

2002

When Hope No Longer Springs Eternal: A Proposed Remedy for Employee Fall-Outs in Small Member-Managed LLCs

Jordan L. Strauss

Follow this and additional works at: <https://scholarlycommons.law.case.edu/caselrev>



Part of the [Law Commons](#)

Recommended Citation

Jordan L. Strauss, *When Hope No Longer Springs Eternal: A Proposed Remedy for Employee Fall-Outs in Small Member-Managed LLCs*, 53 Case W. Res. L. Rev. 585 (2002)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol53/iss2/17>

This Comments is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

WHEN HOPE NO LONGER SPRINGS ETERNAL:

A PROPOSED REMEDY FOR EMPLOYEE FALL-OUTS IN SMALL MEMBER-MANAGED LLCs

INTRODUCTION

In 1977 Wyoming became the first state to recognize Limited Liability Companies (LLCs);¹ by 1996, every state had followed suit.² The most commonly credited impetus for the states' rush to pass LLC statutes is a 1988 Internal Revenue Service ruling³ applying single-level, partnership type taxation to Wyoming-style LLCs. That ruling rendered LLCs more favorable than partnerships or close corporations for certain kinds of activities.⁴ LLCs have spread, in the words of one commentator, "like wildfire."⁵ Prior to the 1988 Revenue Ruling, there were roughly one hundred LLCs in the United States.⁶ By 1991, there were more than 1700.⁷ In 1995 over 110,000 new LLC filings were reported by forty-seven states.⁸ The LLC form is clearly here to stay, and at least one commentator predicts that its adoption will "dramatically

¹ See Wyoming Limited Liability Company Act, WYO. STAT. ANN. § 17-15-101 (Michie 2001 & Supp. 2002).

² See Warren H. Johnson, Note, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*, 35 NEW ENG. L. REV. 177, 184-87 (2000) (discussing the history of LLCs).

³ See Rev. Rul. 88-76, 1988-2 C.B. 360 ("[The LLC] has associates and an objective to carry on business and divide the gains therefrom, but lacks a preponderance of the four remaining corporate characteristics. Accordingly, [the LLC] is classified as a partnership for federal tax purposes.").

⁴ Although beyond the scope of this Comment, such activities may typically include private ventures in particularly risky fields, such as aerospace engineering or biotechnology. In such cases, the LLC form might be particularly attractive for its limited liability.

⁵ David L. Cohen, *Theories of the Corporation and Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 447 (1998) (discussing the rapid expansion of the LLC business form).

⁶ *Id.* at n.108 (citing Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 402-03 n.46 (1996)).

⁷ Cohen, *supra* note 5, at 440.

⁸ *Id.* at 445.

[change] the law of business organizations and the decision-making process as it pertains to the choice of business entity.”⁹ The rush by the states to pass LLC statutes and the meager collection of LLC case law leaves several key questions unanswered. This Comment attempts to resolve one such question, namely, absent contract or operating agreement provisions, what duty does a member-managed LLC majority owe to member-employees?

A principal feature of the LLC form is the ability to decrease the duty of loyalty that members owe each other; this stands in sharp contrast to other business associations such as partnerships and statutory close corporations, where courts have required a heightened duty of loyalty between partners or shareholders. Although this may not be a source of problems for sophisticated entities who professionally account for the risk of failure, at the drafting stage many small member-operated LLCs fail to anticipate the possibility of future fall-outs between member-employees. Because many aspects of LLCs are governed by basic contract principles, a failure to explicitly contract for such events as termination and dissolution can lead to substantial problems in situations where members of an LLC wish to restrain decision-making ability to employees only.

The issue of fiduciary and loyalty duty in LLCs has been extensively discussed in the literature¹⁰ but almost no attention has been paid to the particular problems facing member-employees of LLCs. Using Ohio LLC law¹¹ as a prototype, this Comment argues that the rationale leading to heightened fiduciary and loyalty duties in other business associations should apply with equal force to member-employees in member-managed LLCs.

Although this Comment presupposes a basic understanding of business associations,¹² Part II contains a brief discussion of the fundamental differences between LLCs and other business associations. Part III reviews how courts in Ohio have treated partnerships and close corporations, particularly in situations where shareholders or partners have also been employed by the associa-

⁹ Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 467 (1994).

¹⁰ See, e.g., J. Mark Meinhardt, Note, *Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited-Liability Business Organizations: Delaware Law and its Adherents*, 40 WASHBURN L.J. 288 (2001); Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21 (1994); see also Johnson, *supra* note 2; Miller, *supra* note 9.

¹¹ Ohio Limited Liability Companies Act, OHIO REV. CODE ANN. §§ 1705.01-.58 (West 1994 & Supp. 2002).

¹² Specifically the fundamental differences between corporations, close corporations, partnerships, and LLCs.

tion. Part IV questions whether LLCs should be treated any differently than other business associations in terms of default duties of loyalty, and Part V concludes that they should not.

I. CONCERNS SPECIFIC TO LLCs

The LLC is best described as an amalgam of traits borrowed from partnership and corporate associations. LLCs enjoy the limited liability of corporate associations while retaining a partnership's ability to be operated by the owners. Day-to-day operations can be conducted by either members or managers¹³ and like a partnership, a private agreement determines the management and profit-sharing properties of the firm.¹⁴ In a recent case, the Delaware Supreme Court described a typical LLC statute¹⁵ as "designed to achieve what is seemingly a simple concept - to permit persons or entities ("members") to join together in an environment of private ordering to form and operate the enterprise under an LLC agreement with tax benefits akin to a partnership and limited liability akin to the corporate form."¹⁶ Importantly, as the Delaware court noted, LLCs allow participants to "engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of [the LLC statute]."¹⁷

Beyond a bare minimum of statutory requirements,¹⁸ LLCs are essentially governed by private contracts ("LLC agreements").¹⁹ In addition to certain information-sharing requirements,²⁰ many

¹³ See Miller, *supra* note 9, at 468-69 (noting that operations can be conducted by members or managers). An LLC manager does not have to be a member of the LLC unless the LLC agreement requires otherwise. See, e.g., OHIO REV. CODE ANN. § 1705.25(C) (West 1994) ("Except as otherwise provided in the operating agreement, a person who is both a manager and a member of a limited liability company has the rights and powers of a manager, is subject to the restrictions and liabilities of a manager, and, to the extent of his membership interest, has the rights and powers of a member and is subject to the restrictions and liabilities of a member.").

¹⁴ See Miller, *supra* note 9, at 469.

¹⁵ Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, § 18-101 (1999 & Supp. 2000) (resembling Ohio's LLC Act).

¹⁶ Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. 1999) (holding that an LLC Agreement was binding as to forum jurisdiction and discussing the properties of LLCs).

¹⁷ *Id.* at 290.

¹⁸ See *infra* note 20.

¹⁹ What this Comment refers to as an LLC agreement is sometimes referred to as an operating agreement or LLC contract.

²⁰ Beyond those duties founded in principles of equity (borrowed from the corporate and partnership form of enterprise), an Ohio LLC owes certain statutory responsibilities to all members. If there is no contrary provision in the operating agreements, an LLC has an obligation to: provide certain records to each of its members, give each member the opportunity to vote as provided in the operating agreement, and make equal distributions to all members when distributions are made. See OHIO REV. CODE ANN. §§ 1705.11(B), .22, .26 (West 1994 & Supp. 2002).

state statutes provide default provisions that can be muted by provisions in an LLC agreement. In some states, the ability to privately structure a firm is so extensive as to grant the LLC agreement drafters the discretion to excuse LLC members from almost any consequences for their behavior.²¹

The freedom with which LLC fiduciary duties can be altered raises the concern that LLC minorities can be squeezed out by LLC majorities without recourse. Although a purist might argue that such an outcome is consistent with the principles of private ordering upon which LLCs are founded, the question of inequitable result has been the subject of at least one scholarly work.²² A more narrow issue is whether employee-members of LLCs should be offered remedies outside of those explicitly stated in an LLC agreement in the event of squeeze-outs or freeze-outs by other LLC members.

II. HOW COURTS HAVE TREATED OTHER BUSINESS ASSOCIATIONS

In other organizational forms, courts adjudicating disputes have had the luxury of expansive precedent, often resulting in additional safeguards for non-controlling stakeholders.²³ Because of the LLC's relative youth in American law, they do not enjoy such a rich history.²⁴ In the absence of precedent, courts and current LLC members should examine how other corporate forms have been treated. Close corporations, like LLCs, are a fusion of corporations and partnerships, and close corporation cases can provide guidance through the gaps in LLC precedent.

A. *In Firms for Which Ownership Stakes are Illiquid, Stakeholders Owe Each Other a Heightened Duty of Care*

In partnerships and close corporations, participants owe each other a high duty of care. That duty is breached when a stakeholder uses his or her power to deprive others of an equal opportunity to share in a benefit. Under the heightened standard, each stakeholder has an obligation to act with the highest regard for the

²¹ See, e.g., DEL. CODE ANN. tit. 6, § 18-306 (1999) (“[a] limited liability company agreement may provide that: (1) A member who fails to perform in accordance with, or to comply with the terms and conditions of, the limited liability company agreement shall be subject to specified penalties or specified consequences.” (emphasis added)).

²² See Miller, *supra* note 9.

²³ See *infra* note 36 and accompanying text.

²⁴ See, e.g., *Child Care of Irvine v. Facchina*, No. CIV.A. 16227, 1998 WL 409363, at *6 (Del. Ch. July 15, 1998) (noting that “[u]nlike the rich body of corporate law decisions that often provide members of this Court with at least an intuitive sense about the parties’ likelihood of prevailing in this matter, in this dispute [the judge does] not enjoy the luxury of interpretive decisions upon which to make a reasoned judgment”).

principles of good faith and fair dealing.²⁵ In cases involving employee-shareholders or employee-partners, courts have consistently applied (or alluded to) a substantially higher requirement of loyalty.²⁶ The heightened standard in small organizations has its roots in one of the earliest and most influential decisions regarding partnerships, *Meinhard v. Salmon*.²⁷

1. *Partnerships and the Meinhard Duty of Loyalty*

Partnerships are the most straightforward association in terms of fiduciary duty, following what is effectively a common-sense approach to loyalty. Partners are liable for the obligations of the partnership,²⁸ and each general partner has the ability to bind the partnership to obligations incurred in the course of the partnership business.²⁹ Because of the ease, and subsequent danger with which partners can hobble each other with partnership debts, courts have consistently applied the highest possible requirement of good faith dealing among partners.³⁰

Meinhard is one of the earliest cases to resolve the issue of partnership duty and is also one of the most oft-quoted in modern American corporate law.³¹ Determining that the defendant breached his duty to the plaintiff, his partner, by arranging a number of favorable business deals to the exclusion of the plaintiff, Judge Cardozo wrote that “[j]oint adventurers, like copartners, owe to one another . . . the duty of the finest loyalty”³² and that “[m]any forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties.”³³ Cardozo wrote that “[a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”³⁴ The *Meinhard* test survives to this day³⁵ and

²⁵ See generally *Gigax v. Repka*, 615 N.E.2d 644 (Ohio Ct. App. 1992) (holding that partner-employees in Ohio close-corporations owe each other a duty of the highest loyalty).

²⁶ *Id.*

²⁷ 164 N.E. 545 (N.Y. 1928).

²⁸ See, e.g., UNIF. P’SHIP ACT § 306(a) (1997) (Partner’s Liability).

²⁹ See, e.g., UNIF. P’SHIP ACT § 301 (1997) (Partner Agent of Partnership).

³⁰ See, e.g., *Meinhard*, 164 N.E. at 545.

³¹ A Shepard’s report of citations to *Meinhard* on October 5, 2002, revealed more than 1,400 citing references.

³² *Meinhard*, 164 N.E. at 546.

³³ *Id.*

³⁴ *Id.*

³⁵ See Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 CARDOZO L. REV. 51, 53 (2000):

Meinhard has aged well. No case of its period is of comparable contemporary influence in the business law area. *Meinhard* is cited today

is the baseline duty applied by most courts in general partnerships,³⁶ including those in Ohio.³⁷ As such, absent explicit provisions in a Partnership Agreement,³⁸ courts will require the utmost standard of good faith in dealings between partners employed by their partnership.

2. Close Corporations

Shareholders of close corporations do not enjoy the remedies available to shareholders of large publicly traded corporations. For non-publicly traded companies, particularly those involved in unique businesses for which there is a relatively small market, it can be difficult or impossible to value an ownership stake. This problem is compounded in the case of small firms that are engaged in "knowledge work" with no tangible product or inventory, like advertising or asset-management firms. Close corporations present unique opportunities for minority-shareholder oppression, particularly when a minority shareholder is in the employ of the majority.

for the power and vitality of the idea it expresses rather than as a window to an era the values of which have long since been abandoned. The 'punctilio of an honor' precept is as enduring as any expression of partnership or corporate law and continues to guide courts in determining the duties business partners owe one another.

³⁶ See, e.g., *Boxer v. Husky Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981) (refusing to dismiss a suit by limited partners against general partners for causing the sale of the limited partners' shares at an inadequate price, the court noted that "It is . . . clear that a partner owes a fiduciary duty to the other partners at common law"); *Slattery v. Bower*, 924 F.2d 6, 10 (1st Cir. 1991) (applying the *Meinhard* duty to a close corporation); *Dardovitch v. Halmon*, No. CIV.A. 97-52, 1998 U.S. Dist. LEXIS 207, at *39 (E.D. Pa. January 14, 1998) (involving a trustee of a corporation), *rev'd on other grounds*, 190 F.3d 125 (3d Cir. 1999); *Granik v. Perry*, 418 F.2d 832, 836 (5th Cir. 1969) ("Florida also recognizes the fiduciary relationships which arise from the more particularized situation of a joint venture"); *In re Van Sweringen Co.*, 119 F.2d 231, 234 (6th Cir. 1941) ("We uphold the standard of [the *Meinhard*] doctrine" to a situation involving the directors of a close corporation accused of self-dealing); *In re Combined Metal Reduction Co.*, 557 F.2d 179, 196 (9th Cir. 1977) ("It is well established that a trustee in a reorganization is required to act in accordance with the highest standards."); *Bakalis v. Bressler*, 115 N.E.2d 323, 326 (Ill. 1953) ("Each of the partners occupied a fiduciary relation to the other, and each was therefore bound to the utmost good faith in all dealings and transactions that affected the other in the partnership business. Since Bressler was the managing partner the duty rested more heavily on him.").

³⁷ See *Schafer v. RMS Realty*, 741 N.E.2d 155, 178-79 (Ohio Ct. App. 2000) (citing *Meinhard* with approval).

³⁸ For example, the Uniform Partnership Act provides that a partnership agreement may not:

eliminate the duty of loyalty under Section 404(b) or 604(b)(3), but: (i) the partnership agreement may identify specific types or categories of activity that do not violate the duty of loyalty, if not manifestly unreasonable; or (ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

UNIF. P'SHIP ACT § 103(b)(3) (1997) (Effect of Partnership Agreement).

For this reason, courts have consistently recognized a heightened duty among close corporation shareholders, particularly in cases involving employee-shareholders.³⁹

In Ohio, the resemblance between close corporations and partnerships, particularly the restriction on alienability of ownership shares and shareholder-management, "has permitted courts to venture outside the laws of corporations 'to borrow from allied disciplines those principles and rules which seem best to comport with the mixed nature of the close corporation form.'"⁴⁰ The rationale that Ohio has used in dealing with close corporations will likely arise in similar cases involving LLCs.

The issue of fiduciary duty in Ohio close corporations first arose in *Estate of Schroer v. Stamco Supply Inc.*,⁴¹ a 1984 Ohio Court of Appeals decision. There, the defendant close corporation, helmed by CEO Ralph Grimme, purchased the shares of Grimme's mother at book value without informing the other shareholders.⁴² When the corporation, controlled by the Grimme family, refused to purchase minority shareholder Dorothy Schroer's shares, she (and later her estate) sued and won an order, affirmed on appeal, that the corporation had to purchase her shares at the same price basis as the other shares. The appeals court held that "the holders of a closely held stock in a corporation . . . bear a fiduciary duty to deal fairly, honestly, and openly with their fellow stockholders and to make disclosure of all essential information."⁴³ The appeals court reasoned that the close corporation blended features from the corporate and partnership form and therefore imposed a similar duty.⁴⁴

In *Schroer*, the Ohio appellate court adopted the reasoning of a classic Massachusetts case, *Donahue v. Rodd Electrottype Company*.⁴⁵ That case, frequently cited in close corporation cases,⁴⁶ arose when the majority shareholders/directors of a family-controlled business (the Rodds) attempted to buy out the shares of Harry Rodd, the company's retiring patriarch. The offer was not extended to the survivors of Joseph Donahue, an employee from

³⁹ See, e.g., *Gigax v. Repka*, 615 N.E.2d 644 (Ohio Ct. App. 1992) (applying heightened duty of loyalty among shareholder-employees of a close-corporation).

⁴⁰ *Id.* at 648 (citing *Estate of Schroer v. Stamco Supply Inc.*, 482 N.E.2d 975, 978 (Ohio Ct. App. 1984)).

⁴¹ 482 N.E.2d 975 (Ohio Ct. App. 1984).

⁴² After purchasing Agnes Grimme's shares, the corporation purchased shares belonging to Ralph Grimme's brother. *Id.* at 977.

⁴³ *Id.* at 980 (citing with approval *Cressy v. Shannon Continental Corp.*, 378 N.E.2d 941, 945 (Ind. Ct. App. 1978)).

⁴⁴ *Id.* at 979.

⁴⁵ 328 N.E.2d 505 (Mass. 1975).

⁴⁶ A Shepard's report on September 29, 2002, for *Rodd* revealed more than 450 citing sources.

1935 to his death in 1971, and one of the only shareholders who was not a member of the Rodd family.⁴⁷ Donahue's wife sued, seeking to either rescind the purchase of Harry Rodd's shares or to compel the purchase of Joseph's shares. The Massachusetts Supreme Court reversed the trial court's dismissal, noting that when close corporations have "(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction, and operations of the corporation . . . [then the close corporation] bears a striking resemblance to a partnership."⁴⁸ Since shareholders often have a substantial investment in the close corporation and an expectation of job security, if a minority shareholder is oppressed or "frozen out"⁴⁹ by the majority, he or she "cannot afford to wait passively"⁵⁰ for a change in management policy and must liquidate assets to his or her disadvantage.⁵¹ Because of the close resemblance between partnerships and close corporations, the *Donahue* court adopted the *Meinhard* rule of partnership fiduciary duty and required "the finest loyalty"⁵² to close corporation shareholders.⁵³

Donahue appears to be the law in Ohio, although it has never been directly applied. In the 1989 case of *Crosby v. Beam*,⁵⁴ the Ohio Supreme Court examined whether minority shareholders of a closely-held corporation should be allowed to bring direct actions against corporate directors, or whether their remedy should be limited to shareholder derivative suits. Crosby, a minority shareholder in a closely-held corporation sued the controlling shareholders claiming that they unjustly enriched themselves with cor-

⁴⁷ *Rodd*, 328 N.E.2d at 509-10.

⁴⁸ *Id.* at 511-12. ("Commentators and courts have noted that the close corporation is often little more than an 'incorporated' or 'chartered' partnership.") *Id.* at 512.

⁴⁹ A "freeze-out" is a scheme by a majority to withhold dividends or salary from a minority shareholder, constructively forcing the minority shareholder to sell his or her shares at an inequitable price - more generally, the oppression of the minority by the majority. *Id.* at 513 ("The minority is vulnerable to a variety of oppressive devices, termed "freeze-outs," which the majority may employ.").

⁵⁰ *Id.* at 514.

⁵¹ *Id.* The court noted that:

At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation.

Id. at 515. The court went on to discuss how remedies available to disaffected partners in forced dissolutions are not available to shareholders in a close corporation who may be "trapped in a disadvantageous situation." *Id.*

⁵² *Id.* at 516.

⁵³ *Id.* at 515. The court expanded its holding to include both majority *and* minority shareholders. *Id.* at 515, n.17.

⁵⁴ 548 N.E.2d 217 (Ohio 1989).

porate funds, improperly used corporate funds against the best interest of the corporation, and conspired civilly to commit the same.⁵⁵ Traditional standing requirements precluded Crosby from bringing the suit directly, and his claim was dismissed at trial. The Ohio Supreme Court affirmed the court of appeal's reversal of the lower court, thereby extending the right to bring direct action to shareholders in close corporations.⁵⁶

In arriving at its holding, the court collaterally resolved the issue of duties owed to minority shareholders in close corporations. The *Crosby* court noted that the close corporation form provides unique opportunities to oppress minority shareholders, for example, by refusing to declare dividends.⁵⁷ Because of this risk, the court adopted a heightened duty of loyalty for shareholders in a close corporation, much like the duty owed between partners in a partnership, because of "the fundamental resemblance between the close corporation and a partnership."⁵⁸ The *Crosby* court wisely observed that "[i]n essence, the ownership of a close corporation is limited to a small number of people who are dependent on each other for the enterprise to succeed"⁵⁹ and "[j]ust like a partnership, the relationship between the shareholders must be one of trust, confidence and loyalty if the close corporation is to thrive."⁶⁰ The court held that "[w]here majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, *absent a legitimate business purpose*, is actionable."⁶¹ The *Crosby* court concluded with the just proviso that "[c]ontrol of the stock in a close corporation cannot be used to give the majority benefits which are not shared by the minority."⁶²

⁵⁵ *Id.* at 217.

⁵⁶ *Id.* at 221.

⁵⁷ *Id.* at 220.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 221 (emphasis added).

⁶² *Id.* (citing *Alaska Plastics Inc. v. Coppock*, 621 P.2d 270, 276 (Alaska 1980)).

B. In the Partnership and Close Corporation Form, Stakeholder-Employees Have an Expectation of Continued Employment or Just Cause Termination.

In *Gigax v. Repka*,⁶³ the plaintiff and two defendants were the sole shareholders of an Ohio close corporation. At the formation of the close corporation, the parties agreed that each of them would work for the corporation. Plaintiff and defendants had equal ownership of the stock and drew equal salaries. However, there was no written agreement. In 1992, the defendants terminated Plaintiff, alleging poor performance. Plaintiff sued for breach of duty and lost at trial, but the verdict was reversed on appeal. The appeals court stated that a minority shareholder who is a director of a close corporation is more than simply an at-will employee.⁶⁴

The *Gigax* court reiterated that partners' fiduciary duty to each other requires that a termination of a partner-employee be for a legitimate business reason. Noting the similarities between close corporations and partnerships, the court found that close corporation "participants often consider themselves as partners *inter sese* while obtaining the advantages of the corporate form . . . [That] resemblance has permitted Courts to venture outside the laws of corporations 'to borrow from allied disciplines those principles and rules which seem best to comport with the mixed nature of a close corporation.'"⁶⁵ To determine whether a termination is acceptable, a court must "[balance] the need to protect the minority shareholder-employee with the needs of the close corporation in ridding itself of the unproductive or troublesome employee."⁶⁶

In *Gigax*, the court found that the plaintiff had *not* been removed for legitimate business reasons. In reaching this conclusion, the court considered evidence demonstrating that each partner experienced a decline in profitability at some time since the company's formation, as well as an admission by the defendants that the decline of profitability in the jobs assigned to Plaintiff was not necessarily attributable to him. The court was also sensitive to the fact that, prior to Plaintiff's dismissal, the defendants failed to

⁶³ 615 N.E.2d 644 (Ohio Ct. App. 1992).

⁶⁴ *Id.* at 649 ("We disagree with the finding that employee/shareholder/directors in a close corporation are at-will employees terminable *at any time* by the majority or controlling shareholder/directors.").

⁶⁵ *Id.* at 648 (quoting *Estate of Schroer v. Stamco Supply Co.*, 482 N.E.2d 975, 978 (Ohio Ct. App. 1984)).

⁶⁶ *Id.* at 650.

inform him of their dissatisfaction with his performance.⁶⁷ In this respect, the *Gigax* court was appropriately weary of the delicate balance between an equitable outcome and interfering with the freedom to do business.

III. SHOULD LLCs BE TREATED DIFFERENTLY THAN OTHER CORPORATE FORMS?

A. *In the Absence of an Explicit Clause in an LLC Agreement, Stakeholder Relations in LLCs, Particularly in the Case of Stakeholder-Employees, Should be Treated In the Same Manner As Close Corporations Have Been.*

In Ohio, fiduciary duty can be reduced, and possibly eliminated, through an express provision in an LLC operating agreement.⁶⁸ However, if the parties do not draft an alteration of duty in the LLC operating agreement, then the default duty should be one of utmost loyalty. Since an LLC shares the fundamental traits of a close corporation, the members of an LLC should owe each other the same duty of loyalty that partners in a partnership owe each other or that shareholders in a closely held corporation owe each other. In short, there is no justification for leaving minority stakeholders at risk for indiscriminate abuse by the majority.

B. *LLC Stakeholders Who Are Also Employees of the LLC Have an Expectation of Continued Employment and Deserve the Highest Possible Duty of Loyalty from Other Stakeholders.*

Since the private-ordering principle is so fundamental to the value of the LLC as a business association, any rule that attempts to look past an explicit clause in the LLC agreement would be dangerously short-sighted, and incompatible with the core LLC principle of private ordering.⁶⁹ One remedy that is consistent with the contract principles upon which LLCs are founded is to require all employee-stakeholders of LLCs to obtain written employment contracts specifically stating the terms upon which termination is proper.⁷⁰

⁶⁷ *Id.* (“[The other partners] admitted in their testimonies that the decline of profitability in the jobs assigned to Gigax was not necessarily attributable to him, and that Gigax was not apprised of his partner’s dissatisfaction with his profitability prior to his removal.”).

⁶⁸ *McConnell v. Hunt Sports Enters.*, 725 N.E.2d 1193, 1215 (Ohio Ct. App. 1999) (holding that “a contract may define the scope of fiduciary duties between parties to the contract”).

⁶⁹ *See Miller, supra* note 9, at 474 (“[LLCs are] governed largely through the direction of an operating or managing agreement.”). *See generally supra*, note 16 and accompanying text.

⁷⁰ Should this remedy be adopted, requiring that LLC agreements stipulate the manner in which the stake of a disassociated member is to be valued, would be of great assistance in

Unfortunately, LLC participants caught in the optimistic grip of a new venture may be unwilling, or simply unaware of the need, to recognize and plan for the possibility of dissolution or disaffection. Although a barrier to recovery in the absence of such contracts would surely have the effect of encouraging rapid change, it would be unjust to impose such a cold and indiscriminate rule.⁷¹ As such, courts adjudicating disputes without prior planning by LLC participants should adopt a more comprehensive, functionalist rule to determine whether there is a heightened duty of loyalty and fair dealing owed a stakeholder-employee.

C. A Proposed Rule

In cases where the duty of loyalty has not been spelled out in an LLC agreement or employment contract, an ideal test would first ask whether the LLC resembles a close corporation by using the *Donahue* formulation.⁷² That is, to ask whether: (1) there are a small number of stakeholders; (2) there is no ready market for the stakes; and (3) there is substantial majority stakeholder participation in the management and operations of the firm.⁷³ If all three criteria are answered affirmatively, stakeholders in the LLC should qualify for the *Meinhard* duty of "finest loyalty."⁷⁴ In such organizations, stakeholder A violates this duty if (1) without a legitimate business reason, she (2) uses her position and influence to (3) extend benefits to (4) parties similarly situated⁷⁵ to stakeholder

avoiding future conflicts. Valuation of a membership stake in an LLC can be extremely difficult, as LLCs are often engaged in highly specialized activities, and the book value of the assets encompassed by a membership stake can be grossly out of step with the going-concern valuation. Along these lines, it is easy to envision a situation in which an LLC agreement requiring departing members to sell their membership stake to the firm for book value produces some degree of forfeiture, or, similarly, that a firm does not have the liquid assets to purchase a departing members stake as valued by a going-concern method. Suffice to say, valuation of ownership interest for which there is no apparent market is just one barrier to disaffected members and is best addressed through careful planning and contracting at the time of LLC formation.

⁷¹ For example, such a rule could result in the sanctioning of a member-employee's ouster based on a decision that would only benefit certain other similarly situated members.

⁷² See *supra* Part II.A.2.

⁷³ *Donahue v. Rodd Electrotyping Company*, 328 N.E.2d 505, 522 (Mass. 1975).

⁷⁴ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

⁷⁵ To elaborate, assume that B is a secretary of Widgets Unlimited, a statutory LLC with privately traded classified ownership shares. Over the years, B has amassed a small amount of LLC ownership shares, available to employees for profit-sharing and incentive purposes. Per his employment agreement and the LLC agreement, B can purchase additional shares at the price of two dollars. At the end of the fiscal year, Widgets Unlimited falls on hard times. Faced with the prospect of immediate bankruptcy, C, a large investment bank, swoops in and agrees to provide life support funding for the LLC in exchange for convertible debt. According to the terms of the debt agreement, should Widgets Unlimited default, C's debt will convert into ownership shares of the type B currently owns. The net effect of this transaction is that, *in the event of default*, C will have acquired a controlling percentage of Widgets Unlimited shares at a price substantially less than two dollars a share. B sues, claiming that the LLC has discriminated

B without (5) giving B an equal opportunity to share in (6) those specific benefits.⁷⁶ In the context of a stakeholder-employee, such a duty would be violated if, for example, for no reason relating to employee performance, a routine distribution of profits was made to majority stakeholders and not to a minority stakeholder.

The above test should apply not only to outright termination or squeeze-out/freeze-out situations, but also to operational issues such as compensation and workplace quality-of-life.⁷⁷ The principles discussed above logically extend to scenarios falling short of outright termination, as the equitable factors necessitating protection of minority stakeholders (like depending on the firm for livelihood) apply proportionately to lesser degrees of discrimination. The reduction of an employee-stakeholder's compensation or other factors that might contribute to an employee's constructive discharge should also fall under the *Donahue/Meinhard* purview. For example, under this reasoning, a controlling stakeholder may only reduce a stakeholder-employee's compensation if (1) the controlling stakeholder's actions are warranted by legitimate business purposes (such as encouraging an improvement in performance by the stakeholder-employee or a shift in economic factors); (2) the majority stakeholders inform the stakeholder-employee that his or her performance is inadequate prior to the reduction of compensation; and (3) they do not act with the sole purpose of ousting the stakeholder-employee for the *controlling stakeholder's* benefit, as opposed to the *firm's* benefit. Evidence of unilateral action taken

against him, and breached its fiduciary duty by not allowing him to buy a smaller quantity of convertible debt for the proportionately same price as C. Here, in the absence of bad faith or self-dealing, B should *not* prevail, as B, an individual of limited means, is clearly not in the position to offer the same scale, quantity, or quality of benefits in exchange for convertible debt as C, a large and experienced investor. Although it may very well come to be that B and C are similarly situated as owners of Widgets Unlimited ownership shares, at which time the two are similarly situated and thus in a relationship requiring a high fiduciary duty, *at the time C acquires the convertible debt*, there has been no breach of duty.

⁷⁶ "Those benefits" refers to the specific benefits extended to one or some, but not all, of the stakeholders.

⁷⁷ Many LLC statutes contemplate the establishment of compensation schemes for stakeholders. For example, Ohio allows a majority of the voting interest of an LLC to establish reasonable compensation for members, managers, and officers. *See* OHIO REV. CODE ANN. § 1705.31(A)(3) (West 1994). Courts dealing with similar situations in the closely-held corporation context have been sensitive to the possibility that shareholders may rely entirely on a form of compensation from the company. *Donahue*, 328 N.E.2d at 514 ("The stockholder may have anticipated that his salary from his position with the corporation would be his livelihood."). In this respect, so long as there is no self dealing, such as paying officers disproportionately large salaries, any reasonable compensation plan should be acceptable to a court. *See generally* *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989) ("[T]he close corporation structure may also give majority or controlling shareholders opportunities to oppress minority shareholders. For example, the majority . . . may grant majority shareholders-officers exorbitant salaries and bonuses.").

without either a formal meeting or a chance for the stakeholder-employee to defend himself or herself will cut against a finding of legitimacy.

In applying this rule to LLCs, courts must be sensitive to the possibility that they could, in theory, be made complicit in a “reverse freeze-out.” Such an event, perhaps more aptly entitled a reverse-hijack, would involve a stakeholder using a court to force his or her will upon the majority under the guise of broken duties of loyalty. Although such an admittedly remote situation may seem unlikely, it is imperative that courts distinguish between cases of actual stakeholder oppression, and cases of the majority causing unfortunate results for the stakeholder by simply exercising its will to further the ends of the firm. Courts should instruct juries to use evidentiary factors, such as secret meetings, improper or uneven distributions, and quality and quantity of information sharing to distinguish between necessary business decisions and bad will.⁷⁸

CONCLUSION

Although a majority’s exercise of control over an enterprise is certainly not in and of itself a breach of duty, courts have generally taken a protectionist approach to the rights of minority owners.⁷⁹ A small, member-managed LLC bears many of the same characteristics as a close corporation, most notably an encumbrance on, or outright prohibition of, the transfer of ownership interest.⁸⁰ Because there is generally little or no market for ownership interest in small specialized firms the classic market solution of simply dumping shares on the open market is not available to members of close corporations and LLCs who disagree with a management decision. Despite the baseline rules for information sharing found in many LLC statutes,⁸¹ a minority stakeholder is bound by the majority’s decisions whether or not he or she personally benefits.

Because of the key similarities among partnerships, close corporations, and LLCs, if the issue of LLC default loyalty ever reaches a court, a member-managed LLC should be treated like a

⁷⁸ Such factors might include examining what is to be gained by the plaintiff (besides a right to share in the benefits created by the defendant) should he or she prevail, evidence of how prejudiced a plaintiff truly is by an act of another stakeholder (for example, although a billionaire partner in a small venture certainly has the same right not to be frozen out as any other party, the billionaire might not require as high a level of protection as a wage-earning employee), and evidence of animosity between the parties as an ulterior motive for bringing suit.

⁷⁹ See *supra* Part III.

⁸⁰ For example, an LLC organized to provide dental hygiene to the public may prohibit the sale of a membership interest to a non-dentist.

⁸¹ See *supra* note 20.

close corporation for the purposes of loyalty, at least in the presence of the factors enumerated above.⁸² Although courts must strive to uphold the key LLC principle of private ordering, they must at the same time be sensitive to inequitable results affecting employee-stakeholders. In practice, many stakeholders in small LLCs are constructively at the behest of the LLC majority, and can be frozen or squeezed out with relative ease; courts must carefully balance the policy interests of private ordering to avoid unjust outcomes for minority stakeholder-employees.

JORDAN L. STRAUSS[†]

⁸² By definition, LLCs can be crafted to be very different; each is unique, and an LLC that does not fit into the factors described above may not need to be treated as advocated in this Comment.

[†] B.A., Hampshire College, 2000. J.D. Candidate, Case Western Reserve University, 2003. I thank Atossa Alavi and Michele Connell for their assistance and patience, Hugh McKay and David Bell for their valuable insight on the core issues discussed here, and Case Western Reserve University School of Law for its Spring 2002 Business Associations class.

