the sample LLCs had a member or a group of affiliated members controlling a majority of the voting rights. This share was the highest in LLCs with more than ten members (around 83%) and

[438]This comparison excludes one-member LLCs taxed as a sole proprietorship and is more appropriate given that the sample includes only firms with two or more members. The data on LLCs taxed as a partnership are taken from Ron DeCarlo, Lauren Lee & Nina Shumofsky, Internal Revenue Serv., *Partnership Returns, 2011*, STAT. INCOME BULL., Fall 2013, at 81, 184–86, *available at* http://www.irs.gov/pub/irs-soi/13pafallbulpartret.pdf [https://perma.cc/YH9H-HUH4].

the lowest in those with 3–10 members (around 64%). In two-member LLCs, 72% had a controlling member.

Unlike the listed firms cases, it was not common for non-listed firms to detach voting and economic rights: only a small number of companies issued non-voting units. In the majority of cases, these were units issued either to company managers and employees for the purposes of incentive schemes or to creditors of the firm. In the latter case, the owners of non-voting preferred units, in addition to fixed interest payments, usually were offered additional guarantees, such as the company's obligation to repurchase the preferred units at a fixed price after a certain period of time.

Finally, all sample firms, except five LLCs taxed as corporations, elected partnership taxation.

IV. THE PRACTICE OF GOVERNANCE AND MEMBER RIGHTS IN NON-LISTED LLCS

A. Legal Formalities

The partnership-like structure of the LLC and the enhanced role of default rules in LLC statutes imply that formalities have a narrower scope in this entity. Only the following formalities apply to LLCs formed in Delaware: the certificate of formation of an LLC shall be filed in the office of the Secretary of State; each LLC shall have and maintain a registered office and a registered agent in Delaware; an LLC shall maintain certain records such as membership lists and tax returns; if the LLC agreement provides for the management by a manager, a manager (managers) shall be chosen; and each LLC shall pay an annual Delaware franchise tax in the amount of $250.00.[439]

Appraisal rights of LLC members in the cases of mergers and consolidations are only contractual, which means that they are available only if they are provided for in an LLC agreement, an agreement of merger or consolidation, or a plan of merger.[440] Because Delaware LLC members have the opportunity to provide for unanimous decisions on important matters such as mergers and consolidations, and they can agree on withdrawal rights, appraisal rights are less important in LLCs than they are to corporations with many minority stockholders where voting rights alone may not be an effective protection from conflicts arising in the context of control transactions. Access to the information and

[439] DEL. CODE ANN. tit. 6, § 18–1107(b) (2015); *see also* tit.6, §§ 18–201(a), 18–206(a) (filing requirements); *id.* § 18–104(a) (registered office and agent requirements); *id.* § 18–305(a) (records requirements); *id.* § 18–402 (selection and assumption of office of manager); *id.* § 18–1107(b) (franchise tax). The manager can be named in the LLC agreement, or designated pursuant to the procedure set forth in the LLC agreement. *Id.* §§ 18–101(10), 18–401.

[440] *See id.* § 18–210.

records of an LLC by its members and managers, by contrast, can be restricted by the LLC agreement.[441]

According to Delaware law, procedural formalities of member and manager meetings—such as notices, establishment of a record date, quorum requirements, and minimum voting thresholds—shall be defined in an LLC agreement.[442] As mentioned earlier, this flexibility may lead to gaps in poorly drafted governing documents.[443] Therefore, the regulation of legal formalities in the sample LLCs' operating agreements can shed some light on Hypothesis 1. The absence of many corporate legal formalities in the LLC context makes it an attractive structure to organize new businesses. On the other hand, this flexibility may lead to unforeseen risks. Hence, it is reasonable to expect members to regulate, in detail, the formal aspects of the LLC management's internal affairs in the operating agreement where the number of members is large, or some of them hold minority interests, or are passive investors, or have limited means of access to the LLC and to information about its activities.

Among the two-member sample LLCs, it was uncommon to organize annual member meetings and annual board or officer elections (11.9% and 8.33%, respectively). Most of them (63.1%) had boards of directors, which often substituted for member meetings rather than functioned as traditional boards of directors. More than 90% of the LLCs from the group with boards of directors also had procedural rules for board meetings. The share of the firms with the procedural rules for member meetings was lower (just above 65%), but in more than 22% of the firms, board meetings were substituted for member meetings.

Annual member meetings and annual election of managers were not common in the companies with 3–10 members either (22.6% and 16.1%, respectively). Boards of directors functioned in almost two-thirds of the firms, though it was not common to substitute member meetings with board meetings. In the LLCs with more than ten members, boards of directors never exercised the functions of member meetings. All firms with 3–10 members that had boards of directors also adopted procedural rules for board meetings, but only 64.5% had procedural rules for member meetings. Similarly, all boards in the LLCs with more than ten members had procedural rules, which, as a rule, also specified minimum quorum requirements and notice periods.

In all sample firms, a well-adopted practice was to reduce legal formalities by allowing written decision-making by the boards of directors without holding formal meetings. Decision-making without formal meetings by members was less common. Nevertheless, in all three groups of companies, more than half of the sample provided for

[441]*See id.* § 18–305(a), (b), (g).

[442]*See id.* § 18–302(c) (stating requirements for member meetings); *id.* § 18–404(c) (stating requirements for manager meetings).

[443]*See* Friedman, *supra* note 38, at 55.

this option. While the operating agreements sometimes required a unanimous vote of directors for the board to act without a meeting, similar requirements were not common for written decision-making by member meetings, and unanimous member votes were never required in the LLCs with more than ten members, where achieving unanimity, due to the number of members entitled to cast their votes, could be problematic.

Appraisal rights in cases of mergers were an exception: only two firms provided such rights to their members. In both, mergers could be approved without a unanimous vote.[444] The vast majority of the two-member and 3–10 member LLCs extended the statutory information rights of their members and provided access to all company books and records (82.7% and 74.2%, respectively). In both ownership groups, this access was more likely to be provided for any purpose than to be limited by the need to establish a reasonable purpose.[445] Given the large member holdings and the members' active roles in management, the unlimited inspection right does not come as a surprise. However, the situation changes when the number of members increases. Less than one-third of the sample firms with more than ten members entitled their members with the right to access company books and records. With the aim of ensuring necessary conditions for continued centralized management, most of the firms in this ownership group limited their members' inspection rights with the requirement to indicate a reasonable purpose. The remaining firms, as a rule, had minimum information rights provided by the Delaware LLC Act. Detailed information on legal formalities in the sample firms is provided in Table 2–IV.

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[444]In one of the two companies, the LLC agreement specified that appraisal rights did not apply if the LLC units were listed on a stock exchange or the company had more than 2,000 unit-holders. This limitation is perhaps influenced by § 262(b)(1) of the Delaware General Corporation Law, which denies appraisal rights for shares of stock listed on a national securities exchange or held by more than 2,000 holders. *See* DEL. CODE ANN. tit. 8, § 262(b)(1) (2015) (limiting appraisal rights for publicly traded companies).

[445]Minimum information rights of LLC members provided by the Delaware LLC Act are subject to the qualifying standard of "*any purpose reasonably related to the member's interest as a member of the limited liability company. . . .*" DEL. CODE ANN. tit. 6, § 18–305(a) (emphasis added). Similarly, in the setting of corporations, § 220(b) of the Delaware General Corporation Law conditions the right to inspect a corporation's books and records "*for any proper purpose*". tit. 8, § 220(b) (emphasis added). This qualifying standard aims to balance the information right of stockholders with the need to prevent undue interference from stockholders with the management rights of directors. *See* Seinfeld v. Verizon Commc'ns, Inc., 909 A.2d 117, 122 (Del. 2006). The LLC statute's "reasonable purpose" standard should be considered in this context as well.

Table 2–IV: Legal formalities in the sample companies, %

	2 members	3–10 members	> 10 members
Annual member meeting	11.90	22.58	8.47
Annual board election	8.33	16.13	6.78
Board of directors	63.10	64.52	40.68
Board substituting member meetings	22.62	6.45	0.00
Procedural rules for board meetings*	90.57	100.00	100.00
Board action without meeting*	87.74	90.00	95.83
Procedural rules for member meetings	65.48	64.52	30.51
Written decision-making by members	55.36	66.13	81.36
Appraisal rights	0.60	0.00	1.69
Right to inspect company books & records	83.33	74.20	28.81
Right to audit	22.62	9.68	0.00

Note: * In the total number of the sample companies that formed a board of directors.

The data on legal formalities support both hypotheses. First, the sample LLCs tailored formal rules on decision-making to their needs, thereby saving time and reducing unnecessary costs. An example with procedural rules in the two-member sample companies is illustrative. As mentioned earlier, where the companies formed boards of directors, it was also common for them to have defined procedural rules for board meetings. However, in a few cases, these procedural rules were not full: ten companies had no quorum requirement and six firms did not define minimum notice period. Yet, two-member firms can often dispose with full procedural rules for decision-making. First, if none of the members owns enough votes to endorse decisions, then the minimum voting threshold acts as a veto right and by itself is enough to protect the interests of the members. Second, the sample firms filled gaps of the Delaware LLC Act by adopting detailed procedural rules for member and management meetings where necessary. Weak procedural rules were often supplemented with strong information rights for members. Nevertheless, some firms did not have these rules. This problem can be more acute in smaller firms. However, including default procedural rules for member and board meetings in the statute could cancel out the benefits of reduced legal formalities in small firms.

B. Management Structure

According to the default rule of the Delaware LLC Act, the management of an LLC is conducted by its members in proportion to the members' interests in the LLC's profits.[446] This default rule can be changed by opting for centralized management, meaning that a manager or several managers—rather than all LLC members—are responsible for the day-to-day decision-making.[447] Notably, choosing a centralized management structure for a Delaware LLC does not automatically activate corporate formalities like annual member meetings of LLC members and annual management elections. Taking into account that the number of LLC members is typically small, and also that they do not encounter collective action problems, the presumption of the Delaware statute is that members should be able to organize such meetings and management elections themselves, as needed.

Unlike in close corporations, where the choice of the management structure shall be made in the certificate of incorporation, in LLCs this is a matter that is defined in an LLC agreement.[448] As the certificate of incorporation is a publicly available document that can be obtained for a certain fee, creditors of close corporations have an opportunity to find out information about the management structure of the corporation and define whether a stockholder or a manager can bind the corporation.

In Delaware LLCs, this issue is more complicated. In 1994, a new sentence was added to Section 18–402 of the Delaware LLC Act stating that unless otherwise provided in an LLC agreement, "each member and manager has the authority to bind the limited liability company."[449] Given that under centralized management all members cannot be involved in the management, this sentence should be interpreted as giving each member the authority to bind the LLC in member-managed LLCs and giving each manager the authority to bind manager-managed LLCs. Yet, because the choice of the management structure is made in an LLC agreement, creditors do not have any other means to obtain this information but to ask the company itself to provide a copy of the LLC agreement.

In this context, it is reasonable to expect the courts to use the general agency law concepts of actual and apparent authority to decide

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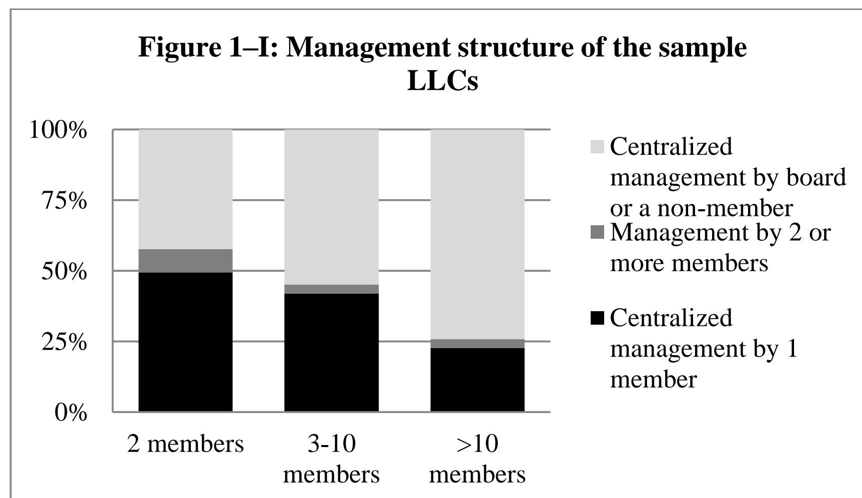
[446] *See* DEL. CODE ANN. tit. 6, § 18–402.

[447] *See id.* The default rule of the statute is driven by the restricted transferability of an LLC interest: in the absence of the freedom to exit an LLC, its members are actively involved in the management. *See* Robert R. Keatinge, Larry E. Ribstein, Susan Pace Hamill, Michael L. Gravelle & Sharon Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 428 (1992).

[448] *See* DEL. CODE ANN. tit. 6, § 18–402. *Compare* tit. 8, § 351 (providing management requirements for close corporations), *with* tit. 6, § 18–402 (providing management requirements for LLCs).

[449] 69 Del. Laws 260 (1994) (internal quotation marks omitted).

whether a member or a manager has authority to bind the LLC. If, according to the LLC agreement of a member-managed LLC, a member does not have actual authority[450] to bind the LLC (for instance, the transaction requires the consent of all members or a majority decision, which was not obtained), then, based on the concept of apparent authority,[451] her act does not bind the LLC when a third party has notice or knowledge of the lack of authority.[452] Similarly, if the Delaware Court of Chancery's approach is extended to manager-managed LLCs, it can be argued that if, in a manager-managed LLC, a manager (or member) does not have actual authority, her act will bind the LLC only where a third party did not have notice or knowledge of the lack of authority and reasonably relied on the authority of the manager manifested by the LLC members. Alternatively, third parties can use contractual representations and warranties to seek indemnification of damages incurred as the result of a LLC member or manager's false representation with regard to their actual authority to bind the LLC. The presence of such representations can probably also be considered by courts as a reasonable basis to rely on the authority of an LLC member or manager (in the absence of other facts that cast doubt on the reasonableness of the third party's reliance on apparent authority).



[450]"*Actual authority* is that authority which a principal expressly or implicitly grants to an agent." Albert v. Alex. Brown Mgmt. Servs., Inc., No. 762–N, 2005 WL 2130607, at *10 (Del. Ch. Aug. 26, 2005) (unpublished opinion) (emphasis added).

[451]"*Apparent authority* is that authority which, though not actually granted, the principal knowingly or negligently permits an agent to exercise, or which he holds him out as possessing." *Id.* (emphasis added).

[452]B.A.S.S. Grp., LLC v. Coastal Supply Co., No. 3743–VCP, 2009 WL 1743730, at *15 (Del. Ch. June 19, 2009) (unpublished opinion) ("[T]he party seeking to show the existence of such [apparent] authority must 'show reliance on indicia of authority *originated by the principal*, and such reliance must have been reasonable.'" (quoting *Albert*, 2005 WL 2130607, at *10)).

Although the Delaware approach is less certain for third parties, it allows more flexibility in defining the internal governance structure of LLCs. Moreover, the distinction between centralized management structures in member-managed and manager-managed LLCs can be very subtle. For instance, the difference is actually absent between a situation where—in a member-managed LLC—only some members can bind the company and a situation where in—a manager-managed LLC—one or two, but not all, managers can bind the company. Therefore, the disclosure of the general management structure of an LLC (member-managed or manager-managed) hardly tells third parties much about the authority of persons that can bind the company. Given this flexibility, the law should define a rule on binding a company without introducing any distinction between the general management structures. This is what the Delaware LLC Act does in Section 18–402.

The data from the sample confirm that member-and manager-managed LLCs can have very similar governance structures. More than half of the two-member sample companies were member-managed, but both members had management rights in only fourteen companies. In most cases, the management was centralized, as only one member was responsible for it. The remaining 42.2% had centralized management by a non-member or by a board of directors. With increasing member numbers, centralized management by a board of directors becomes more common. Almost 55% of the 3–10 member firms had boards of directors. The corresponding figure is 74% in firms with more than 10 members. Figure 1–I illustrates these data.

C. Transferability of Interests

Transfers of voting rights in Delaware LLCs are restricted by a default rule. The assignee of an interest has "no right to participate in the management of the business and affairs of a limited liability company except [(1)] as provided in the limited liability company agreement, or . . . [(2)] upon the affirmative vote or written consent of all of the members . . . [u]nless otherwise provided in the [LLC] agreement."[453] The assignee receives only the right to participate in sharing the profits and losses of the LLC.[454] At the same time, the assigning member "ceases to be a member" after the assignment of all of its LLC interest.[455] An LLC agreement can ban the assignment of an LLC interest entirely: members

[453]DEL. CODE ANN. tit. 6, § 18–702(a)–(b).

[454]*See id.* § 18–702(b)(2). This rule applies to involuntary transfers—for example, by a court order or as the result of forfeiture—as well. As involuntary assignees are not substituted members and cannot participate in the management, an LLC interest is a limited collateral. Yet, this is not a restriction of creditors' rights. Creditors are supposed to be aware that the law allows only partial security in dealings with LLCs and can price this risk at the contracting stage.

[455]*See id.* § 18–702(b) (3).

can agree that an LLC interest is not assignable "prior to the dissolution and winding up of the limited liability company."[456] Combined with the statute's default rule prohibiting members from resigning from an LLC prior to its "dissolution and winding up," the Delaware LLC Act permits restraints on the alienation of property and makes them strongly enforceable.[457]

The described rule of the Delaware LLC Act imposes an approval clause for interest transfers by default and thus limits the drafting costs for the members of an LLC. Moreover, the default transfer restriction rule also includes a statutory mechanism aimed to limit the enforcement costs of the transfer restriction. As the assignee of an LLC interest does not acquire membership rights apart from the right to share the profits and losses of the LLC, while the assigning member loses his or her membership status and rights, the statute creates an effective mechanism to encourage members to conform with the restriction.[458] This effectiveness is evident if the restriction is contrasted with other transfer restrictions, such as first purchase rights, which may lead to court proceedings in cases of their breach.

Notwithstanding the default approval clause, the operating agreements of the sample LLCs very often contained various contractual interest transfer restrictions. Typical restrictions were first purchase rights and different forms of buy-sell options, including tag-along and drag-along rights. Although the outcome of approval clauses is very close to that of first purchase rights, in some companies members agreed to have both restrictions, but usually as substitutes.[459] Tag-along and drag-along rights are focused towards balancing the conflicts between present and new investors and are also an exit opportunity for incumbent investors. Therefore, they are likely candidates to be included in LLC agreements. Contingent ownership structures (buy-sell provisions) are effective mechanisms to overcome agency and hold-up problems and

[456] *See id.* § 18–603.

[457] *See id.*; *see also* tit. 6, § 18–701 ("A limited liability company interest is personal property."). Guided by Delaware partnership law's requirement to honor the contractual intent of the parties, Delaware courts are inclined to uphold restraints on alienation of interests also in partnership agreements. *See In re* Estate of Conaway, No. 6056–VCG, 2012 WL 524190, at *4 (Del. Ch. Feb. 15, 2012) ("[Parties] are free to restrict the transfer of partnership interests as they see fit.").

[458] *See* DEL. CODE ANN. tit. 6, § 18–702(b).

[459] The most likely explanation for using first purchase rights is that transfer consents are extremely strong means for incumbent members to affect third-party transfers and can thus cause hold-up problems. Each member, as a rule, can block such a transfer. First purchase rights, though they give incumbent members priority in purchasing the units of selling members, do not prevent third-party transfers completely. A third party can become a substituted member subject to the willingness/ability of incumbents to exercise their preemptive rights. At the same time, first purchase rights are backed up by a default approval clause in order to prevent any transfers in violation of first purchase rights. However, if a third party buyer complies with the procedure of first purchase rights, it automatically becomes a substituted member.

deadlock situations by inducing parties to negotiate and continue relations or by determining the status of one of the conflicting parties as a member of the company.[460] Hence, they are likely to appear in the agreements as well.

In the two-member sample LLCs, more than 86% left intact the default approval clause of the Delaware LLC Act. In about 43.5% of the two-member firms, the members agreed to restrict alienation of their interests by first purchase rights: the right of first refusal and, less commonly, right of first offer.[461] These rights very often, but not necessarily, substituted default approval clauses (negative correlation at 5% level).[462] Drag-along and tag-along rights appeared only in 20.8% and 26.8% of the two-member firms, respectively.[463] Tag-along rights, if adopted, almost always were subject to activation after the first purchase rights were not used. In 36.9% of the LLCs, minority members had a right to put their units to majority members or the company, and in 43.5% of the firms, majority members had a right to call the units of minority members.[464] The conditions for these put-call options were a deadlock event in decision-making, an agreed schedule, a default event by a member (typically a member's bankruptcy, dissolution, or a material breach of the agreement, including the provisions on interest transfer), or anytime at the discretion of a member activating the option.

The correlation analysis of interest-transfer restriction usage in the two-member sample companies shows the restrictions' importance in balancing the conflicts between the members and protecting members' rights. The minority-put right had a strong positive correlation with

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[460]Gilles Chemla, Michel A. Habib & Alexander Ljungqvist, *An Analysis of Shareholder Agreements*, 5 J. EUR. ECON. ASS'N 93, 103–04, 111–13 (2007).

[461]For a discussion of rights of first refusal versus rights of first offer, see RCM LS II, LLC v. Lincoln Circle Assocs. LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. July 28, 2014) ("The key difference between the [right of first refusal and the right of first offer]is when the right is activated."). Based on the former case, the owner of securities is entitled to sell its securities to a third party only if the right-holder passes by either refusing to buy the securities at the price and upon the terms offered by (agreed with) the third-party buyer or failing to react timely. *See id.* Under a right of first offer, the owner of securities who intends to sell, but has not formalized any transaction with a third party, shall inform the right-holder about its intention to sell. *See id.* If the right-holder does not timely accept the offer or the owner rejects to sell to the right-holder according to the terms of the right-holder's offer, the owner is entitled to sell to a third party at a price that is at least equal to the price negotiated by the owner and the right-holder. *See id.*

[462]The results of the correlation analysis are reported below in Appendix 2–III.

[463]A tag-along right allows minority members to mitigate the effect of a possible change of control in a firm by selling pro rata along with the controlling seller on the same terms. A drag-along right allows its holder—a large owner of securities—to force other investors to sell along with the right-holder on the same terms in a third-party control transfer.

[464]Whereas, for a minority member, the identity of the buyer does not make difference, the creditors are directly effected if the buyer is the company itself, rather than the majority member. If the buyer is the company, then a minority-put right resembles a withdrawal right in the sense of liquidating some assets for buying-out a member. This limits the pool of assets available to the firm's creditors. If the buyer is the majority member, then the firm's assets are not affected.

companies that had an express controlling member in general and controlling managing member in particular (the correlation is significant at 10% and 0.1% levels, respectively). Thus, minority members who were not able to participate in everyday decision-making, influence board decisions, or veto major decisions could sell their interests to the company or the majority member at a fair value. In these situations, minority members were also protected by default approval clauses (positive correlation at 5% level). Minority tag-along rights played an important protective role too. This right was significantly and positively correlated with companies that waived the duties of care and loyalty of the members and managers, absent minority right to affect decision-making at the board of directors level, and allowing the controlling member to amend the LLC agreement without the consent of the minority member. In all mentioned cases, the change of control in a firm may lead to severe risk for minority members, because they do not have effective means to curb the opportunistic behavior of a new controlling member. Hence, the agreements let minority members sell in proportion with the majority member. If the majority member exits the investment fully, the minority member receives the same opportunity; or, if the majority member retains a small stake, the majority member has to share the risks of being a minority with the minority member, thus encouraging the majority member to carefully choose a buyer.

With the growth of the number of company members, most of the interest-transfer restrictions—with the apparent exception of a tag-along right—become less common. The default approval clause was used in 71% of the 3–10 member LLCs. In many cases, this clause appeared together with first purchase rights, which were used in 38.7% of the sample firms. First purchase rights were also very likely to be combined with tag-along rights of minority members (positive correlation at 0.1% level). Tag-along rights were used in these firms more frequently than in the LLCs with two members (43.5% of the sample had a tag-along right). This could be attributed to the larger number of minority members that face conflicts with controlling members. However, the use of minority-put and majority-call rights in this group of the sample firms dropped to 24.2% and 16.1%, respectively.

In the 3–10 member companies, the evidence does not support that minority-put rights have an important role in protecting investments. Tag-along rights were actively used for this purpose, in particular in companies that waived fiduciary duties of members and managers or granted important decision-making rights to controlling members, which included rights to unilaterally amend the operating agreement and approve mergers (the correlations are significant mostly at 5% and 10% levels). The default approval clause and first purchase rights were used to prevent interest transfers to outsiders where an LLC had a controlling-managing member or a member with a power to affect decision-making

by the board of directors. It is difficult to speculate whether these two provisions played a major role in protecting minority members. While this finding could suggest a special relationship between the two groups of members and minority investor reluctance to give away guarantees that stem from these relations by preventing control changes, the causation can also be reversed and the provision's use in LLC agreements could be motivated by strong controlling members who desire to prevent interest transfers by minority members to third parties. The latter, by locking minority members, can exacerbate majority-versus-minority conflicts.

In the sample companies with more than ten members, the default approval clause was used in 64.5% of cases. Contrary to the LLCs with few members, the approval often had to be given by the board or the managing member, rather than by each member. Additionally, the restriction was not likely to appear together with other strong minority rights, such as special conflict-of-interest rules for self-dealing transactions by members (negative correlation at 10% level) and managers (negative correlation at 5% level) and company purpose limitations (negative correlation at 5% level). These data suggest that the right was an instrument for large members to control interest transfers by minority members. First purchase rights were used in only 41.9% of the sample firms with a large number of members. Drag-along and tag-along rights appeared in 51.6% and 58% of cases, respectively. However, put-call options were extremely rare: only two firms provided minority members with put-options and none had call rights for majority members. As is shown below, the rights and interests of minority members in these firms were protected by other means.

D. Continuity of Life, Dissolution, and Member Withdrawal

The Delaware LLC has a perpetual existence that is not terminated by the withdrawal of its members, unless otherwise provided in the LLC agreement.[465] From an organizational perspective, this is justified because the limited liability of the LLC members eliminates the need for permitting each withdrawing member to trigger dissolution.[466] On the other hand, LLC units are typically illiquid investments; hence, some sort of investment liquidation option is needed to dissolve the LLC. The Delaware LLC Act offers such an option only if it is specifically included in an LLC agreement.

[465]*See* DEL. CODE ANN. tit. 6, § 18–801(a)(1) (2015).

[466]In partnerships, the withdrawal of general partners not accompanied by dissolution rights leads to a situation where a withdrawing partner cedes his or her decision-making rights, though the partner remains liable to the partnership's creditors that pre-dated the withdrawal. *See* Friedman, *supra* note 38, at 86–87. This situation offers a reach ground for the remaining partners to engage in abusive acts. *See id.*

Indefinite existence means that if an LLC has not been formed for a limited period of time specified in the LLC agreement, it has perpetual existence and can only be dissolved in the cases defined by the statute. These cases are few. First, an LLC is dissolved upon the occurrence of events specified in the LLC agreement, for instance, after fulfilling the purpose for which the LLC has been formed.[467] Second, an LLC dissolves upon the affirmative vote or written consent of its members, who hold more than 2/3 of the interest in the LLC's profits.[468] This default rule can be changed by an LLC agreement, meaning that either the voting threshold can be changed or the right to dissolve by vote or consent can be modified or waived completely. Third, an LLC dissolves at any time there are no members.[469] Finally, an LLC can be dissolved by the court if it is not reasonably practicable to carry on its business in conformity with the LLC agreement.[470]

Delaware courts very carefully approach their right to dissolve an LLC and consider judicial dissolution of LLCs as "*a limited remedy that Delaware courts grant sparingly.*"[471] Courts will not dissolve an LLC merely because it is not profitable or has not met the original expectations of the members.[472] Section 18–802 of the Delaware LLC Act also does not entitle courts to order the dissolution of an LLC if the company violates the provisions of the LLC agreement.[473] The Delaware Court of Chancery defined two cases where judicial dissolution of an LLC can be granted. First, where there is a deadlock that, given the ownership structure of the LLC (including not only joint ventures between two partners with equal interests, but also two ownership fractions with equal interests), prevents it from operating.[474] Second, "where the defined purpose of the [LLC] is fulfilled or is impossible to

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[467]*See* DEL. CODE ANN. tit. 6, § 18–801(a)(2).

[468]*See id.* § 18–801(a)(3).

[469]*Id.* § 18–801(a)(4).

[470]*Id.* §§ 18–801(a)(5), 18–802.

[471]Wiggs v. Summit Midstream Partners LLC, No. 7801-VCN, 2013 WL 1286180, at *12 (Del. Ch. Mar. 28, 2013) (unpublished opinion) (emphasis added) (internal quotation marks omitted).

[472]*In re* Arrow Inv. Advisors, LLC, No. 4091-VCS, 2009 WL 1101682, at *2 (Del. Ch. Apr. 23, 2009) ("*[S]uch events are, of course, common in the risk-laden process of birthing new entities in the hope that they will become mature, profitable ventures.*" (emphasis added)).

[473]*See* Seneca Invs. LLC v. Tierney (*In re* Seneca Invs. LLC), 970 A.2d 259, 263 (Del. Ch. 2008) ("*The role of* this Court in ordering dissolution under *§ 18–802 is* limited, and the Court of Chancery will not attempt to police violations of operating agreements by dissolving LLCs." (emphasis added)).

[474]*See* Phillips v. Hove, No. 3644-VCL, 2011 WL 4404034, at *26 (Del. Ch. Sept. 22, 2011); *In re* Silver Leaf, LLC, No. 20611, 2005 WL 2045641, at *10–11 (Del. Ch. Aug. 18, 2005) ("The vote of the members is deadlocked and the Operating Agreement provides no means around the deadlock."); Haley v. Talcott, 864 A.2d 86, 95, 97–98 (Del. Ch. 2004) (finding that due to deadlock between parties and absence of reasonable exit mechanism in LLC agreement, it was not reasonably practicable for LLC to continue to carry on business in conformity with LLC agreement).

carry out."[475] However, where the purpose of an LLC is defined broadly in the LLC agreement (e.g., any lawful act or activity), it is rather difficult to prove that it is no longer reasonably practicable for an LLC to operate in accordance with its broad purpose clause.[476] Moreover, "even in cases where the standard for dissolution [is] met," it is within the equitable discretion of the Court of Chancery to "decide whether it should issue a decree of dissolution."[477] Indeed, nothing prevents LLC members from agreeing in the LLC agreement to additional grounds that may lead to the judicial dissolution of the LLC—such as violation of minority interest holders' rights—or complete waiver of the possibility of judicial dissolution based on statutory grounds.[478] In a recent judgment, however, the Delaware Court of Chancery ruled that statutory judicial dissolution is not the sole exclusive extra-contractual means of obtaining dissolution of an LLC; under specific circumstances, the court has an equitable power to dissolve an LLC.[479] Although this case has very specific circumstances and the court's judgment only created an equitable standing for de facto LLC members to seek judicial dissolution of an LLC, the move suggested that the Delaware court is not hostile to the idea that, in addition to the two statutory causes for judicial dissolution, it can rely on parallel equitable causes for dissolving a solvent LLC.

"[T]he death, retirement, resignation, expulsion, bankruptcy or dissolution of any member," or the termination of membership in any other cases, does not lead to the dissolution of an LLC; however, this rule can be changed by an LLC agreement.[480] Similarly, the Delaware LLC Act imposes a default rule, according to which a member cannot resign from the LLC prior to its dissolution and winding up.[481] The cases where such resignation is possible prior to the dissolution and winding up of an LLC should be specified in the LLC agreement.[482] This rule is combined with the restricted transferability of an LLC interest.

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[475]*See Wiggs*, 2013 WL 1286180, at *12.

[476]*See id.* at *13; Seneca Invs., 970 A.2d at 263. *But see Silver Leaf*, 2005 WL 2045641, at *11 (looking instead at actual purpose of LLC based on its past activities).

[477]*See In re* Mobilactive Media, LLC, No. 5725-VCP, 2013 WL 297950, at *33 (Del. Ch. Jan. 25, 2013) (exercising its equitable powers, court denied request for dissolution of LLC); Vila v. BVWebTies LLC, No. 4308–VCS, 2010 WL 3866098, at *6 (Del. Ch. Oct. 1, 2010).

[478]*See* Huatuco v. Satellite Healthcare & Satellite Dialysis, LLC, No. 8465–VCG, 2013 WL 6460898, at *5–6 (Del. Ch. Dec. 9, 2013); R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803–CC, 2008 WL 3846318, at *6 (Del. Ch. Aug. 19, 2008).

[479]*See In re* Carlisle Etcetera LLC, 114 A.3d 592, 601 (Del. Ch. 2015). Earlier in *Huatuco*, the Delaware Court of Chancery upheld the contractual waiver of the right to seek statutory dissolution under Section 18-802, but reserved decision on "[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires". *See Huatuco*, 2013 WL 6460898, at *5-6. *Huatuco* implies that courts might create equitable grounds for judicial dissolution where LLC members are locked without any alternative exit options.

[480]*See* DEL. CODE ANN. tit. 6, § 18–801(b) (2015).

[481]*See id.* § 18–603.

[482]*See id.*

Taking into account the approach of the Delaware legislature and courts that minority holders of illiquid stocks and LLC units can use contractual corporate governance instruments to protect their interests—rather than expect courts to grant them ad hoc buy-out rights on a case-by-case basis—it is highly expected that such instruments can be found in stockholders' and LLC agreements. This is particularly true where opportunistic behavior by controlling parties is likely. Dammann and Schündeln have found evidence that LLCs are more likely to be formed in states with strong oppression rights—rights granting local courts the power to dissolve companies as a means of last resort when controlling members oppress minority members.[483] Against this background, it is more likely that the LLC agreements of Delaware LLCs will either change the default rule of the statute in order to provide for broader grounds for judicial dissolution or employ substitute mechanisms that offer protection for minority investors. These mechanisms aim to prevent minority oppression, for example, via unanimous voting and minority member veto rights, or can provide ex post exit options to minority investors in the form of buy-sell options, tag-along and drag-along rights, and resignation rights (at will or upon the occurrence of specific events).

Only one-quarter of the sample firms were formed for limited time periods, which, however, were too long to consider these restrictions as constraints on controlling members and managers. With the shortest lifetime of eight years and the longest of ninety-nine years, an average LLC with a definite existence was formed for forty-one years. The typical limited time period was fifty years. Therefore, mandatory liquidations cannot be regarded as a widespread instrument to discipline insiders by compelling them to distribute company ownership among the investors after liquidation and by incentivizing reputation-building.[484]

None of the sample firms expanded judicial dissolution by agreeing on additional grounds that would authorize a court to issue a dissolution order, such as minority oppression, but a few of them waived the default statutory grounds for judicial dissolution. The most common of these waivers were in the sample firms with two members (12.5% of the sample), which perhaps has to do with this group's highest probability of facing decision-making deadlocks due to their ownership structure and the unanimous voting requirements in their LLC agreements.

As shown above, the minority members in the sample firms, particularly those companies with two members, were protected by minority-put rights. Tag-along rights and other transfer restrictions were important as well. In addition to this, the operating agreements of the sample companies contained unanimous voting requirements and

[483]*See* Dammann & Schündeln, *supra* note 37, at 757.

[484]For a similar conclusion in the context of listed LLCs and LPs, see Manesh, *supra* note 15, at 580.

minority veto rights for major decisions. In the companies with two or more minority members, these rights could also take the form of requiring the consent of several large minority members (rather than all of them) or, in addition to the vote of controlling members, establishing a condition to receive the majority vote of minority members for approving decisions. Minority voting rights could also be conditional and would terminate if the right-holders reduced their holdings below a certain level of the total company capital or their original interest.

Unanimous voting rights were actively practiced in the two-member LLCs where the members had equal voting rights. In cases where the managing member had a minority interest, large investors used veto rights for major decisions to prevent opportunistic self-dealing by the minority managing member (positive correlation at 10% level). Unanimous or majority-of-the-minority voting rights were also used to protect minority members in LLCs with more than ten members where the company waived the fiduciary duties of the managers. While also used in the 3–10-member firms, the data do not point to these rights' role as substitutes for modified traditional investor protection mechanisms.

Some firms entitled their members to the right to dissolve the company in cases of deadlock, default by the other member (breach of the agreements or failure to make promised investments), or at anytime at their discretion. This is an extremely strong minority protection right—particularly if it allows activation at the right-holder's discretion at anytime—that can substitute for many other investor protection rights. Any action by the other member that oppresses the rights and interests of the right-holder can lead to the withdrawal of capital. On the other hand, the unchecked ability to threaten company dissolution, especially in the case of relation-specific investments, can be used strategically by right-holders to fully or partially deprive the other party of the expectations it had when it was making an investment.[485] Hence, the dissolution right had restricted use and was most often used in the two-member firms (13.3%), followed by the 3–10-member LLCs (8.9%); only one firm with more than ten members provided its members with a unilateral dissolution right.

It was not an accepted practice to condition LLC dissolution upon the resignation, retirement, expulsion, death, bankruptcy, or dissolution of its members. The right of members to resign unilaterally by receiving the fair value of their interest or the full initial interest was an exception as well.

[485] *See* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216, 232–33 (1992).

E. Amending the LLC Agreement

The default rule of the Delaware LLC Act is that the LLC agreement may be amended with the approval of all of the LLC members.[486] This default rule can be modified by the parties of an operating agreement via substituting the unanimous-vote requirement with another standard, including one that allows amendments without the vote or approval of any member or class or group of members.[487] The amendments may also require the consent of non-members, such as managers or other third parties.

In almost 83% of the two-member LLCs, the amendments of the LLC agreements required the approval of both members, irrespective of their voting rights. Another 6% of the firms imposed a supermajority voting threshold. In the remaining companies, amendments were possible either by the vote of a simple majority or by the decision of a board of directors. In thirteen companies (7.7% of this ownership group), there was a member that could amend the agreement unilaterally, either directly or through its control of the board. Unanimous and supermajority voting were less common among the 3–10 member firms (33.9% and 22.6%, respectively). In the LLCs with more than ten members, the unanimity requirement was never used, but approximately 22% had a supermajority voting requirement. The remaining firms allowed the majority of their members to make the amendment decisions. In the latter two ownership groups, there were more companies where one controlling member could amend the operating agreement without the consent of the other members.

The typical means for protecting minority members against abusive actions of the controlling members entitled to amend the operating agreements by their sole decision were: the requirement to put the matter to a minority vote if the amendments adversely affected the rights of the minority members; a ban on amending certain provisions in the agreements; and a tag-along right of the minority members allowing them to exit the firm if change of control occurred. Additionally, minority members can always resort to the implied contractual covenant of good faith and fair dealing in cases where the controlling member attempts to take away any minority right negotiated at the stage of making investments, though relying on this standard alone implies higher litigation costs.[488]

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[486]*See* DEL. CODE ANN. tit. 6, § 18–302(f).

[487]*See, e.g.*, *id.* § 18–302(a).

[488]*See* Thomas E. Rutledge, *Minority Members and Operating Agreements*, 10 J. PASSTHROUGH ENTITIES 21, 22 (2007).

F. Ownership Structure and Member Contributions

The Delaware LLC Act affords maximum flexibility with regard to member contributions. In addition to tangible contributions, the Act allows individuals to obtain membership interest in exchange for a promise to pay in the future (promissory notes) or to provide some future services (e.g., to conduct the daily management of an LLC).[489] The Act goes further to allow individuals to be admitted as members without obligating them to make a contribution.[490] In addition, unless otherwise provided in an LLC agreement, a person may be admitted to an LLC as a member without acquiring an LLC interest.[491]

The ownership structure of the Delaware LLC is flexible as well. An LLC agreement may provide for classes or groups of members having such relative rights, powers, and duties as provided in the LLC agreement. Moreover, certain classes or groups of members may be sidelined from voting on actions specified in an LLC agreement, including such actions as the amendment of the LLC agreement or the creation of a new class or group of LLC interests.[492]

In most of the sample, flexible statutory rules to form the assets of the companies were not demanded. A few firms issued units to their initial or new members without requiring any contribution in return. These were, typically, cases where the managers and employees were issued incentive units that could be redeemed by the companies after employment termination. Indeed, this practice was more common in LLCs with more than two members, because employee participation increased with the number of the members. In several cases, contributions were made in the form of promissory notes and future services. Two firms allowed members to be admitted without issuing units.

The use of different classes of units was not common either. In the LLCs with two members, the rare cases where units were issued with different rights to the members were aimed to provide their holders' distribution and liquidation preferences. In companies with more members, different classes of units, when issued, usually included non-voting units issued to employees within incentive schemes and very seldom included units with enhanced voting rights. The likely explanation for sticking to the parity between economic and voting rights is related to the flexible management structure of LLCs. If one of the

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[489] *See* DEL. CODE ANN. tit. 6, § 18–501.

[490] *See id.* § 18–301(d). It is necessary to distinguish two different situations with regard to this provision. Substituted members (i.e., the transferees of units from other members) usually do not make new contributions to the firm; they succeed the contributions of the former members. For initial members and purchasers of units directly from a company, however, we would traditionally expect some contribution.

[491] *See id.*

[492] *See id.* § 18–302(a).

members is an investor without an active role, the direct way of giving strong control rights to an entrepreneur is to appoint the latter as the managing member of the firm. A dual-class unit structure makes sense only if an investor wishes to receive a guaranteed cumulative interest rate on investments or needs a liquidation preference.

Series LLCs were not popular either: only four firms were formed as series LLCs (less than 1.5% of the sample). In many situations, the results of using series can be achieved by establishing separate subsidiary entities. It is not clear whether the creation of different series in such situations simplifies corporate structures. There are cases, however, where the creation of series can make difference. One of the sample firms, Windermere Mortgage Services Series LLC, was formed to offer home loans. It had twenty-one series, which each allocated assets and liabilities in the business and represented one or several closely located sales offices. The series were jointly controlled by HomeStreet Bank and different brokerage franchise owners. As a result, the sales offices were legally isolated without the need to establish separate legal entities and to apply for separate licenses.[493]

Almost 70% of the sample—mostly due to the fact that many sample firms were member-managed and one or more members were the managers—had managers holding membership units. The answer to the question of whether management holdings could align the interests of the managers with those of the other members is not straightforward. Although management holdings can be incentivizing, the sample firms were not subject to constant valuations by the market. Therefore, the results of bad management and opportunistic self-dealing were not easily reflected in the unit prices. Not constrained by regular market valuations, the managers and controlling members also had more freedom to choose actions during corporate conflicts with other members.

More effective in incentivizing managers were, perhaps, management incentive distributions—special provisions of the operating agreements promising more share in a company's profit after the distribution of an agreed level of profits to its members. For instance, as long as the distributed profit is below the agreed level, managers receive the same amount of distributions as other members. But after profits exceed this level, the share of management distributions increases at the expense of distributions to other members. The increase in management distributions could be gradual after passing certain minimum levels. Such incentive schemes were used in 11.9% of the two-member firms and in 18.6% of the LLCs with more than ten members. These schemes were hardly used in the 3–10-member firms (less than 2% of the sample).

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[493]For more ideas when the use of series LLCs is likely see Allen Sparkman, *Through the Looking Glass: Series LLCs in 2015*, at 18–20 (2015), *available at* http://ssrn.com/abstract=2591548.

Another profit distribution practice among the sample companies was to include specific target distribution clauses in their operating agreements requiring a minimum share of regular distributions to be made to the members. This obligation could be waived by the vote of the members on an ad hoc basis before making monthly/quarterly/annual distributions. Hence, under this provision, the traditional default rule for profit distribution is reversed—a regular distribution of profits is the rule, and without member approval the company cannot retain profits.

Theoretical literature attaches an important investor-protection role to minimum profit distribution provisions; by compelling the management and controlling members to distribute company cash, they reduce the discretion of the insiders in using the resources of the company.[494]

The share of the firms among the sample two-member LLCs that included specific target distribution clauses in their operating agreements was almost two-thirds of the total sample. This share dropped to 41.9% in the 3–10-member firms and further dropped to 10.2% in the companies with more than ten members. By reducing the retained cash, the parties of the operating agreements limited management discretion in cases where the manager was a minority member in the two-member firms and where the manager was a controlling member in the 3–10-member firms (in both cases the statistical significance of the positive correlations is below 5%). In addition to requiring minimum distributions in the first group, the discretion of the management was also reduced by other mechanisms, such as (1) large transaction rules (requiring member approval for transactions above a certain amount); (2) conflict of interest rules for managers (requiring the consent of the non-interested member); and (3) company-purpose limitation clauses (defining specific fields or types of operations, or both, for the company business). In the 3–10-member LLCs, minimum distribution obligations were combined only with company-purpose limitation clauses. In general, purpose limitation clauses, with the exception of the firms with more than ten members, were widely used to limit management discretion.

Unlike in listed LLCs, specific target distribution rights, were defined narrowly if used in non-listed LLCs. The broad language of such provisions in listed non-corporate entities stems from granting management the discretion to define "available cash" for the purpose of making distributions.[495] In the sample firms, this discretion was trimmed in many cases by either specifying the exact share of distributions in net

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[494] *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 655 (1984); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986); *see also* RIBSTEIN, *supra* note 213, at 209–10.

[495] *See* Manesh, *supra* note 15, at 579.

profits or, more frequently, by requiring the consent of each member to define the amount of cash available for distributions. The easiest way to do this is to provide each of the small number of company members with consent rights. Hence, the relatively smallest share of broadly defined specific target distribution provisions were in the two-member firms, while the companies with more than ten members usually opted for broad definitions.

New capital calls are a common means for financing growing firms. They are also an additional burden for the incumbent members and can be used by the majority to diffuse the holdings of minority members. The sample firms typically used two strategies to address these problems. One strategy was to grant preemptive rights to members by allowing them to buy a proportional share of new offered units before the units were issued to the other members or third parties. This strategy was commonly used where the number of company members was more than two. Preemptive rights were also used in the LLCs with two members, but only in less than 17% of those firms. It was more common to grant each member a right to block new issuances. The latter mechanism is preferable for minority members because it allows them to preclude dilution of minority interest without investing additional capital. However, it can impede business development if the number of minority members is large and each member can opportunistically block new capital calls. Both strategies are purely contractual in the sense that they are applied only if so agreed by the members of Delaware LLCs.

G. Fiduciary Duties

The freedom to contract out of fiduciary duties is one of the principal differences between Delaware LLCs and corporations. Initially, the Delaware LLC Act was not clear on the elimination of fiduciary duties; the statute used the wording "duties . . . *may be expanded or restricted by provisions in a limited liability company agreement*." After the Delaware Supreme Court's judgment presumably suggested that fiduciary duties could not be waived completely in partnerships and LLCs, the Delaware General Assembly amended the statute in June 2004.[496] The amendments allow the expansion, restriction, or elimination of fiduciary duties for LLC members or managers, or the limitation or elimination of any and all liabilities for breach of the fiduciary duties for LLC members or managers.[497] The Delaware Court of Chancery judgments following these amendments confirmed the legality of the waivers and, at the same time, clarified that

[496]Lyman Johnson, *Dynamic, Virtuous Fiduciary Regulation* (Wash. & Lee Legal Studies Paper No. 2013–14), *available at* http://papers.ssrn.com/abstract=2273869 [http://perma.cc/Q4CS-62FC].

[497]*See* 74 Del. Laws 275 (2004).

in the absence of clear waivers in an LLC agreement, managers owed fiduciary duties to the LLC and its members, and controlling members owed those duties to minority members by default.[498] After the Supreme Court of Delaware exposed this approach to doubts in a much-publicized decision, the General Assembly again moved in promptly by amending Section 18–1104 of the Delaware LLC Act.[499] The amended act, effective August 1, 2013, confirms that the rules of law and equity relating to fiduciary duties apply to LLCs by default.[500]

Thus, Delaware LLCs allow their members to (1) expand, restrict partially, or waive in full the fiduciary duties of members or managers, with the exception of the "implied contractual covenant of good faith and fair dealing,"[501] or (2) limit or eliminate liability for breach of fiduciary duties, with the exception of acts violating the implied contractual covenant of good faith and fair dealing in bad faith (exculpation provisions).[502] The second option means that LLC members and managers continue to owe fiduciary duties, and courts may grant positive or negative injunctions with regard to their acts; however, these members and managers cannot be held liable (or will incur only limited liability, as applicable) for damages caused by the breach of their fiduciary duties.[503]

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[498] *See, e.g.*, Phillips v. Hove, No. 3644–VCL, 2011 WL 4404034, at *24 (Del. Ch. Sept. 22, 2011) ("Unless limited or eliminated in the entity's operating agreement, the member-managers of a Delaware limited liability compan[y] owe traditional fiduciary duties to the LLC and its members."); Kelly v. Blum, No. 4516–VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) ("Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act . . . . Delaware cases interpreting Section 18-1101(c) have concluded that . . . 'in the absence of a contrary provision in the LLC agreement,' LLC managers and members owe 'traditional fiduciary duties of loyalty and care' to each other and to the company." (footnote omitted)); *In re* Atlas Energy Res., LLC, No. 4589–VCN, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010) ("[I]n the absence of explicit provisions in a limited liability company agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the limited liability company context."); Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658–VCS, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) ("[I]n the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC.").

[499] *See* Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1219 (Del. 2012) ("[T]the merits of the issue whether the LLC statute does—or does not—impose default fiduciary duties is one about which reasonable minds could differ."); David Benoit, *Delaware Supreme Court Judge Gives Strine Another Lash*, WALL ST. J., Mar. 21, 2013, http://blogs.wsj.com/deals/2013/03/21/delaware-supreme-court-judge-gives-strine-another-lash/ [http://perma.cc/E9GK-SUYB]; Peter Lattman, *In Unusual Move, Delaware Supreme Court Rebukes a Judge*, N.Y. TIMES, Nov. 9, 2012, http://dealbook.nytimes.com/2012/11/09/in-unusual-move-the-delaware-supreme-court-rebukes-a-judge/ [http://perma.cc/Y3KP-Y3VC]. For more details on the disagreement between the two Delaware courts, its context, and possible reasons, see Mohsen Manesh, *Damning Dictum: The Default Duty Debate in Delaware*, 39 J. CORP. L. 35, 41–48, 62–64 (2013).

[500] *See* 79 Del. Laws 74 (2013).

[501] *See* DEL. CODE ANN. tit. 6, § 18–1101(c), (e) (2015).

[502] *See id.* § 18–1101(e).

[503] *See* Solar Cells, Inc. v. True N. Partners, LLC, No. 19477, 2002 WL 749163, at *4, *8 (Del. Ch. Apr. 25, 2002).

In LLCs with a small number of members, the concept of offering fiduciary duties by default is reasonable. The absence of the default rule creates possibilities for opportunistic behavior and increases transaction costs in cases where the duties are needed. As the initial drafters of the agreement are usually those who would benefit from opportunistic behavior, they have fewer costs opting out of duties than minority investors have in opting in. More controversial is the question of whether this should be an enabling rule. There are some strong arguments that in the LLC setting, these duties are often not necessary. Where LLCs have only a few members with large interests, or even those that are fully controlled by one member, members can rely on their control rights to discipline managers instead of fiduciary duties. Additionally, in small LLCs, members or managers are typically involved in day-to-day activities and do not bear high monitoring costs.[504] These members and managers can often be involved in extensive dealings with the company, and strict duty of loyalty rules may create unnecessary costs of compliance.[505] Moreover, under some circumstances parties can benefit from their waiver, for instance, to prevent ex post speculative litigation. On the other hand, the right to waive fiduciary duties can become an unlimited license in the hands of controlling insiders to engage in self-dealing and to expropriate business opportunities at the expense of the firm and its outside investors.

In order to establish the actual role of fiduciary duties in the sample firms, the duties were divided into two main groups—the duty of care and the duty of loyalty. The latter, in turn, includes the component that prevents opportunistic self-dealing and the duty not to compete with the firm. This classification was used to define the scope of fiduciary duties of members and managers in all sample firms and the extent of their liability for the breach of these duties.

The waivers of the members' duty not to compete with the firm were quite common in all sample firms.[506] In the two-member firms, this duty was waived in 69% of the sample. Half of the LLCs with 3–10 members waived non-competition duty as well. The corresponding share of LLCs with more than ten members was the lowest: only in 27.1% of these firms were the members free to compete with the firm. Along with the members, many firms also waived the duty for managers, though the employment contracts with managers, which are outside the scope of this study, could have contained separate non-competition obligations.

[504]Friedman, *supra* note 38, at 80–81.

[505]*See id.* at 81.

[506]Non-competition duty is required in joint ventures where each founder can individually pursue the project either from the beginning or after accessing information and technology provided by the other founder. But many joint ventures do not face strong risks of parent competition. For example, in real estate-related firms, due to their limited purpose and property ownership, parent competition requires large investments to buy and develop similar properties. This may marginalize the role of non-competition obligations.

The waivers and modifications of other fiduciary duties were not common. One-quarter of the firms with two members waived or modified both fiduciary duties for members. Almost the same share of the LLCs waived or modified these duties for managers. The waivers and modifications of fiduciary duties, however, did not affect all managers—in half of the firms, the duties of care and loyalty were waived only for board members, but not for officers or managing members. As indicated earlier, in the two-member sample firms, boards often replaced member meetings and the company directors acted more like member representatives. Even where boards of directors do not replace member meetings, in firms with a small number of members, it is common practice to entitle each member with a right to appoint directors that will represent their interests. In such cases, members intend that directors will promote the interests of the members who appointed them. Standard fiduciary duties can imperil such intentions. But waivers or modifications allow directors to fetter their discretion to make independent judgments as company directors ensured by fiduciary duties and to act in the interests of particular members. Under these circumstances, what becomes more important are the duties of the members to each other and their ability to compel the directors they appointed to approve decisions that unfairly promote the interests of some members at the expense of others.

Therefore, where the operating agreements waive or modify the fiduciary duties of the members and managers, it is reasonable to expect the regulation of member and manager conduct by contractual alternatives that can achieve similar results to waived fiduciary duties. Contractual substitutes can be large transaction rules that require special approval procedures, such as member consent, for transactions above a certain amount, or special conflict-of-interest rules for a company's transactions with its members and managers. The latter can take the form of specific stand-alone procedural rules that require the consent or vote of non-interested members/managers to approve transactions in which a member or manager (or a group) is interested, or standards that establish requirements of fair price (e.g., terms of the transaction shall be substantially equivalent to the terms of a comparable unaffiliated transaction).

Under stand-alone procedural rules, compliance with these rules precludes any possible judicial review of the underlying transaction under the entire fairness standard. Hence, the transaction is never voidable if the contractually prescribed procedure of approval is met.[507]

[507]In the traditional corporate law setting, compliance with the procedural rules of approving interested transactions does not extinguish the duty of loyalty; such compliance either subjects the transaction to the business judgment rule (if a self-dealing transaction with a minority stockholder, director, or officer is fully disclosed and approved by disinterested directors, or the majority-of-the-minority stockholder vote or a self-dealing transaction with a

When relying on the fairness standard, which is, in effect, a contractually created fiduciary duty of loyalty, the manager or member can either bear the burden "to perform a reliable market check or valuation analysis *ex ante* or bear the risk of any uncertainty that exists *ex post*."[508] The contractual standard of fairness can be combined with a fair dealing alternative, which serves a similar role to the safe harbor provisions of corporate statutes.

There is evidence that these expectations materialized in practice and that fiduciary duty waivers did not put the minority members in a vulnerable position. In particular, it was very likely that members' duties were waived when the firm was manager-managed (positive correlation at 1% and 5% levels for duty of loyalty and duty of care, respectively). In such situations, as members do not manage the firm, waiver of their duties is not likely to negatively affect minority rights as long as managers owe fiduciary duties to the members and to the firm.[509]

The problem is that the fiduciary duties of members and managers, as a rule, were waived in the same companies. However, as mentioned earlier, in half of the two-member firms, the waivers and modifications of the managers' fiduciary duties left intact the duties of the managing members and company officers. Hence, the managing members were not bound by the fiduciary duties in only one-eighth of the firms. Additionally, in the sample two-member LLCs where the managers had no fiduciary duties, the operating agreements imposed special conflict-of-interest rules for related-party transactions with members. This means that every time the company engaged in a self-dealing transaction with a member or its affiliate, no matter whose competence was to approve the transaction, it should have been either approved by non-interested members (their board representatives) or entered at arm's-length terms.

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controlling stockholder is conditioned upon both the approval of independent directors and informed vote of the majority-of-the-minority stockholders) or retains the entire fairness as the applicable standard of review but shifts the burden of proving the unfair nature of the transaction to the plaintiff (if an interested transaction with a controlling stockholder or its affiliates is approved by an informed majority-of-the-minority vote or by disinterested directors). *See* Kahn v. M & F Worldwide Corp., 88 A.3d 635, 644 (Del. 2014); Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1213 (Del. 2012); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115–17 (Del. 1994); *In re* Wheelabrator Techs., Inc. Shareholders Litig., 663 A.2d 1194, 1203 (Del. Ch. 1995).

[508]*See* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1, 27 (Del. Ch. 2001), *aff'd in part, rev'd in part*, 817 A.2d 160 (Del. 2002); *see also Gatz*, 59 A.3d at 1213.

[509]The default rules of the Uniform Limited Liability Company Act (§ 409(h)) and the Revised Uniform Limited Liability Company Act (§ 409(g)) state that a member in a manager-managed LLC does not owe fiduciary duties to the company or to the other members but managers do. *See* Revised Uniform Limited Liability Company Act § 409(g)(5) (2006) ("In a manager-managed limited liability company, the following rules apply: . . . A member does not have any fiduciary duty to the company or to any other member solely by reason of being a member."); Uniform Limited Liability Company Act § 409(h)(1) (1996) ("In a manager-managed company: (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member . . . .").

More common were clear procedural conflict-of-interest rules, rather than standards. Finally, conflict-of-interest rules for managers were widely used in the LLCs where there were managing members with minority interests, or controlling members that had the majority of board votes or were managing members (in both cases the correlation is positive at the 1% level). These rules aimed to protect large investors in the former situation and minority members in the latter.

The story, however, does not end here. If it was uncommon to waive or modify the duties of loyalty and care in the two-member LLCs without the members agreeing to contractual alternatives, very often the LLC agreements of these companies limited the liability of members and managers for breaching their fiduciary duties. In more than half of the companies, the members were not liable for the breach of their fiduciary duties, and in more than three-quarters of the LLCs, the managers were exculpated for breach of the fiduciary duties. Although in some cases exculpation clauses were for directors and did not apply to officers, the large share of firms that exculpated members and managers from the breach of their fiduciary duties is alarming for minority members. The correlation analysis does not hint that limiting the liability of members and managers who breach their fiduciary duties made the parties of the LLC agreements use alternative contractual rights to compensate for the risks created by such liability limitation clauses.

A closer look at the exculpation clauses, however, points to their limited scope. Only in exceptional cases was the limitation of liability for the breach of fiduciary duties full for both members and managers (five firms with two members, or 3.2% of the sample, fully exculpated their members and managers). Cases where the operating agreements carved out parts of fiduciary duties from these liability limitation clauses were common. Typical carve-outs included fiduciary obligations not to engage in willful or intentional misconduct or in behavior that is grossly negligent. Other common carve-outs from exculpation clauses, though less common than the former, were prohibiting actions not done in good faith, refraining from engaging in fraudulent conduct, or knowingly violating (criminal) law. These carve-outs in all sample firms were often used together and rarely acted as substitutes.

The carve-outs did not create or establish the scope of any duties; rather, they defined the extent of the liability of the fiduciaries. As long as the fiduciary duties of the members and managers were not completely waived, the members and managers were liable for the breach of the duties of care or loyalty to the extent defined by the carve-outs.[510] The typical carve-outs of the operating agreements were those

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[510]The carve-outs were applicable not only in the context of fiduciary duties, but also in the breaches of contractual provisions, including the contractual substitutes of fiduciary duties. For instance, if an LLC agreement waived fiduciary duties but imposed an arm's-length standard for self-dealing, carve-outs, such as willful misconduct and bad faith actions, did not

listed in Section 409(c) of the Uniform Limited Liability Company Act[511] as elements of the duty of care: "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law." Therefore, as long as the duty of care was not waived completely, the exculpation provisions did not cover large parts of this duty, and fiduciaries were liable for its breach. In most cases, the standard for liability was gross negligence; a stricter standard of reasonable or ordinary care was not practiced. The result was a standard of liability similar to the standard that results from application of the business judgment rule.[512] In this way, the sample LLCs actually relaxed the standard of review for the duty of care and created a contractual equivalent of the corporate business judgment rule (see Figure 2–II). The primary motivation for this was, perhaps, to make it clear to the members (and ex post decision-makers) that members and managers were not liable for their poor investment and management decisions.[513] Depending on the scope of the carve-outs, the extent of liability differed from company to company.

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allow self-dealing members and managers to benefit from liability limitation provisions. *Cf.* Dawson v. Pittco Capital Partners L.P., No. 3148–VCN, 2012 WL 1564805, at *29 (Del. Ch. Apr. 30, 2012) (determining breaches of duties listed in carve-outs can be analyzed as either breach of contract claim or breach of fiduciary duty claim).

[511]*See* Uniform Limited Liability Company Act § 409(c). The Uniform Limited Liability Company Act was prepared by the National Conference of Commissioners on Uniform State Laws and was promulgated in 1994. *See id. prefatory n.* It was promulgated in 1995 and amended in 1996. *See Why States Should Adopt RULLCA*, UNIF. L.COMM'N, http://www.uniformlaws.org/Narrative.aspx?title=Why%20States%20Should%20Adopt%20RULLCA [http://perma.cc/D8NU-ZDLZ] (last visited Nov. 5, 2015). It had been adopted by nine states. *See* Uniform Limited Liability Company Act *prefatory n.* In December 2006, the National Conference published the Revised Uniform Limited Liability Company Act, which by February 2015 had been enacted by twelve states. *See* UNIF. L. COMM'N, *supra*, *Legislative Fact Sheet*, http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013) [http://perma.cc/W4WC-RDAC]. Updated information on the enactment status of the Revised Act is available through the website of the National Conference of Commissioners on Uniform State Laws. *See id.*, *Legislative Enactment Status*, http://www.uniformlawcommission.com/LegislativeMap.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013) [http://perma.cc/454L-FSW3].

[512]For a comparison of the standards of review for the duty of care in general and the gross negligence standard of liability in particular for partnerships and LLCs with the standard of review under the business judgment rule, see Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 359–61, 365, 369 (2005) (discussing general partnerships, limited partnerships, and limited liability companies).

[513]Even without carve-outs, full exculpation clauses are not likely to be enforced by courts to the maximum effect because intentional misconduct, knowing violation of law, and other similar actions are contrary to public policy. *See* Mark J. Loewenstein, *Freedom of Contract For Alternative Entities in Delaware: Myth of Reality?*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 28, 29 (Robert W. Hillman & Mark J. Lowenstein eds., 2015). This is an alternative explanation for the described practice of contracting.

Figure 2–II. Fiduciary duties in non-listed LLCs

OPTION	FIDUCIARY DUTY STANDARD
1. FIDUCIARY DUTIES	
1.1. Default fiduciary duties	Duty of care & Duty of loyalty
1.2. Restricted fiduciary duties	Duty of care or any part of it &/or Duty of loyalty or any part of it
1.3. Fully waived fiduciary duties	No fiduciary duties
2. LIABILITY FOR THE BREACH OF FIDUCIARY DUTIES	
2.1. No exculpation	Full liability for the breach of Duty of care & Duty of loyalty
2.2. Partial exculpation	Limited liability for the breach of Duty of care or any part of it &/or Duty of loyalty or any part of it
2.3. Full exculpation	No liability for the breach of fiduciary duties

In combination with unrestricted duty of care create a liability standard equivalent to the business judgment rule of corporate law

CARVE-OUTS FROM PARTIAL EXCULPATION

- willful or intentional misconduct
- grossly negligent behavior
- actions in bad faith
- fraudulent conduct
- knowing violation of (criminal) law

It is true that, unlike the duty of care, carve-outs usually do not cover the duty of loyalty or any parts of it. Because in the most wanting cases—namely, control of daily management and board of directors—this duty was substituted with special conflict-of-interest rules, the fiduciaries' limitation on liability for the breach of their duty of loyalty was not of much importance. Even if liability for the breach of the common law duty of loyalty was limited, the members and managers were liable for the breach of their contractually created duties—be this in the form of special stand-alone procedural rules for approving interested transactions or in the fair price standard. The only situations where the exculpation clauses could limit the liability of the members and managers for the breach of their contractual duties were the cases where the operating agreements exculpated them not only for the breach of their fiduciary duties, but also for any duties and obligations arising out of contracts. These cases, however, given the role of contractual agreements in regulating the relations between the members of non-listed LLCs, were very rare.

The situation observed in the sample firms with 3–10 members was similar. The duties of care and loyalty were waived or modified in 21.4% of the firms for members and in 23.2% of the LLCs for managers. In almost half of the cases, the waivers and modifications of the

managers' fiduciary duties affected only the board members. It was very likely that in cases of waived or modified duties of loyalty of members, the LLC agreements of the sample companies imposed special conflict of interest provisions for transactions between the members and their affiliates on the one hand and the companies on the other (the correlation is significant at 5% level). Because the waivers and modifications of the members' and managers' fiduciary duties usually coincided, these conflict of interest provisions could be invoked by minority members in the few cases where the managers did not owe to the members fiduciary duties.

Similar to the two-member firms, the firms with 3–10 members commonly employed the exculpation of liability of members and managers for the breach of their fiduciary duties. The members were exculpated in 42.9% of the LLCs, and the managers were not liable for the breach of their duties in 60.7% of the companies. Exculpatory provisions covered entire fiduciary duties of members and managers in only one company; the rest of the sample carved out parts of the duty of care in the same way as the two-member companies did in their operating agreements. Though the duty of loyalty or any parts of it were not excluded from the liability limitation clauses, conflict-of-interest rules prevented opportunistic self-dealing by controlling members (positive correlation between the conflict of interest rules and the cases of waived duty of loyalty or eliminated liability of the members for its breach is significant at 5% level).

Finally, in the firms with more than ten members, members and managers' duties of care and loyalty were waived or modified in 27.6% and 24.1% of cases, respectively. The substitution of the duty of loyalty with contractual alternatives is particularly apparent in this group of the sample LLCs. The waived or modified duties of the members were, as a rule, substituted by large transaction rules and conflict-of-interest rules for members, while the managers were subject to conflict-of-interest rules where their fiduciary duties were waived or modified (10% level of statistical significance holds in all these cases). Exculpatory provisions eliminated the liability for breach of fiduciary duties in 48.3% of the LLCs for the members and 72.4% of the LLCs for the managers. The exculpation of liability, however, was never full, and the duty of care applied mostly based on the gross negligence liability standard.

V. DISCUSSION OF THE RESULTS

The analysis of sample LLCs' operating agreements provides evidence in support of the two hypotheses developed above. The detailed private ordering of legal formalities in the absence of functionally equivalent statutory default rules in the Delaware LLC Act provides strong support for the argument that the members of LLCs tailor their governance structures to their company's specific needs by

changing statutory defaults as necessary or filling the gaps. Indeed, this evidence is based on the agreements of large firms that often choose the LLC form for a specific reason and can afford the services of professional consultants. The situation, however, can be different for small firms.[514] First, as the result of minimum lawyering, controlling and minority groups in small firms are more likely to establish formal relations that rely on statutory default rules. Second, as a usual practice, one of the member groups—typically a controlling member—offers the terms of the LLC agreement on a take-it-or-leave-it basis and the other members either accept the terms or choose to pass on the project. The smaller the firm is, the higher the likelihood that an offeree will not review the terms thoroughly and insist on changes.

This has implications. Minimum lawyering leads to regulating member relations by LLC agreements that are full of gaps. Presenting contracts on a take-it-or-leave-it basis establishes unfavorable legal positions for non-controlling members. The likelihood of disputes between the parties increases. Because of gaps and the wide room for self-interested opportunistic behavior, the parties of poorly drafted agreements are more likely to appear before the courts and incur high ex post transaction costs. Should the Delaware LLC Act, then, maintain its general status but offer detailed gap-filling default rules for smaller firms with two or more members, for instance, in the form of a model LLC agreement that supplements the statute? Should the legislature, in order to mitigate the effect of unequal bargaining power of LLC governance, adopt "two-layer default rules"? Under this approach, a waived default rule is automatically substituted by another statutory rule; if the parties also waive this second default, then their private regulation shall prevail.

Both strategies have their pros and cons. Preparing a supplement can reduce transaction costs for many users of the LLC form. Two-layer default rules, in turn, reduce agency costs by complicating waivers of important investor protection standards and rules and, at the same time, in contrast to mandatory rules,[515] leave room for an efficiency-driven choice between statutory defaults and their privately drafted alternatives. As shown later in this section in the duty of loyalty example, such private ordering can benefit the involved parties by reducing transaction costs and uncertainty.[516]

Yet, the same transaction costs imply that new legislative solutions will also affect optimal private ordering for those contractual parties that would do better by adopting alternatives to the statutory defaults.

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[514]*Cf.* Harner & Marincic, *supra* note 21, at 888.

[515]In a recent paper, Chief Justice Leo Strine of the Delaware Supreme Court and Vice Chancellor Travis Laster of the Delaware Court of Chancery propose a statutory framework where the fiduciary duty of loyalty is non-waivable. *See* Strine & Laster, *supra* note 419, at 13.

[516]*See infra* notes 521–522, 526–532 and accompanying text.

Moreover, as the theory of network externalities suggests, the transaction-cost bias of choosing statutory defaults will be compounded by network externalities, turning the defaults into the main rules of practice. Because default rules are more likely to be chosen, they become the rules around which contract networks are formed.[517] The developing networks further strengthen the position of default rules and weaken the role of their possible alternatives because more and more parties will be inclined to adopt the default structures offered by statutes.[518] While the network effects are not strong for simple rules such as legal formalities, they can be substantial for other default provisions directed at mitigating conflicts of interests between LLC members. The evidence that (1) smaller firms prefer to form LLCs within the state of their principal place of business and (2) the share of out-of-state LLCs formations and Delaware LLCs increases along with the increase in the size of firms[519] is a another argument against developing detailed statutory regulations for small firms.

The evidence from this and similar studies can help in drafting default rules desired by private parties to fill the gaps of private contracting. For example, the statute could provide that if there is a board of directors in the company, then certain procedural rules apply, and the statute could go on to describe these rules. Or the statute could provide that if the parties waive the duty of loyalty, then all related party transactions involving conflicts of interest shall require the approval of non-interested directors or members. But cases where possible default rules are desired by most of the parties are rare. In order to be able to supply the members of LLCs with optimal defaults, statutes should offer different options depending on the circumstances of contracting. However, this makes their drafting extremely complicated and costly.

The contractual practices of the LLC members also support the hypothesis that members very often opt out of statutory defaults and develop alternative rights and obligations. In this way, they achieve governance structures that best fit their needs and, at the same time, ensure the rights and interests of the contracting parties. Waivers and modifications of traditional corporate governance mechanisms and investor protection rights do not exacerbate internal conflicts of interests inherent to the firm and do not free the hands of insiders to engage in opportunistic behavior.

The contractual alternatives developed by private parties for the protection of their rights differ depending on the number of members in a firm and the prevalence of particular conflicts of interests. In firms with a smaller number of members, interest-transfer restrictions and minority-

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[517] *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 828 (1995).

[518] *Id.* at 827–28 .

[519] *See* Dammann & Schündeln, *supra* note 37, at 745–46.

put rights play an important role. They ensure stability among the parties, secure special relations between them,[520] and provide minority members with exit opportunities where the potential for oppression—either by incumbent insiders or the acquirers of control—is strong. They act as a remedy where other investor protection rights are weak. Minority member exit opportunities can also be achieved by the right to dissolve an LLC at-will or conditioned upon decision-making deadlock or member default. Put/call rights and dissolution rights in the context of firms with a small number of members with unanimous decision-making rights encourage parties to cooperate if there is a disagreement between them. Any of the parties can threaten to put an end to the project and exercise this threat if cooperation fails. The more parties depend on each other (relation-specific investments), the stronger this effect is.

The importance of many interest transfer restrictions, contingent ownership rights, and dissolution rights decreases with the increase of the number of firm members. Firms with more members often alter the default approval clause of the Delaware LLC Act to make interest transfers by members easier. This is not surprising given the limits of unanimous consent rights where many parties are involved. Yet, tag-along rights are used in these firms more often, perhaps because the larger the number of minority members and the weaker their vote in opposing control transactions, the stronger the need is to have exit rights. Tag-along rights, by requiring controlling sellers to choose acquirers carefully and holding back acquirers that wish to enrich themselves at the expense of minority members, encourage minority investments and make possible capital accumulation in the first place.

In change-of-control transactions, tag-along rights can also effectively substitute the fiduciary duties of managers and controlling members. It is well-known that takeover regimes in Europe and the United States are based on two different approaches; whereas European legislation relies on the mandatory bid rule,[521] the dominant U.S. approach, both for listed and non-listed firms, does not support the idea of equally sharing control premiums among all shareholders, and, where it does so, the sharing occurs ex post based on the fiduciary duties of directors and controlling shareholders.[522] Therefore, contracting for a

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[520]Special relations of trust between members can explain situations where contractual parties vest control upon one of the members and at the same time waive almost all legal measures that can be invoked as a check on the discretion of the controlling member. A legal ban on transferring membership interests to third parties in these situations can be a strong indicator that trust is, indeed, the reason for choosing such contract design.

[521]Under the mandatory bid rule, any third-party buyer that has established control over a certain percentage of shares of a listed company has to make an offer to the remaining shareholders at the highest price paid for acquiring the initial holding.

[522]*See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 225, 258 (2d ed. 2009) (stating U.S. approach relies on assumption that "permitting sales at a premium price gives both seller and acquirer [of controlling block of shares] an appropriate reward for their extra monitoring costs").

tag-along right is a matter of choice between (1) relying on standards and their ex post clarification by courts to protect minority members of LLCs in the event of value-decreasing control transactions and (2) opting for ex ante drafting of detailed rules in the agreement. In cases where controlling members do not owe any fiduciary duties to minority members in a sale-of-control transaction, then a tag-along right is the only means that can protect the minority interests.

Investments in firms with a small number of members are also protected by unanimous voting requirements and by veto rights of outsiders in cases of major decisions. In addition to this, by requiring the managers to distribute available company cash to members, the contracting parties limit the discretion of insiders. In firms with more members, fiduciary duties and their contractual substitutes—special rules allowing self-dealing upon the informed approval of non-interested members or directors—play a greater role in the protection of the rights and interests of the contractual parties. These rules are a common way of preventing opportunistic self-dealing by insiders when their liability for the breach of the duty of loyalty is eliminated. Minority members in LLCs with many members—in the absence of member fiduciary duties, minority put rights, and dissenters' rights—are also protected by special large transaction rules. These rules require unanimous, supermajority, separate class,[523] or majority-of-the-minority[524] vote for mergers, acquisitions, other change-of-control transactions, sales of all or almost all company assets, acquisitions of assets or incurring of indebtedness above a certain amount or relative percentage,[525] and other similar transactions.

There are several reasons that can encourage contractual parties to limit the role of fiduciary duties. An obvious situation where members can elect to dispense with the fiduciary duties of board members is where a member appoints a director as its designee who is expected to act as the member's representative and advance the member's interests on the board. This is a common practice in firms and joint ventures where agreements stipulate that directors are not elected by member vote, but rather appointed and removed by members. This practice, however, can be problematic in the traditional corporate law setting because the actions of directors serving the interests of nominating investors at the expense

For a discussion of the duty of care and potential liability directors and managers face when their company has been threatened with a takeover and a brief comparison of European regulations with United States' regulations under these circumstances, see Marco Ventoruzzo, *Europe's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political and Economic Ends*, 41 TEX. INT'L L.J. 171, 186–88 (2006).

[523]Majority of each class of units voting separately must approve a transaction.

[524]Majority-of-minority members voting separately must approve a transaction.

[525]Large transaction rules are usually defined by specific amounts, but they can also be tied to the value of the assets of a company as a certain percentage or, if members approve annual budgets, be a certain cap in absolute or relative terms on the amounts of transactions exceeding the budget.

of other investors are treated as transactions involving a conflict of interest.[526] Imposing traditional fiduciary duties on such representatives by a mandatory legal provision would contradict the nature of the underlying relations and hamper investments.[527] For example, passive investors and corporate lenders condition financing upon a right to have a board designee that will advance their interests and transfer first-hand information about the company to the financier. Why negotiate an appointment right in the first place if the appointed director cannot act in the interests of the member who appointed the director?[528] By relieving directors of their fiduciary duties in such situations, members reduce unnecessary risks of speculative litigation. Meanwhile, the officers, unlike board members, remain subject to fiduciary duties.

Another situation is where fiduciary duties are substituted by contractual alternatives. A recurring practice in the sample firms was to draft special related-party and large transaction rules for members and managers, instead of relying on the members' or managers' duty of loyalty. Along with eliminating or restricting the role of fiduciary duty constraints on the discretion of members and managers, the sample companies strengthened the role of contractual constraints.[529] This practice can be viewed in the prism of an efficiency-based choice between rules and standards at the stage of contracting. Where ex ante transaction costs are lower than ex post enforcement costs, the parties prefer to negotiate and draft clear rules instead of relying on abstract standards that depend heavily on the enforcement by a third-party adjudicator.[530] There is a tradeoff between incurring these costs at the two different stages, which obviously affects the choice of contracting parties.

The role of fiduciary duties is to deal with difficulties in (1) regulating the behavior of agents ex ante due to transaction costs and (2) monitoring after contracting due to information asymmetries between the

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[526]*See* D. Gordon Smith, *Duties of Nominee Directors*, *in* COMPARATIVE COMPANY LAW: A CASE BASED APPROACH 61, 61–62 (Mathias Siems & David Cabrelli eds., 2013).

[527]For the underinvestment argument, see Martin Gelter & Geneviève Helleringer, *Lift Not the Painted Veil! To Whom Are Directors' Duties Really Owed?*, 2015 U. ILL. L. REV.1069, 1104 (2015) (showing that under assumption of incomplete contracting and inability to specify all future contingencies, parties invest if they have right to affect decision-making on non-contracted matters ex post).

[528]*See id.* at 1074 (noting paradox in allowing specific shareholders to design directors and applying uniform fiduciary duties to all directors).

[529]According to Smith and Lee, there are four layers of constraints that limit the discretion of fiduciaries—statutory or regulatory, contractual, fiduciary, and non-legal. Among legal constraints, fiduciary duties are measures of last resort that are activated only where all other legal constraints have been exhausted. *See* D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 612–13 (2014).

[530]*See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 840–44 (2006).

principals and agents.[531] By substituting the duty of loyalty with contractual rules, contracting parties, in effect, incur additional transaction costs to reduce the discretion of managers and members (e.g., for all transactions above a certain amount or a percentage of the firm's annual budget). This lets parties enforce the contract at a lower cost in the future. Contrary to this, relying on fiduciary duties implies a partial shifting of transaction costs to the enforcement stage. Under the fiduciary duty of loyalty, the obligations of managers and members are open-ended at the moment of decision-making, but they are subject to an ex post review by a court or arbitrator. This, notwithstanding broad discretion, incentivizes them "to act in the interests of . . . principal[s]."[532] The effect of substituting fiduciary duties with contractual rules is to limit the discretion of agents instead of giving them broad discretion that is subject to ex post control. This can enhance protection by reducing the unpredictability of the application of fiduciary duties by ex post decision-makers in particular disputes. The contractual substitutes also reduce the costs of parties by reducing litigation costs and discouraging speculative litigation. Hence, it is reasonable for the parties to incur additional transaction costs and develop clear rules of behavior for members and managers if it is not difficult to verify the outcomes of their actions (here, the amount of a transaction or the fact of an affiliation), and the involvement of principals instead of agents in decision-making is not complicated and costly. The latter can be problematic in publicly traded firms with many passive investors facing collective action problems, but it is easier to achieve in non-listed firms where investors are more willing and able to play an active role.

Under some circumstances, the contractual substitutes of the traditional fiduciary duties giving minority members approval rights for related-party transactions can provide even stronger protection to minority investors than the duties themselves. The reason for this is that they apply to all related-party transactions, while under fiduciary duties an agent can proceed with a related-party transaction notwithstanding the opposition of minority investors if the fair price and fair dealing standards are formally met. Indeed, there are also situations where the procedural substitutes of the duty of loyalty offer weaker protection than the duty of loyalty itself. These substitutes can be compared to the judge-made safe harbor provisions of corporate law that, as a rule, affect the allocation of the burden of proof in fiduciary duty breach litigation.

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[531]*See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1048–49 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426–27 (1993); Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1040–43 (2011).

[532]*See* Sitkoff, *supra* note 531, at 1043.

However, in the traditional corporate law setting, the safe harbor provisions never substitute duty of loyalty.

Meanwhile, in the LLC context, certain procedures for approving interested transactions typically preclude additional ex post judicial review under the entire fairness standard. This can be reasonable in two-member firms and other LLCs with a small number of members, where each of the members has a veto right upon important decisions, directly or via the right to appoint board representatives. Under member-veto rights or obligations to regularly distribute company profits, minority members need not worry that their refusal to approve related-party transactions with controlling members or their affiliates could possibly result in some kind of retaliation in the future. Yet, as the number of minority members grows and the influence of controlling members increases, such stand-alone procedural rules applied in lieu of duty of loyalty become more prone to controlling member abuse.

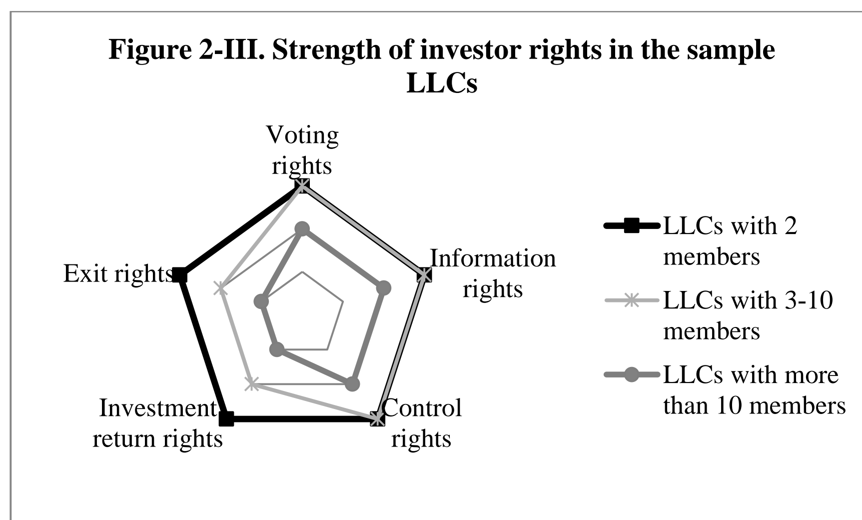

Figure 2-III. Strength of investor rights in the sample LLCs

In summary, the protection of outside investors in non-listed LLCs within the framework of the rights to (1) vote, (2) information, (3) control, (4) return, and (5) exit[533] can be presented in the following way (see also Figure 2–III). Voting rights of minority members are stronger in firms with a small number of members. For important matters, large transactions, and related-party transactions, minority members can hold voting power via member voting or board representation that exceeds their share of the capital. Sometimes minority members can influence voting through supermajority quorum requirements by refusing to attend a meeting. Minority-member control by means of appointing a minority

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[533]This framework is borrowed from Arthur R. Pinto, *Protection of Close Corporation Minority Shareholders in the United States*, 62 AM. J. COMP. L. 361, 363, 365 (2014).

member as a managing member also is more common in firms with few members. As the number of members increases, centralized management with the right of a controlling member to elect the majority of directors becomes a rule. Yet, even in companies with many members, minority investors have strong voting rights where the fiduciary duties of controlling members and managers are waived or modified. All members, as a rule, have strong information rights. In addition to the right to access the books and records of a firm, which sometimes can be limited by the standards of establishing a proper or reasonable cause, members are entitled to regularly receive financial statements and balance sheets of the firm.[534] In order to ensure a return for invested capital and limit the discretion of insiders, the distribution of profits is often an obligation, rather than a discretionary choice of the management, particularly where a firm has few members. Finally, given restricted opportunities for exiting investments via a liquid market and the absence of appraisal rights, minority members receive a right to put their units to the firm or controlling member or a right to sell the units along with the controlling member in change of control transactions. While the former is common only in firms with a small number of members, the latter is widespread in all non-listed LLCs, but its use increases along with the increasing number of investors.

VI. CONCLUSION

The results of this study demonstrate how the provisions of the Delaware LLC Act are applied or not applied (given opt-outs, modifications, or application of contractual alternatives) in the practice of non-listed LLCs. The members of these firms engage in active contractual planning with the aim of balancing the conflicts of interests and limiting opportunistic behavior. The practice of investor rights and governance models changes heavily depending on the number of firm members. The increasing number of members also changes the optimal model of governance because of the need to organize a centralized management relatively independent from the influence of individual investors. Along with the change in the management structure comes changes in the inherent conflicts of interest. Firms with few members have strong investor protection rights. As the number of members increases, however, the balance shifts towards the management and controlling members who have a strong say in the process of forming the management.

One of the controversial issues of contracting in the context of LLCs is the ability of the members and managers to contract around their fiduciary duties. If default fiduciary duties are altered without

[534] *See id.* at 365.

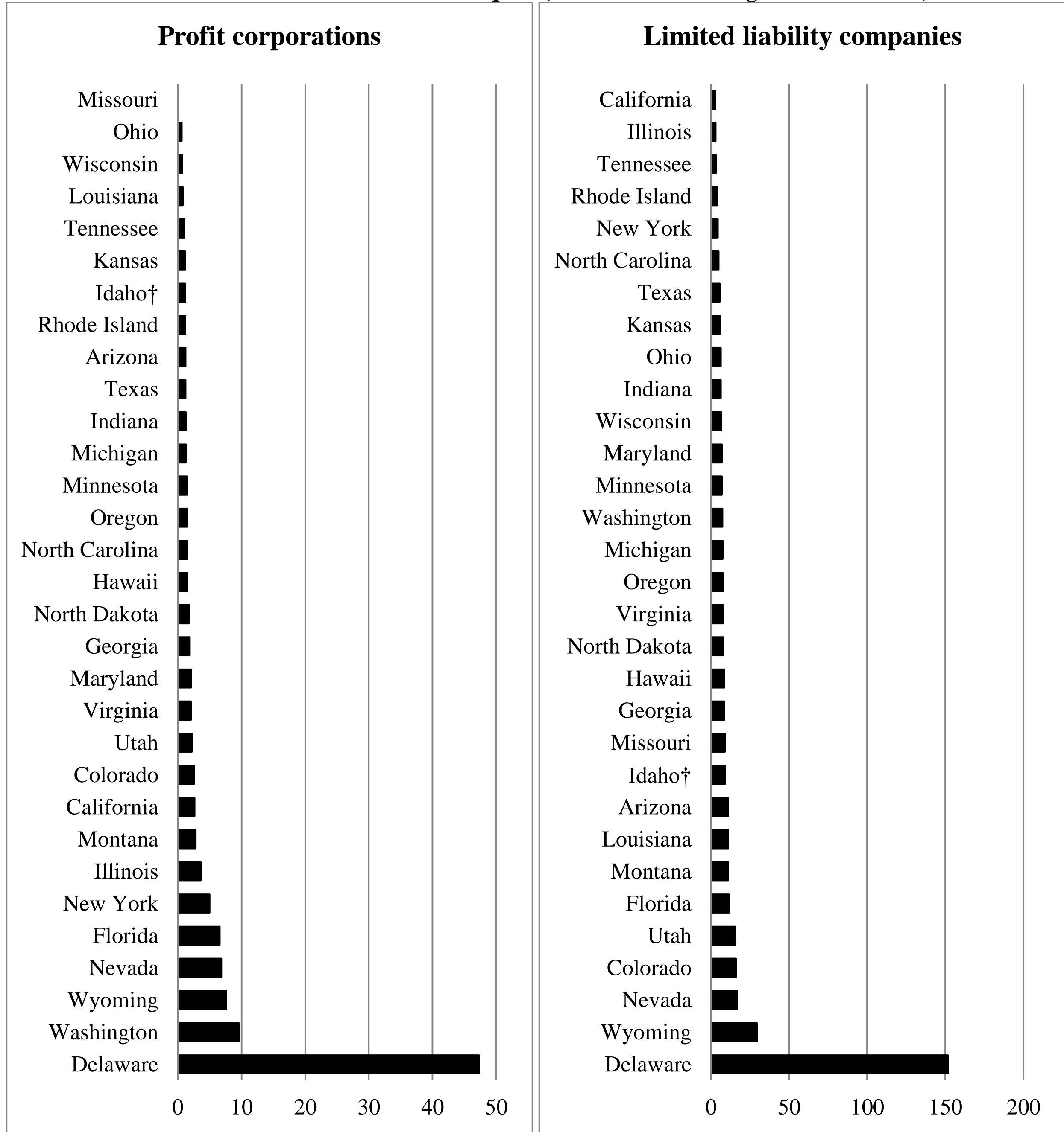
contracting for equivalent protections, outside investors can be left at the mercy of managers. This study provides strong evidence that fiduciary duties are indeed at the center of contractual planning in LLCs. However, full waivers of the duties and full exculpation for the breach of fiduciary duties are an exception rather than a rule. In the majority of the cases, the modifications of the duties have limited extent. These modifications do not seem to be arbitrary. They tend towards minimum levels of investor protection offered previously by courts (for example, the duty of care can be modified with a new standard reflecting the business judgment rule) and lawmakers (for instance, the provisions of the model LLC acts or the Delaware General Corporation Law). In addition, the modified fiduciary duties are often substituted by contractual alternatives. This leaves the practice of investor rights in Delaware LLCs at a level that is not very different from what the corporation laws require.

The situation, however, may be different for creditors. Contractual agreements of members, intentionally or accidentally, may deprive creditors of their legitimate expectations. For example, in two LLCs, minority members owned preferred units entitling them to a certain monthly interest, which, if not paid, was accrued. According to the operating agreements, the preferred units had a liquidation preference and the claims of their holders should be satisfied ahead of the claims of other creditors. Such a subordination of creditor claims increases uncertainty and can create wide opportunities for firms to avoid fulfilling contractual obligations. Many other companies imposed an obligation on involuntary transferees—parties who acquired LLC units as the result of a court order, forfeiture, or another reason—to sell their units to the LLC, sometimes at a price defined by the company insiders. The problem is that creditors who become involuntary transferees never agreed to such a provision. These are the cases that require careful treatment by courts and legislatures. Future research will focus on the implications of broad contractual freedom on the creditors of LLCs.

The choices of sophisticated private parties documented in this Article have important implications for the future users of the LLC form, as well as for the courts and the legislature in the debate on fiduciary duties in non-corporate business forms—should they remain default, as they are now, or should they be imposed on LLC members and managers by the means of mandatory provisions?

APPENDIX 2–I

Number of New Business Formations per 1,000 Inhabitants Aged 18 and Over, 2013



Sources: Data on new business formations in 21 states were obtained from the Annual Reports of Jurisdictions made available by the International Association of Commercial Administrators, http://www.iaca.org; data on 10 other states were collected from the offices of the secretary of state. Population estimates come from the U.S. Census Bureau, Population Division. The estimates are based on the 2010 Census and are for July 1, 2013.

Notes: † Data for Idaho are for 2012.

The figures do not make any suggestion about the business environment in a given state; rather, they indicate to the popularity of state statutes on corporations and limited liability companies for organizing business relations.

APPENDIX 2–II

Typical Provisions of LLC Agreements

Board action without a meeting	On any matter requiring an approval or consent of directors under this Agreement or the Delaware LLC Act, the directors may take such action without a meeting, without prior notice, and without a vote if a consent or consents in writing, setting forth the action so taken, shall be signed by all of the directors.
Member action without a meeting	Any action that may be taken at any meeting of members may be taken without a meeting by written consent of members holding outstanding voting membership interests sufficient to approve such action were a meeting to be held.
Books and records inspection right	Subject to the confidentiality provisions of this Agreement, any company books and records are subject to inspection and copying at a reasonable notice, and at the expense, of any member during ordinary business hours by such member or member's agent.
Default approval clause/transfer consent	Except as permitted by this Section, no member may sell, assign, pledge, transfer or otherwise dispose of, directly or indirectly, all or any portion of such member's units (whether with or without consideration and whether voluntarily or involuntarily or by operation of law or the sale or issuance of any securities) (a "*Transfer*"), and no Transfer will be effective, unless (i) the board/non-transferring members shall have approved the Transfer, except a Transfer by a member to its affiliate, and (ii) the transferee agrees to be bound by all of the terms and conditions of this Agreement.
Minority put right	Beginning after the first year anniversary of the effective date of this Agreement, each non-managing member shall have the right to require the company to redeem all or a portion of the non-managing member units held by such non-managing member for the amount defined according to this Agreement.
Tag-along right	If a member or members shall propose a transfer of any units to one or more third parties pursuant to a bona fide offer, then such member or members (the "*Selling Member(s)*") shall provide written notice of such offer to the company and each of the other members. Each of the other members shall have the right (but not the obligation), for a period of at least ten (10) business days from the receipt of the notice, to include in such transfer up to all of the units held by such members at the same price per unit, upon the same terms and conditions and for the same type of consideration. If the proposed purchaser elects to purchase

	less than all of the units offered for sale as a result of the members' exercise of their respective rights, the Selling Member(s) and each member exercising its tag-along rights will have the right to include its pro rata portion of the units to be transferred to the proposed purchaser.
Mandatory distribution right	Except as expressly consented to by the non-managing member, the managing member shall distribute all net cash flow monthly/quarterly/annually.
Fiduciary duty waiver	None of the members or directors, shall have any duties or liabilities to the company or any other member (including any fiduciary duties), whether or not such duties or liabilities otherwise arise or exist in law or in equity, and each member hereby expressly waives any such duties or liabilities.
Exculpatory provision	No director or officer shall be liable, responsible or accountable to the company or to any member for any mistake of fact or judgment, or doing or failing to do any act, or any loss or damage sustained by the company or any member, unless the loss or damage shall have been the result of gross negligence, reckless or intentional misconduct committed fraudulently or in bad faith, or a knowing violation of law by the director or officer.
Conflict of interest rule	No agreement shall be entered into by the company or any subsidiary with a member or any affiliate of a member and no decision shall be made in respect of any such agreement (including, without limitation, the enforcement or termination thereof) unless such agreement or related decision shall have been approved in writing by the non-interested members/directors.
Fair price standard	No agreement shall be entered into by the company or any subsidiary with a member or any affiliate of a member unless any such agreement shall be on arm's length terms and conditions.
Large transaction rule	All of the actions listed below ("*Major Decisions*"), shall require the written approval of all members, which approval shall be in the sole discretion of each member [examples follow]: ▪ incurring of any cost or expense or incurring of any obligation or liability by or for the company that is in excess of ten percent (10%) with respect to each item in the operating budget approved annually by the members; ▪ sale, lease or otherwise disposal of any asset of the company which has a reasonable value not exceeding five hundred thousand US dollars ($500,000.00).

APPENDIX 2–III

Results of the Correlation Analysis

The tables in this appendix show whether the pairs of the provisions of the LLC agreements of the non-listed LLCs and some other aspects of their governance structures are positively correlated (likely to appear together), negatively correlated (likely that one appears without the other), or are not correlated. The calculations are based on phi coefficient of correlation for 2x2 tables of categorical variables of each pair. φ values range from 0 (no relation between the pairs) to 1 (perfect positive relation) or –1 (perfect negative relation). One asterisk indicates significance at the 10% level, two asterisks at the 5% level, three asterisks at the 1% level, and four asterisks at the 0.1% level.

The results of the correlation analysis are presented separately for three different groups of the sample LLCs based on their ownership structure differences. The first group consists of the firms that had 2 members. The initial number of these companies in the sample was 168. After removing the 2–member LLCs where the members had special relations, such as employment by one company or possible affiliation between the members due to the ability of one member to affect decisions of the other, 10 LLCs were removed from this group. The second group consists of the LLCs that had minimum 3 members and maximum 10 members. The initial sample was reduced from 62 companies to 56 LLCs in order to keep the results unaffected by the special relationships between the members. The last group includes the sample companies with more than 10 members. For the same reason, the initial sample of 59 companies was reduced to 29.

The tables in Panels A show interactions between different provisions of the LLCs agreements and governance aspects that create risks for outside investors, on the one side, and investor protection mechanisms that potentially can deal with the former, on the other side. In Panels B the same investor protection mechanisms are analyzed as a separate group.

LLCs with two members
Panel A

	No duty of loyalty for members	Waiver or exculp. of duty of loyalty of members	No duty of loyalty for managers	Waiver or exculp. of duty of loyalty of managers	>50% member	Board control	Controlling managing member	Minority managing member	Board and managing member control	No duty of care for members	No duty of care for managers	Member who can amend the LLC agreement	Member who can dissolve the LLC	Member who can approve mergers
Large transaction rules	-0.034	0.179**	0.030	0.034	-0.025	-0.124	-0.024	0.277****	-0.050	-0.024	0.038	-0.181**	-0.168**	-0.264****
Conflict of interest rules for members	-0.003	0.104	0.164**	0.062	-0.082	0.082	-0.121	0.075	-0.069	0.006	0.133*	-0.019	-0.085	-0.290****
Conflict of interest rules for managers	-0.038	-0.074	-0.016	0.066	0.079	-0.079	0.011	0.282****	0.243***	-0.055	-0.055	0.042	-0.143*	-0.141*
Purpose limitation	-0.036	0.026	0.036	0.056	-0.048	-0.109	-0.001	0.240***	-0.029	-0.027	-0.027	-0.156**	-0.112	-0.228***
Specific target distribution right	-0.212***	0.025	-0.058	-0.075	0.055	-0.114	0.045	0.211***	0.025	-0.231***	-0.108	-0.177**	-0.016	-0.300****
Minority put right	-0.110	0.039	-0.046	0.005	0.201**	-0.030	0.281****	0.048	0.152*	-0.091	-0.062	-0.086	0.063	-0.003
Unanimous voting or veto right	-0.063	0.005	0.116	0.006	-0.245***	-0.172**	-0.385****	0.148*	-0.273****	-0.054	0.112**	-0.171**	-0.448****	-0.570****
Tag-along right	0.319****	0.046	0.184**	0.074	0.093	0.193**	0.083	-0.192**	0.099	0.308****	0.144*	0.291****	0.049	0.106
Default approval clause	-0.129	0.017	-0.014	-0.044	-0.076	-0.175**	0.194**	0.072	0.002	-0.122	-0.079	-0.071	-0.088	-0.103
ROFO or ROFR	0.125	0.001	0.109	0.088	-0.045	-0.039	-0.042	-0.066	-0.070	0.111	0.053	0.056	-0.052	-0.159**

LLCs with two members
Panel B

	Conflict of interest rules for members	Conflict of interest rules for managers	Purpose limitation	Specific target distribution rights	Minority put right	Unanimous voting or veto right	Tag-along right	Default approval clause	ROFO or ROFR
Large transaction rules	0.380****	0.184**	0.247***	0.294****	0.250***	0.252***	-0.147*	0.063	0.043
Conflict of interest rules for members		0.403****	0.162**	0.222***	0.126	0.322****	-0.057	0.169**	0.051
Conflict of interest rules for managers			0.174**	0.171**	-0.108	0.245***	0.062	0.141*	0.161**
Purpose limitation				0.177**	0.025	0.069	-0.060	0.109	0.145*
Specific target distribution right					0.066	0.088	-0.323****	0.260****	0.001
Minority put right						-0.098	-0.121	0.150*	-0.117
Unanimous voting or veto right							-0.054	0.041	0.138*
Tag-along right								-0.252***	0.402****
Default approval clause									-0.197**

LLCs with 3–10 members
Panel A

	No duty of loyalty for members	Waiver or exculp. of duty of loyalty of members	No duty of loyalty for managers	Waiver or exculp. of duty of loyalty of managers	>50% member	Board control	Controlling managing member	Minority managing member	Board and managing member control	No duty of care for members	No duty of care for managers	Member who can amend the LLC agreement	Member who can dissolve the LLC	Member who can approve mergers
Large transaction rules	0.013	0.186	-0.293**	-0.011	-0.166	-0.099	-0.122	0.156	-0.087	0.013	-0.293**	-0.162	-0.117	-0.251*
Conflict of interest rules for members	0.330**	0.287**	0.107	0.214	-0.104	0.205	-0.231*	0.027	-0.088	0.330**	0.107	0.077	0.027	-0.019
Conflict of interest rules for managers	0.045	-0.009	0.011	0.088	0.031	0.099	0.098	-0.012	0.010	0.045	0.011	-0.169	-0.012	-0.135
Purpose limitation	-0.225*	-0.138	-0.186	-0.088	-0.077	-0.178	0.251*	0.197	0.146	-0.225*	-0.186	-0.217	-0.174	-0.135
Specific target distribution right	-0.050	-0.182	-0.173	-0.392***	0.149	-0.181	0.336**	-0.010	0.138	-0.050	-0.173	-0.341**	-0.100	-0.137
Minority put right	0.125	0.062	-0.202	-0.231*	0.017	0.074	-0.002	0.048	0.037	0.125	-0.202	-0.035	-0.059	0.022
Unanimous voting or veto right	0.115	0.029	-0.009	-0.041	-0.199	-0.240*	-0.009	0.247*	-0.041	0.115	-0.009	-0.280**	-0.306**	-0.242*
Tag-along right	0.299**	0.248*	0.167	0.138	0.253*	0.433***	-0.088	-0.190	0.062	0.299**	0.167	0.220*	0.351***	0.299**
Default approval clause	0.041	-0.102	-0.027	-0.119	0.212	-0.073	0.254*	-0.284**	-0.119	0.041	-0.027	-0.221*	-0.185	-0.151
ROFO or ROFR	0.144	-0.004	0.017	0.112	0.149	0.228*	0.017	-0.173	-0.115	0.144	0.017	-0.137	0.008	-0.031

LLCs with 3–10 members
Panel B

	Conflict of interest rules for members	Conflict of interest rules for managers	Purpose limitation	Specific target distribution rights	Minority put right	Unanimous voting or veto right	Tag-along right	Default approval clause	ROFO or ROFR
Large transaction rules	0.536****	0.447****	0.149	-0.062	0.134	0.401***	0.155	0.011	0.197
Conflict of interest rules for members		0.600****	-0.009	-0.105	0.277**	0.337**	0.397***	0.023	0.435***
Conflict of interest rules for managers			-0.010	-0.129	0.098	0.283**	0.240*	0.000	0.492***
Purpose limitation				0.351***	0.076	0.019	-0.240*	-0.408***	-0.121
Specific target distribution right					0.167	0.204	-0.077	0.034	-0.116
Minority put right						0.077	-0.003	0.067	0.102
Unanimous voting or veto right							-0.162	0.185	0.013
Tag-along right								0.034	0.532****
Default approval clause									0.250*

LLCs with more than ten members
Panel A

	No duty of loyalty for members	Waiver or exculp. of duty of loyalty of members	No duty of loyalty for managers	Waiver or exculp. of duty of loyalty of managers	>50% member	Board control	Controlling managing member	Minority managing member	Board and managing member control	No duty of care for members	No duty of care for managers	Member who can amend the LLC agreement	Member who can dissolve the LLC	Member who can approve mergers
Large transaction rules	0.310*	-0.154	0.193	0.168	-0.519***	-0.401**	-0.077	n.a.	-0.330*	0.310*	0.193	-0.285	-0.285	-0.362*
Conflict of interest rules for members	0.330*	0.044	0.261	0.061	-0.447**	-0.038	-0.441**	n.a.	-0.171	0.330*	0.261	0.170	-0.265	-0.111
Conflict of interest rules for managers	0.265	0.080	0.344*	0.147	-0.409**	-0.053	-0.383**	n.a.	-0.169	0.265	0.344*	0.127	-0.315*	-0.137
Purpose limitation	-0.123	-0.180	0.099	0.070	-0.222	-0.216	0.053	n.a.	-0.170	-0.123	0.099	-0.221	-0.221	-0.020
Specific target distribution right	0.066	-0.127	0.110	-0.309*	-0.236	-0.289*	-0.008	n.a.	-0.358	0.066	0.110	-0.371**	-0.012	-0.083
Minority put right	-0.117	-0.242	-0.107	0.107	0.143	-0.170	-0.086	n.a.	-0.196	-0.117	-0.107	-0.137	-0.137	0.225
Unanimous voting or veto right	-0.117	0.148	0.335*	0.107	-0.258	-0.170	-0.086	n.a.	-0.196	-0.117	0.335*	-0.137	-0.137	-0.159
Tag-along right	0.005	0.121	0.109	0.223	-0.244	-0.153	-0.584***	n.a.	-0.329*	0.005	0.109	0.119	-0.180	0.080
Default approval clause	0.123	0.031	0.240	-0.070	0.222	-0.075	0.139	n.a.	0.025	0.123	0.240	0.068	0.221	0.168
ROFO or ROFR	0.219	-0.010	0.302	0.184	-0.352*	-0.255	-0.228	n.a.	-0.239	0.219	0.302	-0.216	-0.070	-0.194

LLCs with more than ten members
Panel B

	Conflict of interest rules for members	Conflict of interest rules for managers	Purpose limitation	Specific target distribution rights	Minority put right	Unanimous voting or veto right	Tag-along right	Default approval clause	ROFO or ROFR
Large transaction rules	0.484***	0.421**	0.201	0.066	-0.117	-0.117	0.005	-0.201	0.219
Conflict of interest rules for members		0.870****	0.170	0.018	-0.183	-0.183	0.329*	-0.315*	0.100
Conflict of interest rules for managers			0.274	0.089	-0.159	-0.159	0.512***	-0.422**	0.228
Purpose limitation				0.525***	-0.137	0.260	0.119	-0.389**	0.221
Specific target distribution right					-0.097	-0.097	-0.127	-0.167	0.053
Minority put right						-0.036	0.148	0.137	-0.170
Unanimous voting or veto right							0.148	0.137	0.210
Tag-along right								-0.119	0.419**
Default approval clause									0.070

3. PRIVATE ORDERING OF INTEREST (SHARE) TRANSFERS: THEORY AND EVIDENCE FROM BUSINESS ORGANIZATION CONTRACTS*

I. INTRODUCTION

In October 2014, a New York court put an end to a lengthy dispute between the founders of Arizona Beverages Co., maker of the popular AriZona Iced Tea, over the issue of parting their ways.[535] Two friends from Brooklyn, Don Vultaggio and John Ferolito, launched the successful business of producing ready-to-drink tea in 1992. Long friendship and business success, however, did not prevent the two founders from running into a conflict. Mr Ferolito, in an effort to avoid decision-making deadlocks, distanced himself from active management. Later, invoking a provision in the shareholders' agreement that banned share transfers to third parties, Mr Vultaggio blocked the attempts by Mr Ferolito to sell his 50% holding in the company. This led to numerous lawsuits, the first dating back to February 2008. After a failed effort to challenge transfer restrictions in a court, Mr Ferolito sought judicial dissolution of the corporation based on shareholder oppression grounds. Mr Vultaggio opted for buying out his partner on the corporation's behalf. But the huge gap between the parties on price—whereas the party looking for an exit valued the firm at up to $4 billion, the valuation of the party willing to buy out was less than $500 million—prevented the possibility of a negotiated buy-out. At the last stage of the lengthy and costly court proceedings, the court had to reconcile the differing valuations.[536] The proceedings involved depositions of ten individuals, with some continuing over multiple days, testimonies of many witnesses, hundreds of thousands of pages of documents and financial data, and generated nearly $200 million in estimated legal fees.[537]

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*This chapter is based on forthcoming articles in the *American Business Law Journal* and the *European Business Law Review*. *See* Suren Gomtsian, *Exit in Non-Listed Firms: When and How to Use Share Transfer Restrictions?*, 27 EUR. BUS. L. REV. (forthcoming in 2016); Suren Gomtsian, *Private Ordering of Exit in Limited Liability Companies: Theory and Evidence from Business Organization Contracts*, 54 AM. BUS. L.J. (forthcoming in 2017).

[535] *See* Ferolito v. AriZona Beverages USA LLC, No 004058–12, 2014 WL 5834862 (N.Y. Supr. 2014).

[536] The narrative of the dispute is based on court documents and newspaper publications. *See* Ferolito v. Vultaggio, 78 A.D.3d 529 (N.Y. App. Div. 2010); Ferolito v. Vultaggio, 99 A.D.3d 19 (N.Y. App. Div. 2012); Ferolito v. Menashi, 918 F.Supp.2d 136 (E.D.N.Y. 2013); Ferolito v. AriZona Beverages USA LLC, et al., 2014 WL 5834862 (N.Y. Supr. 2014); Mike Esterl, *The Heated Litigation Over Arizona Iced Tea*, WALL ST. J., Sep. 4, 2014; Mike Esterl, *Judge Values AriZona Iced Tea Maker Around $2 Billion*, WALL ST. J., Oct. 15, 2014.

[537] In a recent interview, one of the founders called the corporate conflict "a decade of waste and foolishness" and reckoned he had spent 70% of his time on litigation instead of running the business. Though the industry sales grew at an annual average rate of 6.5% in the

Had the parties negotiated more detailed transfer restrictions, the outcome would have been different. Business partners encounter many problems both at the stage of structuring their relations and later during the functioning of the venture. Examples are the definition of each party's contribution and of corresponding voting rights, self-dealing by one of the parties, opportunistic renegotiation of cooperation terms with the aim of extracting more benefits from the project, deadlocks in decision-making and the resulting paralysis of the firm. Transactional lawyers have designed different contractual provisions dealing with these problems in cases where legislative solutions are deemed insufficient or inappropriate. In particular, under many circumstances they can be efficiently and effectively solved by private ordering of interest or share transfers.[538] Contingent ownership provisions (explicit and implicit options)[539] encourage investments, limit agency, moral hazard, and hold-up problems, prevent escalations of conflicts, and provide business partners with swift means for exiting investments.[540] Ignoring private ordering of interest transfers or badly drafted exit clauses, as the case of AriZona Beverages Co. demonstrates, can cost time, money, and lost business opportunities. Paraphrasing Shakespeare, the fault is not in the stars, but in business organization contracts, that partners turn into adversaries.[541]

In publicly-traded firms, liquid equity markets perform the role of contingent ownership structures allowing minority investors to exit and creating conditions for new controlling investors to appear.[542] In partnerships, notwithstanding restrictions on the transferability of partnership interests,[543] the right of each partner to force the dissolution

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five years through 2014, the firm's share during this period fell to 20.7% from 24.9%. Mike Esterl, *AriZona Iced Tea Pops Open a Can-Do Spirit*, WALL ST. J., Aug. 26, 2015.

[538]This study relies on data from the operating agreements of non-listed limited liability companies. Hence, more appropriate is the use of the terminology applied in the context of limited liability companies, such as "interest transfer" instead of "share transfer", "unit" instead of "stock", "operating agreement" or "limited liability company agreement" instead of "shareholders' agreement", and "member" instead of "stockholder".

[539]Put and call options are explicit options, while tag- and drag-along rights can be considered as implicit options where a party can put its interest to a third-party buyer or can call the interests of other parties, respectively. Chemla et al., *supra* note 460, at 95.

[540]*See* Chemla et al., *supra* note 460, at 100–03; Georg Nöldeke & Klaus M. Schmidt, *Sequential Investments and Options to Own*, 29 RAND J. ECON. 633, 639–48 (1998).

[541]In *The Tragedy of Julius Caesar*, Gaius Cassius Longinus, a leading conspirator to assassinate Julius Caesar, attempts to convince Marcus Brutus that Caesar should be killed. Cassius suggests that the rise of the dictator is the result of their own actions and men can be masters of their fate: "The fault, dear Brutus, is not in our stars, / But in ourselves, that we are underlings." WILLIAM SHAKESPEARE, THE TRAGEDY OF JULIUS CAESAR, act I, sc. 2, 230 (1599), *available at* http://www.opensourceshakespeare.org/.

[542]*See infra* Part II of this Chapter.

[543]Unlimited liability of a general partner coupled with the right to bind the partnership creates a reasonable expectation for each partner to block the entry of new partners with governance rights because the actions of an arriving partner can endanger not only the other partners' investments but their personal wealth as well. *See* RIBSTEIN, *supra* note 213, at 52;

of the firm ensures an equivalent result.[544] The situation is different in non-listed limited liability firms where the members, because of locked investments, are in stronger dependence upon each other's actions.[545] This explains the importance of private ordering of interest transfers in ensuring successful cooperation in the setting of non-listed limited liability firms, particularly where the probability of private benefit extraction or hold-up is high.

And yet business partners often overlook governance planning.[546] They are thus likely to direct attention towards the economic side of the business idea and limit the design of the governance structure by agreeing about the most evident matters—allocation of ownership and voting rights. Statutory default rules are relied upon for filling the gaps of planning. Meanwhile, these rules can be inadequate or insufficient. The pool of available contractual instruments is much larger. Initial allocation of ownership and voting rights, in its turn, is a one-time event. Theoretical models demonstrate that unconditional ownership structures alone are not able to limit control inefficiencies and induce efficient investments neither for the case of simultaneous,[547] nor for the case of sequential investments.[548] The dynamic nature of relations between business partners requires mechanisms that can assist ownership re-allocation in response to changing conflicts. Interest transfer clauses create contingent ownership structures that can be altered at the initiative of the parties along with evolving conflicts of interests.[549] In addition, by offering ways out of decision-making deadlocks, contingent ownership structures allow the parties to choose optimal initial ownership structures for every project.[550]

Hansmann & Kraakman, *supra* note 423, at 424–25. Although limited liability smoothens this concern, the active role of members in the governance of non-listed firms can still generate a legitimate motive to limit the transferability of investments.

[544]*See infra* Part II of this Chapter.

[545]*See infra* Part II of this Chapter.

[546]*See*, *e.g.*, Jason M. Hoberman, *Practical Considerations for Drafting and Utilizing Deadlock Solutions for Non-Corporate Business Entities*, 2001 COLUM. BUS. L. REV. 231, 242 (2001) (enthusiasm about engaging in a new venture complicates advanced contractual planning).

[547]Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POLIT. ECON. 691, 701–04 (1986) (if one of the parties controls the project, it will tend to overinvest, while the non-controlling party will underinvest; if none of the two parties controls, each will invest more than it would have invested under the control of the other party, but these investments will still be less than optimal; therefore, the project will be controlled by a party whose investments are more important and if both are making important investment, the control is expected to be joint).

[548]*See* Nöldeke & Schmidt, *supra* note 540, at 640–41.

[549]*See* Chemla et al., *supra* note 460, at 100–03; Nöldeke & Schmidt, *supra* note 540, at 639–48.

[550]For example, a fear of decision-making deadlocks may prevent equal allocation of voting rights even though both parties are making equivalent contributions and expect equal say on governance matters.

The primary focus of this chapter is the use of various transfer clauses by investors in firms that are closely held. All rights covered in this study are purely contractual in the sense that they are not provided by statutes and thus apply only if so agreed by the members of firms. These are private choices. Nevertheless, transfer restrictions are relatively standardized and have been tested many times.[551] Their widespread use is a strong suggestion that transfer restrictions are both joint-efficient for the contracting parties and effective for achieving the pursued aims.

Transfer restrictions were the subject of theoretical models.[552] Testing the predictions of these models has always been a problem because special rules on interest transfers are typically used in closely-held business entities where the agreements of the investors are, as a rule, confidential. For a long period, the best scholars could do was to test the theoretical implications in simulated laboratory experiments.[553] This study is the first attempt to fill this gap by looking to the contracting practices of real businesses in dealing with interest transfers. The study analyzed governance structures in 289 non-listed limited liability companies (LLCs) whose operating agreements were filed with the United States Securities and Exchange Commission (SEC). The sample companies were thus not start-ups or small corner shops; rather they were independent large firms or joint ventures formed by large corporations.

The findings support some theoretical predictions, show the weaknesses of others, provide insights that have never been considered before, and explain some puzzling questions. In brief, the contractual choices are not accidental. Depending on the underlying conflicts and ownership structure, the parties not only contract for different transfer clauses, but also choose strategically different variations of these clauses. Since the founders of the studied companies usually had access to the services of highly-qualified professional consultants, their contracting preferences offer valuable lessons for understanding the governance structures of non-listed firms in general and the use of transfer clauses in particular. By analyzing the operating agreements, the study identified best drafting practices and circumstances where particular transfer restrictions are preferable.

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[551]*See*, *e.g.*, Corporation Law Committee of the Association of the Bar of the City of New York, *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153, 1172–94 (2010) (describing typical transfer clauses, important drafting considerations, and case law) [hereinafter Corporation Law Committee].

[552]*See infra* Part III of this Chapter.

[553]*See, e.g.*, Brit Grosskopf & Alvin E. Roth, *If You are Offered the Right of First Refusal, Should You Accept? An Investigation of Contract Design*, 65 GAMES & ECON. BEHAV. 176 (2009); Claudia M. Landeo & Kathryn E. Spier, *Shotguns and Deadlocks*, 31 YALE J. ON REG. 143 (2014).

The chapter is divided into five parts. Following the brief discussion of corporate governance in non-listed firms in Part I, the remainder of the article focuses on the theory and practice of contingent ownership structures. Part II briefly introduces transfer clauses and proceeds to the development of arguments for using interest transfers by reviewing the theoretical literature. Where theoretical explanations are contradictory or incomplete, an attempt is made to develop the theory further by relying on models that come closer to the real practice of using transfer clauses. The sample collection process, descriptive data, and research design are presented in Part III. Part IV reports the results of the statistical analysis and offers explanations. Part V uses information from the sample agreements to illustrate common techniques of drafting interest transfer clauses. The chapter concludes that standard forms of interest transfer clauses applied by lawyers to all firms on a one-size-fits-all approach cannot be satisfactory. The empirical results highlight that adaptation of contracts to the needs of each deal are important.

II. AN OVERVIEW OF CORPORATE GOVERNANCE IN NON-LISTED LIMITED LIABILITY FIRMS

A typical governance framework of the firm includes three elements—voice, liability, and exit. Investor voting is one of the distinctive features of the law of business organizations.[554] Corporation statutes grant shareholders the right to nominate and elect board members,[555] vote on amendments to corporate charters and bylaws, on fundamental changes,[556] and make their own proposals for shareholder meetings.[557] The Dodd-Frank Act has added to this list a universal, yet advisory, say-on-pay vote for top executives' compensation of listed companies with at least $75 million public equity float since the beginning of 2011.[558] In addition to formal voting, investors can also express their concern by engaging in private negotiations with managers.[559] This practice is widespread among active institutional

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[554]EASTERBROOK & FISCHEL, *supra* note 423, at 63.

[555]*See* Michael J. Goldberg, *Democracy in the Private Sector: The Rights of Shareholders and Union Members,* 17 U. PA. J. BUS. L. 393, 407–08 (2015).

[556]*Id.* at 413.

[557]*Id.*

[558]*See* Dodd-Frank Act, Pub. L. No. 111–203, § 951, 124 Stat. 1899 (2010); SEC Final Rule, 17 C.F.R. § 240.14a–21(b) (2011), *available at* http://sec.gov/rules/final/2011/33-9178.pdf. *See also* Randall S. Thomas & Christoph Van der Elst, *Say on Pay around the World*, 92 WASH. U.L. REV. 653, 660–61 (2015).

[559]*See* Bart Bootsma, *An Electric Approach to Loyalty-Promoting Instruments in Corporate Law: Revisiting Hirschman's Model of Exit, Voice, and Loyalty*, 2013 ERASMUS L. REV. 111, 117 (2013).

investors—they often use behind-the-scenes discussions with officers and directors to influence behavior.[560]

Where voice, due to the negligible size of equity holding, is not effective, investors can turn to liability laws. In addition to regulatory and contractual constraints that prescribe the behavior of managers and shareholders, corporate law traditionally imposes on directors and officers fiduciary duties of care and loyalty[561] and on controlling stockholders,[562] at a minimum, the duty of loyalty.[563] The threat of ex post liability for failure to act in the interests of the corporation and its stockholders gives fiduciaries an incentive to act so.[564] The liability instrument is further strengthened by the right of shareholders to bring derivative suits on behalf of the corporation for injury done to the corporation.[565]

The third possible investor action is exit. Investors can liquidate investments by selling in the market, thereby terminating their exposure with the firm. This option is the easiest for minority investors but may be costly if a larger investor or many small investors are selling, for such

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[560]*See* Joseph A. McCahery, Zacharias Sautner, & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FINANCE (forthcoming in 2016).

[561]The duty of care requires that directors and officers act on an informed basis and with care; in Delaware corporations, the applicable standard of care is gross negligence. Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985). The duty of loyalty requires directors and officers to act in the best interests of the corporation and its stockholders rather than further their private interests. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Courts traditionally describe these duties as owed to the corporation and its stockholders. This formulation "captures the foundational relationship in which directors owe duties to the corporation for the ultimate benefit of the entity's residual claimants." *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 36–37 (Del. Ch. 2013). *See also* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that officers owe fiduciary duties that are identical to those owed by corporate directors).

[562]The owner of more than 50% of voting shares, whether directly or indirectly, is a controlling stockholder. A minority stockholder who exercises actual control over the corporation's business affairs qualifies as a controller as well. *See, e.g.*, *In re* Crimson Expl. Inc. S'holder Litig., No. 8541−VCP, 2014 WL 5449419, at *10 (Del. Ch. 2014).

[563]*See, e.g.*, Kahn v. Lynch Commc'n Systems, 638 A.2d 1110, 1113–14, 1115 (Del. 1994) ("[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." (emphasis omitted)); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719 (Del. 1971). Delaware courts operate with the term "fiduciary duties of controlling shareholders" without specifying the exact type of the duty. Nevertheless, unless a controller engaged in a conflicted transaction, entire fairness review cannot be triggered. *In re Crimson Expl.*, 2014 WL 5449419, at *12–14.

[564]*See* Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U.L. REV. 1039, 1043 (2011).

[565]*See* STEPHEN M. BAINBRIDGE, CORPORATE LAW 187 (2nd ed. 2009) (the most important function of derivative suits is providing means by which breaches of fiduciary duty are remedied). Derivative actions have been criticized for giving minority shareholders and their attorneys perverse incentives to sue—because of small investments in the firm, the complaining shareholder has very little incentive to consider the effect of the action on the firm and other shareholders. *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 271–73 (1986).

sales can depress the stock price.[566] It is because of this effect that exit can have positive effect on corporate governance. A threat of a takeover, which becomes more likely when the firm's value is low, disciplines managers.[567] Even in the absence of such a threat, exit of a large number of minority investors, by putting equity prices under a downward pressure, can discipline insiders. Thus, the threat of exit is a form of investor activism that can be used behind the scenes to affect managerial decisions.[568]

The governance of listed firms revolves around the triad of the described corporate governance elements. The situation, however, is different in non-listed firms. The absence of a readily-available market in which equity can be traded has important implications.[569] Limited exit increases the reliance of the firm's members on the two other elements—namely, voice and liability.[570] One way to strengthen voice is to trade off diversification of investments with increased exposure to one firm. If members of non-listed firms are small, which is often the case, then lack of diversification arises even in the absence of such a trade-off.[571] This further reinforces the reliance on voice and liability. Strengthened voting power—such as the common practices of equal distribution of voting rights or granting veto rights to minority investors—make a decision-making impasse not only possible but probable.[572] As a result, locked

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[566]*See* Bootsma, *supra* note 559, at 116.

[567]*See* David Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185, 190–92 (1988).

[568]*See* Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2445, 2457–58 (2009); Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2493–95 (2009); Alex Edmans & Gustavo Manso, *Governance through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395, 2406–08 (2011); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?* 23 CARDOZO L. REV. 1419, 1437–38 (2002). Recent empirical evidence supports this argument. *See* McCahery et al., *supra* note 560.

[569]*See generally* MCCAHERY & VERMEULEN, *supra* note 424, at 8 (explaining that investors in non-listed companies, as opposed to publicly-held companies, have fewer market mechanisms to restrict opportunistic behavior); BAINBRIDGE, *supra* note 565, at 442 (emphasizing the absence of a market out mechanism as a critical difference between the public and close corporation).

[570]*Cf.* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 34–36 (1970) ("the role of voice would increase as the opportunities for exit decline, up to the point where, with exit wholly unavailable, voice must carry the entire burden of alerting management to its failings"). *See also* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 284 (1986) (lack of diversification induces investors in close corporations to take care); F. Hodge O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and Bylaw Provisions*, 18 LAW & CONTEMP. PROBS. 451, 452 (1953) (the difficulty of disposing of holdings strengthens the desire for a power to veto corporate decisions).

[571]*See* Easterbrook & Fischel, *supra* note 570, at 274.

[572]*See* Carlos L. Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778, 781 (1952); F. Hodge O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses*, 10 VAND. L. REV. 1, 39 (1956).

investments in non-listed firms strengthen the dependence of the firm's members upon each other's actions. Individual personalities of the members and trust between them become important.

Legislators have reacted to this reality in two ways. First, they offer rules that smoothen exit in non-listed firms and thus bring investors in these firms closer to the position of stockholders of listed firms. In particular, in partnership law, each partner has a right to dissolve the partnership.[573] This solution, however, when applied universally, increases the uncertainty risk and hold-up problems, for every partner can threaten to dissolve the partnership.[574] Holdups are less likely in closely-held corporations where minority investors, costly though it may be, can resort to statutory and judicial remedies of minority oppression.[575] Such remedies may include an extreme option of a judicial dissolution of a firm or less radical options, such as oppression and appraisal rights, which preserve the firm as a going concern but allow minority members to exit at a fair market value of their holdings.[576]

The second solution is the reverse of the first—further weakening of exit with the aim of preventing disruptions of the balance of power within the firm by arrival of third parties. In particular, default statutory rules in partnerships and limited liability companies allow partner (member) substitution only by the consent of all other partners (members).[577] Similar to the first case, a universal solution applied to all non-listed firms increases the hold-up problem because every member can strategically veto interest transfers by others. Moreover, paradoxical as it may seem, reduced exit can weaken voice. Earlier we saw that limited exit increases the reliance of the members of non-listed firms on voice.[578] But it is also true that a threat to exit is a form of voice.[579] Hence, if exit is not possible, voice may be handicapped in the same way where exit is too easy.[580] In other words, exit and voice work best in a balanced combination.

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[573]*See, e.g.*, RIBSTEIN, *supra* note 213, at 53. Indeed, from the firm's and its members' perspective, the outcome of exiting a partnership by dissolving it is very different from selling corporate stock in the secondary market. But from the viewpoint of the exiting investor, both options result in the liquidation of the investments.

[574]*See* Deborah A. DeMott, *Transatlantic Perspectives on Partnership Law: Risk and Instability*, 26 J. CORP. L. 879, 888 (2001).

[575]*See* Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"*, 30 CORNELL INT'L L.J. 381, 387 (1997).

[576]*See* PAUL P. DE VRIES, EXIT RIGHTS OF MINORITY SHAREHOLDERS IN A PRIVATE LIMITED COMPANY 8–11 (2010); Miller, *supra* note 575, at 388.

[577]*See* RIBSTEIN, *supra* note 213, at 51 (for partnerships), 182 (for LLCs). In the absence of the consent of the firm's members, the assignee typically receives economic rights, but not the right to participate in decision-making.

[578]*See supra* note 570 and accompanying text.

[579]*See supra* notes 567–568 and accompanying text.

[580]*See* HIRSCHMAN, *supra* note 570, at 55, 82–83.

Accordingly, statutory default rules can be inadequate or insufficient.[581] The pool of available contractual instruments, which can be tailored to the specific circumstances of investing in each firm, is much larger. Whereas strengthening exit can be achieved by employing various forms of put and call options,[582] including tag-along and drag-along rights,[583] first purchase rights[584] can preserve the established balance of power within the firm without excessively scaling down exit.[585]

Theoretical models of contingent ownership rights in shareholders' agreements show the importance of these provisions in providing shareholders with certainty with regard to their expectations and in stipulating ex ante efficient investments. In a simple model of sequential relationship-specific investments by two partners, Nöldeke and Schmidt show that options to buy shares at a fixed price prevent opportunistic renegotiations and induce both parties to invest efficiently.[586] In the absence of contingent rights, parties have incentives to engage in renegotiations in order to prevent opportunistic behavior by one of them. For instance, after initial investment, the intention of one of the parties to transfer its interest to a third-party buyer in a value-decreasing control transaction requires alterations of the ownership structure of the firm in order to prevent the transfer. By constraining renegotiation directed at exploiting a vulnerable contract party, privately designed contingent ownership structures ensure the parties' shares of the firm's payoff in initial proportions and, therefore, allow optimal ex ante investments in the firm.[587]

This study is the first attempt to fill the gap in the scholarly literature and explore the practice of using transfer restrictions. It does so by analyzing operating agreements of large non-listed limited liability

[581]*See*, *e.g.*, Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO. L.J. 1207, 1252 (2009) (no solution is right for every corporation).

[582]A put option allows its holder to sell the holder's interest to the other investors in the firm (or to the firm) at the will of the holder or upon the occurrence of contingencies specified in the agreement. A call option, on the contrary, is the right of the holder to buy the interests of other investors. For details see *infra* Part III.D of this Chapter.

[583]A tag-along right allows minority members to mitigate the effect of a possible change of control in a firm by selling along with the controlling seller on the same terms. A drag-along right allows its holder—a controlling or dominating member—to force other members to sell along with the right-holder on the same terms in a third-party control transfers. *See infra* Parts III.B and III.C of this Chapter, respectively.

[584]Different forms of first purchase rights give their holder a priority to buy interest sold by other investors in the firm ahead of third parties at the same price and on the same terms offered by or to third parties. *See infra* Part III.A of this Chapter.

[585]Particularly, the right of a minority investor to put its share at a specified price can discipline the controlling shareholder; first purchase rights discourage interest transfers to third parties and provide the right-holders with a weak veto right if the transfer is proposed. For more details see *infra* Parts III and V of this Chapter.

[586]*See* Nöldeke & Schmidt, *supra* note 540, at 639–48.

[587]*See* Chemla et al., *supra* note 460, at 100–03.

companies formed in Delaware. Most of these LLCs elected corporate-like governance structures, thereby functioning in the setting approximated to the corporate governance of closely-held corporations.[588] To be sure, the Delaware Limited Liability Company Act restricts interest transfers to third parties by a default rule. In the absence of a modifying agreement of the LLC's members, the assignee of an interest receives only the right to participate in sharing the profits and losses of the company and has no right to participate in the management of the company's business and affairs.[589] Full member substitution requires the consent of all members.[590] By contrast, stockholders in corporations are free to transfer their shares to third parties unless shares are subject to transfer restrictions.[591] Hence, in the LLC context—at least in the case of first purchase rights and tag- and drag-along rights—it is more appropriate to talk about "relaxations" of interest transfers, rather than restrictions.[592] Interest transfer rules thus enhance exit for otherwise locked LLC members.

The inverted default rules of corporate and LLC statutes can affect the incentives of their users to contract for special transfer clauses and, if they decide to do so, put them in different negotiating positions.[593] The following characteristics of the sample on which this study is based, although ameliorate these differences, do not cancel them. First, with very few exceptions, the majority of the sample LLCs had a centralized managements structure and were not organized as partnerships.[594] Corporate-like centralized management reduces the need to restrict the investors' ability to alienate their interests.[595] Second, although in the majority of the sample, the statutory transfer restriction rule was not

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[588] *See infra* Part IV of this Chapter (describing the management structure of the sample firms).

[589] DEL. CODE ANN. tit. 6, § 18–702(a), § 18–702(b)(2) (2015). This default rule follows naturally from another default rule of the statute—the authority of each member to bind the limited liability company. *Id.* § 18–402.

[590] *Id.* § 18–702(a).

[591] *See, e.g.*, Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 278–79 (1967).

[592] First purchase rights, tag-along rights, and drag-along rights are activated where one of the existing members proposes to transfer its equity holding to a third party. By contrast, put and call options typically mandate intra-firm transfers—among the existing members or between the firm and its members—for reasons not related to third-party transfers (it is, indeed, possible to design options that are activated in cases of change-of-control transactions: when a third party establishes control over one of the firm's members).

[593] For example, an investor opposing possible entry of outside third parties to the capital of the firm may find it easier to promote a first purchase right in an LLC, where members are by default subject to transfer restrictions, than in a close corporation, where share transfers are not restricted. The default governance structure is one of the factors affecting the election of an appropriate organizational form to start a business project.

[594] *See infra* Part IV of this Chapter.

[595] *Cf.* Easterbrook & Fischel, *supra* note 570, at 273 (arguing that where principal investors also manage, restricted share transfers can ensure that investor-managers are compatible).

waived, it was often substituted with other transfer clauses and could be applied only if the members failed to comply with the contractually agreed alternatives.[596] The subordination of the statutory restriction to contractual transfer provisions allows comparing the sample LLCs with corporations where shareholders have contracted for similar transfer clauses. Nevertheless, this does not mean that corporate shareholders are equally likely to choose the same transfer restrictions under identical circumstances. Therefore, whereas the effects of transfer restrictions for the contracting parties can be the same both in the LLC and corporate settings, their incentives to contract and thus the practices of contracting may differ.

III. REASONS FOR USING INTEREST TRANSFER CLAUSES

Transfer restrictions ordering exit in non-listed limited liability firms can be classified into two main groups. The first group includes provisions that are usually activated when a current investor intends to transfer its interest to a non-member. The aim of first purchase, tag-along, and drag-along rights is to balance conflicting interests of the involved parties in such transfers. Change-of-control transactions in particular and third-party interest transfers in general, however, are extraordinary events in the life of closely-held business organizations. In the course of ordinary business, investors face many other instances abundant with conflicting interests. Put and call options, which form the second group, deal with these cases.

Theoretical literature offers various justifications for including interest transfer clauses into business organization agreements. The following sections build on the results of these studies to show the effects of transfer restrictions.

A. First Purchase Rights

Preemptive rights of purchasing LLC interests in non-affiliated interest transfers (first purchase rights) allow right-holders to control or impede changes in the ownership structure of the enterprise by giving them a priority (first right) to buy interests sold by other members ahead of third parties.[597] There are two main variations of these rights subject to the moment when the right is activated.[598]

A right of first refusal is triggered when an owner of LLC interest has received a bona fide offer from an unaffiliated third-party buyer which it is willing to accept or, subject to such right, has agreed to sell its

[596] *See infra* Parts IV and V.E of this Chapter.

[597] *See infra* notes 606–607.

[598] *See* RCM LS II, LLC v. Lincoln Circle Assoc., LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. 2014).

interest to an unaffiliated third-party buyer.[599] According to a right of first refusal, the owner of interest is entitled to sell to a third party only if the right-holder passes by either refusing to buy the interest at the price and upon the terms offered by (agreed with) the third-party buyer or failing to react timely.[600]

Under a right of first offer, the owner of LLC interest that has an intention to sell but has not formalized any transaction with a third party shall inform about its intention to sell to the right-holder.[601] The offer price is either (1) the price at which the owner wishes to sell and is thus offered by the owner, or (2) the owner's only obligation is merely to notify about its intention to sell and it is the right-holder who is invited to offer the price.[602] In either case, the offer defines the minimum price of the transfer.[603] If the right-holder does not timely accept the offer or the owner rejects to sell to the right-holder according to the terms of the right-holder's offer, as applicable, the owner is entitled to sell to a third party at a price which is at least equal to the offer price.[604]

Both a right of first refusal and a right of first offer give the seller limited time to transfer its interest to a third party.[605] After this period, a first purchase right is re-activated. The two rights are compared in Figure 3–I.

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[599]*See Lincoln Circle Assoc.*, 2014 WL 3706618, at *7. Good faith requirement in a right of first refusal aims to prevent abusive collaboration between the seller and an outside buyer which can result in an unjustified high offer price forcing the right-holder to exercise its right at this price or passing on the right and being deprived of it (if the transfer encumbrance is tied to the seller and is not reinstated by the buyer). This problem was discussed by the New York State Supreme Court in *Story v. Wood*, 166 A.D.2d 124, 128, 569 N.Y.S.2d 487, 489 (N.Y. App. Div. 1991) (a good faith offer is "a genuine outside offer rather than one contrived in concert with the seller solely for the purpose of extracting a more favorable purchase price from the holder.").

[600]*See Lincoln Circle Assoc.*, 2014 WL 3706618, at *7.

[601]*See id.*

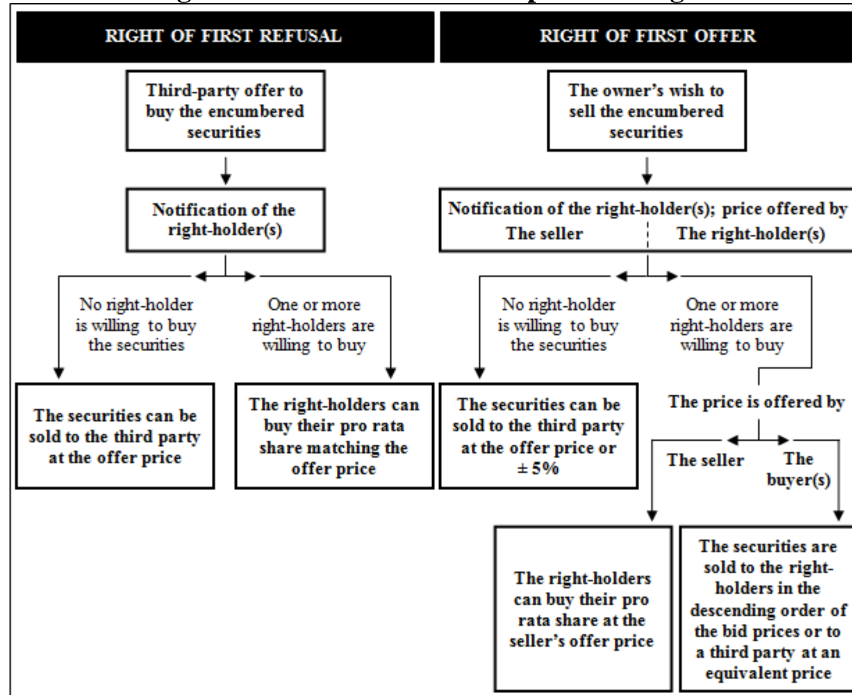
[602]Most studies of rights of first offer focus only on one type of this right where the offer price is defined by the seller. *See, e.g.,* Grosskopf & Roth, *supra* note 553, at 176; Xinyu Hua, *The Right of First Offer*, 30 INT. J. IND. ORGAN. 389, 389 (2012); Marcel Kahan, Shmuel Leshem, & Rangarajan K. Sundaram, *First-Purchase Rights: Rights of First Refusal and Rights of First Offer*, 14 AM. L. & ECON. REV. 331, 332 (2012).

[603]If the right-holder must offer the sale price but it fails to do so, then, in the absence of a minimum price constraint, the owner can market its interest at any price.

[604]*See* Corporation Law Committee, *supra* note 551, at 1178.

[605]*See* F. Hodge O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 794 (1952).

Figure 3–I. Variations of first purchase rights



First purchase rights, in effect, are a weak form of a veto right on third party entries into the capital of a firm[606] and on disposing interests by existing owners.[607] The reasons for exercising this "veto right" can be different and context specific—for instance, the desire to keep the small number of investors, confidentiality issues, the importance of personal expertise or special relations of the members, or the need to keep the existing balance of power in a firm.[608]

Where such reasons are present, existing members place higher (intangible) value on interests than potential outside buyers. Hence, in

[606]*See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 45–46 (Del. Ch. 2010) (according to the facts of this case summarized in the masterly written opinion of Chancellor Chandler, the two controlling stockholders of craigslist, Inc., which runs the popular advertisement website, sought to impose a right of first refusal on the minority stockholder, eBay, Inc., an e-commerce company, to protect their "interests in controlling the culture of craigslist, including the composition of its stockholders."); Easterbrook & Fischel, *supra* note 570, at 273 (referring to the importance of share transfer restrictions in maintaining family control in non-listed corporations).

[607]*See* David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 43–46 (1999) (emphasizing the importance of the right for inhibiting unilateral sales of shares, as opposed to controlling sales to undesirable third-party buyers).

[608]If the parties lack financial resources to preempt a third party offer, then the company itself can be named as a right-holder. *See* O'Neal, *supra* note 605, at 794. In more than one-quarter of cases of employing first purchase rights by the LLCs included in the study sample, the firm itself, in addition to or instead of its members, was the holder of a first purchase right. Original Research (on file with the author).

the absence of transfer restrictions, a party can use the threat of selling interests to a third party strategically for the purpose of strengthening its bargaining position in other matters or extracting a higher price from other LLC members. First purchase rights provide a solution to this hold-up problem, for they discourage changes in the initial ownership structure or, if not enough, allow the right-holder to prevent transfers to outsiders by buying the selling member's interest. It follows that by preventing opportunistic renegotiation of investment terms, very much alike other contingent ownership rights, first purchase rights stipulate ex ante efficient investments.

Both variations of first purchase rights pursue the same result, but they have different implications for the contracting parties. Incentives of the parties in applying one or the other vary depending on circumstances. Several studies tried to show individual and joint-efficiency implications of a right of first refusal and a right of first offer for the contracting parties, as well as compare these implications.[609]

1. Economic Analysis of a Right of First Refusal

Under a right of first refusal, potential third-party buyers need to incur evaluation and negotiation costs to make an offer.[610] At the same time, the right-holder has better knowledge about the firm and its business prospects.[611] The size of transaction costs that third parties face and information asymmetry gap between the right-holder and third parties increase with the uniqueness of the property at sale.[612] Obviously, in non-listed firms, where first purchase rights are usually employed, lack of market prices and exemption from extensive disclosure lead to large transaction costs for third-party buyers and to strong insider information advantages. In the absence of a right of first refusal, the argument goes, the outside buyer's probability of success depends on the probability of the valuation of the buyer being higher of the price offered by the right-holder.[613] Where a transfer is subject to a right of first refusal, an outside buyer can succeed only if the right-holder is not buying.[614] Therefore, in the presence of a right of first refusal, third-party buyers, due to uncertainty, are discouraged from making

[609] *See, e.g.,* Albert H. Choi, *A Rent Extracting Theory of Right of First Refusal*, 57 J. IND. ECON. 252 (2009); Walker, *supra* note 607 (for a right of first refusal); Grosskopf & Roth, *supra* note 553; Hua, *supra* note 602; (for a right of first offer); Kahan et al., *supra* note 602 (for comparing the two rights as to their joint-efficiency implications).

[610] Walker, *supra* note 607, at 16.

[611] *Id.* at 17–18.

[612] *Id.* at 18.

[613] *Id.* at 19.

[614] *See supra* note 600 and accompanying text.

offers. As a result, either the seller's realization potential or the offer price of the interest is reduced.[615]

If there is a guaranteed potential third-party buyer, the economic effect of a right of first refusal is thus to transfer welfare from the seller to the right-holder. From the stand-alone perspectives of each contract party, a right of first refusal is beneficial for the right-holder. From joint-efficiency perspective, however, the parties are better off or, at least, indifferent, as the loss of the seller is offset by the gain of the right-holder.[616] First purchase rights are contingent options for which a right-holder is expected to pay.[617] Hence, to the extent the seller is compensated at the contracting stage for agreeing to encumber its transfer right with a right of first refusal, the parties in combination are not incurring additional costs.[618]

But a third-party offer is never guaranteed. Transaction costs and uncertainty imposed by a right of first refusal on potential outside buyers reduce the combined wealth effect for the contractual parties. Weak demand from potential competing outside bidders who value LLC interests more than the right-holder, results in an opportunity cost for the seller that cannot be offset proportionally by the gain of the right-holder.[619] Meanwhile, an alternative measure, such as a mandatory open auctioning of interests, would ensure a superior joint-efficient result for the contracting parties for the purposes of controlling third party entries into the firm's capital.[620] Consequently, a right of first refusal can be as efficient as an auction if (1) the third-party transaction costs are low, (2) the third-party interest in the LLC units put up for sale is low, or (3) right-holders are not likely to exercise their rights.[621]

Let's consider first the last case. When faced with an intention of a member to exit, a holder of a right of first refusal is not choosing between preserving the (intangible) value of holding interests by exercising its right or not-exercising the right and losing this value. A

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[615]Kahan et al., *supra* note 602, at 346–49; Walker, *supra* note 607, at 19–21. This argument also appears in the decision of the Delaware Court of Chancery in *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 45 (Del. Ch. 2010).

[616]Choi, *supra* note 609, at 259–60.

[617]*See, e.g.*, Bateman v. 317 Rehoboth Ave., LLC, 878 A.2d. 1176, 1183–84 (Del. Ch. 2005). A rough intuition why an option comes with a price is that it is a right that is expected to be exercised only where a right-holder expects a gain. In the absence of a downside risk, a party is expected to pay a price for buying an option. Accordingly, from the right-holder's perspective, the question whether to contract for an option depends solely on the difference between the potential benefits of the right and the costs of obtaining it.

[618]In the practice of business organizations, this compensation would commonly take place by the mutual encumbrance of the transfer rights of the contracting parties by a right of first refusal. *See infra* note 719.

[619]Kahan et al., *supra* note 602, at 351–52; Walker, *supra* note 607, at 26–27.

[620]Walker, *supra* note 607, at 41.

[621]*See* Kahan et al., *supra* note 602, at 351–52 (arguing that a right of first refusal generates a joint-efficient result for the contracting parties when third-party transaction costs are low).

third-party buyer could be a good fit to the project, which preserves or increases this value. Thus, when a third party is considering whether to incur costs and make an offer for LLC interest encumbered by a right of first refusal, it takes into account not only the probability of its offer price being higher of the valuation of the right-holder, but also the probability of fitting into the project as perceived by the right-holder. Even if the right-holder may have a higher valuation of interest than the third-party buyer, the latter can be the purchaser if the right-holder does not consider the transfer value-destroying for the project.[622] In other words, if the right-holder expects the third party to be at least as good as the departing member, the probability of exercising the right is low. In fact, what a right of first refusal achieves is involving the right-holder indirectly into the negotiations between the seller and an outside buyer.

This implies that if the time horizon for analyzing the right is broadened to include the initial contracting stage and ex post effects of the interest transfer, the right might still ensure the most efficient result for the contracting parties by encouraging cooperation and preventing value-decreasing transfers. This is mostly the case where the contracting parties have made investments in relation-specific capital or have developed special relations. In both cases, the possibility of strategic bargaining after investments are sunk can create incentives for both parties to hold up and behave opportunistically.[623] A right of first refusal, by reducing the marketability of interests in cases of strategic transfers to third parties, drives up the costs of behaving opportunistically. In the absence of this right, given uncertainty following a transfer by a member, the parties have weaker incentives to cooperate and invest.

Special relations is not the only scenario where a right of first refusal is superior to an auction. Auctions are not necessary in sales of readily-available assets whose prices are easy to establish, but are useful in defining prices of assets whose value, due to the asset's idiosyncrasy or uncertain consumer demand, might be unclear.[624] Equity participation

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[622]In this setting, not all third parties are discouraged from incurring transaction costs and bidding for interests encumbered by a right of first refusal. Only potential buyers that are expected to be opposed by a right-holder might be deterred. Although stipulating all potential buyers might ensure the best joint-efficient result for the contracting parties at the time of exit of one of them, it can prevent cooperation in the first place and is likely to destroy value after the sale.

[623]*See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 52–56 (1985); Benjamin Klein, Robert Crawford, & Armen Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 298–302 (1978); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233, 241–42 (1979).

[624]*See* Liran Einav, Chiara Farronato, Jonathan D. Levin, & Neel Sundaresan, *Sales Mechanisms in Online Markets: What Happened to Internet Auctions?*, 5–6 (NBER Working Paper No. 19021, 2013), *available at* http://www.nber.org/papers/w19021.

in non-listed firms normally is a unique asset and, indeed, belongs to the second group.[625] If it were easy to establish the price of the offered interest, there would have been no need in auctions, for the seller would have known how close the price offered by the right-holder was to the market price. Likewise, when the uniqueness of the property is so strong that it is not likely to attract significant outside interest, giving away a right to an auction is again not costly. Therefore, where a firm pursues a project that is strongly tied to the interests and abilities of its members, contracting for a right of first refusal, rather than organizing an auction for selling the members' interests, can be an efficient solution.[626] In particular, two highly-specialized IT companies can combine their efforts to develop a new technology for memory cards. Given the specificity of the knowledge, it is not likely that participation in the joint venture can generate strong interest from (many) third parties. Meanwhile, the parties, because they are disclosing and providing to each other their technological developments, can be strongly interested in limiting the access of third parties to the project.

2. Economic Analysis of a Right of First Offer

The effect of a right of first offer is different. According to this right, encumbered interests can be transferred to a third party only at a price equal to or exceeding the price negotiated between a seller and a right-holder.[627] Depending on the type of a right of first offer, either a seller or a right-holder has to disclose its valuation. Hence, the bargaining behavior of a seller or a right-holder, as applicable, is affected. Both scenarios, however, benefit outside buyers by signaling insider information about the value of the interest. This reduces their transaction costs. In addition, under a right of first offer, potential outside buyers, as second movers, benefit from increased certainty of the fate of their offers.[628] Consequently, a right of first offer is expected to increase the interest of third parties and, as a direct result of this, the joint-efficiency of the contracting parties. A closer look, however, reveals a more complicated story.

The problem is that a right of first offer shifts the uncertainty from outside buyers to the contracting parties. Now it is the seller who, given

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[625]*See* Walker, *supra* note 607, at 16.

[626]Similarly, where asset-specificity results in high transaction costs for third parties, but not for the right-holder (for instance, because of the right-holder's insider knowledge and prior relationships), a right of first refusal can generate a positive joint-efficient result. *See* Kahan et al., *supra* note 602, at 352–53.

[627]*See supra* notes 601–604 and accompanying text.

[628]*See* O'Neal, *supra* note 605, at 802 (under a right of first refusal, prospective buyers may be reluctant to make offers if their offers will fix the price at which the right-holders are privileged to buy; third-party interest can be strengthened by permitting a seller to offer a price).

information asymmetry with regard to the private valuations of third parties, needs to offer a lower sale price to the right-holder (if the right requires the seller to define the sale price) or to decide whether to sell to the right-holder or reject the latter's offer and look for other buyers on a market (if the sale price is offered by the right-holder).[629] It may thus cause a situation where, following the seller's decision not to risk and solicit higher valuations at a market, the right-holder gets the encumbered interest even if its valuation is lower than the valuations of potential outside buyers.[630]

In practice, the problem of information asymmetry of the seller can be, and often is, solved. Particularly, the seller can—in order to inform itself about whether to sell, on what terms, and whether to pass on the right-holder's offer—test the market by engaging in preliminary discussions with potential outside buyers before activating a right of first offer.[631] Often such preliminary discussions can reach a quite advanced stage, rendering a right of first offer to a mere formality that the seller needs to comply with in order to finalize the sale with the outside buyer. Indeed, it is possible that the right-holder preempts the third-party buyer by accepting the seller's offer price or, if the right-holder has to define the price, the right-holder's offer price exceeds the price agreed by the seller and the third party. In these cases, the third party cannot recover valuation and negotiation costs it has incurred. Thus, the further negotiations with the third-party buyer advance, the higher the risks of the third party and the lower the seller's risks are. This, as long as outside buyers are informed that the interest is encumbered by a preemptive right, is expected to deter them from investing too much resources in negotiating a transfer prior to the clarification of the position of the right-holder.[632]

Preliminary accumulation of information by a seller, who as the result is better informed about its bargaining strategy, has two important

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[629]Indeed, if delays are not costly, the seller can always choose not to trade with the right-holder and test the market afterwards. Following this, the seller, if it has to lower the sale price, can go through another procedure of a right of first offer. However, this strategy also informs the right-holder who can adapt its bargaining strategy.

[630]*See* Hua, *supra* note 602, at 392; Kahan et al., *supra* note 602, at 354–56.

[631]This practice is permitted by case law. *See* RCM LS II, LLC v. Lincoln Circle Assoc., LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. 2014).

[632]In *Lincoln Circle Assoc.*, the seller and the third-party buyer exploited the wording of the contractual right of first offer to compensate the third party for the incurred costs in the case the right-holder would have elected to exercise its preemptive right. According to the right of first offer, if the right-holder did not timely accept the seller's offer, the seller could transact with any outside buyer at a sale price not lower than 97% of the price offered by the seller to the right-holder. After agreeing a sale price with the third party, the seller offered slightly higher price to the right-holder (within the 3% discount range); if the right-holder elected to buy, the third party would have received half of the price difference as a termination fee. The court ruled that the seller breached the right of first offer by failing to state accurately the price at which it was willing to sell to the outside buyer. *See Lincoln Circle Assoc.*, 2014 WL 3706618, at *2, *3, *8.

implications. First, the seller is no longer forced to lower its offer (if the right requires the seller to define the sale price) and is better informed whether to accept or reject the right-holder's offer (if the right-holder is required to offer the price). Therefore, the seller can extract the highest price on a market for its interest. This will increase the joint-efficiency of the parties of a right of first offer. Second, advanced negotiations transfer value from the right-holder to the seller. In particular, if the seller is offering the sale price, it will indicate a price equal to the highest valuation in an open market, which is not necessarily the valuation of the right-holder; if the right-holder is invited to make an offer, the seller is better informed whether to accept this offer or to reject it and auction the interest at a higher price on a market. As a result, the right-holder may end up in a situation where it paid for obtaining an ineffective right of first offer. Hence, at some point market testing by the seller shall be curbed not to frustrate the results of the agreement between the parties of a right of first offer.

As to the information asymmetry problem of the right-holder, it has information neither about interest from third parties, nor about the negotiations between the seller and any third party. If the offer is made by the seller, the right-holder will use its preemptive purchase right if its valuation of the interest is higher. If the right-holder is making the offer, the only way to overcome the effect of information asymmetries is to indicate an offer price close to the right-holder's maximal valuation of the interest.

A mandatory open auctioning of interests, by analogy to the case of a right of first refusal, would ensure a better joint-efficient result for the contracting parties than a right of first offer if the only thing what mattered was the maximization of the combined profit of contracting parties at the stage of transferring interests by one of them. Yet, a right of first offer impacts the joint-efficiency of the parties by making cooperation possible.

Compared with a right of first refusal, however, a right of first offer is a weaker means for controlling third-party entries into a firm's capital and inhibiting exit by parties. The right-holder cannot decide on acting after observing a third-party. Given the information asymmetry gap, the right-holder has to act if it places higher (intangible) value on LLC interest than any outside buyer does. After failing to timely accept the seller's offer or the seller's rejection to deal with the right-holder, outside buyers no longer face uncertainty and are thus encouraged to bid.

It follows that the implications of a right of first offer for the joint-efficiency of contractual parties are different from the effects of a right of first refusal—the seller, rather than a right-holder, is expected to reap the larger portion of the parties' joint profits. In addition, where a right of first offer requires the right-holder to define the sale price, the seller can elect to sell at the same price to a third party. This weakens the

preemptive right of the right-holder and lowers the probability that the right-holder will get the interest. The right is effective only if the right-holder's valuation of the interest is higher than the valuations of outside buyers. Therefore, contracting parties are expected to pay the lowest price for obtaining this particular form of a right of first offer[633] and the highest for having stronger veto power of a right of first refusal; a right of first offer where the seller offers the sale price is situated in the middle of the two.

B. Tag-Along Rights

A tag-along right is contracted primarily for addressing conflicts between investor groups in sales of interests of significant size to third parties.[634] In a typical situation of applying a tag-along right, the selling owner of interest is in a possession of a controlling block and the co-selling investors hold minority positions. It is the obligation of the former to inform the right-holders about their right to exercise their co-sale rights. The two main effects of a tag-along right are (1) serving as a put option on the interests of the remaining holders in cases of large member changes and, as such, providing them with an opportunity to exit the firm and (2) effectively forcing the main seller to share a control premium with the remaining investors.[635]

There are two main variations of this right with different effects on the seller and outside buyers. According to one form, an outside buyer, after acquiring large interest in a target company, has to extend its offer to the remaining members on the same terms (full tag-along right).[636] The second variation does not oblige an outside buyer to make an offer for all outstanding LLC units. Rather, if there are any right-holders willing to participate in a third-party transfer, then the main seller is required to reduce its share in the transfer and provide right-holders an opportunity to co-sell their interests on a pro rata basis (proportional tag-along right).[637] As a result, the seller, instead of fully cashing out its investment, may become a minority investor along with others (Figure 3–II).

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[633]Although a right of first offer increases the payoff of the seller in the joint profits of the parties, it does not make the right-holder worse off compared with the no-right case. The right-holder can nullify any effect of the right by simply abstaining from exercising it.

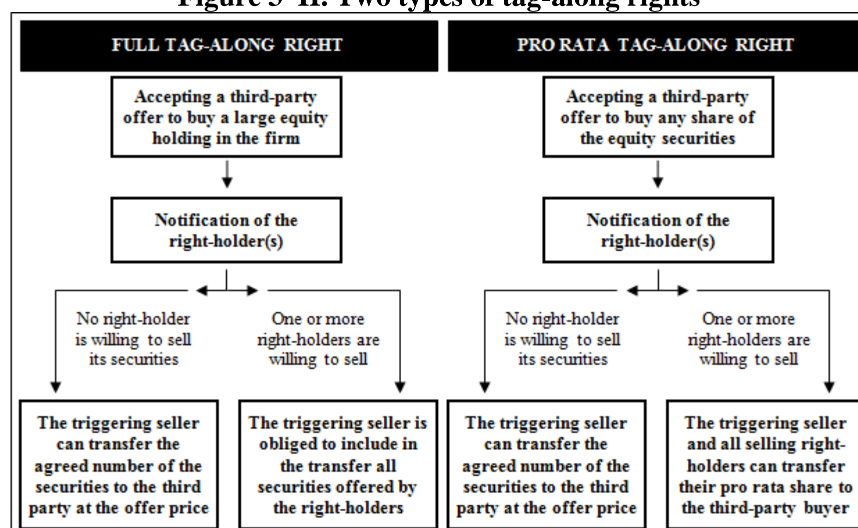
[634]*See* Corporation Law Committee, *supra* note 551, at 1185.

[635]*See* Corporation Law Committee, *supra* note 551, at 1185. A tag-along clause may exclude minority co-selling right-holders from sharing the control premium with the main seller. None of the sample agreements, however, had a provision fixing a discounted price for the right-holders. Original Research (on file with the author).

[636]*See infra* Figure 3–VIII.

[637]*See infra* Figure 3–VIII.

Figure 3–II. Two types of tag-along rights



Theoretical models predict that the size of a controlling block affects the incentives of a controlling group for private benefit extraction.[638] The lower is the size of a holding an outside buyer needs to obtain for establishing control over the firm, the stronger its incentives for extracting private benefits of control are. Small economic interest allows sharing the costs of private benefit extraction with other investors.[639] Contrary to this, investors with large cash flow rights internalize more costs of their own opportunistic actions and thus extract less costly private benefits.[640]

A tag-along right anticipates this conflict and offers solutions. A full tag-along right compels a third party to buy more interest than it is necessary to obtain control.[641] This reduces its incentives to extract private benefits and makes moral hazard less severe. Instead, cash flow maximization incentives are strengthened. A proportional tag-along right gives the seller incentives to conduct an ex ante check of a potential

[638]*See* Morten Bennedsen & Daniel Wolfenzon, *The Balance of Power in Closely Held Corporations*, 58 J. FIN. ECON. 113, 115 (2000); Mike Burkart, Denis Gromb, & Fausto Panunzi, *Why Higher Takeover Premia Protect Minority Shareholders*, 106 J. POL. ECON. 172, 178–81 (1998).

[639]*See* Bennedsen & Wolfenzon, *supra* note 638, at 115; Burkart et al., *supra* note 638, at 178–81.

[640]*See* Bennedsen & Wolfenzon, *supra* note 638, at 115; Burkart et al., *supra* note 638, at 178–81. Empirical evidence from listed companies supports this claim. *See* Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, & Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FINANCE 2741, 2754–64 (2002) (using data for listed companies from East Asia region); Paul A. Gompers, Joy Ishii, & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1061ff. (2010) (using data for listed US companies).

[641]*See supra* note 636 and accompanying text.

buyer or face ex post risks of becoming a disadvantaged minority vis-à-vis the new controlling investor.[642] The seller is expected to sell only if the buyer is not likely to destroy firm value or if it agrees to purchase all LLC units. In addition, under both variations, the beneficiaries of a tag-along right get a fair exit option before the conflict materializes itself. As such, tag-along rights, in analogy with the mandatory bid rule, prevent value-decreasing control transactions where the benefits of the seller and the buyer come at the expense of other investors, rather than owing to value creation.[643]

As a corollary, tag-along rights encourage investments by the contracting parties. Normally contractual agreements entitle their parties with special rights that are not provided in statutes and organizational documents of firms.[644] These rights serve as guarantees for the protection of the parties' interests. Being contractual rights, they cannot be enforced against third-party buyers, unless the assignment of the agreement occurs.[645] A third-party buyer is thus free to extract more private benefits than the former controlling investor did. This implies that a controlling member can threaten to sell to such a third party with the aim of leveraging its bargaining position. Even in the absence of strategic opportunism, uncertainty created by a possible value-decreasing control change can frustrate initial investments. Tag-along rights provide an opportunity to exit if an outside buyer is not willing to join to the agreement. This opportunity is important for ex ante planning of investments because without special rights the investments can be worthless.[646]

Tag-along rights are substitutes for other investor protection rights.[647] In firms with a small number of members (up to 10), minority co-sale rights are actively used in cases of waiving the fiduciary duties of members and managers, as well as granting important decision-making

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[642]*See supra* note 637 and accompanying text.

[643]*See* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957, 971 (1994).

[644]*See* John J. Ghinger, III, *Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances*, 4 U. BALT. L. REV. 211, 211–12 (1975).

[645]The situation can be different if investments are organized via the use of the LLC form. The governance structure of LLCs and special rights of members are typically found in LLC operating agreements. Any limited liability company member or an assignee of a limited liability company interest, regardless of executing the LLC agreement, is a party to and bound by it. DEL. CODE ANN. tit. 6, § 18–101(7) (2015). *See also* Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. Supr. 1999); Seaport Vill. Ltd. v. Seaport Vill. Operating Co., No. 8841–VCL, 2014 WL 4782817, at *2 (Del. Ch. 2014).

[646]The effect of a tag-along right on stipulating cooperation in relationship-specific investment projects is analyzed in Chemla et al., *supra* note 460, at 105–06 and Maria Isabel Sáez Lacave & Nuria Bermejo Gutiérrez, *Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses*, 11 EUR. BUS. ORG. L. REV. 423, 437–38 (2010).

[647]*See supra* Part IV.C of Chapter 2.

rights to controlling members.[648] In cases where controlling members do not owe any fiduciary duties to minority members in a sale-of-control transaction and minority members are not in a position to block such a transaction, a tag-along right is the only means that can protect the minority interests.[649]

However, a tag-along right comes at a cost. A full tag-along right forces an outside buyer to buy more interest (up to 100%) at a higher price or obliges the selling holder to share control premium with all minority investors. Whether by discouraging third-party interest or by limiting the size of the premium the seller expects to receive, this right impedes interest transfers.[650] This discourages not only value-decreasing control transfers, but also reduces the probability of value-increasing transactions and results in losses for both contracting parties in the form of forgone cash flow increases.[651]

Consider the failed privatization of Cesky Telecom, a telecommunications company dominating the market in the Czech Republic, in late 2002. The consortium of buyers agreed to pay a premium to the Czech government for its 51% shareholding. According to the requirements of the tag-along right, the same price should have been paid to key investors in Cesky Telecom with a combined 33.5% holding. The negotiations between the buyers and the beneficiaries of the tag-along right directed towards lowering the purchase price failed frustrating the deal.[652]

A pro rata tag-along right hinders interest transfers as well, but for different motives. Unlike the former case, the buyer here is not affected—if it is not willing to buy all offered interests, then the selling member and each exercising tag-along right-holder shall reduce the

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[648]*See supra* Part IV.C of Chapter 2.

[649]*See supra* Part IV.C of Chapter 2.

[650]Consider a potential buyer (*B*) ready to pay v_1 for all outstanding units of a target LLC. The LLC has a controlling member *S* whose share in the ownership structure is $1 - \alpha$. *S* and the other members are parties of an agreement entitling the latter to sell all their LLC units along with *S* at the price offered to *S*. In *B*'s valuation of the LLC, β is the control premium—part of additional pecuniary and non-pecuniary benefits that *B* expects to get after acquiring control (if β were equal to full private benefits of *B*, then it would not make sense for *B* to transact). Accordingly, the combined value of all single units is $v_1 - \beta$. Without the tag-along right, *S* would get $(1 - \alpha)*(v_1 - \beta) + \beta$ (total value of its interest plus the entire control premium). The $\alpha*(v_1 - \beta)$ left would be shared between the remaining members. Under the tag-along right, the payoffs are different: *S* receives $(1 - \alpha)*v_1$ and the minority members get $\alpha*v_1$. Either *B* has to increase its payments to $v_2 = v_1 + \alpha*\beta$ to be able to pay the control premium also to the minority members, or *S* has to agree to the reduced control premium. For *S*, the sale will be optimal if the reduced control premium exceeds its current private benefits of control. For *B*, increasing the total payments to v_2 will be rational if the expected benefits of full control are not less than the additionally paid control premium. If the initial price v_1 is not changed, *S*'s payoff is reduced, decreasing the probability of the deal.

[651]*See*, *e.g.*, Bebchuk, *supra* note 643, at 971; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 711–12 (1982).

[652]*See* Robert Anderson & Ian Bickerton, *Doubts Surround Cesky Sale*, FINANCIAL TIMES, Nov. 25, 2002.

amount of the offered units so as to permit each party to sell interest proportionate to their respective percentage holdings. The main impact of the right is thus on the seller. First, the seller is not guaranteed that it will be able to sell the number of LLC units negotiated with the buyer; if any right-holder wishes to exercise its option, then the seller's share of the interest is reduced. Therefore, a pro rata tag-along right discourages third-party interest only to the extent that the seller is not willing to become a minority investor and insists on a full transfer. This is more likely to occur if a control transaction is value-decreasing. The incidence of value-increasing control transfers is not reduced and the seller will continue receiving third-party solicitations. Second, the seller has to share the control premium with the remaining investors.[653]

Therefore, the costs of a full tag-along right are particularly high where a non-listed firm has a strong single controlling member co-existing with a large number of minority investors and are low where either voting rights are distributed relatively evenly among the members or minority investors are entitled to special rights.[654] In the first case, the low costs of tag-along rights follow from the high probability that the existing investors, if not acting in cooperation, are less likely to require a control premium. In the second case, special minority rights justify the claims for sharing a control premium with the controlling seller.

This analysis shows that a tag-along right imposes different costs on its contracting parties depending on the particular circumstances of organizing and structuring investments. The joint-efficiency implications of this right can vary from case to case. Contracting for a tag-along right is a strategic choice of investors made if the benefits of such encumbrance exceed the costs of the reduced marketability of their holdings. Provided that controlling investors are more legitimate to require a control premium, more tag-along rights are expected in the governance agreements of firms where there is no single controlling

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[653]Suppose, a controlling member *S* owns interest representing $1 - \alpha$ of the LLC's ownership structure. An outside buyer *B* is willing to become a new controlling member by acquiring $1 - \alpha$ at a price ν which includes a control premium. The interests are encumbered by a tag-along right entitling each member to sell its pro rata share in a control transfer at the same price offered to the controlling member. By negotiating only with *S*, *B* will achieve its goal at minimum transaction costs (buying the same interest from more than one member requires more negotiations and thus increases costs). Without the right, *S*'s payoff would be equal to ν. With the tag-along right, if all right-holders join, *S* cannot sell its entire interest. It can sell only $(1 - \alpha)*(1 - \alpha)/100$ at a price $\nu - \alpha*\nu$, as $\alpha*\nu$, including partial control premium, will be distributed among the right-holders. Because the transfer price ν is not affected by the right, *B* is not discouraged from bidding as long as it can effectively commit not to divert more private benefits than *S*. Otherwise, in order not to bear the risk of losses as a minority member, *S* will agree to sell only in a full 100% transfer.

[654]Evidence from Brazilian listed companies corresponds with this conclusion: tag-along rights were less likely in companies where large shareholders leveraged their control by holding more voting rights than economic interest. *See* Morten Bennedsen, Kasper Meisner Nielsen, & Thomas Vester Nielsen, *Private Contracting and Corporate Governance: Evidence from the Provision of Tag-Along Rights in Brazil*, 18 J. CORP. FINANCE 904, 916 (2012).

group or the potential for private benefit extraction is limited.[655] With a strong controlling founder, high costs of a tag-along right are justified to the extent that a tag-along commitment against self-dealing facilitates finding investors for the proposed project.

C. Drag-Along Rights

By contrast, a drag-along right allows its holder—the main selling owner of LLC interest—to force other investors to sell along with the right-holder on the same terms in a control transfer to a third party.[656] A drag-along right functions as a balancing mechanism to a tag-along right. It increases the control premium of the seller, facilitates control transactions by increasing the benefits of a potential buyer, and stipulates relationship-specific investments.

From the seller's perspective, this right, by adding the interests of other investors, allows selling more interest than the seller actually owns. Depending on the activation threshold, this might render a small holding into a controlling package. Therefore, a drag-along right contributes to obtaining a better price for the interest of the seller and other investors that are being squeezed out.

For potential buyers, the main benefit is in the opportunity to establish full control without costly individual negotiations with each minority investor.[657] The desire to acquire a larger holding or full control is driven by two reasons. First, the freedom of each investor to abstain from selling can be used strategically in value-increasing sales with the aim of getting a higher price later.[658] A drag-along right prevents such an opportunistic behavior.[659] Second, there are additional costs and risks

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[655] *See* Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review*, 169 J. INST. THEOR. ECON. 160, 169 (2013); Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 812–13 (2003).

[656] *See* Corporation Law Committee, *supra* note 551, at 1182.

[657] *Cf.* Joseph A. McCahery, Luc Renneboog, Peer Ritter, & Sascha Haller, *The Economics of the Proposed European Takeover Directive*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, 575, 637–38 (Guido Ferrarini et al. eds., 2004).

[658] For an argument that minority free-riding increases the costs of a takeover for an acquirer of the shares of a listed firm see George K. Yarrow, *Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process*, 34 J. INDUS. ECON. 3, 10–12 (1985).

[659] Consider a buyer B willing to pay ν for 100% interest of an LLC. It is reasonable to expect that B values the interest at a higher price ν', otherwise it would not benefit from the transaction. The holding of the controlling member S equals to $1 - \alpha$ and the minority member M, accordingly, owns α share of units. Under a drag-along right, S and M will divide ν in proportions $(1 - \alpha)*\nu$ and $\alpha*\nu$, respectively. Without a drag-along right, M can refuse to sell in order to capture in future part of B's added value in the amount $\alpha*(\nu' - \nu)$. This reduces the difference $\nu' - \nu$ that B expects to earn by acquiring control. Hence, B is less attracted by the prospects of the transaction. However, to the extent that this positive difference is fully attributed to private benefits of control that B expects to get, M cannot increase its payoff by not selling; all private benefits will flow to B.

that minority investors can create for a potential buyer.[660] Nevertheless, it should be admitted that these costs are larger in listed firms because they face extra costs of conforming to regulatory and listing requirements and high corporate governance standards.[661]

Finally, by preventing opportunistic refusal by a minority investor to sell in a value-increasing acquisition, a drag-along right forces the contractual parties to stick to the agreed shares of the payoff.[662] In the absence of a drag-along right, a minority party can require an increase in its payoff. This hold-up threat reduces the benefits to a potential third-party buyer.[663] In order to proceed with the transaction, the majority seller has to share part of its initially agreed payoff with the minority investor. Precluding such hold-ups encourages investments.[664]

D. Put Options, Call Options, and Buy/Sell-Out Arrangements

A put option allows its holder to sell the holder's interest to the other investors in the firm (or to the firm) at the will of the holder or upon the occurrence of contingencies specified in the agreement.[665] A call option, on the contrary, is the right of the holder to buy the interests of other members.[666]

Put and call contractual arrangements, due to information asymmetries and bounded rationality of the contracting parties, are difficult to devise at the outset.[667] First, contractual parties have to define the type of the option (put or call), the identity of the holder (majority or minority), and a state when the option can be activated.[668] It is clear that information asymmetries with regard to the nature of ex post problems and ex post bargaining power distribution will prevent parties from optimal contracting.[669] Even in the light of assuming full rationality of parties, private arrangements will generally remain incomplete because

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[660]*See*, *e.g.*, Edward F. Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 494 (1976) (particularly, the presence of minority investors may raise questions of conflict of interest and usurpation of corporate opportunity or create risks of litigation by minority investors over governance decisions).

[661]*See*, *e.g.*, M. Todd Henderson & Richard A. Epstein, *The Going-Private Phenomenon: Causes and Implications*, 76 U. CHI. L. REV. 1, 3 (2009) (ongoing disclosure requirements, mandatory internal procedures, limitations on the qualifications of people who can serve on the board of directors, and other requirements raise the costs of operating as a public corporation); Eric L. Talley, *Public Ownership, Firm Governance, and Litigation Risk*, 76 U. CHI. L. REV. 335, 336 (2009) (many private-equity deals are at least partially inspired by an organizational desire to escape the burdens of public ownership, including litigation risk).

[662]Chemla et al., *supra* note 460, at 106–07.

[663]*See supra* note 659.

[664]Chemla et al., *supra* note 460, at 106–07.

[665]*See*, *e.g.*, Kerry M. Lavelle, *Drafting Shareholder Agreements for the Closely-Held Business*, 4 DEPAUL BUS. L.J. 109, 113 (1991).

[666]*See id.* at 126.

[667]*See* Chemla et al., *supra* note 460, at 115.

[668]*See* BAINBRIDGE, *supra* note 565, at 456; Chemla et al., *supra* note 460, at 115.

[669]*See* Chemla et al., *supra* note 460, at 115.

contracting parties can program future problems but, given transaction and enforcement costs, hardly can fully describe them.[670]

The second drafting problem is the definition of a fair price for exercising the option.[671] Information asymmetries between the parties at the stage of exercising option rights may affect their respective valuations.[672] Theoretical models of optimal options rely either on ex ante fixed prices[673] or third-party valuation of the option price at the exercising date.[674] While in practice efficient fixed prices are almost impossible to define at the outset and it is highly possible that these prices will fail to reflect the reality over extended time periods, third-party valuations are subject to potential biases and are costly.[675]

An alternative is to entitle the party who wishes to exercise an option to define the fair price under the condition that the opposing party can refuse the offer and use the same price to buy or sell the interest. The threat of selling at a low price or buying at a high price gives the triggering party an incentive to offer a fair price.[676] However, such a buy/sell-out mechanism is effective only if the parties hold equal voting

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[670]*See generally* Eric Brousseau & Jean-Michel Glachant, *The Economics of Contracts and the Renewal of Economics*, *in* THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS, 3, 10–12 (Eric Brousseau & Jean-Michel Glachant eds., 2002).

[671]*See* BAINBRIDGE, *supra* note 565, at 456; David Keith Page, *Setting the Price in a Close Corporation Buy-Sell Agreement*, 57 MICH. L. REV. 655 (1959).

[672]*See* Landeo & Spier, *supra* note 553, at 160–61.

[673]*See, e.g.*, Nöldeke & Schmidt, *supra* note 540, at 637.

[674]*See, e.g.*, Chemla et al., *supra* note 460, at 98.

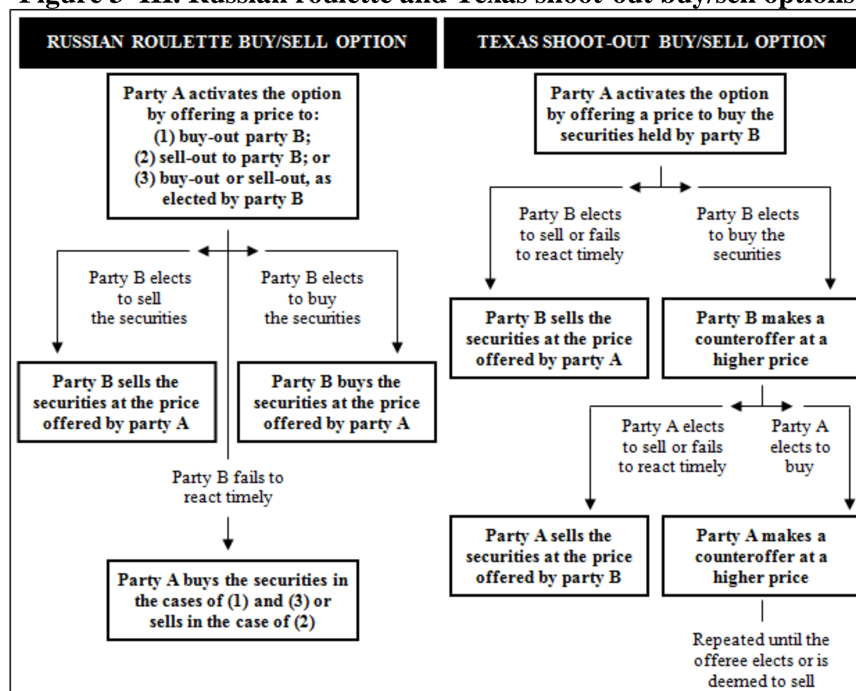
[675]*See* BAINBRIDGE, *supra* note 565, at 459 (the value defined by a third-party appraiser depends in large part on the employed methodology, thereby making this valuation method uncertain and unpredictable); O'Neal, *supra* note 605, at 801, 804 (agreeing on an exact price is usually satisfactory for a short period but the price may lose its relevance after some time; third-party appraisal can become quite expensive); Page, *supra* note 671, at 674 (the major drawback of third-party appraisal is its expense). Two widely used valuation techniques for defining the price of a put or call option are a price formula defined in the agreement or a third-party valuation. Original Research (on file with the author). In the latter case, there are multiple variations. These variations can be combined to curb costs by moving gradually from less costly to costlier versions of third-party valuation. In particular, at the first stage the option value has to be agreed by the parties. If they are not able to agree, each shall present its own valuation and if the two valuations are not different more than a certain percentage (e.g., 5% or 10%), the average of the two is the option price. Otherwise, each has to appoint an appraiser for preparing valuations independently from each other. Again, if the two valuations do not differ significantly, the average is considered the price for the purposes of exercising the option. If they do differ, then the two appraisers appoint a third appraiser. The final price is defined by the latter or is the average of the third appraiser's valuation and the closest valuation offered by one of the two original appraisers. When parties to a contract agree to be bound by a contractually established valuation methodology, courts will refrain from second-guessing the determination of a value as long as it is a product of a good faith, independent judgment. *See* Peco Logistics, LLC v. Walnut Inv. Partners, L.P., No. 9978–CB, 2015 WL 9488249, at *9, *11 (Del. Ch. 2015). Alternatively, the parties can opt for a certain level of judicial review for an appraisal process.

[676]*See* MCCAHERY & VERMEULEN, *supra* note 424, at 149.

rights—so that control premiums and minority discounts can be disregarded—and have equal access to financing.[677]

This valuation technique is in the basis of a so-called "Russian roulette" buy/sell-out option. Instead of relying on a formula, an independent appraiser, or a fixed price, the interests are valued based on the price offered by the first mover.[678] The first moving party is unable at the trigger date to anticipate the decision of the counterparty either to put its interest or to call the interest of the triggering party at the offer price (see Figure 3–III).[679] Thus, the clause is a double-edged sword for its users—the offering party can be forced either to buy or to sell the interest. As a result, the parties have strong incentives to offer a price closer to the fair value of the interest.[680]

Figure 3–III. Russian roulette and Texas shoot-out buy/sell options



The following example illustrates the flaws of the mechanism. The shareholders of VSMPO-Avisma, the world's largest producer of

[677] *See* F. Hodge O'Neal, *Preventive Law: Tailoring the Corporate Form of Business to Ensure Fair Treatment of All*, 49 MISS. L.J. 529, 555–56 (1978)

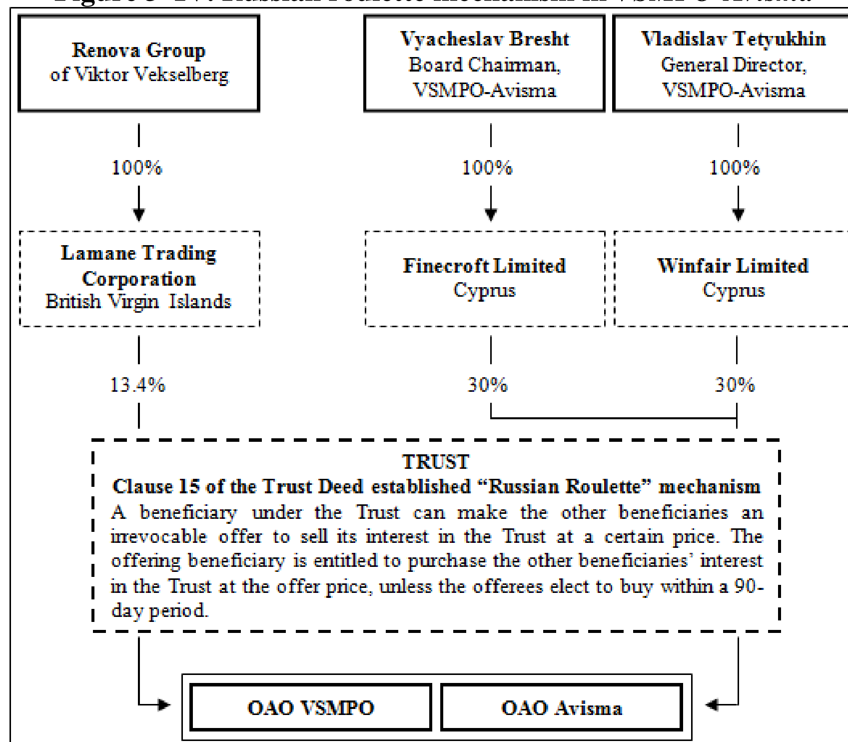
[678] *See*, *e.g.*, Holger Fleischer & Stephan Schneider, *Shoot-Out Clauses in Partnerships and Close Corporations: An Approach from Comparative Law and Economic Theory*, 9 EUR. COMPANY & FIN. L. REV. 35, 38–39 (2012).

[679] *See id.*

[680] *See* Valinote v. Ballis, 295 F.3d 666, 667 (7th Cir. 2002); Urban Archaeology Ltd. v. Dencorp Inv., Inc., 12 A.D.3d 96, 105, 783 N.Y.S.2d 330, 336 (N.Y. App. Div. 2004).

titanium products, contracted for a Russian roulette mechanism. According to the agreement, if one of the parties activated the clause by offering its share for sale at a certain price, it was entitled to purchase the shares of the remaining parties at the offer price, unless the offerees decided to purchase the initiating party's share. Relations among the parties are graphed in Figure 3–IV. In 2005, the outside minority investor, who enjoyed better financial position, put forward a low bid, erroneously expecting that the controlling managers would not be able to arrange necessary financing. This tactics backfired and the triggering party had to sell its share at a low price.[681]

Figure 3–IV. Russian roulette mechanism in *VSMPO-Avisma*



Put and call options are one of the main contractual techniques aimed at resolving hold-up problems in relation-specific investments.[682] These provisions stipulate optimal investments by the means of encouraging cooperation between the contracting parties or ensuring smooth and predictable division.[683] Options, by making use of price

[681]The narrative is based on Arkady Ostrovsky, *A Russian Phoenix Struggles to Stay Free*, FINANCIAL TIMES, Feb. 20, 2006.
[682]Chemla et al., *supra* note 460, at 94–95.
[683]*See id.*

definition mechanisms and distribution of put and call rights between the parties, induce the members to invest optimally and, if nevertheless a conflict arises, to engage in negotiations and solve the conflict.[684] If negotiations are unsuccessful or the parties cannot even be brought together, then put and call options allow eliminating the conflict quickly by removing one of the parties from the firm and terminating their relations. In this situation, an option functions as a dispute resolution mechanism that focuses on the division of assets. In both cases, the main economic benefit is preserving the firm as a going concern, if, indeed, it is an efficient outcome.[685] At the same time, the removed party receives fair compensation.[686] In sum, options contribute towards optimal investments, ex ante deterrence of deadlocks, and stipulation of negotiations if a deadlock nevertheless occurs.

The type of the option (put or call) and the identity of the holder (majority or minority member) jointly depend on the nature of the ex post problems (private benefit extraction or ex post investments) and the distribution of the bargaining power between the parties.[687] In particular, after initial investments, the investing member is vulnerable to hold-up by the other member who should make ex post investments or commit to continue cooperation in order to create value for both parties.[688] Increasing the holding of the latter, for example, by transferring full control to it, will suffice to induce it to make the promised investments.[689] In this case, obviously, the efficiency considerations require granting the first investor, even if it is the majority member, with a put option to sell its interest to the other member.[690] Exercising the put option at fair value will change the initial stakes of the parties in the firm and will induce optimal ex post investments, but it will maintain the parties' initially agreed shares of the payoff.[691]

On the other hand, if the risk is that the minority investor will incur private benefit costs by reason of opportunistic self-dealing by the controlling investor and it is the latter that can exploit its stronger bargaining position for strategic renegotiation, then the put option is granted to the minority investor.[692] If exercised, the majority member will end up as the sole investor of the firm. As such, the mere threat of

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[684] *See generally* MCCAHERY & VERMEULEN, *supra* note 424, at 149 (emphasizing the role of options in stipulating negotiations between joint venture partners)..

[685] *See generally* Richard Arlen Saliterman, *Dissolution and Buy-Out Provisions as Potential Solutions for Close Corporation Dissension*, 1974 UTAH L. REV. 38, 46 (1974) (pointing to the advantage of buy-out provisions in dealing with disagreements without the expense of losing continuous corporate existence).

[686] *See id.*

[687] Chemla et al., *supra* note 460, at 98–99.

[688] *Id.* at 111–13.

[689] *Id.*

[690] *Id.*

[691] *Id.*

[692] *Id.* at 103–04.

exercising the put option by the minority investor has a deterring effect on the majority's incentives to engage in private benefit extraction.[693] The same logic applies to deterring moral hazard behavior by one of the members—i.e. taking more risks or putting suboptimal efforts to manage.[694]

With all these benefits, relying on options can also be problematic. They can give one of the parties opportunistic incentives to create artificial grounds for activating the option.[695] The example illustrated above clearly demonstrates the risks of manipulation of Russian roulette clauses.[696] In particular, where one of the parties possesses information about the financial position of the other party, it can trigger a buy-out mechanism to force a financially weaker party out of the firm.[697] Even if the offered price is below the market price, the financially constrained party may not be able to make a counteroffer. Similar opportunistic behavior can be encouraged in situations where one of the parties knows that the sale or purchase of the interest is costly or not affordable for its counterparty owing to strategic or tax reasons or for public law limitations, such as antitrust rules or foreign investment limitations.[698]

Legal practice has devised several solutions for tackling this problem, but all come with trade-offs.[699] In particular, agreeing on a minimum price threshold or a price formula brings the parties back to the valuation issues discussed earlier;[700] providing the parties with longer time periods to arrange financing increases the costs of a deadlock for the firm. The parties can rely on good faith duty by specifying that any offer should be a good faith valuation of the fair market value of the interest. As a trade-off, this solution heavily relies on ex post adjudication costs in state or arbitration courts. Alternatively, it is possible to provide members with an opportunity to look for a third-party buyer or to buy the interest on flexible terms.

IV. DATA AND RESEARCH DESIGN

The database was created by using the operating agreements of non-listed LLCs filed with the SEC. In most cases, these were subsidiaries or joint ventures formed by listed corporations. Full text search tool of the SEC's Electronic Data Gathering, Analysis, and

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[693] *Id.*

[694] *See* Joel S. Demski & David E.M. Sappington, *Resolving Double Moral Hazard Problems with Buyout Agreements*, 22 RAND J. ECON. 232, 236–38 (1991).

[695] *See*, *e.g.*, O'Neal, *supra* note 677, at 556.

[696] *See supra* note 681 and accompanying text.

[697] *See* O'Neal, *supra* note 677, at 556.

[698] *See* Fleischer & Schneider, *supra* note 678, at 41.

[699] For a brief discussion of those solutions see Fleischer & Schneider, *supra* note 698, at 48–49; Hoberman, *supra* note 546, at 248–49.

[700] *See supra* notes 673–675 and accompanying text.

Retrieval database (EDGAR) provides access to the electronic texts of the documents filed with the Commission during past four years. The search, which was conducted in the annual reports (form 10-K) of all filing entities submitted to the SEC during 2012, yielded LLC agreements of 887 companies formed in different US states. This database was refined by removing all agreements of one-member companies, publicly-traded LLCs, LLCs that were widely held by qualified investors but did not have a public market, and firms formed in states other than Delaware. The last restriction on the data, which reduced the sample of non-listed firms having two or more independent members by less than 14%, aimed to eliminate the possible influence of state statutory differences on contractual choices that parties had made. The final database contains operating agreements of 289 companies formed according to the Delaware Limited Liability Company Act. Of the total number, 168 firms had two non-affiliated members, 62 had from three to ten independent members, and the remaining 59 had more than ten independent members. Most of the LLC agreements in the sample were entered after 2006. A typical agreement is more than 50 pages-long and contains detailed rules of conduct for the contractual parties.

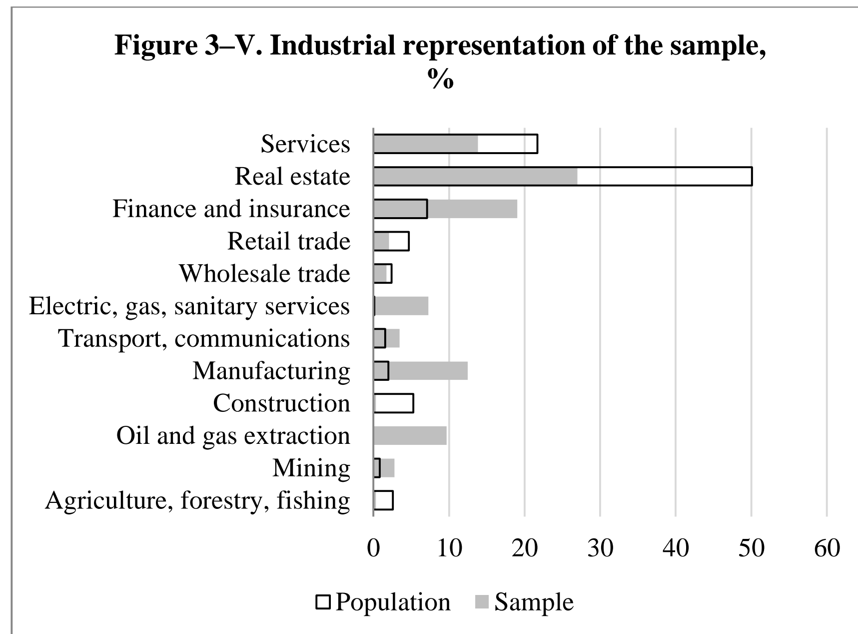
The preliminary study of the sample operating agreements revealed several cases where the LLC members, although not necessarily formally affiliated, had relations making the use of detailed contractual provisions for investor protection secondary. These were cases where one (group) of the members held top-management position(s) at the board of the other member or all members were employees of a third firm. Descriptive statistics includes information for the total sample, but at the stage of conducting inferential statistical analysis these firms, given close relations of their members, were removed from the database. Thus, for defining the circumstances of using transfer restrictions the sample contains a total of 243 LLCs.[701]

The LLC form is used in various business industries. The majority of all LLCs operate in real estate sector; LLCs are also popular in professional services, finance and insurance, construction, and trade (Figure 3–V). The sample contains companies from different industries as well. Figure I compares the industrial division of the sample and the total LLC population based on the first two digits of the Standard Industrial Classification Codes (SIC Codes). Most of the firms in the sample came from finance and real estate sectors (more than 46%). Services, manufacturing, oil and gas, and transportation services are strongly represented as well. The comparison with the industrial

[701]The reduced sample includes 158 firms with two members, 56 firms with the number of members from three to ten, and 29 firms with more than ten members. Few of the discarded LLCs had transfer restrictions in their operating agreements: first purchase rights were used in two LLCs, tag-along and drag-along rights—in five companies, and four LLCs had option clauses.

representation of all LLCs taxed as a partnership reveals many similarities.[702] However, the sample is heavily overrepresented in manufacturing, oil and gas, and electric sectors and is underrepresented in services and construction. The main explanation for these differences can be the fact that the sample is skewed towards larger businesses. The different share of real estate firms can be explained by the fact that many LLCs holding interests in real estate are formed locally.

Figure 3–V. Industrial representation of the sample, %



Note: The total population data include all LLCs that filed partnership tax returns for the tax year of 2011.

Almost all companies in the sample had a centralized management structure. More than half of the sample companies with two members were member-managed, but only in 14 companies both members had management rights. In most cases, the management was centralized and only one of the members was responsible for it. The remaining 42.2% had centralized management by a non-member or by a board of directors. With the increase in the number of members, centralized management by a board of directors becomes more common. Almost 55% in the 3–10 member firms had boards of directors. The corresponding figure is 74% in firms with more than ten members. Figure 3–VI illustrates these data.

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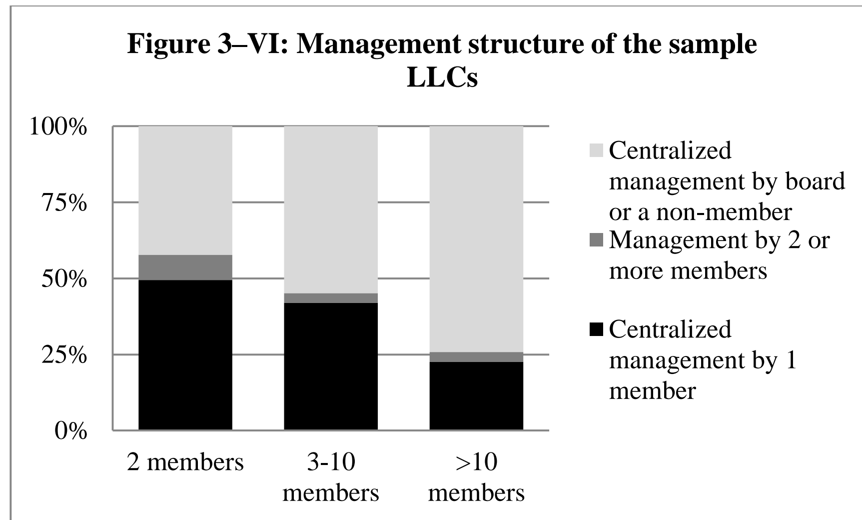
[702]This comparison excludes one-member LLCs taxed as a sole proprietorship and is more appropriate given the fact that the sample includes only firms with two or more members. The data on LLCs taxed as a partnership are taken from Ron DeCarlo, Lauren Lee, & Nina Shumofsky, *Partnership Returns, 2011*, STATISTICS OF INCOME BULLETIN, Fall 2013, at 184–86.



More than 70% of the sample LLCs had a member or a group of affiliated members controlling majority of voting rights. This share was the highest in the LLCs with more than ten members (around 83%) and the lowest in the companies with 3–10 members (about 64%). In two-member LLCs 72% had a controlling member.

In the sample LLCs with two members, more than 86% left intact the statutory transfer restriction.[703] In about 43.5% of the two-member firms, the members agreed to restrict the alienation of their interests by first purchase rights. These rights were very often substituting the default transfer restriction. With the growth of the number of company members, most of the transfer restrictions, with the apparent exception of a tag-along right, become less common. The statutory transfer restriction was not waived in 71% of the 3–10 member LLCs and 64.5% of the sample companies with more than ten members. Contrary to the LLCs with few members, the approval often had to be given by the board or the managing member, rather than by each member. However, similar to two-member companies, often the statutory restriction was subordinated to first purchase rights, which were used in 38.7% and 41.9% of the sample firms with 3–10 and more than ten members, respectively.

All agreements were coded based on a scorecard containing 84 questions affecting investor rights. The general coding criteria were defined based on (1) the background information, (2) information about the voting and equity rights of the LLC members, and (3) the main differences of the legal regime of LLCs as opposed to the corporate statute. In addition, a separate questionnaire was used to code detailed information about the contractual design of transfer restrictions. These questions included information about the type of the right, its variations,

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[703] *See supra* notes 589–590 and accompanying text.

and typical characteristics (for instance, grounds for activating the right). The author read all 289 sample agreements and coded the variables as either zero (a negative answer) or one (a positive answer).

Likely circumstances of using different forms of transfer restrictions were defined by using regression analysis. Because both dependent and independent variables are categorical, the analysis relies on logit regressions. Dependent variables in all regressions are different forms of interest transfer restrictions. Independent variables are grouped into four categories—the number of LLC members, voting rights, contractual rights, and industrial division. Since the number of members is strongly correlated with the ownership structure of the sample firms (e.g., two-member firms tended to have members with equal voting or veto rights and firms with a larger number of members were likely to have a large controlling member), these two groups of independent variables were used as alternatives in two separately-run regressions.

The freedom to contract out of fiduciary duties is one of the principal differences of a Delaware LLC as opposed to corporations. Whereas mandatory fiduciary duties of shareholders and managers play an important role in investor protection in the traditional corporate setting, the members of Delaware LLCs are free to expand, restrict partially, or waive in full fiduciary duties of members or managers[704] or limit or eliminate liability for breach of these duties.[705] In addition to voting rights, the contractually agreed scope of fiduciary duties is used to define the strength of investor rights.

The last group of independent variables includes information about the industry of the sample firms. The size of the firms is another important factor that can define the choice of transfer restrictions—the larger the firm, the stronger the reasons of rational investors to spend resources on contractual design are.[706] Unfortunately, financial results are available for few sample firms, which as non-listed firms are not obliged to disclose such information. Nevertheless, it is reasonable to assume that most of the LLCs, given the disclosure of their LLC agreements by listed firms, were large.

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[704] DEL. CODE ANN. tit. 6, § 18–1101(c) (2015).

[705] *Id.* § 18–1101(e). *See also* Winnifred A. Lewis, Note, *Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 82 FORDHAM L. REV. 1017, 1029–34 (2013) (describing the current state of Delaware law on fiduciary duties in LLCs and its development); Mary Siegel, *Publicly-Traded LLCs: The New Kid on the Exchange*, 68 SMU L. REV. 885, 886–90 (2015) (describing different views on the permissive treatment of fiduciary duties in Delaware LLCs and contrasting this to the mandatory fiduciary duties in corporations).

[706] *See*, *e.g.*, Elisabeth de Fontenay, *Law Firm Selection and the Value of Transactional Lawyering*, 41 J. CORP. L. 393, 424–25 (2015) (with large transactions, the cost of engaging a high-volume law firm is more likely to be offset by the additional benefit from obtaining better economic terms); Means, *supra* note 581, at 1222 (few initial assets of a firm is a rational impediment to incurring bargaining costs).

There is only one other point that needs to be addressed here. Learning externalities of lawyers, rather than ensuring joint-efficient outcomes for business partners, can define the choice of interest transfer rules.[707] Associates at law firms are normally expected to use the extensive libraries of their law firms to design transfer clauses instead of starting from the scratch in each new case.[708] Hence, the pool of prior knowledge and expertise of law firms can affect subsequent choices.[709] The evidence that lawyers involved in the drafting of the sample agreements adopted boilerplate transfer clauses, however, is not compelling.

Specifically, the texts of the sample documents allow identifying lawyers involved in the drafting of the LLC agreements—assuming that lawyers indicated in the notices clause are the ones who assisted the parties in drafting and negotiating the agreement—in 127 firms, which consist about 44% of the entire sample. About half of the involved lawyers were from the nation's top law firms.[710] Out of ninety-seven law firms, 49 are in *The 2015 Am Law 100* list and 43 are the first 100 law firms in *The 2015 NLJ 350* ranking.[711] Only four law firms were involved in drafting at least five LLC agreements in the capacity of a lawyer of different clients.[712] The comparison of all agreements drafted by each of these four firms reveals that not only the agreements include different variations of interest transfer clauses, but also the design of the clauses varies.[713]

This certainly does not suggest that lawyers draft different contracts every time. The most likely explanation, rather, is that although attorneys at large law firms use boilerplate forms to start the drafting of an agreement, there are clauses which they adjust to the needs

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[707]*See* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 720–21 (discussing learning externalities related to drafting efficiency).

[708]*See*, *e.g.*, Wilson Sonsini Goodrich & Rosati, Professional Corporation, *Professional Development and Knowledge Management Programs* (2013), *available at* https://www.wsgr.com/PDFs/professional-development-brochure.pdf (describing the extensive database of sample documents that attorneys can use as "high-quality starting points for further drafting" or negotiating precedents).

[709]*See* O'Neal, *supra* note 572, at 52 ("What he [the lawyer drafting a corporate charter] has done in the past in drafting charters and what his colleagues at the bar are now doing shape his thinking and limit his conduct.").

[710]There is no standard definition of "Big Law" or top-tier law firms. For the purposes of this article, the definition includes all firms from the *American Lawyer*'s ranking of 100 largest law firms by gross revenue for 2015 and the first 100 law firms from the *National Law Journal*'s ranking of top 350 firms by the total number of attorneys for 2015. *See The 2015 Am Law 100: Rich and Richer*, AM. LAW., Apr. 27, 2015; *The 2015 NLJ 350*, NAT'L L.J., Jun. 8, 2015.

[711]Original Research (on file with the author).

[712]The four firms were Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates (7 agreements), Simpson Thacher & Bartlett LLP (6 agreements), Kirkland & Ellis LLP, and Latham & Watkins LLP (both 5 agreements).

[713]Original Research (on file with the author).

of a transaction at hand.[714] Alternatively, law firms may develop several forms of a boilerplate contract tailored to different circumstances, specifically subject to the voting power of a client, size of the target firm/transaction, the number of investors, an industry of the target firm, or even its geographical location (to accommodate the attitudes of the courts in different states). Surely, interactions between the opposing contract parties or between their lawyers matter as well: bilateral contractual negotiations may lead to results that differ from the standard texts normally employed by each side's lawyer.[715] Consequently, other factors, along with the experiences of law firms, must have driven the choice and the design of transfer clauses covered by this study.[716]

V. THE PRACTICE OF CONTRACTING FOR INTEREST TRANSFERS

This Part presents the results and offers explanations for the findings. Regression models are reported in the appendix.

A. First Purchase Rights

In the sample of 289 companies, in 111 (more than 38% of all) the members contracted for first purchase rights with regard to their interests. In four agreements, the abstract description of the rights did not allow distinguishing a particular type of a first purchase right. After removing these cases, the final sample contains 107 LLCs. The two-

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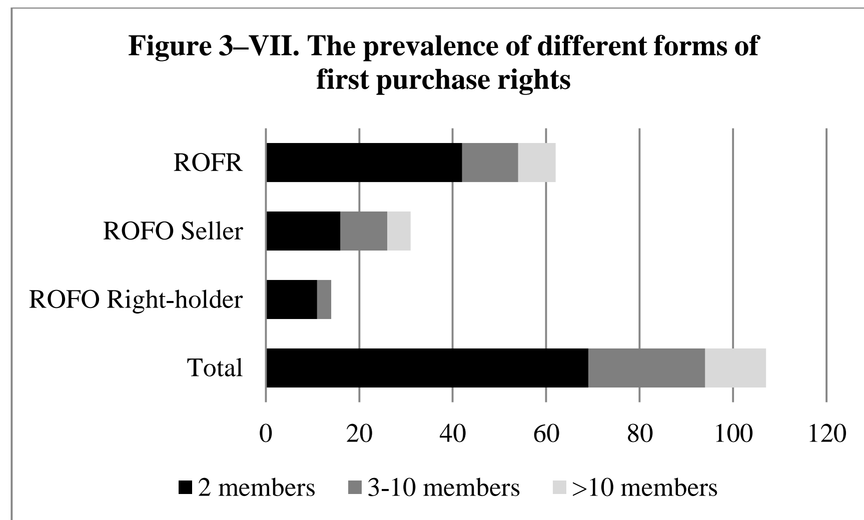
[714]*See* de Fontenay, *supra* note 706, at 397 (suggesting that associates at elite law firms now devote much, if not most, of their time to aggregating and comparing their firm's "market precedent" in preparation for a client's potential transaction and use this knowledge to define appropriate deal terms under prevailing market conditions). *See also* Wilson Sonsini, *supra* note 708 (explaining that the firm's deal database, which contains detailed profiles of acquisitions, public offerings, and venture financings from the past several years where the firm was engaged, allows transactional lawyers to find prior comparable deals and use them to assess the "state of the market", get precedent deal documents, or ask questions to the attorneys who worked on the earlier deals).

[715]*See generally* de Fontenay, *supra* note 706, at 406 (noting that some corporate transactions are heavily negotiated, thereby each agreement, notwithstanding significant overlaps, presents a unique combination of terms tailored to the needs of the parties and to current market conditions).

[716]Professor O'Neal strongly argued for careful adjustment of transfer clauses in particular and governance structures in general to the particular business and to the particular contracting parties. O'Neal, *supra* note 605, at 775–76 (1952) ("The draftsman should use forms and instruments prepared for other businesses only as "idea guides" or as check lists, and not permit them to channel his thinking." (citation omitted)); O'Neal, *supra* note 572, at 43 ("[Most governance provisions] should mold the business form to the needs of a particular business enterprise, and of course no two business situations are exactly alike."); O'Neal, *supra* note 677, at 530 (a standard form should never be used as a substitute for analysis of a client's problem and a clause should never be used if its meaning and purpose are not fully understood). Professor O'Neal's work sought to assist lawyers in drafting custom-made governance provisions for closely-held firms. *See also* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS: LAW AND PRACTICE (Rev. 3d ed. 2014).

thirds of these firms had only two members.[717] The most popular was a right of first refusal—almost 58% of the firms with first purchase rights used this right.[718] The share of firms that used a right of first offer where the seller offers the purchase price was about 29% and the remaining 13% had a right of first offer where the right-holders offer the sale price (Figure 3–VII).



Notes: ROFR stands for a right of first refusal; ROFO Seller and ROFO Right-holder are rights of first offer where the seller or the right-holder offers the sale price, respectively.

Two reasons make it difficult to test the implications of the theories of a right of first refusal and a right of first offer. First, the encumbrance of interests with preemptive rights is often reciprocal.[719] This complicates measuring the value paid for a first purchase right, whether by monetary or non-monetary means, such as other contractual rights. Second, an LLC member may end up as a seller of its interest or a buyer of interests offered by others. Based on the probability analysis of a likely future scenario, the contracting party can choose the particular first purchase right that fits its interests the best. The result of this analysis, however, is private knowledge. Nevertheless, the analysis of the sample rights reveals some interesting results.

Table I in Appendix 3–I shows the prevalence of using different types of first purchase rights depending on the ownership and voting patterns of the sample LLCs. The evidence comes to support the

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[717]*See infra* Figure 3–VII.

[718]*See infra* Figure 3–VII.

[719]The evidence supports the reciprocal nature of first purchase rights in the business organizations setting. Only in one-quarter of the cases the rights were not reciprocal. A right of first offer, regardless of its variation, was more likely to be non-reciprocal than a right of first refusal. Original Research (on file with the author).

argument that first purchase rights are used where LLC members have special contractual relations allowing each to affect decision-making.[720] Under these circumstances, the traditional fiduciary duties are secondary. Special relations make the company vulnerable to the threatened or actual entries of third parties which can change the established balance of power, patterns of the members' behavior, or their priorities. First purchase rights encourage investments by making third-party transfers of interests less likely.[721] The strongest form of these rights, a right of first refusal, gives a right-holder say on any third-party transfer.[722] It is used reciprocally in cases of special relations between the members with equal bargaining power.[723] On the contrary, if there was a controlling right-holder, it was unlikely that it would have a preemptive right under a right of first offer where the right-holder defines the sale price.[724]

These results can be explained by the predicted effects of the variations of first purchase rights.[725] In two-member LLCs with both members holding equal ownership and voting rights, members are the most willing to impede interest transfers to outsiders and influence the replacement of a member by a third party.[726] Therefore, they prefer a reciprocal right of first refusal to a right of first offer. The greater becomes the number of members, the higher the potential costs of a seller resulting from the reduced realization potential of a right of first refusal are (unless the right-holders are passive minority investors that are unlikely to exercise their rights).[727] In firms with a large number of investors, outside buyers face an extremely high uncertainty risk with regard to their offers because any right-holder can thwart a third-party bid. If a member is allowed to sell its equity only after receiving a bona fide third-party offer and complying with the procedural requirements of a right of first refusal, then agreeing to such a right, in effect, means locking in the investors in the firm. The potential losses of a seller from encumbering its interest by a preemptive right are limited under a right of first offer.[728] Not only the increased certainty attracts more third party interest, but the right can create a competitive auction between the

[720] *See infra* Table I of Appendix 3–I.

[721] *See supra* Part III.A of this Chapter.

[722] *See supra* Part III.A of this Chapter.

[723] *See infra* Table I of Appendix 3–I.

[724] *See infra* Table I of Appendix 3–I.

[725] *See supra* Part III.A of this Chapter.

[726] *See supra* note 623 and accompanying text (explaining that special relations or investments in relation-specific capital increase incentives to behave opportunistically by threatening to exit).

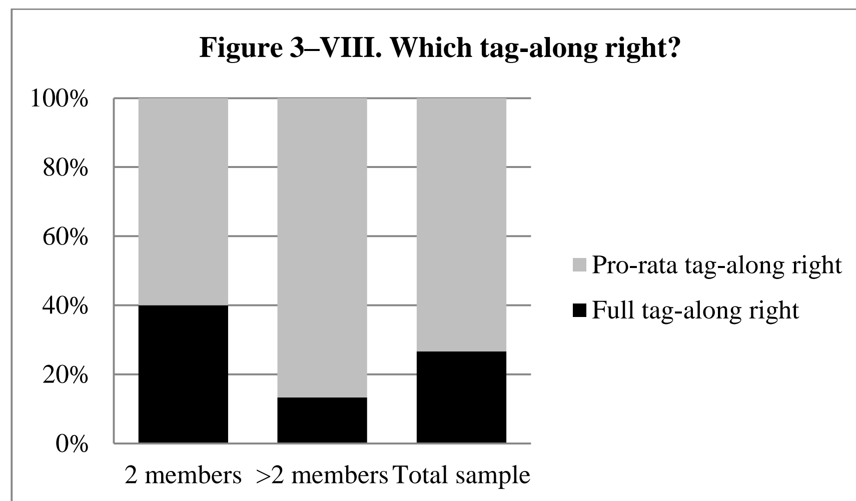
[727] *See supra* notes 613–615 and accompanying text (discussing the effect of a right of first refusal on the incentives of third parties to make offers).

[728] *See supra* notes 627–628 and accompanying text (discussing the incentive effects of a right of first offer on third parties).

numerous right-holders.[729] However, a right of first offer where the right-holder defines the sale price, due to the limited value for its holders, is not attractive for controlling members with strong negotiating power. This type of a right of first offer, consequently, appears mostly in LLCs without a controlling investor.[730]

B. Tag-Along and Drag-Along Rights

The share of the LLCs in the sample with tag-along rights is slightly above 31% (90 firms out of the total of 289). More widespread were tag-along rights entitling the right-holders to sell in proportional shares with the main selling member (73.33%).[731] In the remaining 26.67% of cases, the seller could not sell any units unless the third-party buyer committed to buy all outstanding units (Figure 3–VIII). Table II of Appendix 3–I reports comparative data on the two variations of a tag-along right.



A tag-along right, obviously, has a value where LLC members cannot block third-party transfers of interests to third parties.[732] Therefore, the right was used as an alternative to unanimous voting or veto rights.[733] Given the comparative advantages of a proportional tag-along right as opposed to a full tag-along right, it is not surprising that most of the members of the sample companies contracted for the first

[729]The signs of the correlations of the variations of first purchase rights and the number of LLC members correspond with these analysis, but the relationships are not significant. *See infra* Appendix 3–I.

[730]*See infra* Table I of Appendix 3–I.

[731]*See infra* Figure 3–VIII.

[732]*See supra* notes 647–649 and accompanying text.

[733]*See infra* Table II of Appendix 3–I.

type.[734] This right is more likely to discourage value-decreasing control transactions, but has limited negative effect on value-increasing transfers.[735] A full tag-along right, by contrast, affects equally both types of control transfers.[736]

A full tag-along right was likely to appear in LLCs with a small number of members and if the investors had strong rights.[737] The reason, perhaps, is that in these situations investors contract for rights that balance each other and a controlling member, if any, has limited maneuvering room for extracting private benefits. Contrary, under weak minority rights, a pro rata tag-along right is the appropriate measure.[738] With the increasing number of members, the costs of providing strong decision-making rights to each investor increase as well. Majority voting becomes the most viable decision-making rule. Accordingly, one or several members become a controlling party and enjoy the benefits of such control. In these cases, large members resist a full tag-along right and are likely to agree to a proportional tag-along right, which has a limited effect on discouraging potential interest from outside buyers.

The evidence is supportive of the argument that a drag-along right is balancing tag-along rights. The sample contains 74 companies where the members contracted for a drag-along right. In almost three-quarters of the LLCs, a drag-along right was contracted along with a tag-along right and only 9.46% of the agreements included stand-alone drag-along rights.[739] A drag-along right was commonly contracted in LLCs with a controlling member.[740]

C. Put Options, Call Options, and Buy/Sell-Out Arrangements

Though the theoretical implications of put and call options and of buy/sell-out options have been extensively studied, practical evidence on their use, similar to other interest transfer clauses, is rare. The data from the agreements of the sample companies shed more light on the use of options in non-listed LLCs.

Out of the total sample of 289 firms, in 170 LLCs the members contracted for one or another form of options. Figure 3–IX shows the popularity of different forms of options. The options took the form of minority put and call rights in 21.18% and 27.65% of cases, respectively.[741] Majority call rights appeared in 41.18% of the LLC

[734] *See supra* Figure 3–VIII.
[735] *See supra* Part III.B of this Chapter.
[736] *See supra* Part III.B of this Chapter.
[737] *See infra* Table II of Appendix 3–I.
[738] *See infra* Table II of Appendix 3–I.
[739] Original Research (on file with the author).
[740] *See infra* Table II of Appendix 3–I.
[741] *See infra* Figure 3–IX.

agreements using options.[742] Majority put rights were rarely used.[743] Buy/sell-out clauses, where either party could be a buyer or a seller, were employed in every fourth sample company with an option clause in its operating agreement (26.47%).[744]

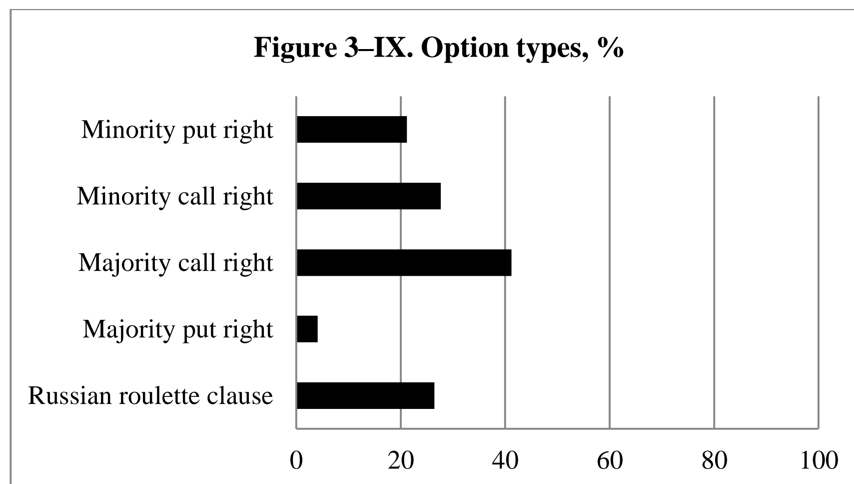


Table III of Appendix 3–I presents the results of the statistical analysis. As predicted, unconditional minority put rights were used to prevent opportunistic self-dealing by controlling members where the minority members could not rely on their voting rights to affect day-to-day decision-making and major decisions.[745] These options, except cases of stipulating optimal investments in relation-specific projects with sequential investing, have limited value in two-member firms with equal voting rights.[746] Indeed, an LLC member can use voting rights to prevent expropriation by the other member.

Where a minority investor has sufficient financial resources and experience relevant to the business project, majority self-dealing and hold-up strategies can be discouraged also by granting a minority investor a call right.[747] Unlike a minority put right, which typically could be activated anytime by its holder, minority call right required a specific cause for activation—decision-making deadlock, failure to make investments by the controlling member, breach of the agreement by the controlling member, or change of control in the controlling member.[748]

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[742]*See infra* Figure 3–IX.
[743]*See infra* Figure 3–IX.
[744]*See infra* Figure 3–IX.
[745]*See infra* Table III of Appendix 3–I.
[746]*See infra* Table III of Appendix 3–I.
[747]*See infra* Table III of Appendix 3–I.
[748]Original Research (on file with the author). Change of control can be dealt with also by first purchase rights entitling the right-holder to acquire the equity holding of a member

Similar causes were required for the activation of majority call options.[749] In the circumstances of equal voting or minority veto rights, the call right of one of the two members was an effective instrument to overcome deadlocks.[750] The option took the form of a call right rather than a put right because a put right could be used strategically to create artificial deadlocks and obtain bargaining advantage over a financially-constrained member not able to perform its obligation to buy the offered interest.

Special types of put and call options, buy/sell-out arrangements, in the majority of cases could be activated anytime.[751] Less often were conditional buy/sell options that could be triggered following a deadlock or breach of the agreement by one of the parties.[752] We would expect buy/sell-out arrangements in 50-50% projects.[753] The data show that these provisions were almost in all cases used in two-member firms.[754] Though equal economic interest in the LLC was not a necessary condition for contracting for a buy/sell-out provision, equal voting rights and equal board representation in general were.[755]

Theoretical models show that where both contractual parties have private valuations not known to each other, buy/sell-out arrangements can lead to inefficient results.[756] In particular, the triggering party defines the price based on the probability analysis of being a seller or a buyer.[757] If it believes that the other party has higher valuation and is likely to buy, the triggering party offers a price above its own valuation.[758] Contrary, if the triggering party is likely to buy, it offers a price below its own valuation. Where these estimates are right, the results of buy/sell-out clauses are efficient.[759] However, if the receiving party has a valuation between the triggering party's own valuation and the offered price, the triggering party may end up as a buyer where it would be more efficient to sell or as a seller where it would be more efficient to buy.[760]

The inefficiencies can be mitigated by choosing the right triggering party. De Frutos and Kittsteiner offer a model based on negotiations

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which is subject to change of control. However, first purchase rights often did not cover indirect transfers of the encumbered units. This necessitates drafting special call options.

[749]Original Research (on file with the author).

[750]*See infra* Table III of Appendix 3–I.

[751]Original Research (on file with the author).

[752]Original Research (on file with the author).

[753]*See*, *e.g.*, O'Neal, *supra* note 677, at 555.

[754]*See infra* Table III of Appendix 3–I.

[755]*See infra* Table III of Appendix 3–I.

[756]*See* R. Preston McAfee, *Amicable Divorce: Dissolving a Partnership with Simple Mechanisms*, 56 J. ECON. THEORY 266, 276–78 (1992). A result is efficient if full control over the firm is transferred to the member that values it most.

[757]*See id.*

[758]*See id.*

[759]*See id.*

[760]*See id.*

before activating a buy/sell-out option that aims to define the right triggering party.[761] Choosing the right triggering party can also ensure a fair result[762] if the parties of a buy/sell-out option have one-sided asymmetric information about the price (one party is better informed than the other).[763] These studies suggest that, when contracting for a buy/sell-out option, the parties would either allow negotiations before activating the option or would define in the agreement the triggering party whose offer would lead to an equitable and/or efficient result. If the latter is the party with better information about the firm which can accurately value the interests, then the parties are looking for an equitable division; if the offering party is the one with the higher valuation, then the outcome is efficient.[764] Contrary, where the agreement is silent and any party can trigger the option, the effect of the buy/sell-out mechanism on resolving deadlocks is very limited—since each party prefers the other party to activate the mechanism, both are expected to refrain and stay deadlocked.[765]

The practice of the sample LLCs does not support these predictions. Only in few cases the agreements specified the party that was entitled to trigger a buy/sell-out procedure.[766] In the vast majority of situations, any of the contractual parties could activate the clause.[767] Interestingly, the evidence points in the direction that buy/sell-out options were often used in real estate firms.[768] The inclusion of the buy/sell-out mechanisms in the governance agreements of real estate joint ventures can be motivated by the long-established practices of professional consultants, rather than by the efficiency or fairness considerations. In particular, in 2008, the American Bar Association's Business Law Section published the Model Real Estate Development Operating Agreement for limited liability companies which included a

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[761]*See* María-Angeles de Frutos & Thomas Kittsteiner, *Efficient Partnership Dissolution under Buy-Sell Clauses*, 39 RAND J. ECON. 184, 188–91 (2008). In a recent study, Professors Landeo and Spier argue that courts, since they design a valuation mechanism ex post and are thus able to pick the right party to make a triggering offer, can use buy/sell-out options to ensure fair division of assets in judicially ordered business dissolutions. *See* Landeo & Spier, *supra* note 553, at 176; Claudia M. Landeo & Kathryn E. Spier, *Irreconcilable Differences: Judicial Resolution of Business Deadlock*, 81 U. CHI. L. REV. 203, 206 (2014).

[762]A result is fair if the allocation of payoffs between the parties accurately reflects the agreed ownership allocation.

[763]Landeo & Spier, *supra* note 553, at 160–62; Landeo & Spier, *supra* note 761, at 210–13. Ensuring equitable results in contractual buy/sell options is important because otherwise the parties have incentives to engage in opportunistic behavior with the purpose of changing the proportions of the initially agreed allocations. For instance, an advantaged party can create an artificial deadlock to activate a buy/sell option and buy out (sell out) its co-investor at a low (high) price.

[764]*See* Landeo & Spier, *supra* note 553, at 162.

[765]*See id.*

[766]Original Research (on file with the author).

[767]Original Research (on file with the author).

[768]*See infra* Table III of Appendix 3–I.

buy/sell provision pursuant to which any of the members could activate the procedure.[769]

Sometimes, but not often, the parties used a modified version of a Russian roulette mechanism where a triggering party is not offering the price of the option.[770] The price is, rather, defined by an independent third party after the activation of the option.[771] Engaging an independent appraiser, if the valuation is performed accurately, mitigates inefficient and inequitable outcomes related to buy/sell-out mechanisms. However, given the additional costs, this modification is useful only where the reasons for sub-optimal outcomes of utilizing buy/sell options are well-pronounced.[772]

VI. The Contractual Design of Interest Transfer Clauses

The study also revealed the main parameters of drafting interest transfer clauses. The contracts commonly addressed the following aspects: triggering events, notification rules, price and payment terms, the size of an interest affected by the transfer, and measures of enforcement in case the parties fail to comply with their contractual obligations.

A. Events Triggering Interest Transfer Clauses

Trigger events define the moment when an interest transfer clause is activated. Rights of first refusal come into effect when an LLC member receives a third party offer or has agreed to sell its interest to a third party.[773] Both grounds are facts that can be easily established. The activation moment of rights of first offer typically was defined broadly—an *intention* of a member to sell its interest.[774] Most of the first offer clauses were silent about the permissibility of any contacts between a

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[769] *See* Joint Task Force of Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385, 472–78 (2008).

[770] Original Research (on file with the author).

[771] *See* Wetmore v. MacDonald, Page, Schatz, 476 F.3d 1, 2 (1st Cir. 2007).

[772] *E.g.*, in *MacDonald, Page, Schatz*, though both parties had equal voting rights, only one was engaged in the daily management of the business and, as a result, could use its experience to organize a competing business if it was bought out. *See MacDonald, Page, Schatz*, 476 F.3d at 1, 2, 5. By agreeing to set a minimum bidding floor defined by an independent appraiser, the parties limited the room for strategic behavior by the better experienced party.

[773] Bateman v. 317 Rehoboth Ave., LLC, 878 A.2d. 1176, 1183–84 (Del. Ch. 2005) (a right of refusal can be exercised only when the [seller] . . . entertains an offer from a third party to purchase the property). *See also*, *e.g.*, Colt Defense LLC, Amended and Restated Limited Liability Company Agreement of Colt Defense LLC (Form S-4/A Ex. 3.1) (Mar. 21, 2011).

[774] *See*, *e.g.*, CityCenter Holdings, LLC, Amended and Restated Limited Liability Company Agreement of CityCenter Holdings, LLC (Form S-4 Ex. 3.1) (Sep. 29, 2011).

seller and potential non-member buyers prior to notifying the right-holder. Evidently, some scope for freedom of action is acceptable.[775]

Likewise, the trigger events for the two variations of tag-along rights were different. In almost two-thirds of cases, proportional tag-along rights applied to any sale of interest, regardless of the number of LLC units being transferred.[776] By contrast, a full tag-along right, as a rule, was activated if a seller agreed to transfer an interest exceeding a certain minimum threshold.[777] The LLC agreement of STi Prepaid, LLC, provider of international prepaid phone cards, illustrates this practice.[778] The company's operating agreement included both types of a tag-along right. If any member desired to sell all or part of its units, the co-selling right-holders could participate in the sale on a pro rata basis. However, if the majority member agreed to transfer more than 25% of the outstanding units, the minority members could elect to sell all their units.[779]

By including a drag-along right in private agreements, the contracting parties voluntarily consent to be squeezed-out. Therefore, as long as the initial expression of the will of the parties is voluntary and informed, the drafters of a drag-along right can, theoretically, set the activation threshold at any level.[780] More than 80% defined a minimum threshold for activating a drag-along right.[781] The lowest threshold was set at 25%.[782] The most frequently adopted triggering point, however, was the transfer of more than 50% of the outstanding LLC units.[783] The parties often did not define a specific threshold and tied the activation of the right to the transfer of all interest by a controlling member, regardless of a specific size.[784]

Trigger events for the types of options differed as well. If minority put options and buy/sell-out arrangements typically could be initiated anytime at the will of a right-holder, majority call options often required a specific cause for activation—such as deadlock in decision-making or

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[775]*See supra* notes 631–632 and accompanying text.

[776]Original Research (on file with the author).

[777]Original Research (on file with the author).

[778]*See* Leucadia Nat'l Corp., Amended and Restated Limited Liability Company Agreement of Sti Prepaid, LLC (Form 10-Q Ex. 10.3) (May 9, 2007).

[779]*Id.*

[780]*See* Christoph Van der Elst & Lientje Van den Steen, *Opportunities in the Merger and Acquisition Aftermarket: Squeezing Out and Selling Out*, *in* CORPORATE GOVERNANCE AND REGULATORY IMPACT ON MERGERS AND ACQUISITIONS: RESEARCH AND ANALYSIS ON ACTIVITY WORLDWIDE SINCE 1990, 191, 206-07 (Greg N. Gregoriou & Luc Renneboog eds., 2007) (explaining that from an economic perspective there are strong justifications for setting low squeeze-out thresholds).

[781]Original Research (on file with the author).

[782]*See*, *e.g.*, Radio One, Inc., Amended and Restated Limited Liability Company Agreement of Interactive One, LLC (Form S-4 Ex. 3.22) (Feb. 9, 2011).

[783]Original Research (on file with the author).

[784]*See*, *e.g.*, Laredo Petroleum, Inc., Second Amended and Restated Limited Liability Company Agreement of Laredo Petroleum, LLC (Form S-4/A Ex. 3.4) (Dec. 12, 2011).

breach of an agreement.[785] Often an option was effective after a certain stabilization period following the launch of the project.[786] This choice reflects the wish of the parties to commit their resources and efforts to ensure the success of the undertaking. Such a commitment is facilitated by the enthusiasm that usually accompanies joint ventures during the initial period of their development; deadlocks are unlikely at this stage.[787]

B. Notice Rules after Interest Transfer Clauses are Triggered

The next aspect of contracting for transfer clauses is the content of the notice and the length of the period during which the right-holders can exercise their right. Lengthy notice periods, with the resulting uncertainty and the need to reserve financial resources for a longer period, and cumbersome information disclosure requirements may discourage potential buyers.[788] On the other hand, short notice periods and limited disclosure may force right-holders to make ill-advised decisions without possessing adequate information.[789] The maximum time period for the completion of the sale is also important because during this period members cannot sell their interests to other buyers.[790]

An effective right of first refusal requires a detailed disclosure of the material terms of the third-party offer, including the identity of the offeror, to the right-holder.[791] Yet, even if the agreement does not require disclosure of all these terms, the selling member is encouraged to disclose, for the right-holder is obliged to match only those terms disclosed in the notice.[792] If non-disclosure of the terms, however, disadvantages the right-holder, notice defects may prevent the right from being triggered.[793]

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[785]*E.g.*, *compare* Am. Railcar Indus., Inc., Amended and Restated Limited Liability Company Agreement of AXIS, LLC (Form 10-K Ex. 10.51) (Feb. 22, 2008) (buy/sell-out option) *with* Emmis Commc'ns Corp., Second Amended and Restated Limited Liability Company Agreement of Merlin Media, LLC (Form 8-K Ex. 10.1) (Sep. 1, 2011) (majority call right).

[786]*See*, *e.g.*, Entravision Commc'ns Corp., Limited Liability Company Agreement of Lotus/Entravision Reps LLC (Form S-3 Ex. 10.2) (Jan. 30, 2002).

[787]*See generally* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1555 (1982) (fear to spoil the deal prevents the parties and their lawyers from focusing on the downside risks).

[788]*See* Corporation Law Committee, *supra* note 551, at 1187.

[789]*See id.*

[790]*See id.*

[791]Under a right of first offer, the seller is required to describe the price and other terms and conditions of the sale or, if the right-holder has to define the price, only the number of the offered units.

[792]*See* Union Oil Co. of Cal. v. Mobil Pipeline Co., No. 19395–N, 2006 WL 3770834, at *14 (Del. Ch. 2006) (if the seller expects the right-holder to match a given term, the term must be stated in the right of first refusal notice).

[793]*See* Robert K. Wise, Andrew J. Szygenda, & Thomas F. Lillard, *First-Refusal Rights Under Texas Law*, 62 BAYLOR L. REV. 433, 472 (2010).

For both types of first purchase rights, the seller's offer shall remain open during an agreed period.[794] A first purchase offer is an irrevocable option that can be exercised by the right-holder anytime during this period.[795] It was very seldom when the parties agreed that an offer could be revoked by the seller.[796]

The majority of the agreements on tag-along rights provided for notice periods ranging from 15 to 30 days prior to the proposed transfer.[797] In addition to the price and payment details, more than half of the agreements required the disclosure of the identity of the buyer and almost a quarter included information about non-cash consideration.[798] More than half of the agreements established a maximum period for completing the transfer.[799]

C. Price and Payment Terms

Similar to notice rules, payment terms are of particular importance where a third-party buyer is involved.[800] Contracting for a right of first refusal does not imply itself that the seller cannot accept any terms from an outside buyer that practically cannot be matched by the right-holder (for instance, receiving a specific property as a consideration in kind).[801] The four main means of addressing non-cash consideration problem in a right of first refusal were (1) allowing only cash or easily-marketable security offers, (2) requiring the seller to include a good faith estimate of the third party's non-cash offer in the triggering notice, (3) designing a procedure of valuation by independent appraisers, or (4) requiring the full disclosure of the third party's offer and letting the right-holder to use this information for making its own valuation.[802] Theoretically the problem of non-cash consideration can reveal itself also in the context of a right of first offer. But the evidence shows that more than half of the right-of-first-offer agreements ignored this issue.[803] The fact that outside buyers, who are the most interested in clarifying the possibility of making non-cash offers, are not a contracting party of a right of first offer and thus cannot affect the negotiating process, can explain this. Leaving the matter out of contracts, however, does not necessarily mean that non-cash consideration is not allowed. Disputes are more likely to

[794] *See* O'Neal, *supra* note 605, at 792.
[795] *See* Wise et al., *supra* note 793, at 493.
[796] Original Research (on file with the author).
[797] Original Research (on file with the author).
[798] Original Research (on file with the author).
[799] Original Research (on file with the author).
[800] *See* O'Neal, *supra* note 605, at 797–98.
[801] *See* Wise et al., *supra* note 793, at 486–87.
[802] Original Research (on file with the author).
[803] Original Research (on file with the author).

boil down to the assessment of a third-party offer as to its compatibility with the terms and conditions of the right-holder's offer.

Determining the proper price of LLC interests in the context of tag-along and drag-along rights is crucial.[804] Differentiated payments to large and minority members can be justified from the perspective of control premiums because minority investors are less legitimate to require such premiums.[805] Nevertheless, transaction costs (e.g., the need to engage independent experts for valuation) and information asymmetries might prevent parties from detailed contracting. Consequently, almost universal in the sample firms was the requirement to pay the same price in the same form to all transferring members.[806]

D. The Size of an Interest Subject to a Transfer

The size of an interest that sellers can or have to transfer is another aspect that the parties of interest transfer clauses commonly determine. The main concern is that if right-holders can exercise their rights partially, then the selling party may be left with a small holding with insignificant voting power and the balance of power in the firm will be affected. Particularly, minority investors in drag-along rights are worried whether they can be forced to transfer their interests in a sale of less than 100% of all issued and outstanding units. The sample agreements solved this issue either by requiring the transfer of the entire interest in the affected company (56.76% of the firms) or allowing each transferring member to sell its pro rata share (32.43%).[807] Similar to a proportional tag-along right, pro rata transfers under a drag-along right have a disciplining effect on the controlling seller.

For the same reason, in call options it was common to require from the calling member to acquire all interest of the seller.[808] On the contrary, the holder of a put right could sell all or any portion of its interest.[809]

When it comes to exercising first purchase rights, an additional factor comes into play. Smaller holdings may generate less interest from potential buyers and can be valued lower.[810] If the right-holders can buy

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[804]Valuation is, perhaps, the most important in the context of buy and sell options. Their effectiveness entirely depends on the ability of the parties to define the proper price for exercising an option. This matter is described in detail above. *See supra* Part III.D of this Chapter.

[805]*See supra* note 655.

[806]Original Research (on file with the author).

[807]*E.g.*, *compare* Emmis Commc'ns Corp., *supra* note 785 (full transfer) *with* Chrysler Group LLC, Third Amended and Restated Limited Liability Company Operating Agreement of Chrysler Group LLC (Form 10-K Ex. 3.6) (Mar. 6, 2012) (proportional distribution).

[808]Original Research (on file with the author).

[809]Original Research (on file with the author).

[810]*See* O'Neal, *supra* note 605, at 792–93 (the restrictive provision should make clear whether the right-holder is entitled to buy less than offered; if the right-holder can buy just

less than offered, a potential deal with a third-party buyer may thus be frustrated. Accordingly, first purchase rights were usually conditioned upon buying all offered interests and only in 17.76% of cases the right-holders were free to buy less than offered.[811]

If there are two or more right-holders entitled to exercise their first purchase rights in a given transfer, the agreement of the parties must define how the offered interest is to be distributed among them and what will happen to the units that one or more right-holders fail to take.[812] In those cases, the parties usually agreed on distributing offered LLC units among purchasing right-holders proportionally and on second round offers that provided a right-holder that elected to purchase all its share with an opportunity to buy the remaining units (if one or more right-holders exercised their preemptive right partially or did not exercise it).[813]

E. Measures Strengthening the Enforcement of Transfer Clauses

The contracting parties supplemented interest transfer clauses with different provisions that reduce the costs of their enforcement. One instance, which is also mentioned above, is the combination of first purchase rights with the statutory default rule restricting interest transfers in LLCs.[814] The evidence on contracting for first purchase rights suggests that the statutory approval clause is not a universal solution for all non-listed firms. But it can be useful for strengthening the enforcement of other transfer clauses. Almost 60% of the sample firms backed up first purchase rights with the statutory approval clauses.[815] If a third-party buyer is in compliance with the procedure of first purchase rights, it automatically becomes a substituted member; otherwise, an approval clause applies.

The explanation of this practice is straightforward: a transfer consent is an extremely strong means for incumbent members to affect third party transfers and is thus prone to hold-outs.[816] Indeed, this restraint is the default rule in the partnership statutes; but it is combined with the power of a partner to dissolve the partnership.[817] The absence of dissolution rights in many limited liability firms turns a consent clause into a device that may lock investors together forever.[818] In a non-listed

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enough of the shares to give it control, the seller's remaining holding is far less attractive to prospective buyers).

[811]Original Research (on file with the author).

[812]*See* O'Neal, *supra* note 605, at 792.

[813]Original Research (on file with the author).

[814]*See supra* note 596 and accompanying text.

[815]Original Research (on file with the author).

[816]*See* O'Neal, *supra* note 605, at 785.

[817]*See* Edwin J. Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139, 141–42 (1969).

[818]*See id.*

firm with a small number of members, each member, as a rule, can block transfers. First purchase rights, while giving incumbent members a priority in purchasing the units of selling members, do not prevent third-party transfers completely.[819] A third party can become a substituted member subject to the willingness/ability of incumbents to exercise their preemptive rights. At the same time, first purchase rights are backed up by a default approval clause in order to prevent any transfers in violation of the contractually agreed first purchase rights.

Such a combination was commonplace also for other transfer clauses. The main contractually agreed remedy for the failure of a selling member to comply with the procedure of a tag-along right was the declaration of the transfer null and void and the refusal to recognize the third-party transferee as a substituted member of the LLC (more than 91% of the cases).[820] Other remedies for enforcing tag-along rights were entitling right-holders to buy-out the seller or put their units to the seller, an option to dissolve the firm, or a termination of special voting rights of a defaulting member.[821] These remedies are easily enforceable and limit the costs of applying a tag-along right.

The parties can strengthen the enforceability of buy/sell-out clauses by using bonding mechanisms. Particularly, the failure of a buyer to close the transaction can be remedied by allowing the seller to retain a certain percentage of the purchase price deposited after activating the buy/sell-out procedure as liquidated damages or to buy out the buyer at a discounted price (usually at 5% or 10% discount).[822] More than half of the contracted buy/sell-out clauses included one of these remedies or both.[823]

A case from the Wisconsin Court of Appeals shows, however, how a bonding provision, if not drafted carefully, can sabotage contractual option mechanisms. In *Decker v. Decker*, a buy/sell-out option to which two brothers, who were in business together, were party, was activated following a deadlock.[824] The LLC operating agreement specified that if one of the parties made an offer and failed to close the purchase, the other party had an opportunity to buy the interest of the failing party on

[819]*See* O'Neal, *supra* note 605, at 785 (first purchase rights weaken the incentives of the right-holder to block transfers opportunistically by reducing the right-holder's influence on the seller; this advantage, however, comes at the expense of the need to tie up funds necessary for exercising first purchase rights).

[820]Original Research (on file with the author).

[821]Original Research (on file with the author).

[822]*See*, *e.g.*, Behringer Harvard Opportunity REIT II, Inc., Limited Liability Company Agreement of Behringer Harvard Arbors, LLC (Form 10-K Ex. 10.15) (Mar. 28, 2012) (if following the activation of a buy-sell procedure the buyer fails to close the transaction, the seller may either retain a 5% deposit as liquidated damages or elect to buy out the buyer's interest for a price equal to 95% of the original offer price).

[823]Original Research (on file with the author).

[824]Decker v. Decker, 726 N.W.2d 664, 666 (Wis. App. 2006).

the same terms and conditions.[825] The brother interested in the dissolution of the firm made an oppressive offer at a very high price without any intention, as later found by the court, to close on the offer. As a reaction to the high offer price, the receiving brother elected to sell and, because the transfer was not closed, the parties appeared in the court at dissolution proceedings.[826] The court considered the contractual provision empowering the seller to buy out the defaulting buyer as an anticipation by the parties that the buyer might not close an accepted buy/sell-out offer. The appropriate remedy, according to the court, was the one clearly stated in the agreement—an activation of the bonding mechanism rather than awarding damages or granting an injunction.[827] If a contractually drafted specific remedy is the only remedy and cannot be invoked by the seller alternatively to other remedies generally available to the parties for breach of contract, such as damages or specific performance, a buy/sell-out mechanism may be turned into a mere formality that can be easily neutralized.[828]

VII. CONCLUSION

This chapter analyzed different interest transfer restrictions from the perspective of joint-efficiency of the contracting parties and looked to the practice for real-life evidence. Because of the locked investments and in the absence of default dissolution rights of each member, transfer restrictions are a crucial part of governance agreements of non-listed limited liability firms. The study shows how transfer clauses balance the interests of the LLC members. Accordingly, investors can rely on these contractual instruments to stipulate efficient investments.

Specifically, first purchase rights achieve two main results—they give the right-holder a say on third-party entries into the capital of the firm and discourage changes in the initially allocated ownership structure of the firm. These effects can lead to efficient results by encouraging investments where the contracting parties have made relation-specific investments or have special relations. Therefore, first purchase rights

[825]*Id.* at 668.

[826]*Id.* at 666–67.

[827]*See Decker*, 726 N.W.2d at 669. The Delaware Court of Chancery offered similar interpretation in a parallel case. *See* Eureka VIII v. Niagara Falls Holdings, 899 A.2d 95, 116 (Del. Ch. 2006).

[828]In another case, the court constructed the buy/sell-out agreement in a way to prevent such abusive behavior. According to the agreement, each party had to submit simultaneously a price for which it would be willing to sell its interest or buy the other party's interest and the higher bidder would be the buyer at the price equal to the average of the two prices. When the higher bidder failed to close, the court ruled that the lower bidder could buy the interest of the higher bidder at its own offer price, rather than at the average price. Otherwise, the party who sought to evade the buy/sell-out mechanism could completely thwart the process by "submitting outrageously high bids on which it had no intention to perform." *See* Larken Minnesota, Inc. v. Wray, 881 F.Supp. 1413, 1415–17, 1418 (D. Minn. 1995).

cannot be a universal optimal solution for all non-listed firms and are chosen by the contracting parties taking into account the individual aspects of each deal. A tag-along right mitigates conflicts in sale-of-control transactions by discouraging value-decreasing transfers. A drag-along right has a high value where minority rights are strong and a potential outside buyer cannot extract large private benefits. Weak minority protection, on the other hand, reduces the value of a drag-along right. In practice, however, other factors than these affect the adoption of a drag-along right—it is typically used in combination with a tag-along right as a counterbalance. Since change-of-control transactions in particular and interest transfers to third parties in general are extraordinary events in the life of LLCs, investors need instruments for dealing with conflicting interests in the course of ordinary business. Put and call options deal with these cases and, not surprisingly, are the most commonly used transfer restrictions. Likely circumstances of using various transfer clauses are summarized in Table 3–I below.

Given the role of contractually created exit rules, investors need explanations when and how to rely on various transfer clauses and their variations. Not only different transfer restrictions are used to address specific problems of cooperation of business partners, but modifications of each of them do have varying outcomes for the involved parties. Accordingly, standard forms applied to all firms on a one-size-fits-all approach cannot be satisfactory. The choices of large sophisticated actors documented in this study can assist in understanding particular circumstances where one or the other transfer restriction ensures the pursued outcomes. Although the study relies on data from the operating agreements of LLCs, the results can be extended to other forms of limited liability organizations—specifically, to closely-held corporations.

Table 3–I. Particular circumstances of employing transfer clauses

TYPE OF THE RIGHT	CONDITIONS FOR APPLYING
First purchase right	Appropriate for companies where the identity of shareholders matters for investing and share transfers to third parties can affect the balance of power within the company. A *right of first refusal* may be used if the number of shareholders is small; in companies with a large number of shareholders, a *right of first offer* may be preferable.
Tag-along right	*Pro rata tag-along clause* is used as a substitute for a minority right to block change-of-control transactions and in cases of waiving the fiduciary duties of controlling members and managers; useful if the company has more than two members and an express controlling shareholder. *Full tag-along right* is suited for companies where groups of shareholders are of equal bargaining power and the arrival of a new shareholder can change this balance.
Minority put/call option	*Put option* is effective for minority protection in cases where minority investors do not have strong voting and other rights to protect their interests. *Call option* is appropriate for dealing with majority self-dealing and hold-up strategies in companies where minority cannot veto large transactions but has strong financial position and expertise to manage the business independently; in companies where minority can affect voting, a call option is used for solving decision-making deadlocks.
Majority call option	Used for overcoming minority veto and other minority hold-up problems; activation is conditional upon special circumstances, such as a decision-making deadlock over large transactions, failure to invest, breach of the agreement, other.
Buy/sell-out option	Appropriate for solving deadlocks and other conflicts in companies where both (groups of) shareholders have equal voting rights, have access to financial resources, and each could continue the business without the other.

Table 1. Logit model of using first purchase rights

Independent variables	**1**				**2**			
	First purchase rights	**ROFR**	**ROFO Seller**	**ROFO Holder**	**First purchase rights**	**ROFR**	**ROFO Seller**	**ROFO Holder**
Number of LLC members								
Two members	0.0521	0.0551	-0.0602	0.0431				
	(0.0674)	(0.0616)	(0.0452)	(0.0365)				
Voting rights								
Unanimous voting or veto rights					0.1708***	0.1112*	0.0226	0.0174
					(0.0609)	(0.0583)	(0.0450)	(0.0321)
Member controlling more than 50%					-0.0728	-0.0864	0.0464	-0.0611*
					(0.0644)	(0.0579)	(0.0484)	(0.0332)
Minority managing member					-0.0069	0.0470	-0.0050	0.0591
					(0.0923)	(0.0857)	(0.0704)	(0.0361)
Contractual rights								
No fiduciary duties for managers	0.1594**	0.1410*	0.0386	0.0288	0.1605**	0.1498**	0.0240	0.0322
	(0.0733)	(0.0731)	(0.0537)	(0.0417)	(0.0721)	(0.0722)	(0.0535)	(0.0404)
Industry effect								
Mining, oil and gas	0.0607	0.0888	-0.0611	0.0357	0.0493	0.0815	-0.0673	0.0371
	(0.0938)	(0.0844)	(0.0760)	(0.0355)	(0.0929)	(0.0838)	(0.0761)	(0.0351)
Manufacturing	0.0798	0.1044	-0.0065	-0.0474	0.0888	0.1146	-0.0016	-0.0342
	(0.0947)	(0.0848)	(0.0650)	(0.0590)	(0.0929)	(0.0836)	(0.0651)	(0.0562)
Real estate	-0.1837**	-0.1369	-0.0364	-0.0918	-0.1654*	-0.1257	-0.0647	-0.0867
	(0.0835)	(0.0843)	(0.0613)	(0.0609)	(0.0903)	(0.0921)	(0.0667)	(0.0614)
Services	0.1739*	0.1665**	0.0301	-0.0085	0.1972**	0.1811**	0.0445	-0.0101
	(0.0939)	(0.0817)	(0.0599)	(0.0455)	(0.0918)	(0.0805)	(0.0603)	(0.0441)
Log likelihood	-156.10	-136.87	-90.25	-48.81	-151.59	-133.48	-90.56	-45.10
Pseudo R^2	0.0607	0.0619	0.0271	0.0883	0.0879	0.0852	0.0238	0.1578
Log likelihood ratio	20.18***	18.07***	5.03	9.46	29.20***	24.85***	4.42	16.90**
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of any first purchase right (columns 2 and 6) or one of the three variations of first purchase rights (columns 3–5 and 7–9). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes). ROFR stands for a right of first refusal; ROFO Seller and ROFO Holder are rights of first offer where the seller or right-holder offers the sale price, respectively.

Table 2. Logit model of using tag-along and drag-along rights

Independent variables	*1*				*2*			
	Tag-along right	**Full tag-along right**	**Pro rata tag-along right**	**Drag-along right**	**Tag-along right**	**Full tag-along right**	**Pro rata tag-along right**	**Drag-along right**
Number of LLC members								
Two members	-0.1841***	0.0451	-0.2029***	-0.1711***				
	(0.0554)	(0.0432)	(0.0443)	(0.0505)				
Voting rights								
Unanimous voting or veto rights					-0.1276**	0.0296	-0.1544***	-0.0894*
					(0.0567)	(0.0384)	(0.0494)	(0.0535)
Member controlling more than 50%					0.0455	0.0543	0.0082	0.1136**
					(0.0622)	(0.0452)	(0.0548)	(0.0570)
Minority managing member					-0.1113	-0.0812	-0.0324	-0.0206
					(0.0997)	(0.0660)	(0.0984)	(0.0986)
Contractual rights								
No fiduciary duties for managers	0.0905	-0.0673*	0.1753***	0.1454**	0.0714	-0.0682*	0.1584**	0.1218*
	(0.0692)	(0.0393)	(0.0647)	(0.0667)	(0.0689)	(0.0399)	(0.0665)	(0.0667)
Industry effect								
Mining, oil and gas	0.0157	-0.0675	0.0429	-0.0757	0.0158	-0.0584	0.0356	-0.0807
	(0.0898)	(0.0940)	(0.0743)	(0.0870)	(0.0899)	(0.0930)	(0.0755)	(0.0873)
Manufacturing	0.1776**	0.0837	0.0885	0.1262	0.1806**	0.0822	0.0934	0.1330*
	(0.0867)	(0.0621)	(0.0720)	(0.0779)	(0.0862)	(0.0615)	(0.0728)	(0.0777)
Finance and insurance	-0.2362*	-0.0277	-0.2055*	-0.0126	-0.2325*	-0.0250	-0.2271*	-0.0026
	(0.1326)	(0.0946)	(0.1220)	(0.0998)	(0.1331)	(0.0943)	(0.1264)	(0.1004)
Real estate	-0.1501*	0.0519	-0.2809***	-0.2522***	-0.1662*	0.0754	-0.3321***	-0.3115***
	(0.0861)	(0.0570)	(0.0992)	(0.0931)	(0.0904)	(0.0583)	(0.1047)	(0.0969)
Services	0.1040	0.0644	0.0456	0.0827	0.1123	0.0684	0.0439	0.0948
	(0.0871)	(0.0646)	(0.0726)	(0.0784)	(0.0877)	(0.0643)	(0.0747)	(0.0794)
Log likelihood	-137.64	-69.33	-110.30	-123.29	-138.05	-67.98	-113.54	-124.18
Pseudo R^2	0.1250	0.0608	0.2068	0.1550	0.1224	0.0791	0.1836	0.1489
Log likelihood ratio	39.32***	8.98	57.53***	45.22***	38.51***	11.67	51.05***	43.45***
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of any tag-along right (columns 2 and 6), one of the two variations of tag-along rights (columns 3–4 and 7–8), or a drag-along right (columns 5 and 9). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes).

Table 3. Logit model of using put options, call options, and buy/sell-out clauses

Independent variables	*1*				*2*			
	Buy/sell-out clause	**Put right, holding ≤ 50%**	**Call right, holding ≤ 50%**	**Call right, holding ≥ 50%**	**Buy/sell-out clause**	**Put right, holding ≤ 50%**	**Call right, holding ≤ 50%**	**Call right, holding ≥ 50%**
Number of LLC members								
Two members	0.2728***	0.0115	0.2315***	0.1947***				
	(0.0784)	(0.0505)	(0.0712)	(0.0661)				
Voting rights								
Unanimous voting or veto rights					0.3164***	-0.0212	0.1544***	0.1876***
					(0.0678)	(0.0462)	(0.0560)	(0.0586)
Member controlling more than 50%					0.0449	0.1087*	-0.0293	0.0729
					(0.0503)	(0.0570)	(0.0536)	(0.0628)
Minority managing member					0.0190	-0.0664	-0.0035	-0.1500*
					(0.0581)	(0.0730)	(0.0668)	(0.0864)
Contractual rights								
No fiduciary duties for managers	0.0116	-0.0470	-0.0309	0.0429	0.0123	-0.0523	-0.0087	0.0555
	(0.0574)	(0.0498)	(0.0577)	(0.0698)	(0.0554)	(0.0494)	(0.0582)	(0.0692)
Industry effect								
Mining, oil and gas	-0.2910**	0.0475	-0.0026	0.0097	-0.2715**	0.0539	-0.0027	0.0154
	(0.1359)	(0.0745)	(0.0809)	(0.0931)	(0.1240)	(0.0736)	(0.0813)	(0.0920)
Manufacturing	-0.0573	0.0241	0.0387	0.0786	-0.0641	0.0205	0.0271	0.0612
	(0.0818)	(0.0791)	(0.0819)	(0.0919)	(0.0759)	(0.0779)	(0.0815)	(0.0906)
Real estate	0.0725	0.0848	0.0756	0.0924	0.0762	0.0919	0.1139*	0.1525*
	(0.0531)	(0.0620)	(0.0620)	(0.0744)	(0.0576)	(0.0636)	(0.0685)	(0.0796)
Services	-0.0452	0.0774	-0.0216	0.0554	-0.0276	0.0760	-0.0311	0.0611
	(0.0825)	(0.0719)	(0.0916)	(0.0942)	(0.0774)	(0.0714)	(0.0916)	(0.0931)
Log likelihood	-96.66	-96.68	-108.12	-137.27	-88.54	-93.35	-110.20	-135.49
Pseudo R^2	0.1669	0.0172	0.0830	0.0471	0.2396	0.0511	0.0653	0.0594
Log likelihood ratio	39.56***	3.38	19.58***	13.56**	55.80***	10.05	15.41*	17.12**
Observations	243	243	243	243	243	243	243	243

Dependent variable is the choice of a minority put option (columns 3 and 7), a call option held by a minority or a majority member (columns 4 and 8 and columns 5 and 9, respectively), or a buy/sell-out clause (columns 2 and 6). The logit model reports marginal effects and standard errors (in parentheses). One asterisk indicates significance at the 10% level; two asterisks denote significance at the 5% level; and three asterisks at the 1% level. The first regression uses the number of LLC members, their contractual investor rights, and industrial division of the sample firms as independent variables. The second regression replaces voting rights for the number of members. All independent variables are dummy variables taking values 0 (if the answer to the underlying question is negative) or 1 (if the answer is positive). Industrial division is defined based on the first two digits of the Standard Industrial Classification Codes (SIC codes).

4. LIMITED LIABILITY PARTNERSHIPS IN THE UNITED KINGDOM

I. INTRODUCTION

The rise of hybrid business forms, which combine the corporate feature of limited liability with partnership-style flexibility and default rules, in different parts of the world during the late 1980s and early 1990s did not pass by the United Kingdom.[829] The Limited Liability Partnership Act 2000 (the LLP Act), which received Royal Assent on 20 July 2000, created a new business vehicle, the LLP. The act came into force in Great Britain in April 2001 and has been extended to Northern Ireland since October 2009, thus entirely covering the UK. The new business form quickly became popular—more than 100,000 LLPs have been incorporated since its introduction. Nevertheless, the arrival of the LLP, in contrast to its US peer, the LLC,[830] has not changed the business organizational landscape in the country. Only 1.7% of the newly incorporated firms chose the LLP during the year ended on 31 March 2014 and less than 2% of all firms on the UK company registers at the end of the same year were organized as LLPs.[831] Most of the businesses prefer the private limited company.

This chapter aims to explore the role of the LLP as an alternative to the private limited company by identifying aspects where the LLP form can offer comparative advantages. The benchmark for the comparison is the US, where LLCs outnumber corporations in new business formations in the majority of the states and where more than one-third of all active businesses are formed as LLCs.[832] More specifically, the focus is on the Delaware LLC—a business form giving its members broad latitude in regulating the matters of internal

[829]In the United States, strong competition among the states induced local legislators to enact different new business forms—limited liability companies (LLCs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLPs), and other—during a relatively short period.

[830]At first glance, given the same names, the US business form comparable with the UK LLP is the limited liability partnership, rather than the limited liability company. However, the UK LLP is very different from LLPs formed in the US states because the LLP Act limits the application of partnership law to LLPs and adapts rules applicable to companies. LLP Act 2000, ss.1(5) and 15. *See also* Caroline Bradley, *Twenty-First Century Anglo-American Partnership Law?*, 30 COMM. L. WORLD REV. 330, 338-39 (2001); Vanessa Finch & Judith Freedman, *The Limited Liability Partnership: Pick and Mix or Mix-Up?*, [2002] J.B.L. 475, 480 (2002); Geoffrey Morse, *Partnerships for the 21st Century?—Limited Liability Partnerships and Partnership Law Reform in the United Kingdom*, [2002] SINGAPORE J. LEGAL STUD. 455, 462 (2002).

[831]*See infra* Part II of this Chapter.

[832]*See supra* Part II of Chapter 1.

governance.[833] Obviously, the success of the LLC in the US is, at least partially, the result of making available features that are not offered by corporations and other equivalent business forms. First and foremost, these features are pass-through partnership taxation and a flexible governance structure (particularly, the ability of the LLC members to restrict the application of fiduciary duties).

The UK LLP is a flexible business form as well. Its internal governance structure is subject to few statutory rules, most of which apply in the absence of a contrary agreement of the members of an LLP. More than fifteen years have passed since the introduction of the LLP. Enough data has been accumulated during this period to judge about the role of the LLP form in the UK business landscape. Even descriptive data show that it has not succeeded in challenging the leading position of the private company both in new incorporations and among all active firms.

The analysis demonstrates that the LLP form is (1) more demanded among large professional firms (accountants, consultants, lawyers), (2) unlike the private limited company, is not used by foreigners, and (3) can be valuable for large businesses as a special vehicle for organizing joint ventures and investment funds, but is of limited use for small businesses. The failure of the LLP to challenge the private limited company is the direct result of its inability to offer significant comparative advantages over the private limited company. The LLP offers only limited improvements both in taxation and in flexible governance. First, the UK regime for corporate taxation is more relaxed than corporate taxation in the US; hence, partnership taxation of LLPs brings limited advantages.[834] Second, a small number of court decisions interpreting rules on LLP governance offer very limited guidance to the potential users of the LLP as to the extent of possible modifications of the statutory default rules. Moreover, traditionally broad freedom of contract offered by the UK companies law reduces the value added of the flexible governance structure of LLPs.[835]

The rest of this Chapter proceeds as follows. Part II tracks the introduction of the LLP in the UK and presents recent statistical data on the use of this business form. Part III is the main comparative part of the study which analyzes the LLP governance in a comparative framework juxtaposing the UK LLP and the UK private limited company, on the one side, and the Delaware LLC and the Delaware corporation, on the other. Part IV summarizes the results of the comparative analysis. Finally, Part V concludes the Chapter.

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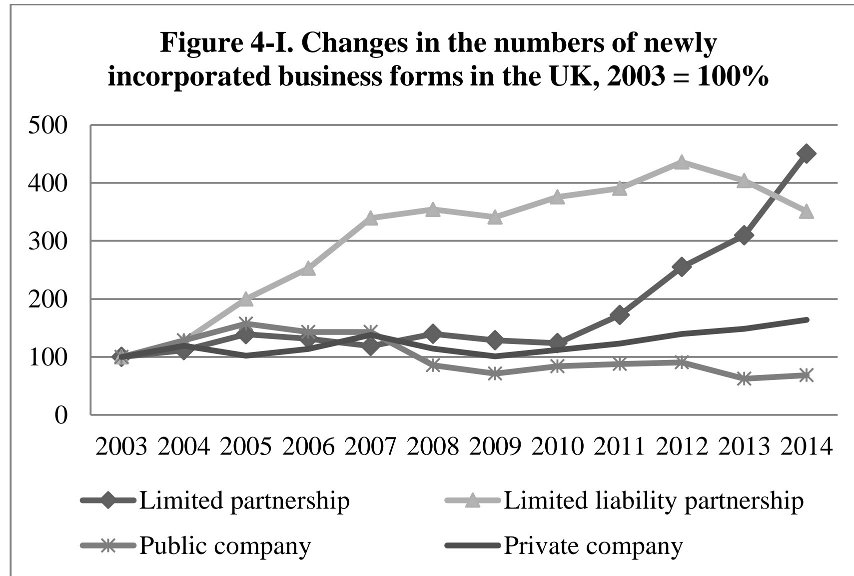
[833] *See* DEL. CODE ANN. tit. 6, § 18–1101(b) ("It is the policy of [the Delaware Limited Liability Company Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.").

[834] *See infra* Part II of this Chapter.

[835] *See infra* Parts III–IV of this Chapter.

II. BRIEF HISTORY OF THE LIMITED LIABILITY PARTNERSHIP

Back in 1997, the UK government proposed the introduction of a new hybrid business form, the first such innovation for over a century.[836] The new form first and foremost was designed for large professional firms which desired limited liability[837] and it was the pressure from these firms that induced the government to act.[838] The legislative proposal was introduced to the parliament in late 1999 and, following the approvals by the House of Lords and the House of Commons, received Royal Assent on 20 July 2000. The LLP Act introduced a new business vehicle, the LLP, in England and Wales and in Scotland. Since October 2009, the act has been effective also in Northern Ireland. The LLP Act is applied along with Limited Liability Partnerships Regulations 2001, 2008, and 2009, which provide detailed rules and extend to LLPs some provisions of the Companies Act 2006.



Source: UK Companies House; own calculations.

The LLP quickly became popular. During the following decade, the number of newly created LLPs was growing steadily at a rate well above other organizational forms (Figure 4–I). Currently it is the third

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[836]Judith Freedman, *Limited Liability Company in the United Kingdom—Do They Have a Role for Small Firms?*, 26 J. CORP. L. 897 (2001).

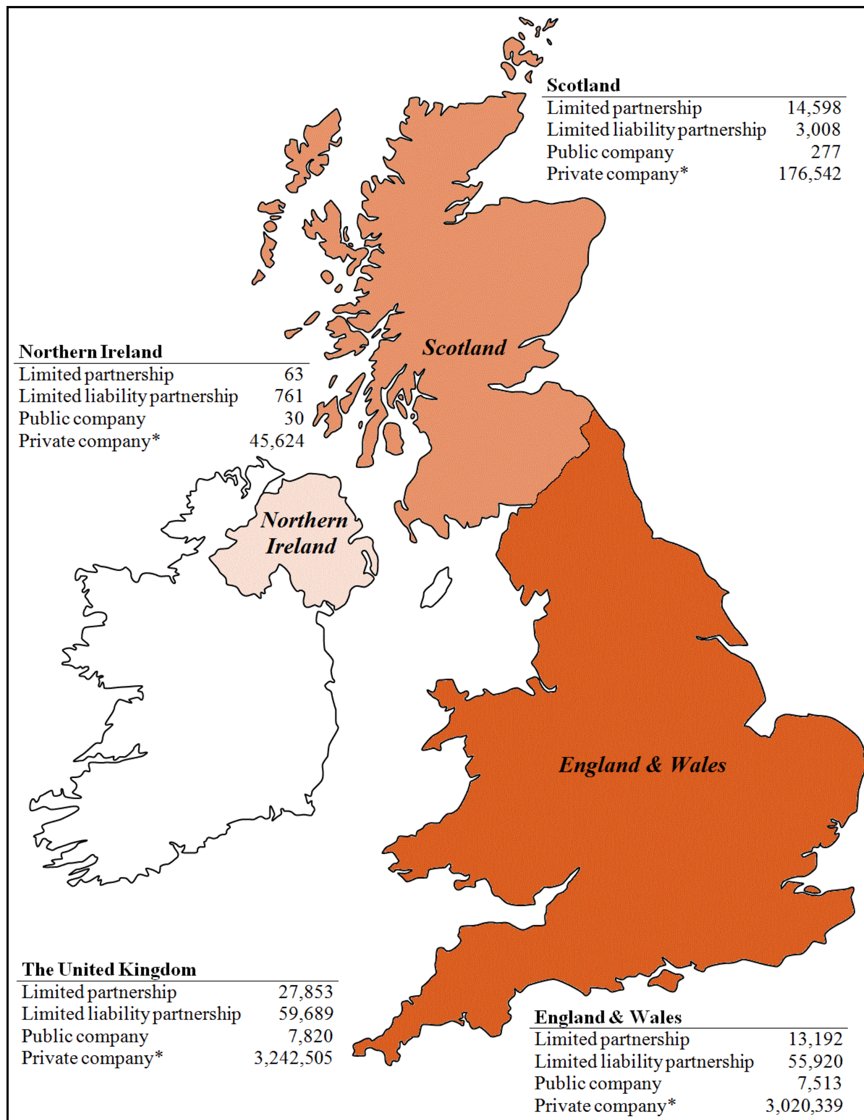
[837]*See id.*, at 899.

[838]*See id.*, at 905; VERMEULEN, *supra* note 4, at 119–20; Mathias M. Siems, *Regulatory Competition in Partnership Law*, 58 I.C.L.Q. 767, 800 (2009).

most popular incorporated business form.[839] But the leading position of the private company limited was and remains so strong that the arrival of the LLP has not altered the general business organizational landscape in the UK. More than 95% both of the newly incorporated firms and of all incorporated firms are private companies, according to the UK Companies House recent data (see Figure 4–II).

[839]According to Business Population Estimates prepared by the Department for Business, Innovation and Skills, in addition to incorporated business forms, there were approximately 3,275,000 sole proprietorships and 456,000 partnerships active at the start of 2014. Most of them were small businesses and together represented 23.72% of employment and 7.67% of turnover of all private sector businesses in the UK.

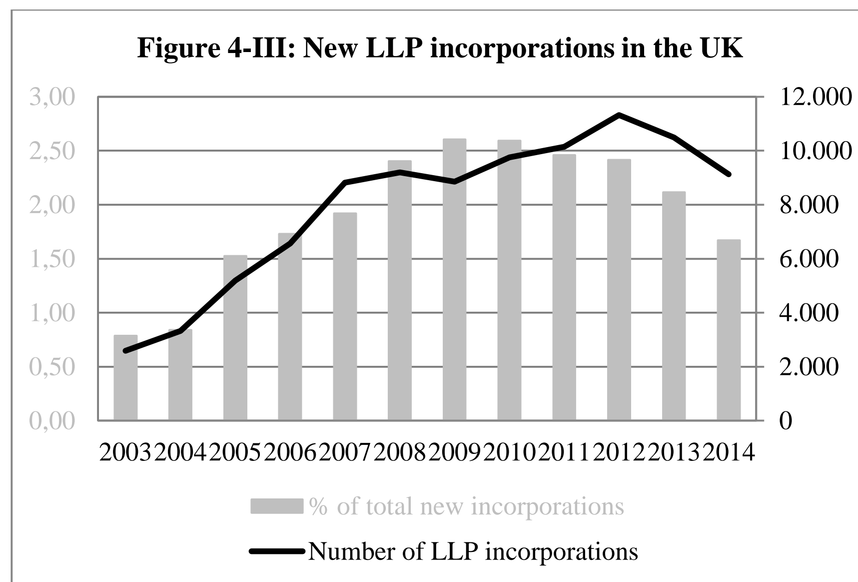
Figure 4–II. Incorporated businesses on the UK registers, 31 March 2014



Source: UK Companies House; own calculations.
* Includes private limited, private limited by guarantee/no share capital, private unlimited, and private unlimited/no share capital companies.

The share of firms choosing the LLP form upon incorporation did not differ significantly in different parts of the UK during the decade following the enactment of the LLP Act. It remained stable in England and Wales and Scotland and was only slightly higher in Northern Ireland at the beginning of the period. Whereas limited liability partnerships play an equal role in different parts of the UK, limited partnership

incorporations are not equally distributed. Historically, Scotland had higher share of LP incorporations than others. Following the 2008 crisis, Scotland's position became stronger as it witnessed stable and strong growth in the numbers of newly incorporated LPs which also affected LP incorporations nationwide. This growth came at the expense of Scottish private companies. Their share, in contrast to the percentage of private companies in England and Wales and Northern Ireland, gradually dropped from 94.2% in 2010 to 87.3% in 2014.



Source: UK Companies House; own calculations.

During the recent years, the rising popularity of private companies nationwide and LPs in Scotland, accompanied by a decline in the numbers of newly established LLPs, led to the reduction of the share of LLPs in new business formations. Figure 4–III shows the dynamics of LLP incorporations in the UK.

The LLP form was designed for professionals and, as is shown below, this has left its mark and, perhaps, has contributed to its limited use thus holding back the reshaping of the business landscape in a manner similar to the US. Indeed, taxation can be another, and perhaps more important, reason contributing to the popularity of LLPs in the US but generating limited interest for LLPs in the UK—whereas both forms are taxed as partnerships, corporate taxation is more burdensome in the United States than in the United Kingdom.[840]

[840]*See* Freedman, *supra* note 836, at 913–14; Finch & Freedman, *supra* note 830, at 500–501.

Table 4–I. Industrial representation of UK LLPs

Industry	Number	Percentage in total
Legal services†	1,733	2.98
Construction	1,134	1.95
Financial services	1,030	1.77
Non-life insurance	748	1.28
Business consulting & other business support	342	0.59
Accounting & audit	323	0.55
Real estate management	322	0.55
Architecture & engineering	240	0.41
Transportation	230	0.39
Real estate agencies	182	0.31

Sources: Orbis; Solicitors Regulation Authority; own calculations.
The sample includes 58,230 LLPs formed in the UK. The latest data are for 2013 or 2014. Industrial classification codes are available for approximately 11.5% of the sample.
† The number of LLPs in the legal services sector includes 1,566 law firms registered in England and Wales in December 2014 and operating as LLPs, 39 Scottish law firms operating as LLPs, and 128 law firms functioning in other EU member states but organized as UK LLPs. The Orbis database includes only 639 UK-based firms classified as law firms and 128 foreign law firms.

Data from Orbis, a global company database provided by Bureau van Dijk, give some impression about the demand for LLPs from different businesses. The database contains information on 58,230 LLPs formed in the UK. This number comes very close to the number of incorporated LLPs on the UK registers. Approximately 11.5% of the firms in the Orbis database have industrial activity classification codes. The data show that these LLPs are mostly used by professional service firms, such as law firms, accounting and audit firms, business consultants, and financial services firms (Table 4–I). In particular, 94 of the 100 largest UK-based law firms ranked by revenue [841] are organized as LLPs. The remaining six, including highly-ranked Slaughter and May, have preserved a general partnership or limited company structure. The share of LLPs among all law firms registered in England and Wales is about 15%, according to the Solicitors Regulation Authority.[842] Half of the top 100 UK accounting firms in 2014 were operating as LLPs.[843] The sample LLPs without industrial activity classification codes, although could also include professionals, were in most cases either

[841]There are several rankings of UK-based law firms. The ranking used here is compiled by Legal Business (LB100 2014: The Main Table).

[842]In December 2014, there were 10,324 registered solicitors firms in England and Wales. The breakdown of these firms by the organizational type was the following: incorporated companies—3,501 (34%), sole practitioners—2,809 (27%), partnerships—2,386 (23%), limited liability partnerships—1,566 (15%), and other—62 (1%).

[843]The ranking of the largest UK-based accounting firms is prepared annually by Accountancy Age, a magazine for accountants.

small businesses or were used in tax minimization schemes and did not engage in actual trade.

A small share of LLPs was formed by foreigners for conducting main activities outside the UK.[844] Among EU member states, the absolute numbers of such LLPs are the largest for the Netherlands and Germany (216 and 92 firms, respectively). Whereas LLPs functioning in Germany were mostly used by local law firms (more than 80% of cases), "Dutch LLPs" represented both professional service firms and small businesses from various industries.

III. CONTRACTUAL FREEDOM IN THE LIMITED LIABILITY PARTNERSHIP GOVERNANCE

A. Legal Formalities

The UK LLP is a flexible business form that is subject to few legal limitations. One of such limitations is the minimum number of members. Although the LLP has more in common with the private limited company than with traditional partnerships,[845] similar to partnerships, it shall have at least two members. If an LLP carries on business with one member for more than six months and the sole member is aware of this fact, then the sole member is personally liable for the debts of the LLP incurred after those six months.[846] Courts may also wind up an LLP when the number of its members is reduced below two.[847]

On the other hand, incorporation of an LLP, like for companies, requires a formal registration.[848] The registration procedure maximally

[844]The database does not provide information about the main center of activities of the firms. Therefore, this chapter follows an approach used previously in the literature for identifying the nationality of LLPs. *See* Marco Becht, Colin Mayer, & Hannes F. Wagner, *Where Do Firms Incorporate? Deregulation and the Cost of Entry*, 14 J. CORP. FINANCE, 241, 244–45 (2008). All LLPs were classified as either *foreign LLPs*, which had their center of activity outside the UK, or *domestic LLPs*, which were doing business in the UK. The first criteria for defining a nationality of an LLP is the geographic location of its members. If at least half of the members of an LLP were nationals or residents of a country other than the UK, the author manually searched for information about the LLP's main center of activities in the internet. In addition to the geographic location or nationality of members, a measure based on address clusters of the sample LLPs was used. For this, the author checked whether the UK address of an LLP was virtual, which could be shared with many other firms from the sample, or was a unique address used only by a particular LLP and other LLPs affiliated with it (sharing main members). This measure is important to prevent treating as foreign LLPs the subsidiaries of foreign firms formed in the UK and doing business there.

[845]According to Professor Geoffrey Morse, it should "perhaps have been called an LLC." PALMER'S LIMITED LIABILITY PARTNERSHIP LAW, para. A1–03 (Geoffrey Morse et al. eds, 2011).

[846]*See* LLP Act 2000, s.4A.

[847]*See* Insolvency Act 1986, s.122(1)(c), as modified by the LLP Regulations 2001, reg.5.

[848]*See* LLP Act 2000, s.3.

resembles the procedure for registration of private companies. In the incorporation document, the LLP founders shall state its name, the address of its registered office, information about the members, and indicate the designated members of the LLP.[849] An LLP comes into existence after the issuance of the certificate of incorporation by the registrar.[850] This procedure is more formal than the formation of a Delaware LLC. The latter does not require an incorporation and is formed after filing a certificate of formation with the office of the Secretary of State.[851] In addition, an LLP must ensure that information about changes in the composition of its members is timely disclosed to the company registrar.[852]

Procedural formalities of member meetings and manager meetings—such as notices, the establishment of a record date, quorum requirements, minimum voting thresholds—shall be defined in an LLP agreement. In this aspect, the LLP does not differ from the Delaware LLC.[853] But this lack of regulation is in stark contrast to companies, where the procedural aspects of shareholder meetings are heavily regulated.[854] This flexibility, although beneficial in cases where members prefer to customize the LLP governance structure, may lead to gaps in poorly drafted governing documents.

The partnership-like internal structure of the LLP implies that formalities have narrower scope than in the company law setting. On the other hand, with limited liability come disclosure and accounting requirements that traditionally apply to companies, but not to partnerships. There is a significant difference in the width of disclosure rules between the European countries on one hand and the United States on the other. Whereas in the US only listed firms are required to disclose their financial results to general public, in Europe all incorporated business forms (and non-incorporated partnerships with incorporated partners) are obliged to disclose their accounting documents.[855] The European legislation distinguishes micro, small, medium-sized, and large firms and allows member states to impose simplified preparation and

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[849]The law imposes certain statutory duties on the designated members, including communications with the company registrar in relation to changes in the LLP's registered particulars and the LLP's accounts. Their functions resemble to the external administrative duties of a director or secretary of a company.

[850]*See* LLP Act 2000, s.3(1).

[851]*See* DEL. CODE ANN. tit. 6, § 18–201(a), § 18–206(a).

[852]*See* LLP Act 2000, s.9(1).

[853]*See* DEL. CODE ANN. tit. 6, § 18–302(c) (for member meetings), § 18–404(c) (for manager meetings).

[854]*See* Companies Act 2006, Pt 13. The Companies Act contains only few rules regulating the conduct of board meetings (e.g., s.248 requires the preparation and maintenance of the minutes of board meetings). However, the model articles of association for both private and public companies contain detailed procedural rules for conducting board meetings. *See* Companies (Model Articles) Regulations 2008, Schedules 1 and 3.

[855]*See* Wolfgang Schön, *Corporate Disclosure in a Competitive Environment—The Quest for a European Framework on Mandatory Disclosure*, 6 J.C.L.S. 259, 260 (2006).

disclosure requirements for micro (can draw up abridged balance sheet and profit and loss accounts; are exempt from disclosing profit and loss accounts), small (can draw up abridged balance sheets and profit and loss accounts; are exempt from publishing profit and loss accounts), and medium-sized (can prepare abridged profit and loss accounts; are permitted to publish abridged balance sheet) firms.[856] Micro and small firms are also exempt from the mandatory auditing requirement.[857]

Since the UK national lawmakers have extended the EU-level requirements to LLPs, in disclosure aspects, the LLP hardly differs from the private limited company. First, an LLP shall annually update information about the address of its registered office, the address where its records are kept, and the identities of its members. This information is filed with the company registrar and is called an annual report.[858] Second, an LLP shall keep adequate accounting records[859] which, if the LLP is not qualified as a small, shall be audited.[860] Third, an LLP shall send a copy of its annual accounts and auditor's report, if applicable, for each financial year to every LLP member and debenture holder.[861] Fourth, designated LLP members shall within nine months after the end of the relevant accounting period file the annual accounts and auditor's report of the LLP with the company registrar.[862] For small LLPs, the filing requirement covers at minimum the year-end balance sheet;[863] medium-sized and large LLPs, in addition to the balance sheet, must file also the profit and loss account and the auditor's report.[864] All information provided to the company registrar can be accessed by the general public.

Disclosure, accounting, and audit requirements distinguish the LLP from the Delaware LLC. The latter, notwithstanding the feature of limited liability, is not subject to equivalent requirements. Therefore, whereas both the LLP and the Delaware LLC are comparable for the purposes of legal formalities in internal governance, the LLP is subject to stringent public control and information rules.

Under the default statutory rule, all LLP members have a right to access to and inspect the LLP's books and records.[865] The default rule

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[856] *See* Directive 2013/34/EU of the European Parliament and of the Council of 26 Jun. 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, 2013 O.J. (L 182), art.14(1) and (2), art.31(1) and (2), art.36(1)(d), art.36(2).

[857] *See id.*, art.34(1).

[858] *See* Companies Act 2006, ss.854, 855 and 855A, as modified by the LLP Regulations 2009, reg.30.

[859] *See id.*, s.386, as modified by the LLP Regulations 2008, reg.6.

[860] *See id.*, s.475(1), as modified by the LLP Regulations 2008, reg.33.

[861] *See id.*, s.423(1), as modified by the LLP Regulations 2008, reg.13.

[862] *See id.*, ss.441 and 442(2), as modified by the LLP Regulations 2008, reg.17.

[863] *See id.*, s.444, as modified by the LLP Regulations 2008, reg.17.

[864] *See id.*, ss.445 and 446, as modified by the LLP Regulations 2008, reg.18 and 19.

[865] *See* LLP Regulations 2001, reg.7(7).

covers any documents and information that relate to the business of the LLP.[866] This right can be limited partially or waived completely by an LLP agreement. The default term is reversed for companies—access to the company's books and records is limited to the officers;[867] shareholders obtain this right only if it is included in the company's articles of association.[868] Under Delaware law, information rights of corporate stockholders and LLC members are subject to the qualifying standard of "any purpose reasonably related to such person's interest as a stockholder (LLC member)."[869] This qualifying standard aims to balance the information right of stockholders (LLC members) with the need to prevent undue interference from passive investors with the management rights of directors.[870] Unlike corporate stockholders, LLC members are free to restrict or eliminate information rights of members and managers.

B. Ownership Structure and Member Contributions

An LLP has no share capital. This is an obvious difference from companies, where share capital is an essential attribute of limited companies with shares.[871] However, at the functional level the difference is less pronounced. A person becomes an LLP member at its foundation or a later stage by the means of contributing tangible and intangible assets to the property of the partnership or in exchange of a promise to contribute such assets in the future or provide some future services to the LLP; it can become an LLP member also without making or being obliged to make a contribution.[872] Because an LLP has a separate legal personality, it is the owner of the contributed assets and the members do not have direct interest in these assets. However, members have rights and obligations conferred upon them by the LLP agreement and/or statutory default rules. These rights and obligations constitute their interest in the LLP. LLP interest, like shares in a limited company, can be transferred in whole or partially. Both company shares and LLP interests provide their holders with similar financial claims. For practical

[866]*See* Hilton v. D IV LLP [2015] EWHC 2 (Ch) at [35].

[867]*See* Companies Act 2006, s.388(1)(b).

[868]*See* Companies (Model Articles) Regulations 2008, Schedules 1 (art.50) and 3 (art.83).

[869]*See* DEL. CODE ANN. tit. 8, § 220(b) (for corporations); DEL. CODE ANN. tit. 6, § 18–305(a) (for LLCs).

[870]*See* Seinfeld v. Verizon Communications, Inc., 909 A.2d 117, 122 (Del. 2006).

[871]Limited companies can be limited by shares or limited by guarantee. In the former case, the liability of a shareholder cannot exceed the amount the shareholder has to contribute for receiving its shares. In limited companies by guarantee, the shareholders' liability is limited to such amount as they undertake to contribute to the assets of the company in the event of its winding-up. Companies Act 2006, s.3(1)–(3).

[872]In addition to new members, LLPs can have also substituted members which become members by the way of an LLP interest transfer from the current members. New members, meanwhile, acquire newly issued interest directly from the LLP.

reasons, whether they are forming a share capital is thus of less importance. The situation is similar in Delaware LLCs.

The rules on ownership structure of an LLP are flexible. By default, all members have equal rights.[873] An LLP agreement may provide for classes or groups of members having such relative rights, powers, and duties as provided in the agreement. Certain classes or groups of members may be sidelined from voting on actions specified in the agreement, including such actions as the amendment of the LLP agreement or the creation of a new class or group of LLP interests. Companies can achieve similar results by issuing different classes of shares.

C. Management Structure

The ability to choose a management structure distinguishes the LLP from the private limited company. UK companies are subject to a mandatory two-level governance structure composed of the board of directors and the shareholder meeting. The requirement to establish a board is mandatory not only for public companies, but for private companies as well.[874] Internal affairs of the LLP, including its management structure, are left to contractual governance by the members of the LLP. In the absence of special regulation of an internal governance structure by the LLP agreement, the few default rules of the LLP Regulations 2001 apply.[875]

According to the default rule, the management of an LLP is conducted by its all members based on the one-member-one-vote rule.[876] The decisions, with the exception of decisions changing the nature of the business of an LLP, which require unanimous vote, are made by the majority of the members.[877] The default governance rule can be changed by opting for a centralized management or establishing other voting rules. Under the centralized management, instead of all LLP members, a single manager or several managers, whether LLP members or not, shall be responsible for the day-to-day decision-making. Different voting rules can alter the minimum voting threshold for decision-making or establish voting rights that can be either proportional to the interests of

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[873]*See* LLP Regulations 2001, reg.7(1) (for rights to financial distributions), reg.7(3) (for management rights), reg.7(7) (for information rights).

[874]*See* Companies Act 2006, s.154. For comparison, Delaware close corporations can choose to be managed by their stockholders. *See* DEL. CODE ANN. tit. 8, § 351. Section 342(a) of the Delaware General Corporation Law establishes minimum requirements for qualifying as a close corporation: a corporation should have not more than 30 stockholders and at least one share transfer restriction; obviously, a close corporation cannot make a public offering of its stock.

[875]*See* LLP Regulations 2001, reg.7.

[876]*See id.*, reg.7(3).

[877]*See id.*, reg.7(6).

the members in the capital and profits of the LLP or provide non-proportional voting rights to some members.

Electing a centralized management structure does not automatically activate company-type formalities like annual member meetings of LLP members and annual management elections. Taking into account that typically the number of LLP members is small and they do not encounter collective action problems, the members should be able to organize themselves such meetings and management elections as may be necessary. In most cases, however, such an election will necessitate detailed regulation of procedural rules in the LLP governance agreement.

D. Fiduciary Duties

The freedom of contract out of fiduciary duties is one of the principal differences of a Delaware limited liability company as opposed to corporate-type business forms. Whereas managers in corporations are subject to fiduciary duties of care and loyalty[878] and controlling stockholders[879] owe to the corporation and its minority stockholders at a minimum the duty of loyalty,[880] the rules of law and equity on fiduciary duties in the LLC setting are set as defaults. Therefore, the members of a Delaware LLC are free to (1) expand, restrict partially, or waive in full the fiduciary duties of members and managers, with the exemption of the implied contractual covenant of good faith and fair dealing,[881] or (2) limit or eliminate liability for breach of fiduciary duties, with the exemption of acts violating the implied contractual covenant of good faith and fair dealing in bad faith (exculpatory provisions).[882]

In practice, the founders of Delaware LLCs typically waive the duties of members where the companies are manager-managed and waive the duties of directors, but not officers, where the directors are

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[878]The duty of care requires that managers act on an informed basis and with care; in Delaware corporations, the applicable standard of care is gross negligence. *See* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985). The duty of loyalty requires directors and officers to act in the best interests of the corporation and its stockholders rather than further their private interests. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). Courts traditionally describe these duties as owed to the corporation and its stockholders. This formulation "captures the foundational relationship in which directors owe duties to the corporation for the ultimate benefit of the entity's residual claimants." *In re* Trados Inc. Shareholder Litig., 73 A.3d 17, 36–37 (Del. Ch. 2013).

[879]The owner of more than 50% of voting shares, whether directly or indirectly, is a controlling stockholder. A minority stockholder who exercises actual control over the corporation's business affairs qualifies as a controller as well. *See, e.g.*, *In re* Crimson Exploration Inc. Stockholder Litig., 2014 WL 5449419, at *10 (Del. Ch. 2014).

[880]*See, e.g.*, Kahn v. Lynch Commc'n Systems, 638 A.2d 1110, 1115 (Del. 1994). Delaware courts operate with the term "fiduciary duties of controlling shareholders" without specifying the exact type of the duty. Nevertheless, unless a controller engaged in a conflicted transaction, entire fairness review cannot be triggered. *See In re* Crimson Exploration Inc. Stockholder Litig., 2014 WL 5449419, at *12–14 (Del. Ch. 2014).

[881]DEL. CODE ANN. tit. 6, § 18–1101(c).

[882]*Id.*, § 18–1101(e).

nominees appointed for representing the interests of appointing members.[883] In the first case, as members are not involved in the management, the waiver of their duties is not likely to negatively affect minority rights as long as managers owe to the members and to the firm fiduciary duties. In the second case, the application of standard fiduciary duties can imperil the ability of nominee directors to promote the interests of particular members or other interested parties, such as large creditors. Special conflict of interest rules for related-party transactions ensure that controlling members cannot approve or direct nominee directors and officers to approve decisions that unfairly promote their interests at the expense of other members. These rules typically require the consent or vote of non-interested members/managers for the approval of transactions in which a member or manager has an interest. Apart from the modifications of fiduciary duties, exculpatory provisions are used to relax the standard of judicial review of the duty of care by creating a contractual equivalent of the corporate-type business judgment rule[884] for managers.[885]

Accordingly, the broad contractual freedom of the Delaware LLC law allows devising governance structures that fully reflect the underlying commercial relations among the members of an LLC. Where ex ante transaction costs are lower than ex post enforcement costs, partners can also engage in an efficiency-based choice between rules and standards at the contracting stage by substituting abstract fiduciary duties, which depend heavily on the enforcement by a third-party adjudicator, with clear decision-making rules. The resulting contractual governance structures reduce legal uncertainty, which otherwise might have encouraged strategic litigation with the aim of altering the results of the original agreements between the partners, and thus encourage investments.

Duties of directors have been an integral part of the UK company law as well. Originally developed in common and equity law,[886] they were codified by the Companies Act 2006.[887] This codification intended

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[883] *See supra* Part IV.G of Chapter 2.

[884] Under the business judgment rule, courts refuse to second-guess on business decisions of disinterested directors and review them under the entire fairness standard presuming that these decisions were made on an informed basis, in good faith, and in the honest belief that they were in the best interests of the corporation. The presumption must be rebutted by a plaintiff attacking the decision. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[885] *See supra* Part IV.G of Chapter 2.

[886] *See* Deirdre Ahern, *Directors' Duties, Dry Ink and the Accessibility Agenda*, 128 L.Q.R. 114, 115–16 (2012).

[887] Although the statutory duties replaced common law rules and equitable principles, they should be interpreted and applied in the same way as the duties they replaced (s.170(4)). The codified duties do not rule out the application of other common and equity law duties that have not been codified (s.170(3)). The first rule emphasizes the role of the preceding cases in assisting to construct and enforce the abstract duties; the second rule ensures the development of the law in areas where it has not been settled.

to improve the standards of corporate governance and to make the law more accessible to directors and their advisors.[888] The seven statutory duties owed by directors to the company are:

- duty to act within powers (s.171);
- duty to promote the success of the company for the benefit of its members as a whole, but taking into account the long-term effects of decisions, the employee interests, relations with suppliers, customers, community, and other factors (s.172);
- duty to exercise independent judgment (s.173);
- duty to exercise reasonable care, skill, and diligence subject to a dual objective/subjective standard[889] (s.174);
- duty to avoid conflict of interest/duty[890] with the company with regard to corporate opportunities and competing with the company (s.175);
- duty not to accept benefits from third parties (s.176); and
- duty to declare interest in self-dealing and related-party transactions to the board of directors (s.177) which is applied along with the rule forbidding substantial property transactions[891] between a company and its director or a connected person without obtaining prior or subsequent approval of the shareholders (ss.190-191). The latter is an extreme case of a self-dealing or related-party transaction[892] which, in addition to disclosure, given its size, is subject to a special approval procedure.[893]

These duties apply to any person occupying the position of a director, whether executive or non-executive, by whatever name called (s.250). They do not apply to shareholders who, under the English law, do not owe to the company and to each other general fiduciary duties.[894]

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[888]Lady Justice Arden, *Regulating the Conduct of Directors*, 10 J.C.L.S. 1, 3–4 (2010).

[889]The objective test of a reasonable diligent person sets the floor; the subjective test displaces it where the particular director under consideration has greater knowledge, skill, and experience than may reasonably be expected. *See* Brumder v. Motornet Service and Repairs Ltd [2013] B.C.C. 381, 392.

[890]Conflict of interest arises where a director has a direct interest in an arrangement. Conflict of duty occurs where, in addition to the duties toward the company, the director owes duties to others.

[891]Substantial property transactions involve assets with a value (1) exceeding 10% of the company's asset value and being worth more than £5,000 or (2) exceeding £100,000.

[892]Parker Hood, *Directors' Duties Under the Companies Act 2006: Clarity or Confusion?* 13 J.C.L.C. 1, 9 (2013).

[893]The rule does not apply (1) to a transaction between a company and its shareholder who is acting in its capacity as a shareholder, for instance, by subscribing for newly issued shares and (2) to transactions between a shareholder and its wholly-owned subsidiary or between two wholly-owned subsidiaries (s.192).

[894]The Companies Act 2006 imposes some limits on the discretion of controlling shareholders by entitling minority shareholders with a right to apply to a court for a remedy if the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of shareholders in general or of some shareholders in particular (s.994). The

According to s.179, the duties are cumulative in the sense that more than one of the general duties may apply in a given case. For the sake of clarifying the comparison of the duties in the UK and the UK, directors' duties of the Companies Act 2006 are grouped into two basic fiduciary duties: the duty in s.174 corresponds to duty of care, whereas the duties in ss.172–173 and ss.175–177 are the elements of duty of loyalty.

Although one of the principles driving the codification of directors' duties was that the company law generally had to be enabling,[895] the Companies Act 2006 places the duties among those provisions that justify prescriptive regulation. Only in limited cases the act allows shareholders to modify the application of some of the directors' duties. In particular, shareholders can approve specific or general derogations from the duty to exercise independent judgment in the company's constitution,[896] e.g., for nominee directors appointed for representing the interests of particular shareholders. The duty to avoid conflict of interest in cases of corporate opportunities and competing with the company can be waived on a case-by-case basis via the ex ante authorization procedure[897] or, under s.180(4)(b) of the Companies Act 2006,[898] in general by agreeing about the narrowed (but most likely not completely waived) duty in the company's articles of association or in a unanimous shareholders' agreement.[899] The duty to disclose interest in self-dealing and related-party transactions cannot be changed or modified. However, the company articles can go beyond a mere disclosure by requiring shareholder or board approval of these transactions. In the latter case, as well as in cases where the transaction falls within the authority of a board, the articles can forbid voting by the interested director(s).

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majority discretion is limited in two additional situations. First, when exercising its power to alter the company's articles, the majority is bound by an implied subjective test to act bona fide for the benefit of the company as a whole. *See* Greenhalgh v. Arderne Cinemas, LD. and Others [1951] Ch. 286, 291. Second, majority shareholders cannot under s.239 of the Companies Act 2006 ratify breaches of directors' duties where they constitute a fraud on the minority or prejudice the interests of creditors. *See* Franbar Holdings Ltd v. Patel [2009] Bus. L.R. D14, D17; Bilta (UK) Ltd v. Nazir [2013] 3 W.L.R. 1167, 1179.

[895] *See* Arden, *supra* note 888, at 4.

[896] *See* Companies Act 2006, s.173(2)(b). The courts have yet to rule on the possibility of waiving the duty altogether by the agreement (consent) of all shareholders.

[897] In private companies, unless the articles otherwise require, the duty can be authorized by non-interested directors (ss.175(5)(a) and 175(6)). In public companies, the authorization by disinterested directors is possible only if the company's constitution allows such authorization (ss.175(5)(b) and 175(6)). Alternatively, the company's articles can empower shareholders with an exclusive right to approve or consent conflicts of interests.

[898] According to s.180(4)(b), "where the company's articles contain provisions for dealing with conflicts of interest, [the general duties] are not infringed by anything done (or omitted) by the directors, or any of them, in accordance with those provisions."

[899] The possibility of abolishing the duty altogether is an open question because it is not clear whether s.180(4)(b) refers to alternative procedural rules for dealing with conflicts of interest or to the duty itself. But *see* Wilkinson v. West Coast Capital [2007] B.C.C. 717, 767 (with the exception of certain core duties, shareholders can agree about a narrower duty than might ordinarily apply or exclude a duty altogether).

In addition to the modifications of the duties, the company can release, whether in advance or after the event, its directors from breaching their duties. According to s.180(4)(a), where allowed by law, a company can authorize its directors specifically or generally to act in a way that would otherwise be a breach of duty. Under common law, actions of directors requested or approved by all shareholders cannot be challenged by the company on the ground of breaching directors' duties, because these actions, due to shareholder ratification, are the acts of the company.[900] This rule insulates directors from claims alleging a breach of duty in cases where they followed specific or general instructions of shareholders. The rule, however, is irrelevant for cases where two and more groups of shareholders may have conflicting views—a common situation in business organizations. The rule also does not apply if an authorized transaction is jeopardizing the company's solvency or causing loss to its creditors.[901] Section 239 of the Companies Act 2006 codified another judge-made rule[902] allowing *ad hoc* ratification by a company of conduct by its director amounting to negligence (duty of care) or breach of the fiduciary duties. Such ratification requires the approval of the majority of disinterested shareholders or unanimous consent of all shareholders.[903] Exculpatory provisions limiting the liability of directors for the breach of their duties are expressly prohibited by s.232(1) of the Companies Act 2006.

Thus, when it comes to private ordering of directors' duties, the users of UK companies have more room for action than the stockholders of US corporations. But contrary to the LLC members, they cannot freely waive or modify fiduciary duties or limit liability for the breach of duties. Some substantive and enforcement differences, however, diminish the importance of altering the duties in UK companies. Duty of care, although not relaxed by the application of the business judgment

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[900]*See* Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd [1983] Ch. 258, 268–69, 288–90.

[901]*See* Bowthorpe Holdings Ltd v. Hills [2002] EWHC 2331 (Ch) at [51]. The insolvency exception is justified because shareholders are not in a position to absolve directors from breaching a duty to creditors. The existence of a wider exception grounded on public policy concerns, which encompasses the insolvency exception, was acknowledged in the context of two of the numerous cases launched by the liquidation trustee of Bernard Madoff's investment firm in an attempt to recover funds lost in the multi-billion dollar fraud. Flaux J. expressed a view that shareholders cannot release directors from liability if the approved transaction is not honest, bona fide, and in the best interests of the company. Madoff Securities International Ltd v. Raven [2011] EWHC 3102 (Comm) at [107]–[123]. Popplewell J. clarified the legal question to ask whether the rule is inapplicable where the directors are acting honestly but the shareholders approve the transaction acting in bad faith. Madoff Securities International Ltd (In Liquidation) v. Raven [2013] EWHC 3147 (Comm) at [286]. Both justices, however, did not rule on the matter.

[902]*See* Pavlides v. Jensen [1956] 1 Ch. 565, 576.

[903]The decision to release directors from liability for a breach of duty, like many other business decisions, involves a risk and may prove to be a mistake. Therefore, the lack of knowledge of a breach of duty before ratifying the action, as long as shareholders are not mislead in their decision-making by directors, does not make the shareholders' act ineffective.

rule, is rarely enforced in practice.[904] In the field of corporate opportunities and conflicted transactions, the Companies Act 2006, just as the general law duties before they were replaced by the statutory duties of directors, takes an ex ante procedural approach. Rather than giving broad discretion to managers, which may become a subject of the fairness review by a judiciary at a later stage, the UK fiduciary law narrows the discretion of directors by imposing on them clear rules of behavior. Breach of these procedural rules amounts to a breach of duty. This, obviously, weakens the need to substitute directors' duties with procedural rules in the pursuit of efficiency, but by no means deals with the question of tailoring governance structures to the needs of the firm's members. The duties of nominee directors, which can arise in different contexts of organizing the activities of non-listed firms (e.g., typical governance structures of joint ventures and special governance rights linked to equity or debt financing by important outside parties), are a good example of limited abilities for such a tailoring.

Nominee directors may often appear in a conflict situation where the interests of the company and the nominee's appointer diverge. To facilitate decision-making by nominee directors, shareholders can insert a provision in the company's articles allowing nominee directors to fetter their discretion and act in the interests of particular shareholders or other groups.[905] But the cumulative nature of the duties implies that while the duty to exercise independent judgment may be modified, another duty, which cannot be limited, may apply. As a result, decisions promoting the interests of one shareholder at the expense of others may be in conflict with the duty of loyalty of s.172 of the Companies Act 2006.[906] One solution, although of limited applicability, is an adoption of a governance structure where a board of directors replaces shareholders' meetings and directors are thus the representatives of shareholders rather than directors in the traditional meaning. Under this structure, any decision of a board is the company's decision and cannot be alleged to breach directors' duties. This structure, however, can be used mostly in

[904] *See* Carsten Gerner-Beuerle & Edmund-Philipp Schuster, *The Evolving Structure of Directors' Duties in Europe*, 15 EUR. BUS. ORG. L. REV. 191, 199 (2014).

[905] Recent cases suggest that shareholders can agree unanimously to dilute the duties of directors to act in the interests of the company, but the cases are silent as to how far such a dilution can go. It is most likely that the waiver cannot be complete. Its scope is very case-specific and is subject to review by courts under flexible standards. *See* Cobden Investments Ltd v. RWM Langport Ltd [2008] EWHC 2810 (Ch) at [64], [67]; Re Neath Rugby Ltd [2010] B.C.C. 597, 605; F & C Alternative Investments Ltd v. Barthelemy (No. 2) [2012] Ch 613, 660. Moreover, in *Cobden Investments Ltd v. RWM Langport Ltd*, Warren J. was clear that even under contractually attenuated duties directors, as long as they participate in decision-making, must act in the best interests of the company ([2008] EWHC 2810 (Ch) at [147]–[149]).

[906] *See* Andrew Keay, *The Duty of Directors to Exercise Independent Judgment*, 29 COMP. LAW. 290, 295 (2008); Deirdre Ahern, *Nominee Directors' Duty to Promote the Success of the Company: Commercial Pragmatism and Legal Orthodoxy*, 127 L.Q.R. 118, 126 (2011).

joint ventures where each member, acting through its representatives, has a veto right. Case-by-case ratification of directors' conduct cannot be a universal solution as well.

In the US, this problem was dealt with by the introduction of the LLC. The closest business form in the UK, the LLP, is a creature of contract as well.[907] Similar to the LLC, the limited liability partnership operating agreement is the primary source of governance for UK LLPs and the statute applies if the agreement is silent. This leads to a strong argument that a different—enabling—regime of fiduciary duties shall apply to the members and directors of LLPs. Although s.172 requires directors to consider the interests and relations with other constituencies other than shareholders, the Companies Act 2006 is clear that the duties are owed by a director to the company (s.170(1)). Any considerations that directors may have to take into account serve the objective of promoting the success of the company for the benefit of its shareholders as a whole. The act does not create any duties owed to shareholders and, even more so, to others. Hence, it is up to shareholders as ultimate decision-makers[908] to decide whether they need these duties or not.[909] If in the company law setting the statutory nature of the regulation may prevent private ordering of the duties, the contractual nature of LLPs does not create such grounds. This means that there are no obstacles for not allowing complete waiver or partial alteration of the duties and full or partial limitation of liability for their breach in an LLP agreement.

The fiduciary duties of LLP members are established in reg.7(9) and (10) of the LLP Regulations 2001 and are clarified by Sir Sales, then Justice of the Chancery Division of the High Court, in *F & C Alternative Investments Ltd v. Barthelemy (No. 2)*.[910] The statutory provisions include specific fiduciary duties, but not a general fiduciary duty of good faith, which are owed by LLP members to the LLP. In particular, a member has a duty to avoid competition with the LLP, taking corporate opportunities from the LLP, and engaging in self-dealing or related-party transactions, unless the partnership gives its consent.[911] The default statutory duties are owed by LLP members to the LLP, but not to each other,[912] and apply if a member has management rights. Because both

[907]Limited liability companies, in the words of a former Delaware judge, Chancellor William Chandler III, "are creatures of contract". TravelCenters of Am., LLC v. Brog, 2008 WL 1746987, at *1 (Del. Ch. 2008).

[908]*See* Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Ltd [1983] Ch. 258, 269 (declaring that the unanimous acts of shareholders are the acts of the company).

[909]For a different view see Ahern, *supra* note 906, at 140 (arguing that once the interests of third parties intrude into the directors' duties, shareholders are less legitimate to waive these interests).

[910][2012] Ch 613.

[911]*See* LLP Regulations 2001, reg.7(9)–(10).

[912]*See* F & C Alternative Investments Ltd v. Barthelemy (No. 2) [2012] Ch 613, 646–47.

provisions of the LLP Regulations 2001 are cast as defaults, LLP members are free to expand, restrict, or waive completely the application of members' statutory fiduciary duties in an LLP agreement.

In an LLP with a centralized governance structure, a non-managing member, even in absence of a private ordering, does not owe fiduciary duties to the firm.[913] However, if an LLP has a centralized governance structure and is managed by one or more, but not all, members, the managing members (in their capacity as managers) are, indeed, subject to the application of the default rules. If an LLP is governed by managers, then the appropriate default duties, unless expressly modified, are the duties of directors found in the setting of companies.[914] LLP members can change the scope of the duties of managers, including by fully relieving them from their fiduciary duties, in the LLP agreement. Managing members of an LLP are also subject to duty of care, but the standard of care (objective versus subjective test) is not clear.[915] If it is not defined in the LLP agreement, the courts will, perhaps, choose the relevant standard on a case-by-case basis.[916]

This analysis leaves aside one important question—do LLP members owe additional duties under equity law? Courts have yet to address this question expressly and, if the answer is affirmative, also clarify whether the duties in equity are subject to modification or waiver. The judgment in *F & C Alternative Investments Ltd v. Barthelemy (No. 2)* offers helpful guidance in approaching this question.

Let's consider first the case of duties between the members. Similar to the case of the default statutory duties, LLP members do not owe each other any specific fiduciary duties or a general duty of good faith on equitable grounds.[917] The question is complicated by reg.7(8) of the LLP Regulations 2001, pursuant to which "[e]ach member shall render true accounts and full information of all things affecting the limited liability partnership to any member." Does this procedural requirement imply that an LLP member, similar to partners, owes a certain fiduciary duty of good faith towards other members in all LLP dealings and transactions? Moreover, since an LLP agreement, in addition to being the constitution of the LLP, governs cooperative contractual relationships between LLP members, the members may owe each other an implied duty of good faith in the performance of the contract.[918] It is true that English contract law has traditionally been

[913] *See id.*, at 645.

[914] *See id.*, at 644, 654–55.

[915] *See* PALMER'S LIMITED LIABILITY PARTNERSHIP LAW, *supra* note 845, paras. A5–38, A6-07.

[916] *See id.*

[917] [2012] Ch 613, 646–47.

[918] *See* Yam Seng Pte Ltd v. International Trade Corporation Ltd [2013] EWHC 111 (QB) at [131]–[142]. The judgment of Leggatt J. did not offer a general principle of good faith applicable to all contracts, but showed that English contract law has tolerated an implication of

hostile towards an implied duty of good faith, but the judgment of Leggatt J. in *Yam Seng Pte Ltd v. International Trade Corporation Ltd* suggests that such an approach—at least in the context of relational contracts, which do not amount to fiduciary relationships but nevertheless require a high degree of cooperation—can be erroneous.[919]

The second case covers duties of members owed to the LLP. Here the answer depends on the management structure of the LLP. If members can participate in the management and bind the LLP, then as agents of the LLP, they may owe usual fiduciary duties of an agent which enters into transactions on the principal's behalf.[920] These duties apply in addition to the default statutory duties of LLP members. Under centralized management with non-member managers, the members (in their capacity as members) do not have direct control over the management of the LLP. It follows that, to the extent that members do not act as the LLP's agents, they do not owe to the LLP any duties imposed by law.[921]

The application of the unfair prejudice remedy of s.994 of the Companies Act 2006 to LLPs can be waived by the agreement of the LLP members.[922]

E. Transferability of Interests

Shares in companies are freely transferable. In private companies, however, in the absence of liquid equity markets or a right of each shareholder to force dissolution of the company,[923] shareholders often

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a duty of good faith under context-specific circumstances. In particular, this duty is likely to be implied in contracts involving long-term relationships between the parties. As explained by the justice at [142]:

> "Such 'relational' contracts, as they are sometimes called, may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements. Examples of such relational contracts might include some joint venture agreements, franchise agreements and long term distributorship agreements."

[919][2013] EWHC 111 (QB) at [120]–[153].

[920]*See* [2012] Ch 613, 649.

[921]*Id.*

[922]*See* Companies Act 2006, s.994(3), as modified by the LLP Regulations 2009, reg.48.

[923]Control inefficiencies, under which minority investors may incur losses because of private benefit extraction by controlling investors and managers, and hold-up problems, where partners behave strategically to advance their personal interests, often deter efficient investments. Along with voting, management, information rights, and other investor protection mechanisms, exit rights can limit the effect of control inefficiencies and hold-up problems. In publicly-traded firms, liquid equity markets assist ownership re-allocation by allowing minority investors to exit and creating conditions for new controlling investors to appear. In partnerships, the right of each partner to force dissolution of the partnership ensures an equivalent result. The situation is different in non-listed firms where, because of locked

agree about restrictions on share transfers or on registration of such transfers. These restrictions can be imposed in the company's articles or in a shareholders' agreement among any or all shareholders or among the shareholders and the company.

Under the default governance structure of LLPs, no party may become a new member without the consent of all existing members.[924] Similarly, none of the existing members can assign its interest, whether to other members or to third parties, without the consent of other members.[925] This amounts to a complete ban of interest transfers without the unanimous consent of other members. Although the default rule is borrowed from partnerships, even in partnership law the partner exit is not banned completely, because each partner can force dissolution of the partnership. In practice, such complete bans often lead to costly and time-consuming disputes between the partners. Thus, LLP members are expected to relax the default rule and impose one of the different interest transfer restrictions developed by transactional lawyers—majority consent rights, first purchase rights, tag-along and drag-along rights, and put and call options.[926]

The Delaware LLC legislation has a similar default rule with a slightly weaker effect on banning interest transfers. The assignee of an interest has no right to participate in the management of the business and affairs of the company except (1) as provided in the LLC agreement, or (2) upon the affirmative vote or written consent of all LLC members, unless otherwise provided in the LLC agreement.[927] Apart from these two exemptions, the assignee receives only a right to participate in sharing the profits and losses of the company.[928] At the same time, the assigning member ceases to be a member after the assignment of its interest.[929] In practice, the members of Delaware LLCs tend to keep the default consent clause, but are contracting for first purchase rights and tag-along rights which apply as a substitute of the default clause.[930] In other words, alternative interest transfer restrictions, which are much more weaker means for incumbent members to affect third-party transfers than the consent clause, are backed up by the consent clause in order to prevent any transfer in violation of the alternative transfer restrictions. If a third-party buyer complies with the procedure of alternative interest transfer restrictions, the consent clause is not

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investments, parties are in a stronger dependence upon each other's actions. For more details see *supra* Part II of Chapter 3.

[924]*See* LLP Act 2000, s.4(2); LLP Regulations 2001, reg.7(5).

[925]*See* LLP Regulations 2001, reg.7(5).

[926]For the description of these transfer restrictions and circumstances under which they are used see *supra* Chapter 3.

[927]*See* DEL. CODE ANN. tit. 6, § 18–702(a).

[928]*See id.*, § 18–702(b)(2).

[929]*See id.*, § 18–702(b)(3).

[930]*See supra* Part IV.C of Chapter 2.

activated and the buyer automatically becomes a substituted member. With the increasing number of the members of a company, the LLC agreements alter the default consent clause to provide for majority approval of transfers by members or a board instead of a unanimous consent.[931]

F. Continuity of Life, Dissolution, and Member Withdrawal

Both the private company and the LLP have indefinite existence and can be wound up and dissolved in limited cases. A company can be wound up voluntarily by the decision of a simple majority of its shareholders made at a general meeting after the expiration of the fixed period for which it has been formed or upon the occurrence of the events specified in its articles of association.[932] In the absence of such special circumstances agreed by the shareholders, a company can be wound up voluntarily by the affirmative vote or written consent of its shareholders holding not less than 75% of votes.[933] The law is rather inflexible as to the type of a required resolution (ordinary or special), voting threshold,[934] the way of passing it (written or at a general meeting), and other procedural aspects (e.g., a passed resolution cannot be a special resolution unless it is expressly specified so)[935]. Compulsory winding up is possible by the court decision in several cases, including the inability of a company to pay its debts and failure to carry out any activity within a period of one year.[936]

Courts have a discretion to wind up a company also as an equitable remedy.[937] This remedy is applied in limited cases, such as a deadlock in decision-making paralyzing the ability of the company to carry on its business[938] or impossibility to carry out the purpose of the firm.[939] Courts applied this remedy also in cases of minority oppression.[940] Its application for this purpose nowadays, however, is less likely. The winding-up remedy cannot be applied by the court in an unfair prejudice petition made by a shareholder under s.994 of the Companies Act 2006.[941] The appropriate remedy in the latter case lies elsewhere.[942] In

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[931]*See supra* Part IV.C of Chapter 2.

[932]*See* Insolvency Act 1986, s.84(1)(a).

[933]*See id.*, s.84(1)(b).

[934]Only where the statute does not specify the type of a resolution, shareholders are free to require a higher majority or unanimity by including a provision in the company's articles. *See* Companies Act 2006, s.283(3).

[935]*See* Companies Act 2006, s. 283(3)(a) and (6)(a).

[936]*See* Insolvency Act 1986, s. 122(1).

[937]*See id.*, s. 122(1)(g).

[938]*See* Re Yenidje Tobacco Co Ltd [1916] 2 Ch. 426, 432, 435.

[939]*See* Re German Date Coffee Co [1882] 20 Ch.D. 169, 188.

[940]*See* Ebrahimi v. Westbourne Galleries Ltd [1973] A.C. 360.

[941]*See* Re Neath Rugby Ltd [2010] B.C.C. 597, 628 (for holding that jurisdictions under s.122(1)(g) of the Insolvency Act 1986 and s.994 of the Companies Act 2006 are

cases of unfair prejudice, the most common remedy is a buy-out of the petitioning shareholder.[943] This remedy does not lead to the dissolution of the company but provides minority members with an exit opportunity at a fair value in cases of majority oppression. This is an important remedy in non-listed firms where the ability to market shares, due to liquidity constraint, is limited.

When it comes to the compulsory winding-up, similar grounds apply to LLPs, including the inability of the LLP to pay its debts, failure to carry out any activity within a one-year period, or decision-making deadlock.[944] In addition, a court can wind up an LLP when the number of its members is reduced below two.[945] Most frequently courts wind up LLPs based on the insolvency petitions brought by the LLP creditors. The insolvency tests, like in companies, are two—failure by the LLP to pay its debts as they fall due[946] or a proof that the value of the LLP's assets is less than the amount of its liabilities.[947]

Rules are much more flexible for voluntary winding-up of LLPs. The procedure, with the exception of the rules on notifying some LLP creditors and the companies registrar, is subject to regulation by the partnership's internal governance documents. LLP members are free to agree on the cases of voluntary dissolution (e.g., determination of the member, breach of the LLP's governance agreement by one of the members, or any other ground) and the minimum required vote for approving the dissolution.[948] This flexibility resembles to the Delaware LLC law where the members are free to modify the statutory voting threshold and voting procedure for a voluntary winding-up and dissolution of an LLC.[949]

Delaware courts have a statutory power, subject to a waiver by the LLC members, to dissolve a solvent LLC where the vote of the members is deadlocked and the operating agreement provides no means around the deadlock.[950] However, in the absence of statutory appraisal rights, the

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separate); Fulham Football Club (1987) Ltd v. Richards [2012] Ch 333, 349 (for suggesting that the jurisdiction now contained in s.994 of the Companies Act 2006 originated as an alternative to winding-up on the just and equitable ground).

[942]Section 996 of the Companies Act 2006 contains an open list of remedies that courts can grant in response to unfair prejudice petitions. The possible judicial orders mentioned in the statute include instructions to the company to act or refrain from acting in a specific way and orders to purchase shares of any shareholders by other shareholders or the company itself.

[943]*See* Sandra K. Miller, *How Should UK and US Minority Shareholder Remedies for Unfairly Prejudicial or Oppressive Conduct be Reformed?*, 36 AM. BUS. L.J. 579, 607 (1999).

[944]*See* Insolvency Act 1986, s.122(1), as modified by the LLP Regulations 2001, reg.5.

[945]*See id.*, s.122(1)(c), as modified by the LLP Regulations 2001, reg.5.

[946]*See id.*, s.123(1), as modified by the LLP Regulations 2001, reg.5.

[947]*See id.*, s.123(2), as modified by the LLP Regulations 2001, reg.5.

[948]*See id.*, s.84, as modified by the LLP Regulations 2001, reg.5.

[949]*See* DEL. CODE ANN. tit. 6, § 18–801(a)(3).

[950]*See id.*, §18–802. *See also* Haley v. Talcott, 864 A.2d 86, 95, 97-98 (Del. Ch. 2004); In re Silver Leaf L.L.C., 2005 WL 2045641, at *10-11 (Del. Ch. 2005); Phillips v. Hove, 2011 WL 4404034, at *26 (Del. Ch. 2011).

courts will not order a dissolution of an LLC, unless otherwise agreed by the members, in cases where the company or its members violate the provisions of the LLC agreement.[951] In a recent judgment, the Delaware Court of Chancery ruled that the statutory judicial dissolution is not the only exclusive extra-contractual means of obtaining dissolution of an LLC; under specific circumstances, the court has an equitable power to dissolve an LLC.[952] Although this case has very specific circumstances and the court's judgment only created an equitable standing for *de facto* LLC members to seek judicial dissolution of an LLC, the move suggested that the Delaware court is not hostile to the idea that, in addition to the two statutory causes for judicial dissolution, it can rely on parallel equitable causes for dissolving a solvent LLC.

Similarly, in UK LLPs, courts will not dissolve an LLP based on a petition brought under s.994 of the Companies Act 2006, which contains the UK equivalent of the American minority oppression remedy,[953] by the LLP member. However, LLP members cannot waive the right of the court to dissolve the LLP as an equitable remedy.[954] Indeed, they may agree that none of the members shall bring such a petition in the court and the breaching party will be subject to contractual remedies, including compensation of possible damages caused by the dissolution. But such an agreement cannot guarantee that a deadlocked LLP will not be dissolved by the judiciary.

An LLP member cannot be expelled by other members unless a power to do so has been agreed by the LLP members. Separate legal personality implies that the death, retirement, resignation, expulsion, bankruptcy, or dissolution of any member or the termination of membership in any other cases does not lead to the winding-up and dissolution of an LLP. Indeed, this rule can be reversed by the agreement of the LLP members. If LLP members agree that a member withdrawal leads to the winding-up of the LLP, the remaining members will typically retain a right to continue the partnership by a simple majority vote.

These default rules do not differ significantly from the rules governing the expulsion and resignation of shareholders in private limited companies: shareholders cannot be expelled by the decision of

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[951]*See In re* Seneca Investments LLC, 970 A.2d 259, 263 (Del. Ch. 2008) (the Court of Chancery will not attempt to police violations of operating agreements by dissolving LLCs).

[952]*See In re* Carlisle Etcetera LLC, 114 A.3d 592, 601 (Del. Ch. 2015). *See also* an earlier judgment in *Huatuco v. Satellite Healthcare*, 2013 WL 6460898, at *1 (Del. Ch. 2013), where the Delaware Court of Chancery upheld the contractual waiver of the right to seek statutory dissolution under Section 18-802, but reserved decision on "[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires." Huatuco v. Satellite Healthcare implies that courts might create equitable grounds for judicial dissolution where LLC members are locked without any alternative exit options.

[953]*See* Miller, *supra* note 575, at 392.

[954]*See* Re Magi Capital Partners LLP [2003] EWHC 2790 (Ch) at [10].

other shareholders; termination of membership of a shareholder, for whatever reason, does not lead to the dissolution of the company. Indeed, shareholders can agree to change these default rules in the articles of association of the company. However, the room for discretion is narrower than in LLPs. In particular, if the articles specify that a membership termination is an event leading to the dissolution of the company, the company will not be dissolved automatically after such an event. Voluntary winding-up of a company based on the grounds specified in the articles of association of a company requires the consent of the majority of its shareholders.[955]

Default rules on member resignation distinguish the LLP from both the private limited company and the Delaware LLC. Under the default LLP governance structure, a member can resign from the LLP by giving reasonable notice to the other members.[956] This resignation does not automatically lead to any entitlement to receive the economic value of the resigning member's interest. Private agreements can ban unilateral member resignation or specify conditions for such a resignation, including a right of the resigning member to claim its original contribution or an equivalent compensation. In the company law setting, shareholders do not have a right to resign from the company and a typical exit occurs based on share transfers. Similarly, in LLCs, a member, if not agreed otherwise, cannot resign prior to the company's winding-up and dissolution.

G. Amending Limited Liability Partnership Agreement

The LLP agreement defines the internal governance structure of the LLP and the rights and obligations of its members.[957] It is the main document regulating the internal matters of an LLP. This agreement is the functional equivalent of the articles of association in a company, but it does not require filing with the registrar. This has important implications. This means that the document has also the advantages of a shareholders' agreement without its drawbacks.

First and foremost, an LLP agreement can be kept confidential from third parties. Second, an LLP agreement combines in one document the provisions of the articles of association and shareholders' agreements. The presence of several corporate documents in companies raises the important question of conflicts between their provisions. In the case of a unanimous shareholders' agreement, these conflicts are easier to solve, because the agreement substitutes bylaws, at least in relations between the shareholders and other parties to the agreement. The question is more complicated where an agreement is not unanimous.

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[955]*See* Insolvency Act 1986, s.84(1)(a).
[956]*See* LLP Act 2000, s.4(3).
[957]*See* LLP Act 2000, s.5(1)(a).

Such an agreement creates reasonable expectations for its parties, but it suppresses the reasonable expectations of non-participating shareholders deriving from the articles. The common response provided by courts is that the provisions of the articles have priority, yet the provisions of shareholders' agreements are valid as well. They create personal obligations between the contractual parties and entitle the aggrieved party to contractual remedies. And third, new members of an LLP, regardless of becoming a signatory to the agreement, automatically obtain all rights and obligations of a member under the LLP agreement. This follows from the fact that the LLP agreement is the constitution of the LLP which defines the existing governance structure of the LLP and the rights and obligations of its members. Indeed, the existing members and a new member can agree to other terms for the latter in the admission agreement or by the means of amending and restating the LLP agreement. In the absence of such an agreement, a new member is bound by the terms of the existing LLP agreement.[958] The Delaware law on LLCs is clearer: members and managers of the company, assignees of the interests, and the company itself are bound by the LLC agreement whether or not they execute it.[959] In the company law context, if rights and obligations of shareholders are imposed by an agreement, rather than by the company's articles of association, then new shareholders, unless they join the agreement, are not bound by it.

Under the common law of contract, amendments of an LLP agreement require the unanimous approval of all signatory members.[960] LLP members are free, however, to define any other procedure for amending the agreement. If so agreed by LLP members, amendments may also require the consent of non-members, such as managers or third parties. In the practice of Delaware LLCs, where LLC agreement amendments require the approval of all members as well,[961] the default rule is typical for 2–member companies, but is substituted with super-majority or simple majority voting in LLCs with larger number of members.[962] Usual means for protecting minority members against

[958]An alternative interpretation, according to which the statutory default rules apply to a new member of an LLP, notwithstanding the fact that the existing members are parties of the LLP agreement, if the existing members and the new member have not specified the new member's rights and duties, was rejected by the Chancery Division of the High Court of Justice in a recent case. *See* Reinhard v. Ondra LLP [2015] EWHC 26 (Ch) at [360], [366]–[367]. If followed, the alternative interpretation, due to the conflicting governance provisions of LLP agreements and the statutory default rules, can lead to absurd scenarios. In particular, if the existing members have opted for a centralized management with a board of directors, the LLP may have parallel management bodies after admitting a new member—the board of directors (for the existing members) and a single managing member (for the new member).

[959]*See* DEL. CODE ANN. tit. 6, § 18–101(7).

[960]*See* PALMER'S LIMITED LIABILITY PARTNERSHIP LAW, *supra* note 845, para. A5–04.

[961]*See* DEL. CODE ANN. tit. 6, § 18–302(f).

[962]*See supra* Part IV.E of Chapter 2.

abusive actions of the controlling members entitled to amend the agreements by their sole decision are the requirement to put the matter to a minority vote if the amendments adversely affect the rights of the minority members and a ban on amending certain provisions of the agreements without the approval of all members.[963]

IV. UK LIMITED LIABILITY PARTNERSHIPS AND DELAWARE LIMITED LIABILITY COMPANIES: SIMILARITIES AND DIFFERENCES

For the purposes of analyzing the similarities and differences of UK LLPs and Delaware LLCs, it is useful to distinguish two aspects of governance—internal and external matters of governance. The first covers the relations among the members of the firm and between the members on the one hand and the managers on the other. External matters of governance include the relations of the firm, its members, and managers, on the one side, and the firm's other constituencies, including its creditors and the general public, on the other. The following paragraphs will present a summary analysis of the similarities and differences in the statutory approaches towards the governance of the UK LLP and the Delaware LLC using this two-dimensional framework.

When it comes to internal governance matters, the LLP is an extremely flexible business form. The members of an LLP are free to choose a preferred governance structure by contracting around the default rules of the LLP Act and the LLP regulations. There is, however, some uncertainty as to the extent to which the fiduciary duties of LLP members can be altered. Courts have yet to rule on this and so far have retained a hypothetical discretion to impose, in addition to the statutory duties, equitable duties on LLP members. Moreover, it is not clear whether these equitable duties, if they do exist, are subject to contractual modification or not.

English law traditionally has been hostile towards a recognition of an implied duty of good faith in the performance of contracts.[964] The duty can exist either if the contracting parties expressly agree about it[965] or is implied in a fiduciary relationship, for example, in partnerships.[966] Recent cases, however, support the implication of a duty of good faith in some contracts—even in the absence of an express agreement or fiduciary relationships—based on the presumed intentions of the

[963] *See supra* Part IV.E of Chapter 2.

[964] *See supra* note 919 and accompanying text.

[965] *See* Mid Essex Hospital Services NHS Trust v. Compass Group UK & Ireland (t/a Medirest) [2013] EWCA Civ 2000 at [105].

[966] *See* R.C. I'ANSON BANKS, LINDLEY & BANKS ON PARTNERSHIP, para. 16–01 (18th ed., 2002). The implication of the duty in fiduciary relationships is justified by the reason of ensuring cooperation which is conditional upon mutual confidence and the need to maintain trust between the partners. *See id.*, para 16–03.

parties.[967] The LLP Regulations 2001 impose specific statutory duties on the managing members of an LLP: (1) a duty to avoid competition with the LLP, (2) a duty not to take corporate opportunities from the LLP, (3) a duty to refrain from engaging in self-dealing or related-party transactions, and (4) a duty of care.[968] The law is not clear with regard to other duties. First, it is uncertain whether LLP members, similar to partners, owe towards other members or to the LLP a general duty of good faith. Most likely they do not.[969] Second, given the relational nature of the LLP agreement, it is also not clear whether the parties to the agreement owe to each other an implied contractual duty of good faith.[970]

Delaware law on fiduciary duties of LLC members and managers is fairly clear. It is a settled law that these duties can be limited partially or waived entirely with the exception of the implied contractual covenant of good faith and fair dealing.[971] This covenant, which is a part of every contract and cannot be modified, can be relied upon to imply only those terms that the parties would have agreed to during their original negotiations if they had anticipated a contingency and had thought to address it.[972] The terms are implied based on the parties' original contractual expectations, rather than a duty applied at the time of the wrong.[973] The covenant is thus a gap filling doctrine applied where the contract is silent. But the doctrine cannot be invoked to rewrite contractual language just because the parties failed to negotiate for terms that, in hindsight, would have made the contract a better deal; it can be applied only when it is clear from the contract that the parties would have agreed to regulate a conduct had they thought to negotiate with

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[967]*See* Yam Seng Pte Ltd v. International Trade Corporation Ltd [2013] EWHC 111 (QB) at [131]–[142]; Bristol Groundschool Ltd v. Intelligent Data Capture Ltd [2014] EWHC 2145 (Ch) at [196]; D&G Cars Ltd v. Essex Police Authority [2015] EHWC 226 (QB) at [174]–[176]; Myers v. Kestrel Acquisitions Ltd [2015] EHWC 916 (Ch) at [40].

[968]*See supra* Part III.D of this Chapter.

[969]*See supra* Part III.D of this Chapter.

[970]Even if an implied duty of good faith applies to LLP agreements governed by English law, the parties—as a consequence of the fact that the duty is based on the parties' presumed intention—can modify the scope of the duty of good faith by the express terms of their contract and are even free to exclude the application of the duty by expressly stating this in the agreement. *See* Yam Seng Pte Ltd v. International Trade Corporation Ltd [2013] EWHC 111 (QB) at [149]. *See also* Simon Whittaker, *Case Comment: Good Faith, Implied Terms and Commercial Contracts*, 129 L.Q.R. 463, 468 (2013). Meanwhile, under Delaware law, the only way to exclude the application of the implied covenant of good faith to a specific conduct is to regulate this conduct by an explicit contractual provision; the parties can never waive the duty by a general waiver clause.

[971]*See supra* Part IV.G of Chapter 2.

[972]*See* Gerber v. Enterprise Products Holdings, LLC, 67 A.3d 400, 418 (Del. 2013).

[973]*Id.*, at 419. The Supreme Court of Delaware clearly distinguished the two components of the covenant from fiduciary duties:

> "'Fair dealing' is not akin to the fair process component of entire fairness . . . . It is rather a commitment to deal 'fairly' in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise 'good faith' does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract." *Id.* (emphasis omitted).

respect to that matter.[974] Obviously, the implied covenant cannot be invoked to override express terms of a contract.[975] One of the main arguments that goes as a "red thread" through the first three chapters of this thesis is that the users of hybrid business forms are largely benefiting from the contractual freedom by using governance structures that, given particular circumstances of cooperation, maximize the welfare of the contracting parties. Certainly, privately designed governance structures do not always achieve a balance between the rights and obligations of different groups of members. The freedom of contract sometimes can be shaped in a way to create conditions for abusive behavior by one of the partners. In such situations, the Delaware courts have relied on the implied covenant of good faith and fair dealing to police abuses.[976]

It is difficult to overestimate the role of the Delaware legislature and courts in clarifying the application of fiduciary duties in the LLC setting.[977] Less responsive approach of the UK legislator and courts has led to a situation where the exact content of rules on the duties of LLP members is still being debated. In addition, weak penetration of LLPs into the UK private businesses limits the supply of case law on LLP governance. Hence, legal uncertainty is dissolving slowly, which, in its turn, is perhaps curbing the expansion of the LLP form.

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[974]*See* American Capital Acquisition Partners, LLC v. LPL Holdings, Inc., 2014 WL 354496, at *5 (Del. Ch. Feb. 3, 2014). In other words, the application of the implied covenant depends whether contractual gaps are related to contingencies that the parties anticipated yet did not regulate or are related to unanticipated contingencies. If the parties thought about the contingency but expressly rejected to include a special term, chose not to bargain for a specific language, or failed to come to an agreement, then the covenant should not be used. Conversely, if the parties did not consider a contingency at the time of negotiations, courts may invoke the covenant to fill contractual gaps. Gaps in this second category can be unintended—for instance, if the parties simply did not think that a contingency was possible—but sometimes also deliberate—for example, if both parties believed that the possibility of a contingency was too remote or thought the term too obvious to include in the agreement. *See In re* El Paso Pipleine Partners L.P. Derivative Litig., 2014 WL 2768782, at *17–18 (Del. Ch. Jun. 12, 2014). *See also* Mohsen Manesh, *Express Contract Terms and the Implied Contractual Covenant of Delaware Law*, 38 DEL. J. CORP. L. 1, 28–34 (2013) (arguing that often courts cannot find out why a particular term was not included in the parties' agreement and thus intervene at the court's discretion based on the grounds of equity and reasonableness).

[975]In *In re El Paso Pipleine Partners L.P. Derivative Litig.*, the Delaware Court of Chancery distinguished three consequential steps that courts must address when presented with a claim under the implied covenant: (1) whether there is a gap that needs to be filled; (2) if a contractual gap exists, whether the implied covenant should be used to supply a term to fill the gap; (3) if the court determines that the gap should be filled, then the court must decide how to fill it. 2014 WL 2768782, at *17–18 (Del. Ch. Jun. 12, 2014).

[976]*See* Strine & Laster, *supra* note 419, at 25–26; Loewenstein, *supra* note 513, at 38–39.

[977]Consider, for example, the role of the Delaware General Assembly in the clarification of the question whether fiduciary duties of LLC members and managers can be waived completely and the controversy over the scope of the default duties of LLC members and managers. In both cases, following contradictory decisions of the Delaware Court of Chancery and the Delaware Supreme Court, the General Assembly moved quickly to dispel the uncertainty. *See supra* notes 496–500 and accompanying text.

Table 4–II. Comparison of business forms in the United Kingdom and the United States

Legal provision	UK private company	UK LLP	Delaware corporation (non-listed)	Delaware LLC
Panel A. Legal Formalities				
Minimum number of members	No	Yes (at least 2 members)	No	No
Formal incorporation	Yes	Yes	Yes	No
Disclosure of the identities of members	Yes (updated annually)	Yes (updated annually)	No	No
Disclosure of financial statements	Yes (annually)	Yes (annually)	No	No
Disclosure of founding documents	Yes	No	No	No
Procedural rules for member meetings	Yes	No*	Yes	No*
Board of directors	Yes	No*	Yes (a close corporation can be managed by stockholders)	No*
Procedural rules for board meetings	No*	No*	Yes	No*
Member right to inspect books and records	No* (unless specifically provided by bylaws)	Yes* (members can restrict partially or waive entirely)	Yes (but only for a purpose *reasonably* related to such person's interest as a stockholder)	Yes* (but only for a purpose *reasonably* related to such person's interest as a member; can be restricted or waived)

Table 4–II (*continued*)

Legal provision	UK private company	UK LLP	Delaware corporation (non-listed)	Delaware LLC
		Panel B. Fiduciary Duties		
Duty of care	Yes	Yes	Yes	Yes
Partial restriction or complete waiver of duty of care	Yes (but only on a case-by-case basis ratification by shareholders of a negligent conduct)	Yes (most likely)	No	Yes
Limitation of liability for the breach of duty of care	No	Yes (most likely)	Yes	Yes
Duty of loyalty	Yes	Yes	Yes	Yes
Partial restriction or complete waiver of duty of loyalty	Yes (only partial restriction; shareholders can ratify breaches of duty on a case-by-case basis)	Yes (most likely)	No	Yes
Limitation of liability for the breach of duty of loyalty	No	Yes (most likely)	No	Yes
Implied contractual duty of good faith and fair dealing	No	Yes (most likely)	Yes	Yes
Partial restriction or complete waiver of implied contractual duty of good faith and fair dealing	n.a.	Yes (most likely)	No	No

Table 4–II (*continued*)

Legal provision	UK private company	UK LLP	Delaware corporation (non-listed)	Delaware LLC
Panel C. Legal Personality, Exit, and Dissolution				
Indefinite existence	Yes	Yes	Yes	Yes
Member oppression remedies	Yes	Yes*	No	No
Member right to resign	No	Yes*	No	No*
Member right to withdraw investments	No	No*	No	No*
Free transferability of interests (shares)	Yes*	No*	Yes*	No*
Statutory remedy of judicial dissolution	No	No	Yes	Yes
Partial restriction or complete waiver of statutory remedy of judicial dissolution	n.a.	n.a.	No	Yes
Equitable remedy of judicial dissolution	Yes	Yes	No	Yes
Partial restriction or complete waiver of equitable remedy of judicial dissolution	No	No	n.a.	No

Fiduciary duties in Panel B are the duties of directors (officers) or of managing members. Asterisks (*) indicate that a statutory provision is cast as a default and can be reversed by the agreement or consent of the firm's members (shareholders).

Apart from this, the internal governance law of the UK LLP does not differ much from the Delaware law applicable to LLCs. In addition to a flexible internal governance, both business forms provide a safe harbor from corporate-type legal formalities. The two business forms, indeed, are very similar. Where they differ significantly are the external aspects. In the LLP, contractual governance is subject to significant limitations for the aims of protecting the rights and interests of third parties. As a result, safeguards offered by LLPs to their creditors are not different from the creditor protection rules in limited companies. As noted earlier in the literature, externally the LLP is a company, but internally it can take the structure of any business form.[978] Delaware LLCs, in contrast, do not require incorporation and thus are subject to less rigorous external governance rules than incorporated business forms, such as corporations.

Comparative information on the internal and external aspects of governance in LLPs and LLCs is summarized in Table 4–II above.

V. CONCLUSION

More than a decade has passed since the introduction of the LLP in the United Kingdom. Yet, many legal questions remain unclear. What is clear is that the LLP is not a universal business form for a wide specter of businesses. Statutory default rules on the internal governance of the LLP are few and this matter is almost entirely left to contractual regulation by the LLP members. If LLP founders fail to anticipate their possible needs and include negotiated solutions in the LLP agreement, they may face governance disputes in the future deriving from the legal vacuum. As a result, they have to rely either on renegotiation or ex post gap filling by courts. Both options can be problematic, as the first puts the party that requires renegotiation in a weaker bargaining position,[979] whereas the second is subject to uncertainty, time-consuming procedures, litigation costs, and the possibility of a judicial error.[980] Moreover, case law is not clear on the application of the implied contractual duty of good faith which can be invoked by courts to fill the gaps of LLP agreements.

Therefore, when used by small businesses, due to minimum lawyering, poorly drafted governance structures of LLPs can lead to conflicts between the members.[981] This business form, however, can offer significant benefits to large businesses who can take advantage of

[978]Morse, *supra* note 830, at 465.

[979]*See* Scott, *supra* note 427, at 2020–21.

[980]*See* VERMEULEN, supra note 4, at 243; MCCAHERY & VERMEULEN, *supra* note 424, at 247 (2008).

[981]For additional arguments why an LLP is not suitable for small businesses see Freedman, *supra* note 836, at 902–04; Judith Freedman, *"One Size Fits All"—Small Business and Competitive Legal Forms*, 3 J.C.L.S. 123, 139 (2003).

its flexibility and, at the same time, fill the gaps of minimum statutory default governance rules. Businesses that are obvious candidates of being organized as LLPs are large joint ventures and entities involved in investment fund structures (both fund managers and funds). In both cases, broad contractual freedom allows founders to incorporate easily widespread contractual practices into the governance structures without a fear of their invalidation by courts. Evidence from Delaware LLCs, which function in a similar light-touch regulatory environment, supports the argument that sophisticated users of LLCs tailor the governance structures of the companies to their specific needs by changing statutory defaults as necessary and filling the gaps.[982]

On the top of the minimalist approach of the legislator in offering default internal governance rules for the LLP, the use of the LLP may be further deterred by its inconsistent default governance structure. The LLP has many characteristics of a company, but is governed as a partnership. This unnecessarily rules out one-member LLPs, gives each member—irrespective of contributions—equal say in decision-making, bans member right to exit investments by subjecting any interest transfer to the unanimous consent of other members, and allows member resignation at will. Indeed, most of these rules are set as default. Hence, sophisticated parties which can afford access to professional consultants are expected to change these rules and adapt the LLP governance structure to their needs. In particular, if exit options are kept limited, LLP members are expected to rely fully on fiduciary duties and strong voting rights. Conversely, if agreements vest control upon one member and at the same time limit or eliminate fiduciary duties, then members are expected to devise clauses allowing minority members to exit at fair value. However, if the LLP is claimed to become a universal business form for both small and large businesses, its statutory default governance structure requires an overhaul. Making it more company-like by correcting the inconsistencies of the LLP's default organizational structure listed above in this paragraph can increase its appeal for small businesses.

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[982] *See supra* Part V of Chapter 2.

CONCLUSION

The increasing use of hybrid business forms—an organizational structure for business that combines the flexible governance structure of partnerships with the limited liability of corporations—along with many benefits, also creates some risks. In particular, the possible partial modification or complete waiver of the standard mechanisms of balancing the conflicting interests in intra-firm relations creates risks for the interests of weak parties. The central question addressed in this thesis is how do the members of hybrid business forms rebalance the arising conflicts of interests under the flexible statutory framework?

This thesis answers this question by (1) establishing the actual demand for modifying or waiving statutory default rules on investor protection, (2) identifying privately designed investor protection rights and other non-legal mechanisms that are alternatives to the statutory rules, and (3) explaining the choices of private actors. The study is based on two samples of operating agreements of LLCs formed in Delaware. The first sample includes 20 LLC governance agreements of publicly traded LLCs, which as of September 2013 were all listed LLCs formed in the US. The second sample includes LLC agreements of 289 large non-listed firms filed with the SEC either by the sample firms themselves or by their listed parent firms. Accordingly, the thesis addresses the central question for both publicly traded and non-listed hybrid business forms.

Chapter 1 presents the results for publicly traded US LLCs. The study shows that the founders of these companies relied on freedom of contract to devise governance structures where the founding members had effective control over managers and faced few formalities during decision-making. However, these companies used different contractual mechanisms to balance the rights of controlling and minority members. In addition to legal mechanisms, the governance of publicly traded LLCs was affected by several non-legal factors—such as ownership structure, board structure and board practices, dividend policies, market disciplining, and standardization of governance agreements. As a result, investors in publicly traded LLCs did not receive investor protection identical to listed corporations, but the contractual freedom to shape the governance of listed LLCs, contrary to expectations, has not led to an extensive lowering of the bar in the protection of investors' rights either.

Chapters 2 and 3 turn to non-listed US LLCs. The members of these firms engage in active contractual planning with the aim of encouraging investments by balancing the conflicts of interests and limiting opportunistic behavior. The practice of investor rights and governance models change heavily depending on the circumstances of investing—such as the number of a firm's members, the size of shareholdings, the strength of voting and other rights.

Chapter 4 shows that the members of hybrid business forms have strong flexibility in determining the internal structure of these firms not only in the US but also in the UK. Given the results of the preceding two chapters, enabling nature of the law should generally benefit rather than disadvantage the users of the UK LLP. There is, however, one important caveat in allowing hybrid business forms to attract equity investments from a wider public via stock markets. Governance structures in publicly traded US LLCs are not only contractual; they are shaped by a specific combination of non-legal factors. Most likely, freedom of contract cannot deliver similar results in other jurisdictions where the contexts is different. Perhaps this is the reason that the US is so far the only jurisdiction that allows organizing publicly traded firms as hybrid business forms.

To conclude, a brief answer to the research question is the following: the users of hybrid business firms, at least in large firms, draft detailed contracts that offer alternative mechanisms of investor protection in cases of altering statutory defaults; moreover, these choices are strategic since they are tailored to the circumstances of particular investments and enhance joint-efficiency of the parties.

This thesis makes several important contributions to the literature and practice. It fills the gap in mostly theoretical literature on hybrid business forms by offering evidence from real-world contracting practices. Such information is wanted in the ongoing debates on the scope of freedom of contract in hybrid business forms. The thesis also informs theoretical discussions of the structure of corporate law in general. Finally, the results show circumstances where different contractual provisions are preferable. This can help users of business forms in choosing particular governance structures and courts in interpreting and making decisions on the enforcement of these provisions.

The only remaining point that needs to be addressed here is that several related questions remained outside the scope of this dissertation. First, the dissertation focuses on the conflicts (1) between different groups of the members of hybrid business forms and (2) between the members and managers of hybrid business forms. This dissertation does not provide insights how contractual practices in hybrid business forms create negative externalities, particularly for the firm's creditors. This important question requires a further study. Second, contractual choices of private actors are a strong standpoint to evaluate whether statutes supply default rules that are preferred by the users of hybrid business forms. These choices can be a basis for defining majoritarian defaults that can reduce transaction costs. One way to do this is by offering a model operating agreement customized to the needs of small firms. And third, data from the contracting practices can be used to test some theoretical predictions of the economic theories of contracts. Law and

economics scholarship, though prolific, has been mostly limited to theoretical models. Increased access to data finally opens wide avenues for testing the predictions of these models. In particular, the data can be useful to clarify the choice of rules versus standards in contracts. The data can also be used to shed more light on the persistence of inefficient default rules by the reason of learning and network externalities—prior experiences and the present value of future judicial interpretations of rules. This can assist in supplying efficient default rules by legislatures and courts and on strategies for drafting such default terms.