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## Have Estate Planners Hijacked the LLC? How Restrictions on Dissolution Have Crippled the LLC as Viable Small Business Entity

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# FLORIDA STATE UNIVERSITY LAW REVIEW



## HAVE ESTATE PLANNERS HIJACKED THE LLC? HOW RESTRICTIONS ON DISSOLUTION HAVE CRIPPLED THE LLC AS A VIABLE SMALL BUSINESS ENTITY

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# HAVE ESTATE PLANNERS HIJACKED THE LLC? HOW RESTRICTIONS ON DISSOLUTION HAVE CRIPPLED THE LLC AS A VIABLE SMALL BUSINESS ENTITY

TANYA SIMPSON\*

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## I. INTRODUCTION

When blushing couples walk down the aisle, they hope to live happily ever after, promising “ ’til death do us part.” Even with such high hopes, many savvy couples sign prenuptial agreements in anticipation of the possibility that the marriage might not turn out as they had planned. Indeed, many individuals will not enter into a marriage without having such an agreement in place. How many would enter into a marriage today if it were possible that their state might not permit them to divorce at all?

When a marriage isn’t going well, all states have a judicial mechanism whereby the unhappy couple can divorce without either spouse having to prove fault, and many states provide the option of proving fault as well.<sup>1</sup> However, when the “marriage” is one of members in a Limited Liability Company (LLC), the availability and mechanisms of dissolution vary from state to state. Some states have

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1. See Peter Nash Swisher, *Marriage and Some Troubling Issues with No-Fault Divorce*, 17 REGENT U. L. REV. 243, 248 (2005).

default rules whereby one member can force a dissolution,<sup>2</sup> while other states require the consent of at least a majority of members.<sup>3</sup> In states requiring majority consent, a minority member may still be able to obtain judicial dissolution, but to do so, the minority member must not only state that the “marriage” is irretrievably broken but must also prove this assertion to the satisfaction of the court by meeting standards that range from relatively easy to nearly impossible to achieve.<sup>4</sup> Furthermore, with the paucity of case law on the subject and the lack of judicial consistency as to which body of law the courts will apply, determining which standards the court will likely apply is a gamble at best—making it difficult for the member to prepare its case appropriately. If the member is unsuccessful in predicting the court’s standards and proving that its case has met them, the member will find itself stuck in the marriage indefinitely, with its capital tied up and no say as to the decisions that affect its investment. This has not always been the case.

Part II of this Comment addresses the history of LLC statutory dissolution provisions and how their devolution has brought about the gradual metamorphosis of the LLC from the ideal small business entity into a much less flexible estate planning vehicle. Part III examines the current state of dissolution statutes among the various states and the bodies of law and model acts upon which they are based. Part IV analyzes the interpretations of these statutes by various courts and illustrates the unpredictability of outcomes through representative case examples. Part V discusses the role of the operating agreement in protecting unwary LLC members against hidden traps that lurk in estate-friendly LLC statutes. Part VI concludes that legislatures must carefully examine the policy reasons behind their entity statutes if they wish to salvage and preserve the LLC as a viable entity for small businesses.

## II. HISTORY OF LLC STATUTORY DISSOLUTION PROVISIONS

The LLC was conceptually designed as an unincorporated busi-

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2. See David M. Deaton, *Check-the-Box: An Opportunity for States to Take Another Look at Business Formation*, 52 S.M.U. L. REV. 1741, 1771 (1999).

3. See *id.*

4. See James R. Cambridge, *The Judicial Dissolution of a Michigan Limited Liability Company When Members Deadlock*, MICH. BUS. L.J., Fall 2005, at 38, 38, available at <http://www.krwpplc.com/BusinessLawJournalFall2005.pdf>.

The court . . . may order the dissolution of an LLC only if the company is unable to carry on business in conformity with its articles of organization or operating agreement. This requires more than the members finding it difficult to carry on the business. It is a very high standard to meet, and it reflects the intent of the Michigan LLC Act that the judicial dissolution of an LLC when the members deadlock should be an extraordinary event.

*Id.*

ness entity that would provide its owners, termed “members,” with three distinct benefits: corporate-like limited personal liability for the obligations of the firm, partnership-like avoidance of double taxation, and broad flexibility to contractually arrange the business as its members and/or managers see fit.<sup>5</sup> An LLC may be structured in one of two ways: member-managed or manager-managed.<sup>6</sup> In a member-managed LLC, all of the members have apparent agency authority, comparable to that of partners in a partnership, to make managerial decisions on behalf of the LLC and to bind the LLC to the extent that the members are carrying on the usual and ordinary business of the LLC.<sup>7</sup> In contrast, in a manager-managed LLC, it is the managers, who are not necessarily members, who have authority to bind the LLC and to make daily operating decisions.<sup>8</sup> Those members who are not managers in a manager-managed LLC are not considered agents of the LLC, and their power to control the firm is generally limited to involvement only in major decisions, if any.<sup>9</sup> It is the manager-managed model that first gave rise to the tug of war between business policy and tax policy with regard to influencing the statutes that govern judicial dissolution of LLCs.<sup>10</sup>

#### A. *Early Dissolution Provisions*

The popularity of the LLC first took off when the Internal Revenue Service (IRS) issued a revenue ruling in 1988 formally recognizing that a limited liability entity could be taxed as a partnership, thus avoiding the dreaded double taxation of a corporation.<sup>11</sup> From that point forward, states moved quickly to adopt LLC statutes, and by mid-1996, all fifty states and the District of Columbia had LLC statutes.<sup>12</sup> The dissolution provisions of these early LLC statutes were designed largely to aid the LLC in obtaining partnership classification for tax purposes under the IRS’s then-existing entity tax classification scheme.<sup>13</sup> Under the now-defunct IRS Regulation 301.7701-2(a)(3),<sup>14</sup> which codified the decision in *United States v.*

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5. For a history of the evolution of the LLC, see generally LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (2d ed. 2004).

6. See MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 500 (8th ed. 2000).

7. See *id.*

8. See Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 337 (1997).

9. See *id.*

10. See discussion *infra* Part II.A.

11. See Rev. Rul. 88-76, 1988-2 C.B. 360, 361.

12. See Ribstein, *supra* note 8, at 328.

13. See Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 426-27 (2001).

14. Treas. Reg. § 301.7701-2(a)(3) (1960).

*Kintner*,<sup>15</sup> an LLC would be taxed as a corporation if it possessed more corporate than noncorporate characteristics as determined by the four-factor *Kintner* test: continuity of life, centralization of management, limited liability and free transferability of interest.<sup>16</sup> Particularly in manager-managed LLCs, where it was quite likely that centralized management would be found in addition to limited liability, it was often critical for the LLC to avoid the corporate characteristic of continuity of life. The United States Treasury specifically recognized continuity of life as being present if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member would not trigger dissolution of the firm.<sup>17</sup>

In an effort to help LLCs avoid the continuity of life characteristic, the majority of early state LLC statutes closely tracked the language of the IRS regulations in defining continuity of life.<sup>18</sup> As an additional precaution, most LLC statutes provided that while LLC members had the power to withdraw from an LLC, similar to partners in partnerships, such withdrawal would trigger the dissolution of the LLC, absent a contrary provision in the LLC's operating agreement.<sup>19</sup> Upon withdrawal, a withdrawing member would receive the fair value of its ownership interest, less any damages for wrongful conduct, and the LLC would be dissolved.<sup>20</sup>

While the characteristic of noncontinuity of life was useful, and indeed often necessary, in achieving partnership tax classification, this characteristic was understandably unattractive to investors, third-party lenders, and contract partners because of the uncertainty associated with potential dissolution.<sup>21</sup> Growing dissatisfied with the rigid requirements for partnership tax classification, business law practitioners increasingly flooded the IRS with private letter ruling requests that sought to narrow the circumstances under which dissolution would occur.<sup>22</sup> Eventually, in 1997, the IRS abandoned the *Kintner* test and enacted the current "check-the-box" regulations that now classify all new LLCs as partnerships for tax purposes, regardless of continuity of life and other "corporate" characteristics, unless

15. 216 F.2d 418 (9th Cir. 1954).

16. *See id.*

17. *See* Treas. Reg. § 301.7701-2(b)(1) (1993).

18. *See* Miller, *supra* note 13, at 428.

19. *See* 1 RIBSTEIN & KEATINGE, *supra* note 5, § 11-2 (2d ed. 2004).

20. *See* Douglas K. Moll, *Minority Oppression & The Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 926-27 (2005).

21. *See* Peter A. Mahler, *When Limited Liability Companies Seek Judicial Dissolution, Will the Statute Be Up to the Task?*, 74-JUN N.Y. ST. B.J. 8, 11 (2002).

22. *See* Miller, *supra* note 13, at 428-29.

they specifically elect to be classified as corporations.<sup>23</sup>

### B. *The Effect of "Check-the-Box" on Dissolution Provisions*

With the advent of "check-the-box" and the elimination of the tax-driven need to avoid corporate characteristics, state legislatures were then free to rewrite statutory provisions governing dissolution of LLCs to be more investor-friendly and to promote sound business policies. With no valid business reason remaining to allow an individual member to cause the dissolution of an LLC at will, and an abundance of strong business policy reasons to disallow it,<sup>24</sup> many state legislatures responded by eliminating provisions requiring "contingent dissolution," or dissolution that is automatically triggered by withdrawal or other separation of a member.<sup>25</sup>

The question remained, however, whether to permit members to dissociate from an LLC. "Dissociation" is a term of art borrowed from partnership law and refers to a termination of some or all of the relational ties between the member and the LLC.<sup>26</sup> Unlike earlier forms of withdrawal, however, dissociation does not necessarily lead to dissolution.<sup>27</sup> Initial statutory default provisions allowed members to dissociate from the LLC and receive the fair market value of their investment interest, less any damages attributed to the member's dissociation.<sup>28</sup> A number of state legislatures, however, have redrafted their dissolution and dissociation provisions to eliminate or severely restrict members' rights to dissociate and liquidate their investments.<sup>29</sup>

The combined effect of eliminating both dissolution and dissociation rights creates a trap for unwary minority members. Members of an LLC whose operating agreement lacks a provision expressly granting dissociation and buyout rights, either because such a provision is statutorily forbidden or nullified or because a buyout provision was simply overlooked by the drafters of the operating agreement, are effectively "locked in" with no way to liquidate their in-

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23. See Treas. Reg. § 301.7701-1 to 301.7701-3 (1996); 2 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 6:2, at 6-3 (rev. 2d ed. 2004).

24. See Miller, *supra* note 13, at 423 (Referring to partnerships, Professor Miller's observations would also apply to LLCs and highlight yet another business policy reason to disallow contingent dissolution provisions: "The threat of a dissolution can be a powerful weapon in the hands of dissatisfied participants in a partnership and creates the potential for wealthy partners to squeeze-out their less well-to-do partners by entering unfairly low bids for the business.").

25. See *id.* at 429-30.

26. See Susan Kalinka, *Dissociation of a Member from a Louisiana Limited Liability Company: The Need for Reform*, 66 LA. L. REV. 365, 365 (2006).

27. See Laurel Wheeling Farrar & Susan Pace Hamill, *Dissociation from Alabama Limited Liability Companies in the Post Check-the-Box Era*, 49 ALA. L. REV. 909, 919 (1998).

28. See Miller, *supra* note 13, at 430.

29. See Moll, *supra* note 20, at 932-33.

vestment interest until such time as the LLC is dissolved.<sup>30</sup> If the operating agreement does not define a specific term for the life of the LLC, minority members could find their investments locked up indefinitely.

*C. States Tailor Dissolution Provisions to Achieve "Marketability Discounts"*

While elimination of both dissolution and dissociation rights may have some business policy merit in that it arguably creates a more stable business environment, the movement to eliminate both dissolution and dissociation rights appears to be driven not by sound business policy but once again by tax motives.<sup>31</sup> Recall that the previous tax policy influence on LLC dissolution provisions was beneficial to small business owners, helping them to achieve pass-through partnership tax classification. The current tax policy influence is not focused on benefiting the small business, but rather is driven by estate planners seizing the family-owned LLC as a vehicle of opportunity to transfer wealth between family generations with minimal tax consequences.<sup>32</sup>

The process works as follows: Investors who own an interest in a closely held entity, such as an LLC, can often claim a "marketability discount" for tax purposes. A marketability discount is a reduced valuation of the investor's interest based on the difficulty of liquidating interest in a firm that is not publicly traded.<sup>33</sup> For members of family-owned LLCs to take advantage of a marketability discount, both the LLC's operating agreement and the state statute must comply with specific federal tax requirements. Not only must the LLC's operating agreement restrict members of the family-owned LLC from cashing out of the business through dissociation or dissolution, but state law itself must restrict such cash-outs.<sup>34</sup> If the state law is less restrictive than the restrictions in the LLC's operating agreement,

30. See Miller, *supra* note 13, at 431.

31. See Farrar & Hamill, *supra* note 27, at 936-37 ("[S]tate legislatures that have revised or are revising their LLC statutes to eliminate the dissolution and dissociation provisions once again experience the tax rules dictating substantive business provisions that should be drafted to further larger business policy concerns."); Miller, *supra* note 13, at 415 ("The driving force behind the reforms is to facilitate estate and gift tax valuation discounts for minority interests in family-owned limited liability companies."); Moll, *supra* note 20, at 936:

Although one could attempt to justify the curbing of withdrawal and dissolution rights on the ground that "locking-in" capital helps to facilitate business development, the movement to restrict exit rights appears to be motivated primarily by a desire to make the family-owned LLC an attractive business structure for estate and gift tax purposes.

*Id.* (footnotes omitted).

32. See Joseph M. Mona, *Advantages of Using a Limited Liability Company in an Estate Plan*, 25 EST. PLAN. 167, 167-71 (May 1998).

33. See SHANNON P. PRATT ET AL., *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 333 (3d ed. 1996).

34. See Moll, *supra* note 20, at 937 n.179.



the LLC's restrictions will be ignored for the purpose of determining a marketability discount.<sup>35</sup> As a result, many states have amended their statutes to facilitate estate planning by further restricting LLC members' ability to liquidate their investment interests.<sup>36</sup>

#### D. *The Cost to Small Business Owners*

While these statutory amendments may accomplish the desired estate tax planning goals, the benefits that inure to the few may come at the expense of the many.<sup>37</sup> By eliminating dissociation and dissolution rights of LLC members, states have left minority members vulnerable to majority oppression, since minority members have virtually no way to exit the LLC and liquidate their investments.<sup>38</sup> Minority members without exit rights often find themselves subject to majority oppression tactics, such as withholding of dividends, employment restrictions, excessive compensation to majority members, withholding of information, violations of firm governance restrictions, and deprivation of a voice in firm decisionmaking.<sup>39</sup>

In theory, minority shareholders should be able to address the consequences of such tactics contractually *ex ante*. This theory, however, assumes a level contractual playing field, and there are many situations, particularly with LLCs, where this is unlikely to be the case. The LLC is often the choice of entity for small businesses, many of which are owned by families and close friends.<sup>40</sup> In these situa-

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35. *Id.*

36. *See id.* at 939 n.181.

37. *See* Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 88-89 (2004):

The focus on estate tax planning as the driving force in shaping of dissolution provisions in LLCs has led legislatures to ignore many of the non-tax implications of corporate-like default rules for dissolution. . . . [L]egislators [should] focus on the business needs of the more typical small business in the state's LLC statute.

. . . .  
. . . . Because the elimination of dissolution at will provisions were driven by estate and gift tax concerns, the larger issues relating to the business relationships of the parties in the typical LLC never surfaced.

*Id.*; Moll, *supra* note 20, at 887 ("Unfortunately, this effort to meet the tax goals of some will come at a high price for many, as the LLC structure is now poised to repeat the oppression experience of the close corporation.").

38. *See* 2 O'NEAL & THOMPSON, *supra* note 23, § 6:4, at 6-8; *see also* Miller, *supra* note 13, at 433 ("The elimination of default exit rights could create a trap for the unwary minority LLC owner without adequate protection under an LLC agreement."); Moll, *supra* note 20, at 939-40 ("While perhaps accomplishing an estate tax goal, the elimination of default withdrawal and dissolution rights leaves minority members vulnerable to oppressive majority actions since the minority can no longer easily exit the venture with the value of its investment.").

39. *See* Miller, *supra* note 13, at 436 (citing *Orchard v. Covelli*, 590 F. Supp. 1548, 1557 (W.D. Pa. 1984)).

40. *See* Moll, *supra* note 20, at 952.

tions, it may not occur to the members that a dispute could arise, the members may simply not want to acknowledge this possibility, or one or more members may persuade another to forego addressing these issues contractually for any number of reasons. In addition, over generations, children may join the business, some members may pass away, and new members may inherit an interest. It is unlikely that negotiations under any of these conditions will be at arm's length.

Furthermore, even if such negotiations do take place, members may not have the resources or foresight to retain competent counsel and will likely lack the sophistication to negotiate and draft an operating agreement that sufficiently addresses the consequences of oppression, other possible disputes, or deadlock among the members. Even if a comprehensive and effective agreement is satisfactorily reached, enforcement at the time a dispute arises will likely require the intervention of a neutral third party, which in many cases will be the court. In these cases, interpretation of any unclear provision of the operating agreement will be at least informed by, if not influenced or trumped by, the state statutory default provisions.

### III. CURRENT LLC STATUTES

Two organizations of legal scholars have put forth separate efforts to develop a standard model limited liability company act. The American Bar Association (ABA) has drafted the Prototype Limited Liability Company Act (PLLCA),<sup>41</sup> while the National Conference of Commissioners on Uniform State Laws (NCCUSL) has developed the Uniform Limited Liability Company Act (ULLCA).<sup>42</sup> The PLLCA was drafted in 1992 by a working group within a subcommittee of the ABA and has never been approved by the ABA or any of its committees.<sup>43</sup> The ULLCA was adopted by the NCCUSL in 1994, with amendments adopted in 1995 and 1996.<sup>44</sup> While these model acts were actively undergoing development, the judicial dissolution provisions of one or the other or both found their way in some form into most state LLC statutes.<sup>45</sup> Because of the vast differences in both the language and the purpose of the two acts' judicial dissolution provisions, the result of these efforts to develop a standard has instead created widespread chaos.

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41. PROTOTYPE LTD. LIAB. CO. ACT § 902 (1992).

42. UNIF. LTD. LIAB. CO. ACT § 801(4)(v) (1996).

43. The PLLCA was drafted by the Working Group on the Prototype Limited Liability Company Act of the Subcommittee on Limited Liability Companies of the Committee on Partnerships and Unincorporated Business Organizations of the American Bar Association's Section of Business Law.

44. See Kalinka, *supra* note 26, at 370 & n.22.

45. See discussion *infra* Parts II.A-B.

### A. Partnership Law-Based Dissolution Provisions and the PLLCA

The judicial dissolution provisions of many LLC statutes follow the language of the PLLCA, which permits judicial dissolution only when it is “not reasonably practicable to carry on the business . . . in conformity with the operating agreement.”<sup>46</sup> This language is borrowed from the Revised Uniform Limited Partnership Act (RULPA), which permits judicial dissolution of a limited partnership whenever “it is not reasonably practicable to carry on the activities of the limited partnership in conformity with the partnership agreement.”<sup>47</sup> The RULPA language is itself borrowed from the Revised Uniform Partnership Act (RUPA), which permits judicial dissolution, among other reasons, whenever “it is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement.”<sup>48</sup>

The vagueness of this language has left it to the courts to determine what is “reasonably practicable” in LLC dissolution litigation. Even the ABA’s own commentary to this section of the PLLCA implicitly admits the vagueness of the language, stating that the “‘not reasonably practicable’ language *probably includes at least some of the causes of dissolution provided for in partnership law.*”<sup>49</sup> This statement necessarily implies that at least some of the causes of dissolution provided for in partnership law may *not* be included in LLC law. The dissolution provisions of LLC law are therefore implicitly more restrictive than the related provisions in partnership law. The extent of these restrictions remains undefined by LLC statutes; thus the statutes provide little guidance to the judiciary as to how to interpret this “reasonably practicable” language.

### B. Close Corporation Law-Based Dissolution Provisions and the ULLCA

With LLC statutes now locking in members’ capital, LLCs are taking on some of the characteristics of the close corporation,<sup>50</sup> and with them, some of the close corporation’s problems.<sup>51</sup> In an attempt to address these problems, a number of states have adopted language from the ULLCA, which seems to be largely influenced by close cor-

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46. PROTOTYPE LTD. LIAB. CO. ACT § 902 (1992).

47. REVISED UNIF. LTD. P’SHP ACT § 802 (2001).

48. REVISED UNIF. P’SHP ACT § 801(5)(iii) (1997).

49. PROTOTYPE LTD. LIAB. CO. ACT § 902 (1992) cmt.

50. See 2 O’NEAL & THOMPSON, *supra* note 23, § 6:3, at 6-4 (“[The manager-managed LLC] look[s] more like a corporation with its entity power centralized in managers who resemble a board of directors.”).

51. See Moll, *supra* note 20, at 896 (“[T]he problem of oppression is ‘portable’ to the LLC context, as the LLC shares certain core features of the close corporation.”). For a discussion of oppression in the close corporation, see *id.* at 888-92.

poration oppression doctrine.<sup>52</sup>

Professor Moll of the University of Houston Law Center identifies four “seeds” of oppression that are common to both close corporations and LLCs: the lack of exit rights, the norm of majority rule, judicial deference to the business judgment rule, and the absence of advance planning.<sup>53</sup> He suggests that in light of the similar opportunities for oppression, courts should extend the oppression doctrine that they have developed for close corporations to LLCs in order to safeguard minority LLC members in the same way that they protect minority shareholders in close corporations.<sup>54</sup>

The ULLCA attempts to address these issues in its judicial dissolution provisions. In contrast to the PLLCA’s “not reasonably practicable” standard, the ULLCA permits judicial dissolution whenever “the managers or members in control of the company have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner.”<sup>55</sup> Several states have adopted the ULLCA’s judicial dissolution provisions, and many also provide for judicial dissolution whenever management is deadlocked.<sup>56</sup> California’s statute goes even further to safeguard minority members from oppression, permitting judicial dissolution whenever it is “reasonably necessary for the protection of the rights or interests of the complaining members,” or when controlling members “knowingly countenance[] persistent and pervasive fraud, mismanagement, or abuse of authority.”<sup>57</sup>

The ULLCA and other oppression doctrine-based judicial dissolution standards are not without their critics. One report suggests that the ULLCA provisions create the reverse problem of “too many opportunities for oppression of the majority by the minority.”<sup>58</sup> In addition, the commentary accompanying the rival PLLCA cautions that allowing judicial dissolution for the often “indefinite concepts” found in many corporate judicial dissolution provisions would encourage opportunistic behavior by disgruntled members and creditors in cases of LLC dissolution.<sup>59</sup>

52. *See id.*

53. *See* Moll, *supra* note 20, at 895-917.

54. *See id.* at 976.

55. UNIF. LTD. LIAB. CO. ACT § 801(4)(v) (1996).

56. For a sampling of states that have adopted this language into their statutes, see Miller, *supra* note 13, at 460-61.

57. CAL. CORP. CODE § 17351(a)(2), -(5).

58. Robert R. Keatinge & James W. Reynolds, *Advisors’ Report on the Uniform Limited Liability Company Act § 4*, submitted Mar. 13, 1995, to the Committee on Partnerships and Unincorporated Business Organizations of the Business Law Section of the American Bar Association.

59. *See* PROTOTYPE LTD. LIAB. CO. ACT § 902 (1992), cmt.

#### IV. JUDICIAL INTERPRETATION OF DISSOLUTION PROVISIONS

Even within states, the judicial dissolution provisions of the same LLC statutes have been interpreted differently. Examples of recent cases from Delaware and New York illustrate how the application of different bodies of law can affect judicial dissolution cases and can sometimes lead to dramatically different outcomes.

##### A. *Judicial Dissolutions in Delaware*

Perhaps the most salient illustration of one state applying different bodies of law to the judicial dissolution of LLCs comprises two recent cases in Delaware. Though heard less than a year apart, these two cases, which both concerned LLCs whose members were deadlocked in a 50/50 split, were interpreted by the Delaware chancery court using corporate law in one case and partnership law in the other.

##### 1. *Haley v. Talcott: Delaware Applies Corporate Law*

In 2004, the Delaware Court of Chancery heard the case of *Haley v. Talcott*.<sup>60</sup> The LLC's two members, Haley and Talcott, each owned a 50% interest in an LLC that owned a parcel of land.<sup>61</sup> The LLC leased its land at a discount to a restaurant, which was wholly owned by Talcott but, prior to the dispute, operated by Haley.<sup>62</sup> The underlying land was mortgaged to the LLC, and Haley and Talcott had both signed personal guarantees on the loan.<sup>63</sup> Haley and Talcott had a falling out and both members desired to go their separate ways but disagreed as to the method for doing so.<sup>64</sup> Haley wished to dissolve the LLC, but Talcott contended that Haley could simply exercise an exit mechanism in the LLC's operating agreement whereby Haley could dissociate from the LLC and receive fair market value for his interest.<sup>65</sup>

The court found that the exit mechanism in the agreement was not a reasonable alternative because, due to Haley's personal guarantee on the mortgage, Haley would remain liable for the debt of an entity over which he no longer had any control.<sup>66</sup> The court thus determined that Haley's only practical remedy to break the deadlock was to seek judicial dissolution of the LLC.<sup>67</sup>

Lamenting the scarcity of case law interpreting judicial dissolu-

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60. 864 A.2d 86 (Del. Ch. 2004).

61. *Id.* at 87-88.

62. *Id.*

63. *Id.* at 88.

64. *Id.* at 87.

65. *Id.* at 88.

66. *Id.*

67. *Id.* at 88-89.

tion of LLCs, the Delaware Court of Chancery looked to corporate law to determine the standards of judicial dissolution.<sup>68</sup> In choosing corporate law, the court reasoned that “[w]hen a limited liability agreement provides for the company to be governed by its members, when there are only two members, and when those members are at permanent odds, [the law of joint venture corporations with only two stockholders] provides relevant insight into what should happen.”<sup>69</sup>

Applying the law of close corporations, the court held that Haley had met the standards for judicial dissolution by demonstrating that there was an indisputable deadlock between two 50% members and that the deadlock precluded the LLC from functioning as provided for in the LLC agreement.<sup>70</sup> The court thus applied corporate-flavored analysis to arrive at its holding that it was “not reasonably practicable for the LLC to continue to carry on business in conformity with the LLC Agreement”—clearly partnership-flavored statutory language—and ordered the LLC dissolved.<sup>71</sup>

## 2. *In re Silver Leaf, L.L.C.: Delaware Applies Partnership Law*

In 2005, less than one year later, the Delaware Court of Chancery again heard a case in which the membership of an LLC was deadlocked in a 50/50 split. In *In re Silver Leaf, L.L.C.*,<sup>72</sup> three members formed an LLC to carry on a french fry vending machine scheme.<sup>73</sup> One member held a 50% interest, one member held a 30% interest, and one member held a 20% interest.<sup>74</sup> The 50% member was at odds with the other two.<sup>75</sup>

In determining which body of case law to apply, the court again bemoaned the lack of case law addressing the dissolution of LLCs.<sup>76</sup> Oddly, although *Haley v. Talcott* has garnered significant media and scholarly attention,<sup>77</sup> the court, in its thirst for case law, only mentioned *Haley* in a footnote, dismissing its usefulness primarily be-

68. *Id.* at 93-94.

69. *Id.* at 94. For a full analysis of the Court of Chancery’s application of joint venture corporate law to this case, see *id.* at 93-96.

70. *Id.* at 89.

71. *Id.* at 98.

72. No. Civ. A. 20611, 2005 WL 2045641 (Del. Ch. Aug. 18, 2005).

73. *Id.* at \*1. For an amusing diversion, read the story of this case as colorfully illustrated in Vice Chancellor Lamb’s opinion. The facts are hilarious, and the telling of them even better!

74. *Id.* at \*3.

75. *Id.* at \*10.

76. *Id.*

77. See, e.g., WILLIAM A. KLEIN ET AL., BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS 681 (6th ed. 2006); Cambridge, *supra* note 4, at 41; John Goodgame, *When Getting Out Is Hard to Do: Lessons in Splitting Up LLCs*, BUS. L. TODAY, May/June 2005, available at <http://www.abanet.org/buslaw/blt/2005-05-06/goodgame.shtml>.

cause *Silver Leaf* involved three members instead of two.<sup>78</sup>

Turning away from corporate law altogether, the court instead looked to limited partnership law to interpret the LLC statute, noting that the dissolution statute for limited partnerships was essentially the same as that for LLCs.<sup>79</sup> Relying this time on Delaware limited partnership case law, the court set the “threshold” standard at whether the LLC could, “pursuant to its Operating Agreement, take the actions necessary to continue functioning as a business.”<sup>80</sup> After determining that the members were deadlocked, that the operating agreement provided no mechanism for breaking a deadlock, and that the business purpose of the LLC was moot, the court, under this standard, dissolved the LLC.<sup>81</sup>

While the application of two different bodies of law to interpret the judicial dissolution provisions of Delaware’s LLC statute resulted in similar outcomes, this may well be largely attributable to the type of corporate law the court applied in *Haley v. Talcott*. The Delaware Court of Chancery applied a very narrow corporate statute that is limited specifically to two-person joint ventures.<sup>82</sup> If the court had applied ordinary close corporation law or broader corporate law, the outcome might have been very different.

### B. *Judicial Dissolutions in New York*

In 1994, Governor Mario Cuomo signed New York’s Limited Liability Company Law (LLCL), which authorizes judicial dissolution “whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.”<sup>83</sup> Nevertheless, the ensuing years have seen judicial confusion about which body of law to apply to New York LLC dissolution cases.

#### 1. *In re Roller: New York Looks to Corporate Law*

In 1999, five years after the LLCL was enacted, the petitioners in *In re Roller*<sup>84</sup> filed a case for judicial dissolution of two LLCs, alleging that it was “no longer reasonably practicable to carry on the business of the companies in conformity with the operating agreement of each.”<sup>85</sup> The court, in its brief analysis, did not look to the operating agreements to determine if the business could be practicably carried

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78. *Silver Leaf*, 2005 WL 2045641, at \*10 n.82.

79. *Id.* at 10.

80. *Id.*

81. *Id.* at 11.

82. See DEL. CODE ANN. tit. 8, § 273 (2004).

83. Mahler, *supra* note 21, at 9-10.

84. 689 N.Y.S.2d 897 (N.Y. A.D. 4 Dept. 1999).

85. Mahler, *supra* note 21, at 13 and nn.27 & 29 (citing *In re Roller*, 689 N.Y.S.2d 897).

on in conformity therewith.<sup>86</sup> Instead, the court considered the following four factors: the respondent had excluded the petitioners from the LLC's business affairs, there was internal dissension and conflict, the respondent had denied the petitioners access to records and had managed the business to his sole benefit, and the dissolution would not harm the public.<sup>87</sup> These are the "classic grounds for dissolution . . . for deadlock and oppression" under New York corporate law.<sup>88</sup>

While the court did not rule on the case, it did state that " 'the petition adequately state[d] a cause of action for judicial dissolution' " under New York LLC law.<sup>89</sup> Although the petition did indeed state an adequate cause of action in accordance with the statute, the court's four-factor analysis suggests that the court would apply the corporate oppression doctrine to LLC judicial dissolution cases.

## 2. *In re Quinn: New York Looks to the Operating Agreement*

Just thirteen months after *In re Roller*, another New York court looked to the operating agreement to determine whether an LLC could be dissolved. While not applying the dissolution statute directly, this case was a prelude to the closer adherence by the courts to New York's LLC statute.

In the unreported decision of *In re Quinn*,<sup>90</sup> the petitioner was the managing member with a minority ownership in a two-member LLC.<sup>91</sup> When the respondent refused to increase the petitioner's compensation, the petitioner left the LLC.<sup>92</sup> In denying the petitioner's motion for a preliminary injunction forcing dissolution, the court focused on whether the respondent's refusal to increase the petitioner's compensation conformed to the operating agreement.<sup>93</sup> While not directly addressing whether it would be reasonably practicable to carry on the business in conformity with the operating agreement, the court did at least look to the operating agreement in its analysis and determined that a compensation decision by a majority member was not an abuse of discretion when the operating agreement granted the majority member a controlling voting interest.<sup>94</sup>

86. Mahler, *supra* note 21, at 13.

87. *Id.*

88. *Id.*

89. *Id.* (quoting *In re Roller*, 689 N.Y.S.2d 897 at 898).

90. N.Y.L.J., Apr. 20, 2000, p. 32, col. 6 (Sup. Ct., Nassau Co.).

91. Mahler, *supra* note 21, at 14 (citing *In re Quinn*, N.Y.L.J., Apr. 20, 2000, at 32, col. 6).

92. *Id.* at 14-15.

93. *See id.* at 15.

94. *See id.*



### 3. *Schindler v. Niche Media Holdings, LLC: New York Applies LLC Law*

In 2003, New York again had the opportunity to interpret LLC dissolution provisions. In *Schindler v. Niche Media Holdings*,<sup>95</sup> Schindler was a 33.3% owner and Chairman of the Board of Niche Media Holdings, LLC.<sup>96</sup> Niche Media was itself the sole member of Hamptons Media, LLC, a successful magazine publishing enterprise.<sup>97</sup> Schindler alleged that another member, Binn, who was Chief Executive Officer with 35.7% ownership, had oppressed him by increasing his own commissions without increasing Schindler's proportionally, withholding commissions from Schindler, canceling Schindler's corporate credit card, and withholding Schindler's promised weekly advance against business expenses that Schindler charged to his personal credit card.<sup>98</sup> Schindler also accused Binn of misappropriating company assets and demanded an accounting of the use of company funds.<sup>99</sup> Among other remedies, Schindler sought dissolution of both LLCs on grounds that "[l]iquidation of the Company Defendants is the only feasible means whereby the Companies' members other than Binn may reasonably expect to obtain a fair return on their investment."<sup>100</sup>

Rather than applying corporate oppression doctrine, as it did to find a cause of action in *In re Roller*, the court dismissed Schindler's cause of action as unauthorized by New York's LLC statute.<sup>101</sup> The court reasoned that Schindler did not allege that it was no longer "reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement" as required by the language of New York's LLC statute<sup>102</sup> and that Schindler had in fact conceded that the business was thriving.<sup>103</sup>

Citing *Schindler*, subsequent cases in New York have dismissed causes of action when the petitioners did not allege or otherwise meet the statutory standard for judicial dissolution of LLCs.<sup>104</sup>

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95. 772 N.Y.S.2d 781 (N.Y. Sup. Ct. 2003).

96. *Id.* at 783.

97. *Id.*

98. *Id.* at 783-84.

99. *Id.* at 784.

100. *Id.*

101. *Id.* at 784-85.

102. *Id.* at 785.

103. *Id.* at 785-86.

104. See *Artigas v. Renewal Arts Realty Corp.*, 803 N.Y.S.2d 12, 13 (N.Y. A.D. 1 Dept. 2005) (holding that the petition for dissolution was properly dismissed because the "entity is a limited liability company, not a corporation; hence, it is governed by the Limited Liability Company Law, not the Business Corporation Law, [and] [t]he petition did not plead the requisite grounds for dissolution of a limited liability company." (citations omitted)); *Horning v. Horning Constr.*, 816 N.Y.S.2d 877, 883 (N.Y. Sup. Ct. 2006) (holding that the petitioner failed to meet his burden to raise a material issue of fact under the statutory

## V. THE ROLE OF THE OPERATING AGREEMENT

With the chaotic state of judicial dissolution provisions and the commensurate uncertainty as to how they will be interpreted, both from state to state and within the same state, a carefully drafted LLC operating agreement appears at present to be an LLC member's best protection.

Recall that in *Haley*, the principal reason that Talcott did not win his argument to keep the LLC intact was that the exit mechanism in the operating agreement that Talcott argued Haley could use was "not a reasonable alternative."<sup>105</sup> Recall also that in *Silver Leaf*, one of the reasons the court gave for dissolving the LLC was that the members were deadlocked and the operating agreement provided no way around the deadlock.<sup>106</sup> In analyzing the outcome of *Haley*, one ABA journal article identifies two "lessons" that LLCs can learn.<sup>107</sup> The first is to draft exit provisions into the operating agreement that require "complete separation of the departing member's interest from the LLC."<sup>108</sup> The second is to "provide for resolution of a management deadlock" in the operating agreement.<sup>109</sup>

The need for a well-drafted operating agreement in the event of judicial dissolution litigation extends beyond the operating agreement's dissolution provision itself. Courts will look to the entire operating agreement to determine whether it is practicable to carry on the business of the LLC in conformance therewith. For example, in the Louisiana case of *Weinmann v. Duhon*,<sup>110</sup> members of an automobile dealership that was organized as an LLC disagreed over the continued employment of the LLC's general manager.<sup>111</sup> The court determined that the operating agreement itself created an impasse in the LLC since, under the agreement, one group of members could fire the general manager while the other group could simply rehire him.<sup>112</sup> The court thus concluded that since it was no longer reasonably practicable to carry on the business in conformity with the oper-

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standard for involuntary dissolution of an LLC where the evidence failed to show that it was not reasonably practicable to carry on the business).

105. *Haley v. Talcott*, 864 A.2d 86, 88 (Del. Ch. 2004).

106. *See In re Silver Leaf, L.L.C.*, No. Civ. A. 20611, 2005 WL 2045641, at \*11 (Del. Ch. Aug. 18, 2005).

107. *See Goodgame, supra* note 77 ("[C]ounsel should learn the lessons of *Haley v. Talcott* and be careful to draft [operating] agreements so that parties intending to avoid judicial dissolution will be able to structure economically acceptable exit provisions in the LLC agreement on which they can rely.").

108. *Id.*

109. *Id.*

110. 818 So. 2d 206 (La. Ct. App. 2002).

111. *See id.* at 207-09.

112. *See id.* at 210.

ating agreement, dissolution of the LLC was the proper remedy.<sup>113</sup>

When drafting an operating agreement, it is critically important to review all provisions of the governing state's LLC statutes and draft a comprehensive agreement. For any issue that is addressed by statute but not addressed in the operating agreement, the statutory provisions could be annexed by the courts into the operating agreement as default "gap-fillers." Furthermore, courts may construe other firm documents as "operating agreements" or gap-fillers in the absence of a written operating agreement. In the New York case of *Spires v. Casterline*,<sup>114</sup> members of an LLC did not have a written operating agreement.<sup>115</sup> The court held that the firm's Interim Voting Agreement contained sufficient provisions to qualify as an "operating agreement" under the statute.<sup>116</sup> The court further held that in the absence of an operating agreement or when an operating agreement does not address the subject in question, the firm is bound by the provisions of the state statute.<sup>117</sup> Thus, the Interim Voting Agreement and the statutory default provisions became the operating agreement for purposes of the court's analysis in this case, in which it ultimately dissolved the LLC.<sup>118</sup>

The very factors that make the LLC most attractive to small business entrepreneurs—simplicity of organization and flexibility of contract—likely also create an environment that is ripe for problematic operating agreements. Because many small businesses are composed of family members and close friends, agreements may not always be negotiated at arm's length.<sup>119</sup> In addition, because of the few required formalities, many LLCs may have unsophisticated or boilerplate operating agreements, or may not have any operating agreement at all.<sup>120</sup> Thus the very nature of the LLC may preclude it from protecting itself against the events of a bad break-up.

## VI. CONCLUSION

The freedom and flexibility to contractually organize the LLC grants members an opportunity to fashion a kind of prenuptial agreement to plan for the challenges of a potential business di-

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113. *See id.*

114. 778 N.Y.S.2d 259 (N.Y. Sup. Ct. 2004).

115. *See id.*

116. *Id.* at 265.

117. *Id.* at 265-66.

118. *See id.* at 266-67. The court held that "[w]hen there is no written operating agreement, these statutory default provisions become the terms, conditions, and requirements for the conduct of the members for the operation of the limited liability company." *Id.* at 266.

119. *See Miller, supra* note 13, at 437-38.

120. *See id.*

voiced.<sup>121</sup> That same freedom and flexibility, however, may lull members into drafting incomplete or unsophisticated operating agreements that, consequentially, will be of little use—or worse—in the event of dissolution litigation. In the absence of an adequate operating agreement or in the likely event that even sophisticated drafters will not have considered every eventuality, courts will look to the default judicial dissolution provisions in the states' LLC statutes to fill in the gaps. To the extent that such statutes and the case law interpreting them are unclear, the LLC may be a less attractive business entity than more established entities with more consistent statutes and better settled case law.<sup>122</sup> Rather than being the best of both worlds, LLCs that lack both the liquidity available to partners in a general partnership and the protective remedies available to investors in a corporation may lock minority LLC owners into the worst of both worlds.<sup>123</sup>

To preserve the LLC as a viable entity for small businesses, it is critical that legislatures, in fashioning and amending state LLC statutes, look beyond the estate planning use of the LLC and consider how their states' statutes will impact small businesses organized as LLCs. Most importantly, legislatures must carefully consider the policy objectives behind establishing the LLC in their state,<sup>124</sup> the policy objectives behind establishing estate planning vehicles in their state, and whether these two objectives are best served by a single entity. I join two leading scholars in suggesting that they are not.<sup>125</sup> In order to serve the purpose for which it was designed, the LLC must be loosed from the clutches of estate planners and returned to the small business owners and entrepreneurs for whom it was originally conceived.

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121. Mahler, *supra* note 21, at 9.

122. *See id.* at 15 (“[T]he uncertainty resulting from the absence of authoritative case law can only serve as a deterrent to greater use of the LLC as one among several competing business entities.”).

123. Miller, *supra* note 13, at 417.

124. *See id.*

125. *See id.* at 417-18 (“[L]egislators should consider . . . the availability of other business entities to achieve estate and gift tax savings . . . .”); Ribstein, *supra* note 8, at 340 (“[A]t least one type of statute should be kept ‘safe’ for non-family firms that do not have tax reasons to restrict member exit.”).