# EQUILIBRIUM DESTABILIZED: FIDUCIARY DUTIES UNDER THE UNIFORM LIMITED LIABILITY COMPANY ACT*

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## I. INTRODUCTION

Fiduciary duty is a thorn in the side of the law and economics school;[1] to other scholars, it is an indispensable, and even efficient, aspect of the business form.[2] What should be the standard for performance of a member in a limited liability company (LLC), a new style of business organization? How should we determine the impact of being both a member and a manager?

The analysis of the LLC is both difficult and interesting precisely because it is, for the United States, a new form defined and created by statute. The limited liability company statutes have spread from one jurisdiction to another with remarkable speed. They promise limited liability for every owner, even owner-managers, and at the same time offer federal tax treatment as a partnership. This combination is irresistible: forty-seven states and the District of Columbia have adopted LLC statutes; before 1988 there were only two such jurisdictions.[3] The National Conference of Com

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1. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) (discussing the issue in the corporate-law context).

2. *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) (advocating a tempered support of fiduciary duties). See also *infra* Part II(B)(2) for a reference to anti-contractarians as supporters of mandatory fiduciary duties.

3. As of August 1995, 47 states and the District of Columbia have adopted such a statute. ALA. CODE §§ 10-12-1 to -61 (Supp. 1993); ALASKA STAT. §§ 10.50.010–.995 (Supp. 1994); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (Supp. 1994); ARK. CODE ANN. §§ 4-32-101 to -1316 (Michie Supp. 1993); CAL. CORP. CODE §§ 17000–17705 (West Supp. 1995); COLO. REV. STAT. ANN. §§ 7-80-101 to -1101 (West Supp. 1994); CONN. GEN. STAT. ANN. §§ 34-100 to -242 (West Supp. 1995); DEL. CODE ANN. tit. 6, §§ 18-101 to -1107 (1993); D.C. CODE ANN. §§ 29-1301 to -1375 (Supp. 1995); FLA. STAT. §§ 608.401–.514

missioners on Uniform State Laws (NCCUSL) has recently put the finishing touches on its Uniform Limited Liability Company Act (ULLCA).[4] The influence of uniform statutes suggests that ULLCA is our best chance to develop any degree of uniformity;[5] it therefore

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(1993); GA. CODE ANN. §§ 14-11-100 to -1109 (1994 & Supp. 1995); IDAHO CODE §§ 53-601 to -672 (1994 & Supp. 1995); ILL. ANN. STAT. ch. 805, para. 180 (Smith-Hurd Supp. 1995); IND. CODE ANN. §§ 23-18-1-1 to -13-1 (West 1994); IOWA CODE ANN. §§ 490A.100–.1601 (West Supp. 1995); KAN. STAT. ANN. §§ 17-7601 to -7652 (Supp. 1993); KY. REV. STAT. ANN. §§ 275.001–.455 (Michie/Bobbs-Merrill Supp. 1994); LA. REV. STAT. ANN. §§ 12:1301–:1369 (West 1994); MD. CODE ANN., CORPS. & ASS'NS §§ 4A-101 to -1103 (1993 & Supp. 1994); ME. REV. STAT. ANN. tit. 31, §§ 601–762 (West Supp. 1994); MICH. COMP. LAWS ANN. §§ 450.4101–.5200 (West Supp. 1995); MINN. STAT. ANN. §§ 322B.01–.960 (West 1995); MISS. CODE ANN. §§ 79-29-101 to -1201 (Supp. 1994); MO. ANN. STAT. §§ 347.010–.187 (Vernon Supp. 1994); MONT. CODE ANN. §§ 35-8-101 to -1307 (1994); NEB. REV. STAT. §§ 21-2601 to -2653 (Supp. 1994); NEV. REV. STAT. ANN. §§ 86.010–.571 (Michie 1994); N.H. REV. STAT. §§ 304-C:1 to :85 (Supp. 1994); N.J. STAT. ANN. §§ 42:2B-1 to -70 (West Supp. 1995); N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1994); N.Y. LTD. LIAB. CO. LAW §§ 101–1403 (McKinney Supp. 1995); N.C. GEN. STAT. §§ 57C-1-01 to -10-07 (1993 & Supp. 1994); N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1993); OHIO REV. CODE ANN. §§ 1705.01–.58 (Anderson Supp. 1994); OKLA. STAT. ANN. tit. 18, §§ 2000–2060 (West Supp. 1995); OR. REV. STAT. ANN. §§ 63.001–.990 (Supp. 1994); 15 PA. CONS. STAT. ANN. §§ 8901–8998 (Supp. 1995); R.I. GEN. LAWS §§ 7-16-1 to -75 (1992 & Supp. 1994); S.C. CODE ANN. §§ 33-43-101 to -1409 (Supp. 1995); S.D. CODIFIED LAWS ANN. §§ 47-34-1 to -59 (Supp. 1995); TENN. CODE ANN. §§ 48-246-101 to -602, 48-248-101 to -606 (Supp. 1994); TEX. REV. CIV. STAT. ANN. Art. 1528n, arts. 1.01–11.07 (West Supp. 1995); UTAH CODE ANN. §§ 48-2b-101 to -158 (1994 & Supp. 1994); VA. CODE ANN. §§ 13.1-1000 to -1123 (Michie 1993 & Supp. 1995); WASH. REV. CODE ANN. §§ 25.15.005–.902 (West Supp. 1995); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1994); WIS. STAT. ANN. §§ 183.0102–.1305 (West Supp. 1994); WYO. STAT. §§ 17-15-101 to -143 (1989 & Supp. 1995). Before 1990, Florida and Wyoming were the only LLC jurisdictions. Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 378 (1992). National Conference of Commissioners on Uniform State Laws' (NCCUSL) Uniform Limited Liability Company Act (ULLCA) was approved July 29–August 5, 1994, at NCCUSL's annual conference. Since then, the ULLCA has been revised several times, the last on August 11, 1995.

4. UNIF. LTD. LIAB. CO. ACT (ULLCA) (1995), *reprinted in* 25 STETSON L. REV. 463 (1995).

5. That the existing state statutes have taken approaches that differ from those of ULLCA is an understatement. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(c) (1993) (to the extent that there are fiduciary duties at law or equity, they can be restricted by agreement). By agreement, the LLC can indemnify "any member or manager or other person from and against any and all claims and demands whatsoever." *Id*. § 18-108. For a brief survey of the statutes, see S. Mark Curwin, Note, *Fiduciary Duty and the Minnesota Limited Liability Company: Sufficient Protection of Member Interests?*, 19 WM. MITCHELL L. REV. 989, 1004–15 (1993). An obvious problem with the Delaware statute is that it does not explain how law or equity would impose a fiduciary duty in the first place; it merely states that Delaware recognizes fiduciary duties. *Id*. at 1007. Agency law would still apply to the extent that a person were an agent, *see, e.g.*, RESTATEMENT (SECOND) OF AGENCY §§ 379(1), 387 (1957), and ULLCA does state expressly that "each member is an agent of the limited liability company for purpose of its business." ULLCA §

deserves close attention.

All drafters of LLC statutes, including NCCUSL, necessarily are experimenting; here we have the privilege of considering fundamental problems without being directly bound by history. The best experience available to us is by analogy to other business forms, but we must remember that the LLC is radically different and has no past. The LLC is fundamentally different, as I discuss below,[6] because it is an unincorporated entity that cannot be formed by inadvertence, that provides limited liability for its owners without concern for the extent of their involvement in management, and that can obtain partnership status for federal tax purposes. The first two characteristics are similar to those of a close corporation. Because most LLCs have few members, the close corporation rather than the publicly-held version is the proper point of comparison.[7] The last characteristic, albeit a tax consideration, is that of a partnership.

Although the LLC is a hybrid, as discussed in Parts II (A) and (B), ULLCA has adopted the Revised Uniform Partnership Act's (RUPA)[8] handling of fiduciary duty,[9] with the important addition of a trigger that eliminates the duty of any owner who is not also officially a manager.[10] While I object to the exclusion from liability of an owner who is functionally but not officially a manager, my disagreement with ULLCA goes to more than technical glitches. I am par-

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301(a)(1). But this duty is owed to the LLC, not to fellow members. Therefore, under what authority could a duty, under agency principles or otherwise, be imposed in favor of other owners? ULLCA § 409(a) refers to the duties owed to both the LLC and its members, but merely to define the only such duties owed and to exclude all others. *See infra* notes 73 & 74 and accompanying text. Given the position that I take on the fiduciary provisions of ULLCA, *see infra* at Part III(C)(4), and given my general view on fiduciary duties, *see* Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U.L. REV. 955 (1995), I believe that the duties should exist.

6. *See infra* Part II(A).

7. *See, e.g.*, Keatinge et al., *supra* note 3, at 391.

8. *See* UNIF. PARTNERSHIP ACT (1994) (RUPA), 6 U.L.A. 280 (Supp. 1995). NCCUSL's Revised Partnership Act is titled the "Uniform Partnership Act (1994)," but is commonly referred to as the "Revised Uniform Partnership Act" to avoid confusion with the original Uniform Partnership Act of 1914. This Article will follow this convention and cite the Revised Act as "RUPA" and the original Act as "UPA."

9. *Compare* RUPA § 404 *with* ULLCA § 409. *See generally infra* notes 66 & 72.

10. I believe that the standard of performance in RUPA is too low for the partnership context. *See infra* note 85 and accompanying text. Nevertheless, for our purposes here, we need only recognize that the NCCUSL drafters intend to transfer to LLCs the standard previously adopted by NCCUSL for partnerships.

ticularly concerned by the owners' ability, under ULLCA, to opt out of fiduciary duties (Part II(C)). Part III(A) of this Article describes the pre-RUPA and pre-ULLCA treatment of fiduciary duty of owners for both branches of the LLC's ancestors: the close corporation and the partnership. It shows that judge-made law balances the actor-owner's control and conflict against the resultant harm that society will permit the actor-owner to inflict on the co-owners who lack control. Part III(B) of this Article discusses the evolution of limited liability, and how increased limitation of liability through the creation of LLCs, especially given the potential for opting out of fiduciary duties, has disturbed this delicate equilibrium.

Finally, Part III(C) suggests that since the owner of an LLC will remain sheltered from liability to third parties, the balance can be reintroduced by presuming mandatory standard of performance determined by the type of business form in question. I discuss and defend the need for a standard of performance and the reason for a mandatory standard. The analysis refines the choice of standard by recognizing the control and conflict of the actor-owner and the harm permitted to be inflicted on the co-owners. This permitted-harm analysis is then applied to the LLC: all other factors being equal, the standard applied to members of the LLC will presumptively be higher than for shareholders, but lower than for partners. The standard will be higher if the actor-owner has both control and conflict of interest, especially if the co-owners are particularly vulnerable to abuse. It will be lowered if the actor-owner has little control or conflict and the co-owners are not particularly susceptible to harm from the actor-owner.

The purpose of this Article, then, is to show how this permitted-harm system avoids a danger inherent in ULLCA. The business form authorized by ULLCA as currently drafted permits even a managing owner to have only minimal personal responsibility. Because this is extremely attractive to these owners, the LLC may well surpass the partnership and the close corporation as the preferred form of business organization, materially reducing the ethical checks on owners, including owner-managers, of businesses in this country. Under the permitted-harm system, ULLCA would continue to allow an LLC's owners, including managing owners, to limit their personal liability to third parties, but it would no longer permit them to reduce, to a good faith standard, their duty of loyalty to co-owners. The LLC would be functionally, as well as structurally, a true hybrid of the partnership and the corporation.

## *II. FIDUCIARY DUTIES AMONG OWNERS WHEN THE BUSINESS FORM IS PURELY A CREATURE OF STATUTE*

LLCs are creatures of statute. Consequently, to the extent that the statutes describe the extent of fiduciary duties, they control.[11] ULLCA does describe fiduciary duty, but permits the parties to define it further, subject to a mandatory threshold of good faith.[12] The questions are whether this is the correct route, and whether it has been constructed properly.

In the abstract, certain theorists approve the ability of parties to opt out of fiduciary duties: the contractarians believe in the freedom of contract and therefore that parties should generally have the freedom to determine the terms of the various business forms.[13] Their preferred statutory definition of fiduciary duties would allow for maximum opting-out. The anti-contractarians believe that the fiduciary duty ought to be a mandatory standard, and some want the mandatory standard to be high.[14] The drafters of ULLCA, avoid-

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11. Certain LLC statutes do attempt to detail the extent of fiduciary duties, although their interpretation may be less clear. Other types of statutes more openly support the opting out concept of the contractarian scholars. In essence, this concept offers to the parties the option of agreeing by contract on the appropriate standard for performance. For a recent analysis, see Curwin, *supra* note 5. It has even been suggested that the indemnification provisions of certain statutes eliminate fiduciary duties. *Id*. at 1013. Assuming that some fiduciary duty would be applied by common law, *see, e.g.*, *infra* Part II(B)(1), discussing evolution of fiduciary duties in corporate law, this proposition is too aggressive a derogation from common law for implied modification.

12. ULLCA §§ 103(b)(4), 409(d); *see infra* notes 72–73 and accompanying text.

13. The corporation as a "nexus of contracts" is a concept commonly used by the contractarians. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426 (1989) (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976)). Whether or not this theory is appropriate for corporations, it has relevance for the general partnership, whose form is substantially as agreed to by the partners. ALLAN R. BROMBERG & LARRY E. RIBSTEIN, PARTNERSHIP § 6.07 (1991); CLAIRE MOORE DICKERSON, PARTNERSHIP LAW ADVISER § 5.1, at 136 (1991). As to the applicability of the contractarian analysis to fiduciary duties in the context of corporate law, see Butler & Ribstein, *supra* note 1, and in the context of evolving partnership law, see Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 454–61 (1987); Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 59 (1993); *see generally infra* Part II(B)(2).

14. In the context of corporations, see Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (demanding a high standard); *see also* Coffee, *supra* note 2, at 1618. For an anti-contractarian discussion of

ing any ideological camp, have recommended composite guidelines: when the LLC arguably looks and acts like a partnership, the applicable fiduciary duty should be the uniform statutes' partnership-law standard, but when the LLC is more like a close corporation, the level of fiduciary duty applied to shareholders of such a corporation would apply.[15]

ULLCA is unsatisfactory in at least two ways. First, it is not supported by a clear understanding of why the LLC is considered a hybrid of the partnership and corporate forms. Second, it does not reflect a full analysis of the standards of performance currently applied to owners of a partnership versus those of a close corporation. We must also consider the limitations of the traditional standards when applied to a hybrid business form that is neither a partnership nor a corporation but, rather, roams broadly on the spectrum between those two.

### A. The LLC as a Statutory Hybrid of the Partnership and Corporate Forms

Commentators are happily confirming that the LLC is a hybrid of the partnership and corporate forms. They emphasize that the LLC is like a corporation because the statutes allow the owners to protect themselves from unlimited liability and to centralize management.[16] Formation of an LLC, like that of a corporation, requires formal filing with the applicable state authorities. On the other

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fiduciary duty in partnership law, see Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111 (1993) [hereinafter Dickerson, *RUPA Fiduciary Duties*]; Dickerson, *supra* note 5; Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 522 (1993).

15. *See infra* Part II(C).

16. *See, e.g.*, Thomas E. Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. REV. 44 (1992); Keatinge et al., *supra* note 3, at 379; Curwin, *supra* note 5. Arguably, the LLC is even more like a limited partnership. Since Frigidaire Sales Corp. v. Union Properties, Inc., 562 P.2d 244 (Wash. 1977), decided under the Uniform Limited Partnership Act (ULPA), and especially under variants of the Revised Uniform Limited Partnership Act (RULPA) that expressly permit a limited partner not only to hold the title of shareholder, director or officer of a corporate general partner, but also to act as such, the limited partner has little worry about losing the protection of limited liability. *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-303 (1993). However, to those of us who grew up under ULPA and have watched the changes brought about by RULPA, the limited partnership is itself an evolving hybrid, and thus an insecure anchor for purposes of comparison.

hand, the LLC as a business form is like a partnership because its structure allows and even encourages owner-management, and because the general flavor of the LLC statutes encourages the parties to tailor the business form.[17] It would, however, be disingenuous to limit our discussion of the LLCs' partnership characteristics to the possibility of owner-management and to the possibility of contractual flexibility. What has driven the LLC engine is not a need for a new business form, but rather the federal taxation regime: the Holy Grail was limited liability for all owners, combined with federal taxation as a partnership.[18]

When we discuss the LLC as a hybrid we should more properly view the LLC to be predominately corporate as a business form, and to be predominately partnership from a tax perspective.[19] The filing requirement on the business-law side is essentially neutral, although supporting the corporate side. Filing as a prerequisite to formation is well-known for corporations, but exists also for limited partnerships, and has not prevented limited partnerships from being considered a form of partnership.[20] To this extent, the LLC is passively in the corporate camp.

In contrast, the limited liability of the LLC's owners is emphatically a corporate characteristic.[21] Not only is it non-existent for gen-

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17. Keatinge et al., *supra* note 3, at 385 (describing how the LLC is not bound to corporation finance and management restrictions); Keatinge et al., *supra* note 3, at 400–01 (describing how management authority is subject to agreement by the parties).

18. *See, e.g.*, Keatinge et al., *supra* note 3, at 384; Geu, *supra* note 16, at 45 (referring to the impact of the Internal Revenue Service's Rev. Rul. 88-76, 1988-2 C.B. 360).

19. Subject, however, to the understanding that, as discussed below, tax characteristics can define the particulars of the business form.

20. Uniform Partnership Act (UPA) § 6(2) stipulates that the terms of the UPA govern unless the applicable limited partnership statute is inconsistent. *See* RULPA § 1105. RUPA § 202(b) is the successor to UPA § 6(1); however, there is no RUPA analogue to UPA § 6(2). If a limited partnership fails to satisfy the substantial-compliance requirement for formation under RULPA § 201(b), it will be a general partnership so long as it satisfies the independent criteria for formation of such a partnership. Peerless Mills, Inc. v. American Tel. & Tel. Co., 527 F.2d 445, 449 (2d Cir. 1975) (decided under the predecessor to RULPA); *In re* Westover Hills Ltd., 46 B.R. 300, 304 (Bankr. D. Wyo. 1985) (decided under RULPA: noncompliance with RULPA filing requirements results only in nonformation of limited partnership, not necessarily in the formation of a general partnership); *see* DICKERSON, *supra* note 13, at 49 n.58.

21. ULLCA § 201: "A limited liability company is a legal entity, distinct from its members." ULLCA § 303 provides for limited liability of members and managers:

LIABILITY OF MEMBERS AND MANAGERS.

(a) Except as otherwise provided in subsection (c), the debts, obligations, and liabilities of a limited liability company, whether ariseral partnerships, but limited partnerships must have at least one partner with unlimited personal liability.[22] The LLC is but the last step in eliminating the characteristic of limited liability as a purely corporate characteristic, but it nevertheless is a corporate characteristic for purposes of analyzing a business form in the context of historical expectations.

Just as the filing requirement is essentially neutral, the nominally partnership characteristic of owner-management also is basically neutral.[23] Particularly in close corporations, there is a long history of owner-managers. Indeed, the concept is so well established that a separate jurisprudence for owner-managed corporations has evolved.[24] Another neutral requirement is the nominally corporate characteristic of centralized management, which is well-represented especially in larger partnerships.[25]

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> ing in contract, tort, or otherwise, are solely debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability, of the company solely by reason of being or acting as a member or manager.
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> (c) All or specified members of a limited liability company are liable in their capacity as members for all or specified debts, obligations, or liabilities of the company if:
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> (1) a provision to that effect is contained in the articles of organization; and
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> (2) a member so liable has consented in writing to the adoption of the provision or to be bound by the provision.

*Id*.

22. In a general partnership, the liability of the ultimate owners can be limited by interjecting a corporation as the general partner — although the corporate general partner itself is fully liable. In a limited partnership, the use of the corporate general partner is well-known; while the ultimate owners are substantially shielded from personal liability, technically the general partner itself, *i.e.* the corporation, has unlimited personal liability. *See infra* notes 138–40 and accompanying text.

23. For an example of how owner-management is part of the partnership structure, see UPA § 18 (e), (h) and RUPA § 401 (f), (j).

24. There is even statutory recognition of owner-management in corporations. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 341–356 (1991); N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986).

25. Large partnerships have traditionally had executive committees, made up of fewer than all the partners, to which management authority has been delegated. For a description of the extensive authority granted to a national law firm's executive committee, see, e.g., Day v. Avery, 548 F.2d 1018, 1020 (D.C. Cir. 1976), *cert. denied*, 431 U.S. 908 (1977). Whether a particular delegation amounts to centralized management for federal tax purposes is a topic discussed *infra* at note 28, but it represents centralized management in the sense that even major policy decisions are made by a body that is smaller than a committee of the whole.

Only a partnership can be created without any formality — indeed, inadvertently, without the subjective intention to create that business organization.[26] Even if the filing requirement is relatively neutral, the absence of a filing requirement is a peculiarly partnership characteristic. An LLC under ULLCA section 202 cannot be created by inadvertence, since it is formed only upon filing of articles of organization with the appropriate state authorities.[27] Finally, treatment as a tax-conduit for federal tax purposes remains a partnership characteristic. Under current federal tax law, limited partnerships are treated as tax conduits presumptively, but even they can fail that categorization if they do not look and act sufficiently like a general partnership.[28] Indeed, the Internal Revenue

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26. BROMBERG & RIBSTEIN, *supra* note 13, § 2.01, at 2:1; DICKERSON, *supra* note 13, § 2.1, at 25; *accord* Runo v. Rothschild, 189 N.W. 183, 184 (Mich. 1922). The result appears unchanged by RUPA § 202. *See also infra* note 66.

27. Although the operating agreement is optional, *see* ULLCA § 103(a), "the existence of a limited liability company begins when the articles of organization are filed." ULLCA § 202(b). The articles of organization are defined in ULLCA § 203, and ULLCA § 202(a) requires that they be filed in an official office. The statute suggests the Secretary of State's office.

28. A limited partnership must fail two of the four corporate characteristics of continuity of life, centralized management, liability for business debts limited to the property of the business, and free transferability of interests. Treas. Reg. § 301.7701-2(a)(1)–(3) (as amended in 1993).

With a lingering doubt about the application of the regulation to a limited partnership under RULPA (1985) as distinguished from the 1976 version, Treas. Reg. §§ 301.7701-2(a)(5), -2(b)(3) (as amended in 1993), a RULPA partnership appears to lack continuity of life by definition.

Similarly, the present version of the Treasury Regulation states that limited partnerships "subject to a statute corresponding to the Uniform Limited Partnership Act generally do not have centralized management." Treas. Reg. § 301.7701-2(c)(4) (as amended in 1993). To ensure protection, the general partners should avoid a representative role, have a substantial ownership interest in the business, and not be subject to removal by the unilateral vote of the limited partners. Larson v. Commissioner, 66 T.C. 159, 176–79 (1976), *acq*. 1979-1 C.B.1. The IRS will consider ruling that there is no centralized management if the general partners, either in that capacity or as limited partners, own at least 20% of the partnership interests, although the actual ruling will depend on all the facts and circumstances. Rev. Proc. 89-12, § 4.06, 1989-1 C.B. 798.

A limited partnership subject to the Uniform Limited Partnership Act is also presumed to lack the characteristic of limited liability. Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993). This presumption is overcome only when the corporate "general partner has no substantial assets [other than his interest in the partnership] . . . and is merely a `dummy' acting as the agent of the limited partners." *Larson*, 66 T.C. at 179–81; *see* Rev. Proc. 89-12, § 4.07, 1989-1 C.B. 798; Zuckman v. United States, 524 F.2d 729, 741 (Ct. Cl. 1975).

The remaining characteristic, free transferability of ownership interests, is easier for a limited partnership to satisfy. If the interests can be transferred without causing

Service and the Treasury Department, too, justify the possibility of new regulations for the taxation of unincorporated businesses by reference to recent changes in state partnership statutes that the tax regulations should recognize.[29] While certain corporations can approximate the tax consequences of partnership states by electing treatment as an S corporation, they are not really treated as partnerships even for purely tax purposes because certain basic differences remain.[30]

As a practical matter, owners typically join an LLC because they wish to be taxed as though they are partners.[31] Some owners also wish to limit their liability while engaging in management of the business.[32] On a more abstract level, the importance of being a tax conduit is that it emphasizes the aggregate aspect of the relationship among the owners. In partnerships, the concept that the business is an aggregation of its owners instead of a separate entity has particular importance in the operation of the business.[33] It is

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dissolution as in *Zuckman* or for general partners under RUPA § 801, and if the interests of the limited partners can be fully transferred subject only to a general partner's consent that is not to be unreasonably withheld, then there is free transferability. *Larson*, 66 T.C. at 183; Treas. Reg. § 301.7701-2(e) (as amended in 1993). And if substantially all the interests are freely transferable, then the characteristic has been fully satisfied. Treas. Reg. § 301.7701-2(e)(1) (as amended in 1993). *But see Zuckman*, 524 F.2d at 742 n.14 (holding that 61% of the ownership interest is insufficient to satisfy the substantiality requirement); *see generally* DICKERSON, *supra* note 13, § 6.2.2.1, at 206–17.

29. Notice 95-14, 1995-14 I.R.B. 7.

30. A corporation for which a valid election is made to be treated as an S corporation is treated substantially as a tax conduit. I.R.C. § 1366 (1988 & Supp. V 1993). However, an S corporation has limitations on the flexibility of allocation of income and deductions. *Compare id*. § 1366 (describing treatment of S corporations) *with* Treas. Reg. § 1.704-1(b) (as amended in 1994) (describing treatment of partnerships). Certain distributions by S corporations are taxed to the shareholders even when the shareholders have an adjusted basis in their ownership shares. *Compare* I.R.C. § 1368 (1988) (describing treatment of S corporations) *with* I.R.C. § 731 (1988 & Supp. V 1993) (describing treatment of partnerships). Moreover, a corporation is ineligible for S corporation status if, *inter alia*, it owns more than 80% of another corporation, if it has a corporate shareholder, or a shareholder that is a non-resident alien. I.R.C. § 1361(b) (1988 & Supp. V 1993). One of the major limitations on the availability of S corporation status is the requirement that there be no more than 35 shareholders. I.R.C. § 1361(b)(1)(A). However, this restriction has become much less important since the Service issued Rev. Rul. 94-43, 1994-27 I.R.B. 8 (determining that any number of valid S corporations with different shareholders can form a partnership to operate a single business).

31. *See* Keatinge et al., *supra* note 3, at 380: "The LLC . . . combines the tax advantages of a partnership with limited liability for all members . . . ." *Id*.

32. *Id*.

33. A. Ladra Jensen, *Is a Partnership Under the Uniform Partnership Act an Ag-*

this aggregate theory that explains, for example, why owners should have unlimited personal liability for the obligations incurred by the business.[34] However, treatment as a partnership by the tax authorities has no direct consequences outside tax law. Such treatment does not, for example, mean that the owners will in fact have unlimited personal liability for the obligations of the business.[35] It does not mean unlimited personal liability even in the tax context: although the tax liability of LLC members is defined by the income of the business, an owner taxed as a partner is not liable to the government for taxes owed and unpaid by a co-owner.[36]

So how can this tax characteristic prevent an LLC from being treated as a corporation for non-tax purposes? The answer is in the requirements that an unincorporated business must satisfy to be taxed as a partnership. Under current federal tax law, the LLC, as an organization that provides limited liability for its owners, cannot satisfy more than one of the following three criteria if it is to avoid being taxed as a corporation: centralized management, continuity of life, and free transferability of ownership.[37] Because the Treasury is

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*gregate or an Entity?*, 16 VAND. L. REV. 377, 379 n.11 (1963).

34. *See, e.g.*, Robert J. Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filling in the Interstices*, 56 N.Y.U. L. REV. 1173, 1173–75 (1981).

35. Limited partners in limited partnerships and members of LLCs, even if treated as partners for tax purposes, can have limited liability. *See, e.g.*, Keatinge et al., *supra* note 3, at 385, 442–46.

36. I.R.C. § 704 (1988 & Supp. V 1993); I.R.C. § 706 (1988). This reality would not be changed by the adoption of the proposed regulations referred to in the text accompanying note 29, *supra*.

37. Treas. Reg. § 301.7701-2 (as amended in 1993). As to the characterization of an unincorporated business as a partnership for tax purposes, the principal differences between a partnership, including a limited partnership, *see supra* note 28, and an LLC are in the application of the four criteria, at least two of which must be lacking for the unincorporated business to be treated as a partnership for tax purposes. I.R.C. § 7701(a)(2) (1988); Treas. Reg. §§ 301.7701-2, -3.

With respect to continuity of life, if a majority in interest must vote in favor of continuation of the business after the withdrawal of any member, then the LLC is deemed to fail the corporate characteristic of continuity of life. Rev. Rul. 93-6, 1993-1 C.B. 229, 230; Rev. Rul. 93-91, 1993-2 C.B. 316, 317.

If there are appointed managers, the LLC will be found to satisfy the corporate characteristic of centralized management, regardless of the equity interests of those managers. *See, e.g.*, Rev. Rul. 94-6, 1994-1 C.B. 314; Rev. Rul. 94-5, 1994-1 C.B. 312; Rev. Rul. 93-92, 1993-2 C.B. 318; *see also* Rev. Rul. 93-38, 1993-1 C.B. 233, 235 (situation 2); Rev. Rul. 93-6, 1993-1 C.B. 229; Rev. Rul. 93-5, 1993-1 C.B. 227.

An LLC might wish to fail the corporate characteristic of limited liability, if, for example, it would otherwise lack only one characteristic but wishes to be treated as a partnership for tax purposes. The Service has not yet ruled when and if the LLC could considering proposing new regulations that would presume partnership status for any unincorporated business, subject to contrary election by the business,[38] the LLC of the future may not feel any pressure to avoid those last three criteria. However, the basis for Treasury's contemplation of a new regime is the perception that partnership, outside of the tax arena, no longer prevents a partnership from satisfying those criteria.[39] In other words, at least according to Treasury, an LLC still contains partnership characteristics. We will look at these concepts again when we consider in Part III how the LLC characteristics influence the need for fiduciary duty. For our present purpose, the status of the LLC as a partnership for federal tax treatment leans the LLC toward the partnership end of the business-form spectrum, because the LLC must be like a traditional partnership in at least two of four fundamental ways, and will in the future continue to be similar to the then-current form of partnership.

We are now prepared to pull together the irreducible differences between partnerships and corporations, and to apply them to LLCs. Corporations, like LLCs, offer limited liability to owners, including owners who also are managers, and only partnerships, unlike the LLC, can be created without formality, and even without subjective intention. So far, the LLC is more like a corporation than a partnership. The remaining functional characteristic of the LLC is one that, in contrast to limited liability and impossibility of inadvertent formation, pushes the LLC in the direction of partnerships — only the partnership is truly a conduit for federal tax purposes: no incorporated business form is a tax conduit to the same degree.

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be considered to lack that characteristic. However, by analogy to the limited partnership, this option should be available if a member can be made liable, has substantial assets, and is not merely a "dummy" for the other, non-liable members. Zuckman v. United States, 524 F.2d 729, 740–41 (Ct. Cl. 1975); Larson v. Commissioner, 66 T.C. 159, 179–81 (1976), *acq*. 1979-1 C.B. 1; Treas. Reg. § 301.7701-2(d)(2) (as amended in 1993); Rev. Proc. 89-12, § 4.07 1989-1 C.B. 798.

Regarding free transferability of interests, the characteristic is lacking if at least a majority in interest of the LLC's members must vote in favor of the admission of a new member. Rev. Rul. 93-92, 1993-2 C.B. 318; Rev. Rul. 93-91, 1993-2 C.B. 316. These rulings do not speak of what happens if there a substantial interest, but less than a majority, is the required vote.

38. Notice 95-14, 1995-14 I.R.B. 7.

39. *Id*.

## B. Partnership Versus Corporation-Law Performance Standards, Currently

### *1. Case Law*

Traditional case law contains two lines of analysis, one applicable to the partnership and the other to the close corporation.

The seminal partnership case is *Meinhard v. Salmon*.[40] It contains Judge Cardozo's exuberant description of fiduciary duty as the "punctilio of an honor the most sensitive."[41] He also condemned any reduction of the standard.[42] The standard of utmost good faith in partnership law, and the categoric insufficiency of simple arm's-length good faith, is considered to reside in Uniform Partnership Act (UPA) section 21.[43] That section is cursory and its express language focuses only on misappropriation of benefits, but the gloss provided by *Meinhard* and its case-law progeny is now firmly imbedded in the eighty-year-old Uniform Partnership Act.[44] Any sub

40. 164 N.E. 545 (N.Y. 1928) (Cardozo, J.). The relationship in *Meinhard* was not a true partnership and may not even have been a true joint venture. Nevertheless, the case is understood to define fiduciary duty in the partnership context. For example, it is the principal case in a prominent casebook's section entitled "The Partner's Duty of Loyalty." WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 56 (6th ed. 1988).

41. *Meinhard*, 164 N.E. at 546.

42. In *Meinhard*, Judge Cardozo insisted on "uncompromising rigidity," *id*., as he had in the agency context. Wendt v. Fischer, 154 N.E. 303, 305 (N.Y. 1926). His view was arguably substantially similar in the corporate context, although there is indication that he would have found that full disclosure would satisfy the obligation. Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. 1918) (addressing interested-director liability). Indeed, *Globe Woolen* represents an effort by Judge Cardozo to apply some flexibility in the context of the fiduciary duty of interested directors. Dickerson, *RUPA Fiduciary Duties*, *supra* note 14, at 126. Nevertheless, in the latter two cases, Judge Cardozo cites approvingly Munson v. Syracuse, Geneva & Corning R.R., 8 N.E. 355 (N.Y. 1886), in which, upon finding a breach of duty, the New York Court of Appeals refused to inquire about the fairness of the transaction. *Id*. at 358. In *Globe Woolen*, Judge Cardozo stretched to void the offending contract on the basis of breached fiduciary duty: he could have voided the contract on contract-law principles, given that the purchaser's sudden and dramatic increase in requirements was evidence of a lack of good faith. *See Globe Woolen*, 121 N.E. at 378; Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 899.

43. UPA § 21. Partner Accountable as a Fiduciary.

> (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of the property.

UPA § 21.

44. That the language is understood to create a general fiduciary duty, see general-

stantive change therefore requires statutory intervention, as is discussed below in connection with the fiduciary duties under ULLCA.

As compared with the UPA's view of the owners' fiduciary duty, a more tempered version of the standard applies to shareholders of close corporations. Although every corporation is formed in accordance with a statute, the corporate statutes do not expressly mandate a fiduciary duty for a corporation's owners: it is case law that has found the fiduciary duty owed by shareholders.[45]

While the court in *Donahue v. Rodd Electrotype*[46] ruled that the controlling shareholder breached his fiduciary duty to the minority, subsequent cases in the same line expressly recognized the shareholder's right of "selfish ownership."[47] A controlling shareholder may act so as to harm the minority if the controlling shareholder has a legitimate business purpose and lacks a less harmful means of achieving that legitimate result.[48] Nevertheless, the fundamental duty, owed at least by the controlling shareholder, is a fiduciary

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ly Jennison v. Bierer, 601 F. Supp. 1167, 1177 (D. Vt. 1984) (relations between partners highly fiduciary; trustees in all dealings with partnership property); Cude v. Couch, 588 S.W.2d 554, 555 (Tenn. 1979) (holding that a duty exists in all matters relating to partnership); BROMBERG & RIBSTEIN, *supra* note 13, § 6.07, at 6:72; DICKERSON, *supra* note 13, § 13.2, at 427.

45. However, statutes do speak of duties of directors. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(e), 102(b)(7) (1991); N.Y. BUS. CORP. LAW §§ 717, 402(b) (McKinney 1986 & Supp. 1995).

46. 328 N.E.2d 505 (Mass. 1975).

47. With respect to close corporations, see Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976). This is a characteristic familiar to partnerships. The ABA subcommittee charged with considering the systematic overhaul of the UPA that ultimately led to RUPA expressly recognized that partners have a dual role as both managers and owners. UPA Revision Subcommittee of the Comm. on Partnerships and Unincorporated Business Orgs., *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121, 151 (1987).

48. Once the controlling shareholders have been accused of breach of fiduciary duty, they can nevertheless succeed in their defense if they can bear the burden of showing a legitimate business purpose for their actions. By dictum, the shareholders who lack control could then show that the controlling shareholder still has breached a duty because the controlling shareholders could have achieved their legitimate business purpose in a less harmful manner. *Wilkes*, 353 N.E.2d at 663. This certainly implies that a legitimate business purpose does not excuse acts that are malicious, as opposed to merely a reflection of "selfish ownership." *Id*.

As to what constitutes a legitimate business purpose, the controlling shareholder is allowed to be concerned with its own personal business, as opposed to the business of the corporation. In Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 803 (Mass. App. Ct. 1981), the controlling shareholder could try to reduce his personal tax liability when non-controlling shareholders failed to respect the controlling shareholder's suggestions of a non-malicious solution (the preparation of a plan for repairs and improvements). *Id*.

duty.[49]

### *2. Scholarly Commentary*

The contractarians have defined the terrain concerning fiduciary duties in business corporations, as a "nexus of contracts."[50] From this assumption, the contractarians conclude that the owners, as parties to the contract, can opt out of obligations otherwise arising out of the relationship as shareholders.[51] Specifically, the shareholders can agree to lower the standard of performance otherwise applicable among them, down to some level of good faith.[52] If the existing standard did allow shareholders to be purely selfish in their relationships among themselves, there would be no standard above the mandatory good faith threshold and the issue of opting out of fiduciary duties would never arise. Therefore, the contractarians' discussion of shareholders' capacity to opt out of fiduciary duties includes a recognition that, at least in the close corporation context of *Donahue* and its ilk,[53] shareholders can be subjected to a heightened standard of performance.

As noted, the contractarians' concession that a heightened standard exists is part of their assumption that the parties can opt out of

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49. *Wilkes*, 353 N.E.2d at 661; *Donahue*, 328 N.E.2d at 515; *Smith*, 422 N.E.2d at 801.

50. *See* Easterbrook & Fischel, *supra* note 13, at 1426 (citing Jensen & Meckling). For an example of other scholars' disputing of the contractarians' analysis, see, e.g., Thomas Lee Hazen, *The Corporate Persona, Contract (and Market) Failure, and Moral Values*, 69 N.C. L. REV. 273 (1991).

51. The contract model allows the parties to seek the economically efficient result. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 2.2, at 23 (4th ed. 1992).

52. See the court's opinion, written by Judge Frank H. Easterbrook, and the dissent, written by Judge Richard A. Posner, in Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 90 (1988). Both are well-known contractarians and former colleagues on the faculty of the University of Chicago School of Law. Judge Easterbrook found that the fiduciary duties had not been waived, but by dictum noted that they could have been waived by a proper agreement. *Id*. Judge Posner found a contract that would serve to waive fiduciary duty. *Id*. (Posner, J., dissenting).

Judge Easterbrook has also specifically confirmed that the fiduciary duty may be waived down to an irreducible good faith level. Easterbrook & Fischel, *supra* note 13, at 1422; *see generally* Dickerson, *RUPA Fiduciary Duties*, *supra* note 14, at 133.

53. Even *Jordan* is a close corporation case: there were only 41 shareholders. 815 F.2d at 432. Of course, this does not mean that the shareholders of a publicly-held corporation owe duties to each other. *See, e.g.*, Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

this standard.[54] This sense of certainty on the part of the contractarians has dominated the discussion, leaving the non-contractarians in a difficult position. The non-contractarians who believe that the heightened standard is mandatory must challenge an orthodoxy either by disagreeing that the corporation is a nexus of contracts, or by conceding that the contract-law approach is correct while disputing that the standards are optional. The first approach reincarnates the old concession theory of corporations.[55] The concession theory suggests that the government can impose on corporations whatever limitations the state wants because the state has created the corporation.[56] One of these limitations can be mandatory fiduciary duties. Others, including those who believe that fiduciary duty should be optional, may be willing to consider non-fiduciary corporate norms subject to agreement among the shareholders,[57] and therefore accept that the state is defining part of the contract.[58] If

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54. In *Jordan*, both Judge Easterbrook (for the court) and dissenting Judge Posner agreed that the parties could opt out of the fiduciary duty. 815 F.2d at 436, 446; *see supra* note 49. As is evident from the fact that one contractarian was writing for the court and the other was dissenting, the judges did not agree as to whether the parties had in fact opted out. Much has been made of this disagreement between titans. *See, e.g.*, Coffee, *supra* note 2, at 1680–81; DeMott, *supra* note 42, at 884–85 (describing the characterization of a fiduciary duty as "the court's guess about what the parties would have agreed to" as "unprecedented").

55. The most famous articulation of the concession theory was by Chief Justice Marshall's statement that a "corporation is an artificial being, invisible, intangible and existing only in contemplation of law." Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819). *See generally* William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1484, 1504–05 (1989).

56. *See* ROBERT W. HAMILTON, CASES & MATERIALS ON CORPORATIONS 12-14 (4th ed. 1990); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 68–69 (1992).

Because LLCs, like corporations, can be formed only by filing, the concession theory would also apply to LLCs. As to the importance of a filing requirement, see generally Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 86 (1991).

57. Subject to the rights of third parties, since these cannot be waived without their consent.

58. *See, e.g.*, Ribstein, *supra* note 56, at 83 (arguing that there is no reason for limited liability to be considered a state-conferred privilege rather than a product of private ordering). This contractarian concedes that "[u]nderstanding the contractual nature of limited liability is the last important step toward full recognition of the contractual nature of the corporation." *Id.* at 130. This concession is itself an admission that corporate-style limited liability, effective as against the world, cannot be created by agreement between two parties.

the state's role in mandating fiduciary obligations is viewed as an efficient means of short-circuiting negotiations by imposing form contracts, the analysis has a contractarian form.[59] At the base, however, the question remains: Why can the state impose this limitation? Even if the parties' basic relationship is viewed as contractual, the mandatory obligations exist either because might makes right, or, more gently, because the state can define its own creation.

This same discussion has also been carried over into the sphere of unincorporated businesses. Contractarians have not been able to use all of their contract-law ammunition on partnership-law fiduciary duty even though the bulk of the partnership relation is subject to definition by contract.[60] The largest category of obligations that cannot be modified by agreement among the partners are, predictably, obligations owed to third parties.[61] The category that has no impact on third parties but is still not subject to modification by the partners under UPA is the fiduciary duty owed by one partner to another. The reason why the contractarians are restricted to cries about the illogic of mandatory fiduciary duties in partnership,[62] as contrasted with their cries that mandatory fiduciary duties do not exist in corporations, is that it is in partnership law, not in corporate law, that fiduciary duty has been found enshrined in the statute.[63] Therefore, any fundamental change to fiduciary duty as ap-

59. *See, e.g.*, John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919, 970–73 (1988) (discussing the use of form contracts to save the costs of negotiating). The pure contractarians reject any mandatory fiduciary obligations: any such obligations should be included in corporate law only as enabling legislation. *See, e.g.*, Butler & Ribstein, *supra* note 1, at 67–68.

60. UPA is principally a "default" statute, subject to modification as among the parties. BROMBERG & RIBSTEIN, *supra* note 13, § 6.07, at 6:72; DICKERSON, *supra* note 13, § 5.1, at 136. RUPA § 103(a) provides that RUPA applies only as a default rule except for those few topics listed in RUPA § 103(b).

61. Case law interpreting UPA has clearly maintained that the partners cannot agree among themselves to unilaterally affect the rights of third parties. *See, e.g.*, Misco-United Supply, Inc. v. Petroleum Corp., 462 F.2d 75, 80 (5th Cir. 1972); Belgian Overseas Sec. Corp. v. Howell Kessler Co., 450 N.Y.S.2d 493 (App. Div. 1982); B-OK, Inc. v. Storey, 473 P.2d 426, 429 (Wash. 1970). RUPA is more explicit: "[t]he partnership agreement may not: . . . restrict the rights of third parties under this [Act]." RUPA § 103(b)(9).

62. *See, e.g.*, Hillman, *supra* note 13.

63. Despite the lack of express language, common law has interpreted the statute to include fiduciary duty. See *supra* notes 43–45 and accompanying text for a discussion of UPA § 21.

plied to partnerships has to be effected by statute.

The battle has been fought during NCCUSL's work on the draft of the Revised Uniform Partnership Act (RUPA), the recently proposed revision to the eighty-year-old uniform partnership law.[64] One of the most significant changes contained in RUPA is the substantial increase in the parties' ability to opt out of fiduciary duties.[65] Generally, RUPA sections 404[66] and 103[67] permit partners in a general

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64. NCCUSL had recently revised the uniform law applicable to limited partnerships. The 1976 Revised Uniform Limited Partnership Act (RULPA) was substantially revised in 1985. Although RULPA was a clear influence on the drafters of RUPA, *see, e.g.*, the comments of RUPA Reporters in Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 7 (1992), it did not change fiduciary duties. *See* RULPA § 403(1). For an explanation that UPA applies to limited partnerships unless the applicable uniform limited partnership statute provides otherwise, see *supra* note 20.

65. That the impact of RUPA on fiduciary duties was of great importance is reflected in the Reporters' discussion of that topic as a main heading. *See* Weidner & Larson, *supra* note 64, at 16. The other major headings of dissolution, partnership property and conversions and mergers are all modifications that flow from RUPA's purposeful effect of shifting partnership law toward the entity theory. *Id.* at 3, 28, 38.

66. RUPA § 404 provides that:

> (a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c).
>
> (b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:
>
> > (1) to account to the partnership and hold as trustee . . . any . . . benefit . . . ;
> >
> > (2) to refrain from dealing with the partnership . . . as . . . a party having an interest adverse to the partnership; and
> >
> > (3) to refrain from competing with the partnership . . . .
>
> (c) A partner's duty of care . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
>
> (d) A partner shall discharge the duties . . . under this [Act] . . . and exercise any rights consistently with the obligation of good faith and fair dealing.
>
> (e) A partner does not violate a duty or obligation under this [Act] . . . merely because the partner's conduct furthers the partner's own interest.
>
> (f) A partner may lend money to and transact other business with the partnership, and . . . the rights and obligations of the partner are the same as those of a person who is not a partner, subject to applicable law.
>
> . . . .

*Id*.

67. RUPA § 103 provides in pertinent part:

(b) The partnership agreement may not: . . .

(3) eliminate the duty of loyalty . . . , but:

partnership to reduce the *Meinhard* duty to a level of good faith.[68] Elsewhere, I have complained that the general partnership is an inappropriate forum for freedom of contract, because it can be formed by inadvertence, and even against specific subjective intent.[69] A person can have the unlimited personal liability of a general partner without ever having had the subjective intent to form a partnership. The risk generated by freedom of contract in this area is compounded by the contract-law principle of objective intent. A person could be found not only to be a partner without subjective intent to do so, but also to have waived any rights to fiduciary protection. Nevertheless, RUPA permits opting out from a significant range of duties. As of this writing, RUPA has been adopted by only three states.[70] When the statute has been adopted by a substantial number of jurisdictions, the option to eliminate fiduciary duties by agreement among partners moves from the realm of scholarly commentary to that of reality.

### C. Fiduciary Duty Under the Draft Uniform Limited

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> (i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or
> (ii) all of the partners . . . may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
>
> (4) unreasonably reduce the duty of care . . . ;
> (5) eliminate the obligation of good faith and fair dealing . . . , but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;
>
> . . . .

*Id*.

68. *See generally* Weidner & Larson, *supra* note 64, at 16–28.

69. Dickerson, *RUPA Fiduciary Duties*, *supra* note 14, at 149–56; Dickerson, *supra* note 5. Professor Eisenberg asserts that an "inadvertent" partnership is a "misconception." WILLIAM L. CARY & MELVIN A. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 39 (7th ed. unabridged 1995). In my view, there is true inadvertence when objective intent is at odds with subjective intent. Dickerson, *RUPA Fiduciary Duties*, *supra* note 14, at 154. In contrast, the courts are reluctant to find the offer that leads to formation of a contract, *see, e.g.*, E.A. FARNSWORTH, CONTRACTS, § 3.10, at 138 (2d ed. 1990), while a partnership is presumptively found if there is profit sharing. UPA § 7(4); RUPA § 202(c). Hence, it is more likely that a partnership than a contract will be formed despite contrary subjective intent.

70. As of August 1995, three states have adopted a version of RUPA. MONT. CODE ANN. §§ 35-10-101 to -644 (1994); TEX. REV. CIV. STAT. ANN. art. 6132b (West Supp. 1995); WYO. STAT. §§ 17-21-101 to -1003 (1995).

Liability Company Act

We have seen that the LLC authorized by ULLCA is located on the spectrum between partnerships and corporations, relatively closer to corporations.[71] Given that we are dealing with a hybrid, the next question is how ULLCA handles the members' fiduciary duties: are they more like those of shareholders in a close corporation, or more like those of partners? Two sections are particularly relevant to issues of fiduciary duty: ULLCA sections 409[72] and 103.[73] The first

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71. *See supra* Part II(A).

72. ULLCA § 409 GENERAL STANDARDS OF MEMBER'S AND MANAGER'S CONDUCT.

> (a) The only fiduciary duties a member owes to a member-managed limited liability company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and (c).
>
> (b) A member's duty of loyalty to a member-managed company and its other members is limited to the following:
>
> (1) to account to the company and to hold as trustee . . . any . . . benefit . . . ;
>
> (2) to refrain from dealing with the company . . . as . . . a party having an interest adverse to the company; and
>
> (3) to refrain from competing with the company . . . .
>
> (c) A member's duty of care to a member-managed limited company and its other members . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
>
> (d) A member shall discharge the duties . . . and exercise any rights consistently with the obligation of good faith and fair dealing.
>
> (e) A member of a member-managed company does not violate a duty or obligation under this [Act] . . . merely because the member's conduct furthers the member's own interest.
>
> (f) A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law.
>
> (h) In a manager-managed company:
>
> (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;
>
> (2) a manager is held to the same standards of conduct prescribed for members in subsections (b) through (f);
>
> (3) a member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company's business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act]; and
>
> (4) a manager is relieved of liability imposed by law for

describes the *only* fiduciary duties owed by an owner (member) of an LLC. The second provides methods by which the parties can agree to reduce the duties, and describes the floor below which those duties cannot be reduced. Section 409 explicitly distinguishes between the duties owed by a member in a "member-managed limited liability company" and those owed by a member or manager in a "manager-managed limited liability company."[74]

Consider that limited liability and the impossibility of formation by inadvertence are the strong corporate characteristics, that the tax treatment is the strong partnership characteristic, and that owner-management in particular does not pull strongly toward partnership status.[75] A difference in standards should not be determined by owner-management alone. Nevertheless, this is what the drafters have done by separating section 409(a) liability for member-managed LLCs from section 409(h) liability for manager-managed LLCs. Except for its last subsection (h), ULLCA section 409 is virtually

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> violation of the standards prescribed by subsections (b) through (f) to the extent of the managerial authority delegated to the members by the operating agreement.

ULLCA § 409.

73. ULLCA § 103. EFFECT OF OPERATING AGREEMENT: NONWAIVABLE PROVISIONS.

> (b) The operating agreement may not:
>
> (2) eliminate the duty of loyalty . . . , but the agreement may:
>
> (i) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; and
>
> (ii) specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;
>
> (3) unreasonably reduce the duty of care . . . ;
>
> (4) eliminate the obligation of good faith and fair dealing . . . , but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;
>
> . . . .

ULLCA § 103(b).

74. ULLCA § 409(a) outlines the standards for a member in a member-managed LLC; ULLCA § 409(h) treats manager-managed LLC. See *supra* note 72 for the text of ULLCA § 409(a) and (h).

75. *See supra* Part II(A).

identical to RUPA section 404.[76] Focusing on a member-managed LLC, ULLCA section 409 expressly provides, as does RUPA section 404, that an owner who benefits personally from a transaction in connection with the entity of which that person is an owner does not necessarily violate the duty of good faith: the owner can lend money or transact other business with its company as though the owner were a third party,[77] and any inherent conflict is ignored. Further, just as is the case for the section of RUPA bearing the same number, ULLCA section 103 specifies that, although the duty of loyalty cannot be eliminated, the operating agreement can specify categories of activities that, by agreement of the parties, do not violate the duty of loyalty.[78] As does RUPA, ULLCA prohibits elimination of the obligation of good faith and fair dealing, but simultaneously permits an agreement among the owners to "determine the standards by which performance of the obligation is to be measured."[79]

In contrast, if the LLC is not member-managed, but instead is manager-managed, ULLCA section 409(h) follows a corporate pattern, and there is no direct RUPA analogue. Subsection (h) imposes no fiduciary duty on a mere member; it is the manager in a manager-managed LLC who has the same duties as any member of a member-managed LLC.[80] In addition, to the extent that a member exercises the functions of a manager *under the operating agreement*, the member will have the fiduciary duties of a manager.[81] Although the draft comments do not explain this subsection,[82] the allocation of responsibility based on management function is presumably too close to classic corporate law to be by accident: normally directors are responsible for and liable for the management of the corpora-

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76. *Compare* ULLCA § 409, *supra* note 72, *with* RUPA § 404, *supra* note 66.

77. *See* ULLCA § 409(e), (f); RUPA § 404.

78. ULLCA § 103(b)(2); RUPA § 103(b)(3).

79. ULLCA § 103(b)(4); RUPA § 103(b)(5).

80. *See supra* note 72 (discussing ULLCA § 409(h)). The manager could, of course, be a member. However, in that case, ULLCA § 409(h) stipulates that any liability of the manager is in its capacity as manager, not as a member. Assuming a manager-managed LLC, a person who is a member but not a manager has liability. ULLCA § 409(h)(1). A manager has the liability of a member in a member-managed LLC. ULLCA § 409(h)(2).

81. *See* ULLCA § 409(h)(3). The specific language of ULLCA § 409(h)(3) must define what is a manager; otherwise, ULLCA § 409(h)(2) makes it superfluous.

82. The comments to ULLCA § 409 are in the form adopted at NCCUSL's July 29–August 5, 1994 annual conference with amendments adopted by its Executive Committee in January, 1995.

tion.[83] Shareholders are personally liable as managers only to the extent that they in fact manage.[84] ULLCA in fact goes farther than that: apparently, if a member is effective in persuading the managers but does not have express authorization under the operating agreement to act as a manager, the member has no liability. This concept is formalistic and, to put it mildly, different from the analysis of *Donahue* and its progeny, where controlling shareholders are held liable whether or not they have the separate designation of an official manager.[85] Clearly, the manager-owner trigger of the ULLCA is imperfect in practice.[86]

Leaving aside what may be dismissed as a correctable technical error, I want to focus on the inadequacy of ULLCA's trigger as a matter of principle. We may not approve either of RUPA's exclusive list of fiduciary duties because it tends to narrow the scope more than does a generalized standard,[87] or of RUPA's support of opting out by owners. I consider RUPA to represent an unacceptable dilution of mandatory fiduciary duties, because I consider these duties to be an important principle of partnership law.[88] We may also reject, as I do, the idea that owner-management should be a litmus test, let alone the sole test, used to determine the type of fiduciary duty imposed on owners. Nevertheless, the ULLCA drafters presumably feel the owner-manager dichotomy distinguishes corporations from partnerships, and they allocate the owners' fiduciary duty on that basis. The question is whether either or both of the standards and the test should be enacted.

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83. Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85 (1880) is an old case that linked liability to management responsibility, and management responsibility to the board of directors. Modern corporate statutes do the same. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141(a) (stipulating management by the board); 350 (stating that in a close corporation, an agreement among shareholders to limit the discretion of the board is valid, but to the extent of that limitation, the liability of the directors is removed) (1991).

84. *See, e.g.*, DEL. CODE ANN. tit. 8, § 350 (1991).

85. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975); *see supra* text accompanying note 49.

86. The language of ULLCA § 409(h)(3) stating that a "member functioning as a manager" under the operating agreement, is not carried over uniformly to other sections. For example, § 801(b)(3) provides that "a member who is also a manager" can cause the dissolution of the LLC in specified circumstances.

87. *See, e.g.*, Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1773 (1976).

88. *See, e.g.*, Dickerson, *RUPA Fiduciary Duties*, *supra* note 14; Dickerson, *supra* note 5.

## III. THE EXTENT OF PERMITTED HARM DETERMINES THE APPROPRIATE STANDARD OF PERFORMANCE

In discussing the appropriate standard of performance for LLCs, we must consider two questions. In the context of the current text of ULLCA, the questions break down as follows: are the articulated standards appropriate, and is the trigger mechanism for selecting one of those standards appropriate? The questions are inextricably linked: if the fundamental standards should be different, that will affect the appropriateness of the trigger. Even if the ULLCA trigger based on owner-management is appropriate, it might not be the proper trigger if ULLCA makes the standards susceptible to opting out by the owners who are managers. It may also be more appropriate to have a system of standards that has more than two default variations.

Before the standards articulated by ULLCA can be analyzed meaningfully, we have to review their context and consequences. In the last section, I stated that the LLC leans toward the corporation end of the partnership-to-corporation spectrum, particularly near the close corporation. The LLC resembles a corporation in that it cannot be formed by inadvertence and creates only limited liability for the owners, but it is not purely corporate because it can also share with the partnership form the federal tax status as a conduit. Because the LLC is created by a statute that provides an express definition of fiduciary duty, the applicable statute must control. It will control quite literally, because there is little room for interpretation. The express language prevents limited liability company law from mimicking the *Donahue* line's common-law incursion into corporate law, while the newness of the statute, as well as its precision, restricts the evolution of a *Meinhard*-style inventive gloss. The possible interpretative leeway is limited to analogies to partnership and corporate law, on precisely the larger theory already reflected by the drafters: the effect of ULLCA should be relatively corporate if the LLC is like a corporation and vice versa. My disagreement concerns how to determine whether and to what extent an LLC is relatively corporate, and what the impact of that distinction should be.

We cannot avoid a careful review of the basic questions set out earlier. First, are ULLCA's trigger and standards appropriate? I will first show that the fundamental differences between business forms are concentrated in the type and extent of the owners' exposure to risk. ULLCA's trigger mechanism, based on owner-management, inadequately reflects a recognition of these differences. In Part III(A), I discuss the critical factors that have been implicitly recognized at common law to ascertain an applicable standard of performance: control and conflict, and risk and harm. Part III(B) describes how the expansion of limited liability has unbalanced the equilibrium created by common law. Finally, Part III(C) proposes a method of assessing the level of an owner's duty that more accurately reflects these very real differences than do the standards or the trigger proposed by ULLCA.

### A. Business Forms and Risk Prior to RUPA and ULLCA: A Balanced Approach

When we consider the LLC, we must remember that the owner will have limited liability and may have management control.[89] Further, because we have seen that the LLC form is used as a means of obtaining both corporate limited liability and partnership tax treatment, under current federal tax law, the owners will seek to ensure that at least two of the four corporate characteristics described by tax law are found lacking.[90] As noted above, continuity of life, centralized management, limited liability and free transferability of interests are those four characteristics.[91] The LLC will almost certainly satisfy the corporate criterion of limited liability. Therefore, if an owner has management control which amounts to centralized management for purposes of federal tax law, the owners will almost certainly wish to avoid both continuity of life and free transferability of their ownership. These limits on how widely the company is held

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89. See *supra* text accompanying note 21 discussing ULLCA §§ 201, 303. Members do have the right to waive the protection of limited liability, something that they would presumably do for tax reasons. ULLCA § 303(c); *see supra* note 37. A shareholder can waive, too, but not in so all-encompassing and unilateral a manner: the typical waiver by a shareholder is in the form of a personal guarantee of the corporation's obligations.

As regarding optional management control, the articles of organization are to specify whether the LLC is to be manager-managed. ULLCA § 203(a)(6).

90. See *supra* notes 28 & 37 for a discussion of corporate characteristics under federal tax law.

91. See *supra* note 37 for a discussion relating to the tax treatment of LLCs, and *supra* note 28 concerning limited partnerships.

will cause this type of LLC to resemble more a closely-held corporation than a public corporation. If, on the other hand, every owner is also a manager, so that there is no centralized management, there will no longer be the same tax-law incentive to avoid free transferability.[92] In that case, even if the ownership is technically freely transferable, there probably is only a very limited market for the ownership interest.[93] In either case, the owners are relatively locked into the business. The power wielded by the owners who individually or as a group are in control can be particularly ominous, especially, as discussed below, if the controlling owners are in a position of conflict with those who have less control.

If the regulations contemplated by Treasury are proposed and approved, to the effect that an election by the unincorporated business, irrespective of those four corporate characteristics, determines whether the LLC, for example, is taxed as a partnership or a corporation,[94] the range of types of businesses run as an LLC may become broader. The principal limitation will be that the LLC seeking tax status as a partnership will have to avoid being publicly held.[95] It will therefore become more likely that an LLC will have centralized management and free transferability of interests as well as limited liability, as all these are defined in the current Treasury Regulations,[96] than is the case today, although the truly publicly-held businesses will probably continue to be in corporate form in most cases. Therefore, even if Treasury revises its tax treatment of unincorporated businesses, LLCs will still tend to be relatively closely-held.

### *1. Control by the Active Owner*

92. Realistically speaking, a business with all owner-managers is likely to have relatively few owners and even those who are championing the LLC recognize that it is a form better adapted to such a situation. *See, e.g.*, Keatinge et al., *supra* note 3, at 391.

93. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975) is a classic example, in the corporate context, of the difficulty of finding a market for ownership participations, even if those participations are technically transferable.

94. Notice 95-14, 1995-14 I.R.B. 7.

95. I.R.C. § 7704 (discussing treatment of publicly traded partnerships); *see also* 60 Fed. Reg. 21475, 21476 (May 2, 1995) (confirming that a publicly-traded LLC is taxed as is a “publicly traded partnership”).

96. *See supra* note 28 (describing the current law's characteristics).

A major variable in considering the standard of performance to be imposed on an active owner of an LLC is the extent to which that owner controls the situation. Presumably, ULLCA intended to reflect this control factor when pivoting the applicable standards on the extent of the owners' management. If the active owner manages, it can have a substantial impact on the complaining owner, and that arguably should increase the active owner's responsibility.

Indeed, this concept is recognized in partnership cases, where a partner, who is also managing the business, is held to an especially high fiduciary duty.[97] This understanding is also at the heart of close corporation cases. In *Donahue*[98] and in *Wilkes v. Springside Nursing Home, Inc.*,[99] the shareholder accused of breaching fiduciary duty was the majority and controlling shareholder. In *Smith v. Atlantic Properties, Inc.*,[100] the breaching shareholder was a minority shareholder found to be in control because of his absolute veto power granted by various supermajority provisions. In *Jordan v. Duff & Phelps, Inc.*,[101] the defendant shareholder was the largest single shareholder and the chief executive officer of the corporation, and in that sense was a controlling shareholder.[102]

Similarly, the member-manager of the LLC may be in control, at least to the same extent as a partner who is able to bind the business within the scope of the owner's authority.[103] A non-manager

97. *See generally* Saballus v. Timke, 460 N.E.2d 755, 760 (Ill. App. Ct. 1983) (holding managing partners to a heightened fiduciary duty); Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 FLA. ST. U.L. REV. 1, 21–22 (1988) (discussing the heightened duty when a managing partner is involved).

98. 328 N.E.2d 505 (Mass. 1975).

99. 353 N.E.2d 657, 660 (Mass. 1977).

100. 422 N.E.2d 798 (Mass. App. Ct. 1981).

101. 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

102. Claire Hansen was the Chairman of Duff & Phelps, Inc., and was also the person who sought a lucrative merger for the company and dealt directly with the minority shareholder-employee, Jordan. *Jordan*, 815 F.2d at 432. Mr. Hansen was also the chief executive officer and largest shareholder. Smith v. Duff & Phelps, Inc., 891 F.2d 1567, 1568 (11th Cir. 1990). *Jordan* has been viewed as a controlling shareholder case. *See, e.g.*, Coffee, *supra* note 2, at 1680.

This concept of liability for controlling shareholders is not found only in Massachusetts law. *See, e.g.*, Harriman v. E.I. Dupont De Nemours & Co., 372 F. Supp. 101, 105 (D. Del. 1974) (holding that a controlling shareholder owes a fiduciary duty to corporation and its shareholders).

103. ULLCA § 301(a) recognizes the apparent and actual authority of a member in language virtually identical to that of RUPA § 301; the principal substantive difference is that ULLCA breaks the RUPA language into two subsections.

member would be more analogous to a minority shareholder in a close corporation, and therefore not an owner with control. For these purposes, a person technically a non-manager member, but who nevertheless has apparent authority, should be considered an owner with control.[104]

### 2. *Conflict of the Active Owner*

Even if active owners have control, they do not necessarily have the motive to use it to its full extent. The risk to the owner without control increases as the active owner's incentive conflicts with the interests of the owner without control. It is in these circumstances that the active owner's duty should be particularly high. This may be inherent in ULLCA's concept of member-manager, but it deserves both to be explicit and to be more subtle in application.

As I have commented elsewhere,[105] the active owner's conflict increases as the owner's investment in the transaction decreases. In *Meinhard*, the reason why Meinhard needed protection from Salmon was not merely that Salmon had control over the business, but also that theirs was a zero-sum game. The more Salmon gave to Meinhard, the less was left for Salmon.[106] Similarly, Harry Rodd, as the controlling shareholder in *Donahue*, could not accomplish everything he wanted without cutting into Donahue's share.[107] In Rodd's perception, in order to receive a pleasant retirement and to provide his children with an affordable future in the company, he had to shortchange Donahue.[108] *Jordan* is no different.[109] If the chief execu-

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104. With respect to a person's status as a non-manager member for these purposes, see *supra* note 80 and accompanying text. The business forms also reflect that a person's actual control should govern. A partner who has delegated management responsibility but nevertheless acts under apparent authority should be held to the fiduciary standard, which is presumably breached by the very fact of acting without actual authority. In the same vein, the *Donahue* line of cases focus on actual effect, *i.e.*, on power to act, rather than on any right to do so.

Nevertheless, under ULLCA § 409(h)(3), such a member in a manager-managed LLC would not have liability; this does seem to be a drafting error. *See supra* text accompanying note 80.

105. Dickerson, *supra* note 5.

106. *See* Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928).

107. *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975).

108. It is typical in such cases that any accommodation to the shareholder without control is at the expense of the controlling shareholder. In Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1977), the controlling shareholders' refusal to pay Wilkes a salary meant that the corporation had more available income. It is not always

tive officer and dominant shareholder were to inform the minority shareholder of the impending merger, the minority shareholder would withdraw the redemption request and await the merger, or ask for a larger payment. This larger disbursement would reduce the value of the corporation, and consequently also reduce the price that the prospective merger partner would be willing to pay to the remaining shareholders, including the dominant shareholder.[110]

The likelihood that the issue of conflict will become significant increases as does the level of control. Owner-management means that some conflict is virtually inevitable,[111] and that the potential to do harm increases as the owner-manager's control increases. Whatever the likelihood, however, conflict and control do not necessarily increase in direct proportion. Although it is difficult to generate a hypothetical person in control but without conflict, it certainly is possible to contemplate a person who has conflict but no control. For example, an owner who lends to its own entity may not control, but has a conflict. There is no reason why the standard of performance of this owner, who has a conflict but no control, should be the same as in *Meinhard*. A rigid rule that merely excludes all owner-lenders from fiduciary liability may, however, allow the pendulum to swing too far. What if the owner-as-lender in fact has control of the business — will not that fact increase the risk of true self-dealing at the

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so pure a zero-sum game, however. In Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981), paying the dividends requested by the noncontrolling majority shareholders would subject the controlling shareholder, Dr. Wolfson, to higher income taxes. However, Dr. Wolfson's refusal to consent to dividends created an indirect loss to all the shareholders when the Internal Revenue Service imposed the accumulated earnings tax on the corporation's undistributed income. *Id*.

109. Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

110. Dickerson, *supra* note 5, at 37–38; *see also* Smith v. Duff & Phelps, Inc., 891 F.2d 1567, 1574 (11th Cir. 1990).

111. Indeed, the mere fact of being both an owner and a manager creates an inherent conflict. Despite the rigorous language of *Meinhard v. Salmon*, even in partnerships the existence of this conflict should not paralyze the actor-partner. *See generally* Dickerson, *RUPA Fiduciary Duties*, *supra* note 14, at 118. RUPA specifically provides that an owner does not breach its duty merely because an act furthers its own interest. RUPA § 404(e).

Corporate common law similarly recognizes that ownership and management create an inherent conflict. *Wilkes*, 353 N.E.2d at 663 and *Smith*, 422 N.E.2d at 801, expressly allow the controlling shareholder to attenuate its fiduciary duty by taking into account this shareholder's own legitimate business purpose. *See generally supra* note 48 (discussing legitimate business purpose).

expense of the business and the lender's co-owners?

What is critical, therefore, is not whether the conflict and control are increasing at the same rate: it is important to know the extent of the conflict and control that in fact exists. Still missing is a system that more smoothly and uniformly takes into account the actual level of control and conflict. The image is that of a continuum: as the aggregate of the owner-actor's control and conflict increases, so does that owner's standard of performance.[112]

### 3. *Risk and Harm*

The extent of control and conflict can be difficult to assess. A useful point of view can be that of the victim. The complainant by definition has a perspective on its exposure to risk and harm at the hands of the active owner. Owners are exposed to different levels of risk in the various business forms depending on the extent of their personal liability.[113] There remains a very serious difference between the two groups of cases.

On the corporate side, the *Donahue* line of cases concerns an alleged abuse by the controlling shareholder that prevents the complainant from obtaining an adequate return on investment. Perhaps the corporation's own assets create a market for the defendant's shares, but not for the complainant's shares.[114] Another abuse occurs when the shareholder who discovered the business opportunity is fired, although salary has historically been the only way the shareholders have received any corporate distribution.[115] Yet another

112. *See generally* Dickerson, *supra* note 5, Part II(B).

113. An owner who is also a manager can have liability as a manager. *See generally supra* note 97. The focus here, however, is on the owner's liability arising from the status and activities as owner.

114. In *Donahue*, the complainant sought to obtain the benefit of a market for the closely held shares. The corporation and fellow shareholders constituted the only available market to all indications, since neither the controlling shareholder nor the complainant had made any apparent effort to offer their shares to anyone else. 328 N.E.2d 505 (Mass. 1975); *Jordan*, 815 F.2d at 433; Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1977); Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981). The corporation and fellow-shareholders therefore represented the only logical source from which Donahue as minority shareholder could obtain a return from his investment.

115. *See Wilkes*, 353 N.E.2d at 661. The only distributions by the corporation to its shareholders were in the form of salaries. When the corporation stopped paying a salary to Wilkes, he lost the ability to receive any current return on his investment. *Id*.

possibility is that a corporation, through its largest shareholder, could encourage an employee to sell his shares to the corporation, knowing that a likely merger would give the remaining shareholders a much greater return.[116] In a more complicated case the defendant refuses, for personal reasons, to acquiesce in any distribution to the shareholders. In that case, not only do the complainants receive no return, but they are also affirmatively harmed because the corporation's large, undistributed income is subject to a penalizing accumulated earnings tax.[117]

Each of these cases, other than the last, concerns only the question of adequacy of the return. The last case does consider the harm to the shareholders, but only indirect harm: the direct loss belongs to the corporation because it is only the corporation's income that is subject to the accumulated earnings tax and only its assets that can be called on to satisfy the tax liability. In other words, the "harm"[118] suffered by the complainants in these cases includes the loss of a return inherent in the corporation, and in the last case includes also the complainants' share in an actual loss of value to the corporation caused by the defendant-shareholder's acts and omissions. Even in this last case, however, the most that the complainants could lose is their investment in the corporation.

In contrast, consider partnership-law cases. While their subject matter is the failure of one partner to permit the other to obtain an appropriate return on investment,[119] the partnership cases speak rather of fiduciary duty. This difference could be for purely historical reasons, but there may be a more satisfying explanation. In its capacity as shareholder, the shareholder cannot lose more than its investment in the business,[120] while the partner can lose not only

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116. *See Jordan*, 815 F.2d at 432. The failure by the controlling shareholder to disclose the probable merger caused the minority shareholder-employee to make decisions that deprived him of what the controlling shareholder knew to be part of the corporation's inchoate value. *Id*. at 433.

117. See *Smith*, 422 N.E.2d at 800, where the distributions by the corporation to the shareholders had been small compared to the retained earnings. *Id*. Unless the corporation made distributions, the non-controlling majority shareholders would receive no current return and the value of their investment would actually be reduced by the accumulated earnings tax imposed by the federal taxing authorities.

118. For a discussion of "harm," see *infra* Part III(C)(1).

119. *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). When Meinhard asked to share in the new lease, he was in essence complaining that he was losing some of the potential return to which he considered himself entitled. *Id*. at 547.

120. A shareholder's loss is not necessarily limited by its investment if the

that investment, but also the partner's separate assets.[121] If partnership income were subject to a tax penalty, the personal assets of the owners are at risk, not just their investment in the business.

Add to this unlimited exposure the fact that in partnership law risk can be imposed on a person who subjectively does not want it, thereby increasing the risk. Incorporation can eliminate this risk since an incorporated business by definition is not a partnership.[122] Therefore, the risk belongs exclusively to the general partnership form.

Historically, the law has reflected this difference by imposing a lower level of responsibility on the shareholder than on the partner. While the partner must act with the utmost good faith, the shareholder's right to "selfish ownership" tempers the impact of any fiduciary duty on the shareholder.[123] Specifically, the *Donahue*-created common-law line of analysis recognizes that the controlling shareholder, who would otherwise have a fiduciary duty, is excused if this controlling shareholder can show a "legitimate business purpose" for its acts.[124] This purpose is related to the business of the shareholder, not of the corporation, which further underscores the shareholder's right to consider its own personal interests. For example, in *Smith*, it appears that the defendant-shareholder's legitimate business purpose was his desire to reduce his personal tax exposure.[125]

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shareholder's conduct is viewed as a breach of fiduciary duty. But then the "loss" is in the form of a penalty imposed because of the breach, not because of any failure of the corporation's business. *See* Perlman v. Feldmann, 219 F.2d 173, 178 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

121. UPA §§ 13–15. This result is unchanged under RUPA §§ 305–306.

122. However, the owners of a corporation could be partners if the corporate veil is pierced and the owners' relationship independently satisfies the elements for partnership formation. UPA § 6; RUPA § 202.

123. *See generally supra* Part II(B)(1). Concerning the "selfish ownership" of shareholders, see, e.g., Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1977).

124. *See supra* note 49 and accompanying text.

125. 422 N.E.2d at 800. See *supra* note 48 describing Dr. Wolfson's legitimate business purpose in *Wilkes*. Dictum in *Wilkes* suggests that Dr. Wolfson can still be held accountable if the non-controlling shareholders carry the burden of showing that Dr. Wolfson could have attained his purpose without hurting them as much. *Wilkes*, 353 N.E.2d at 663. Dr. Wolfson should have refuted the non-controlling shareholders' accusation of breach of fiduciary duty by showing that his business interest of reducing his own tax exposure was incompatible with the non-controlling shareholders' desire for a distribution. However, Dr. Wolfson would still lose if the non-controlling shareholders could show that Dr. Wolfson could have protected that assumedly legitimate business

Therefore, the common law has at least implicitly recognized that a consequence of choosing the corporate form over the partnership form is the reduction of risk, and therefore the reduction of the harm that an owner can suffer. The extent of potential harm to a shareholder is lower than to a partner since only the former is protected by limited liability, and the protection of fiduciary duty has historically been greater for the partner.

### B. Evolution of Limited Liability in Business Forms and the Unbalancing of Fiduciary Duty

As a practical matter, the fiduciary obligation of an active owner prior to RUPA and ULLCA did reflect an effort to take into account the active owner's motive and opportunity to do harm. RUPA modifies this result somewhat, by allowing the parties to negotiate a reduction of fiduciary duty, down to a level of good faith;[126] this disrupts the balance of the continuum that had been evolving under the pre-RUPA partnership law and corporate law. ULLCA does the same, compounding the impact by granting limited liability to the owners.[127]

#### *1. Evolution of Limited Liability*

In the trend leading to close corporations on the one hand, and from general partnerships to limited partnerships on the other, the move has been away from unlimited liability for an owner-manager. The original reason for allowing the owners of corporations to have limited liability was to encourage fund raising. If new owners do not have to worry about personal liability, they will be more willing to

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purpose by a sufficiently detailed regimen of repairs and improvements without hurting them through imposition of accumulated earnings tax on the corporation. The *Smith* court indicated that the corporation would be instructed to pay dividends if the financials indicated that it was in a position to do so: there was a less harmful means, Dr. Wolfson did not pursue it, and dividends would therefore be paid. 422 N.E.2d at 803–04. The court may have faced a very basic conflict and concluded that Dr. Wolfson could have prevented the current return on investment to the non-controlling shareholders if he had prepared a detailed proposal for avoiding the accumulated earnings tax. *Id*. While the court would be protecting the non-controlling shareholders' ultimate return on investment by eliminating the corporation's tax penalty, it would not be protecting those shareholders' interest in receiving a current return. *Id*.

126. *See supra* notes 66 & 67 (discussing RUPA §§ 404, 103).

127. *See supra* notes 72 & 73 (discussing ULLCA §§ 409, 103).

invest even in relatively risky ventures.[128] The corporation would be able to raise more capital because the investors would pay relatively more, in part because their risk would be reduced, and in part because they would then affirmatively spend less on monitoring.[129] The quid pro quo, in effect, was that the owner would not have management say.[130] If the shareholder had management say, then responsibility should follow; this was the reason for the cases that have carefully distinguished between the role of the owners and of the directors.[131]

In time, however, the practical needs of businesses pushing from one end, and technical analysis pushing from the other, has resulted in the approval of even the corporation with a single shareholder who is also the only officer and director.[132] Although this shareholder as owner benefits from limited personal liability, the shareholder will, in an admittedly different capacity, also be managing the business. At least in the corporate arena, the mutual exclusivity of management and limited liability has therefore been broken. Nevertheless, the corporate formalities must be respected. If the sole managing shareholder treats the corporation as a personal wallet, the corporation may be identified as a sham, and the share-

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128. The limited liability that appeared toward the middle of the nineteenth century was seen as a way of encouraging investors of moderate means. *See, e.g.*, Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U. L. REV. 148, 155 (1992); *see generally* MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 37 (1995).

129. *See generally* DOOLEY, *supra* note 128, at 38. Without limited liability, shareholders would have to monitor management more carefully. *See, e.g.*, Rogers E. Meiners et al., *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351, 362–63 (1979).

130. The original nineteenth century model was different. It envisaged the entrepreneur who would "directly invest in and manage a corporation." Presser, *supra* note 128, at 174. However, since the beginning of the twentieth century, the separation of ownership from management has been described as "traditional" although less representative of publicly or closely held corporations today. *See* CARY & EISENBERG, *supra* note 40, at 206–07; *see also* Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 TUL. L. REV. 1143, 1150 (1989) (suggesting that, because limited liability in the hands of the manager will encourage morally questionable behavior, close corporations should be reconfigured to grant limited liability only to those who do not manage).

131. The statutes say that the Board manages. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991). It is the courts that linked liability and responsibility. *See, e.g.*, Charlestown Boot & Shoe Co. v. Dunsmore, 60 N.H. 85 (1880). Some state statutes have subsequently followed suit with a similar, explicit expression of the linkage. *See, e.g.*, DEL. CODE ANN. tit. 8, § 350 (1991).

132. Even the statutes that do not specialize in close corporations recognize this form. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141–142 (1991).

holder may lose the protection of limited liability.[133]

From the other end of the business organizations spectrum, the same trend toward conferring limited liability on owner-managers has been emerging. A partner in a general partnership has the right to manage; even if delegated away by agreement, the right is inherent to the partnership interest.[134] That general partner also has unlimited personal liability.[135] The first unincorporated hybrid, authorized by the state statutes patterned on the 1916 Uniform Limited Partnership Act (ULPA), allowed certain owners, nominally partners, to have limited liability.[136] However, ULPA made it very difficult for these so-called limited partners to maintain limited liability if they exercised any significant control.[137] This is one of the areas of important change brought by the Revised Uniform Limited Partnership Act (RULPA), especially as adopted in a number of important commercial states such as Delaware and New York.

A corporation can be the sole general partner, and now the limited partners, without losing the protection of limited liability, can be the sole shareholders, the sole directors and the sole officers of that corporate general partner, and can even be active in those capacities.[138] Although technically the corporate general partner will have all of its assets at risk, these assets can be kept to a minimum so that, in practical effect, the owners have limited their liability and maintained full management control over the limited partnership. Nevertheless, there is a sense that the limited partners must

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133. For a representation of criteria for piercing the corporate veil, see Walkoszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966). There has been considerable scholarly attention to this topic. *See, e.g.*, Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991). For our purposes, however, it is sufficient to know that the limited liability provided by corporate status is not inviolable.

134. As to the partner's management right, see UPA § 18(e), (h); RUPA § 401(f), (j). That the right to management is inherent in the partnership interest, see the co-ownership element of UPA § 6(1) and the virtually identical RUPA § 202(a). The comment to UPA § 6 states in part: "Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that they each have the power of ultimate control." UPA § 6 cmt. 1.

135. UPA §§ 13–15; RUPA §§ 305–306.

136. ULPA § 7 (1916).

137. ULPA § 7 provided no guidance to the limited partner: it only said that the limited partner would lose the protection of limited liability if it "takes part in the control of the business." *Id*. The only safe harbors available were found in the express list of ULPA § 10 that *inter alia* permitted the limited partner to receive information.

138. RULPA § 303; *see* DEL. CODE ANN. tit. 6, § 17-303 (1993); see also *supra* note 16 discussing § 17-303.

be careful if they are to protect their limited liability while also managing the business, albeit indirectly. They must be careful of the formalities to ensure both that the limited partnership's management is nominal by the corporate general partner,[139] and that the corporate formalities of the general partner also are respected.[140]

Into this scene steps the LLC. Without apology or ambiguity, the statute grants all its members the privilege of limited liability, even if they are managers.[141] This complete integration of management rights and limited liability could be properly accomplished only by statute; indeed, the LLC may signal the end to unlimited personal liability.[142] The consequence to the level of duty owed is profound: if the owners are protected from unlimited liability even if they manage, and this with little risk of error because the benefits of the LLC are inevitably available upon filing the statutorily-mandated formation papers, then the risk suffered by a member of an LLC is much less than that of a partner in a general partnership, or of a limited partner in a limited partnership. It is less even than the risk of a shareholder in a closely held corporation. It is less than if a general partner because the member in an LLC has limited liability. It is less than if a limited partner because the member in an LLC does not risk losing the protection of limited liability when it exercises management control. It is less than if a shareholder in a closely held corporation to the extent that the LLC is relatively unlikely to be recharacterized as a general partnership, since the ULLCA contains no clear analogue to the common-law concept of piercing the corporate veil.[143] According to the common-

139. This is necessary to satisfy the safe harbors of the applicable state law based on RULPA § 303. See *supra* note 28 concerning the criteria to ensure treatment as a partnership for federal tax purposes.

140. This ensures that the corporate general partner's veil is not pierced. See *supra* note 133 concerning corporate veil piercing.

141. ULLCA § 303; *see supra* note 21.

142. It has also spawned questionable progeny. For example, New York's new registered limited liability partnerships are technically partnerships, but they protect the professionals who are the partners from liability to the same extent as professional corporations protect their shareholders. *Compare* N.Y. PARTNERSHIP LAW § 26 (analogue to UPA § 15), §§ 121–1500 (McKinney Supp. 1995) (registered limited liability partnerships) *with* N.Y. GEN. BUS. LAW § 1501 (McKinney 1993).

143. *But see* Keatinge et al., *supra* note 3, at 445–46. Colorado has by statute provided for piercing. COLO. REV. STAT. § 7-80-107 (Supp. 1994). ULLCA has no such analogue, and limited partnerships are not considered to be subject to piercing. Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L.

law's logic described above in Part III(A)(3), the LLC's owners would shoulder a fiduciary duty no higher than would a close corporation's similarly situated shareholders.

### 2. *Control and Conflict*

ULLCA does take into account the relationship between control and conflict on the one hand, and responsibility on the other, but it is an instrument far more crude than the common-law approach described above in Part III(A)(1) and (2). A member in an LLC can have a position of conflict just as can a partner or a shareholder:[144] to that extent, the fact of owner-management as a trigger that increases the responsibility and liability of the owner makes sense.[145] The ULLCA's method is crude because it does not directly take into account the inevitable conflict of an owner-manager,[146] and because it imposes a flat obligation regardless of the level of actual control or conflict. ULLCA corrects for conflict at the low end by allowing the member-manager to engage in selfish acts: a member-manager is not automatically in violation of its duties merely because its activities benefit it personally.[147] This language does not tell us much, however. When does a member's conduct do more than "merely . . . further[] the member's own interest"?[148]

On the high end of conflict, ULLCA is just as blunt a tool because whatever the likelihood, conflict and control do not necessarily increase in direct proportion. We saw, for example, that an owner who lends to its own entity may not control, but has a conflict; flexi-

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REV. 387, 402 (1991). Perhaps, as in Colorado, the LLC should not be subject to piercing at all, absent a Colorado-type statute. However, the LLC may be more similar to the corporation than to the limited partnership because both permit owners to manage. *Id.* at 402–03; Keatinge et al., *supra* note 3, at 445. Neither is required to have an owner who even nominally has unlimited liability. Gazur & Goff, *supra*, at 402–03. Perhaps, therefore, the LLC should be subject to piercing. But even if it is, it occurs as frequently as in a corporation because formalities are less important for LLCs than for corporations, and it will not be possible to argue for piercing because of failure to hold regular board meetings. What will be required are specific facts that indicate the owner's basic and generalized disregard of the LLC's separate existence.

144. *See supra* Part III(A)(2).

145. *See supra* Part II(C).

146. *See supra* Part III(A)(2).

147. ULLCA § 409(e); *see supra* note 66 (discussing RUPA § 404(e)); *see also supra* note 45 (discussing the legitimate business purpose exception).

148. ULLCA § 409(e).

bility would therefore be appropriate.[149] Indeed, ULLCA recognizes that the owner-management trigger can lead to inappropriate results because the statute expressly excludes an owner-as-lender from fiduciary liability.[150] But what if the owner-as-lender in fact does have control of the business — will not that increase the risk of true self-dealing at the expense of the business and the lender's co-owners?[151] How do we create a system that more smoothly and uniformly takes into account the actual level of control and conflict, where an increase in the aggregate of the owner-actor's control and conflict serves to increase the active owner's standard of performance?[152]

### C. Reintroducing Balance by Recognizing Permitted Harm in the Context of Control and Conflict

When discussing the evolution of the different standards for partnerships and close corporations, I noted that partners can suffer more harm than shareholders, because the former do not benefit from limited liability, and can lose far more than their investment plus any potential upside.[153] The purpose of that discussion was to outline existing law and to consider how the concept of "harm" is implicit in the common law's imposition of a higher standard on partners than on shareholders, as they deal with co-owners. However, our focus on the LLC has now trained our sights directly on limited liability, and on harm. If we are to use this concept of harm more explicitly as a means of placing the appropriate standard of performance on a continuum, we must articulate what we mean by "harm." We will look at "permitted" harm and "potential" harm and how these concepts fold back onto the control-conflict continuum. Finally, I will discuss why the standard of performance arrived at in this manner must be mandatory, not optional.

#### 1. *Harm, Permitted Harm and Potential Harm*

149. *See supra* Part III(A)(2).

150. ULLCA § 409(f). RUPA contains the same provision for a partner-lender. RUPA § 404(f).

151. *See supra* Part III(A)(2).

152. *See generally* Dickerson, *supra* note 5, Part II(B).

153. *See supra* Part III(A)(3).

### a. Harm

As I have indicated elsewhere,[154] the scholars who have considered harm most closely are the contractarians.[155] In their concern for economic efficiency, the contractarians view relationships in terms of costs.[156] A cost to which the parties have freely agreed is not harm to the parties who bargained for that cost.[157] If a mandatory standard of performance is imposed on the parties, whether at some fiduciary level or lower, the parties may have an increased cost since they would not have willingly chosen to bear the higher cost of performing to the relatively higher standard.[158] Because the parties' competitors will be similarly burdened, the parties will be able to pass at least some of the costs on to their consumers. Ultimately, however, society will suffer because of the inefficient allocation of societal resources, and for that reason contractarians generally deplore mandatory duties.[159] But even if society is harmed, the individuals would not be, since they have passed on their costs.[160] Therefore, the contractarians see no harm to the individual parties whether or not fiduciary duties are imposed: if the duties are not mandated, the parties freely agree to any cost; if the duties are mandated, it is society and not the individual parties that are harmed.

If that is the contractarian perspective in brief, it still neglects actual harm that can be suffered when fiduciary duties are not

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154. For a more detailed discussion of "harm" and of the contractarians' analysis, see Dickerson, *supra* note 5, Part II(a)(1).

155. Contractarians are generally called lawyer-economists. A classic lawyer-economist and contractarian is, for example, Judge Posner. *See supra* note 52.

156. *See, e.g.*, POSNER, *supra* note 51, § 1.2, at 13–15; JULES L. COLEMAN, MARKETS, MORALS AND THE LAW 71–72, 84–86 (1988); Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512–13 (1980). An allocation of resources that hurts no one and that causes at least one person to be improved is Pareto superior. If no possible Pareto superior allocation exists, the allocation is Pareto optimal. Coleman, *supra*, at 512–13. Kaldor-Hicks efficiency exists when the benefit to the winners would exceed harm to the losers, if the winners compensated the losers. *Id*. The losers do not in fact have to be compensated: if they were, the allocation would become Pareto superior. *Id*. at 513.

157. *See* Dickerson, *supra* note 5, Part II(A)(1); *see generally* Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

158. *See, e.g.*, Butler & Ribstein, *supra* note 1, at 40.

159. *See supra* notes 52–54, Part II(C).

160. Contrary to Judge Posner's example of the firebreak, POSNER, *supra* note 51, § 6.9, at 190–91, this externality would be negative; *see generally* Dickerson, *supra* note 5, Part II(A)(1).

mandatory. We have seen that, in the case where there are no mandatory standards, the contractarians base their conclusion of no harm on the assumption of free bargaining.[161] The free bargaining assumption requires the further assumption of a level playing field.[162] But, as I noted elsewhere, what if the parties are not evenly matched? For example, the owner of a closely-held business will tend not to have diversified and therefore to be in a weak position unless it is also the owner with control.[163] A weaker party will have greater costs than its competition, either to purchase fiduciary protection if not mandated, or to monitor if the protection is not available. This increased cost, due to the party's relative weakness, will be felt as harm.[164] It is for this reason that each party's behavior must meet some minimum threshold.

### b. Permitted Harm

Permitted harm describes the extent of harm that society will allow one person to inflict on another,[165] and helps to define the proper level at which to set the threshold. Permitted harm does not describe the harm that a person can "get away with," in the sense that certain losses may give rise to a technical cause of action but not allow the victim to obtain recovery because, as a practical matter, the cost of litigation is prohibitive in the context.[166] Neither does it focus on a bad act for which there is no remedy because the injury is considered too remote.[167] Rather, it focuses on acts that do harm another, but that are permitted. For example, a person who has not acted negligently can harm another, but, absent strict liability, that

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161. *See, e.g.*, POSNER, *supra* note 51, § 4.1, at 93.

162. Such contractarians as Professor Ribstein emphasize the relative sophistication and general ability of parties to decide freely. *See, e.g.*, Ribstein, *supra* note 13, at 59.

163. *See, e.g.*, Easterbrook & Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 274 (1986).

164. Dickerson, *supra* note 5, Part II(A)(1).

165. *See generally id.*, Part II(A)(2).

166. *See, e.g.*, Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) (illustrating the efficient breach of contract).

167. A victim has no tort cause of action because of lack of proximate cause. *See, e.g.*, Kinsman Transit Co. v. City of Buffalo, 388 F.2d, 821, 824 (2d Cir. 1968). Additionally, damages suffered do not give rise to a cause of action because they were unforeseeable. *See, e.g.*, Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854); RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979).

act will be permitted.[168] Acts that comply with applicable standards of performance also can give rise to permitted harm. Although Judge Cardozo found that Meinhard did suffer harm for which there was a remedy, if the court had not considered the relationship of Meinhard and Salmon to be substantially equivalent to a partnership and therefore governed by fiduciary duty, Salmon's act of entering into the lease would have been permitted, regardless of any harm inflicted on Meinhard.[169]

By considering the extent of harm that society permits if it applies a particular standard of performance, we have another method of assessing ULLCA. In this context, the harm permitted is both actual harm and potential harm.

### c. Potential Harm

Especially at the higher levels of the standards of performance, for example in the context of fiduciary duty, actual harm does not have to be proved for recovery to be allowed. Put differently, potential harm is sufficient.[170]

As the standard of performance falls, the amount of permitted harm, especially potential permitted harm, rises, all other things being equal. But they are not. If the victim is subject to unlimited personal liability the permitted harm potentially generated will be greater than if the same standard were applied and the victim were protected by a limitation on personal liability. I am already on record as criticizing RUPA's reduction of fiduciary duties as being inappropriately low for general partnerships.[171] My view is unchanged. But these same standards may at least as a first cut be appropriate for an LLC that protects its owners from unlimited per-

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168. There could still be a cause of action outside tort law. *See, e.g.*, Sullivan v. O'Connor, 296 N.E.2d 183 (Mass. 1973) (holding that the defendant was not negligent, but was liable in contract).

169. Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). Judge Cardozo expressly found that Salmon had acted in good faith. *Id.* at 547.

170. In the agency context, see, e.g., Tarnowski v. Resop, 51 N.W.2d 801 (Minn. 1952). In the partnership context, see, e.g., UPA § 21(1), holding the partner expressly accountable for the type of kick-back that was the subject of *Tarnowski*. The result is the same under RUPA § 404(b)(1), subject to any agreement pursuant to RUPA § 103(b)(3) limiting the duty. In the corporate law context, see, e.g., Diamond v. Oreamuno, 248 N.E.2d 910, 912–13 (N.Y. 1969) (Fuld, C.J.) (considering that the corporation's reputation had been damaged).

171. Dickerson, *RUPA Fiduciary Duties*, *supra* note 14; Dickerson, *supra* note 5.

sonal liability, precisely because the same standard of performance applied to owners of an LLC permits less harm than it does if applied to fully exposed general partners.

### *2. The Refinement Based on Permitted Harm, and on Control and Conflict*

The form of the business should determine presumptive standards for providing guidelines.[172] This creates a continuum with definable points based on the nature of the business that provides initial predictability. A partnership relation would be presumed to give rise to a high standard, but a corporation's owners would be presumptively subject to a lower standard, in each case subject to the refinement that the victim can overcome the presumption by showing that in the particular circumstance the resultant permitted harm is inappropriate.[173] The presumptive standard for the corporation should be lower, as indeed case law has provided, because the harm that can potentially be inflicted on a shareholder has an automatic ceiling equal to the shareholder's investment in the business. It is only the portion of this potential harm truly permitted by our legal system that would then be considered permitted harm.[174] For example, if the active owner's act that could give rise to harm is within the applicable standard of performance, even if the harm is still potential, that entire loss would be permitted harm subject to a ceiling if the owner has limited liability. Thus, the maximum possible permitted harm is limited if the business organization provides limited liability, as does the corporation and the LLC.

To use only permitted harm as a means of smoothing the quantum aspect of a spectrum that leaps from business form to form, for example from partnership to limited partnership to corporation, is to ask too much of that concept. Permitted harm is a means of hearing the victim,[175] but it inevitably has a subjective flavor. The way to include more purely objective factors is to look at the extent of control of the active owner and its conflict. These factors act as a check on the victim's perception of harm.[176]

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172. Dickerson, *supra* note 5, Part II(C)(1).
173. *Id*.
174. See *supra* Part III(C)(1)(b) for a discussion of permitted harm.
175. *See* Dickerson, *supra* note 5, Part II(A).
176. *See id*. Part II(B)(2).

The greater the active owner's conflict and control, the more likely is the accuracy of the victim's perception of at least some suffered harm. The greater the actual or potential harm, the less likely that society can permit the conduct, since it would be legitimizing abuse. Therefore, the conflicted controlling shareholder in *Jordan*,[177] because his position creates the potential for harm, will be held to a higher duty than if he had no control. A partner who lends to the partnership but has delegated away all management rights would owe a heightened standard because of the conflict inherent in the transaction, but not the highest standard because of the active partner's lack of control (and the partner's resultant reduced ability to harm).[178]

### *3. Permitted Harm Standards of Performance as Mandatory*

Once the presumed standard of performance has been established based on the business form, and once this standard had been refined by taking into account the control and conflict of the active owner and the extent of the permitted harm at that level of standard, the standard must be mandatory. While this is undeniably different from the view of the contractarians,[179] it is mandated by the permitted harm analysis that depends on the relative positions of the parties and assumes a playing field that is most likely not level. If, once the standard had been established, the parties were able to opt out, it would only give the active owner, who in these hypotheticals has been the person with control, another opportunity to exercise that control.[180]

This conclusion is different from what ULLCA provides.[181] Not only does the statute narrow the definition of fiduciary duties by including an exclusive list,[182] but it also permits further opting out by the parties.[183]

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177. Jordan v. Duff & Phelps, Inc., 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988).

178. See *supra* Part III(A)(2), (B)(2), for a discussion of the owner-as-lender.

179. *See, e.g.*, Ribstein, *supra* note 13, at 57–61.

180. *See* Dickerson, *supra* note 5, Part II(B)(2),(3).

181. *See generally supra* Part II(C).

182. For the text of ULLCA § 409(b), see *supra* note 72; *see also* Kennedy, *supra* note 84 (concerning the effect of exclusive lists as opposed to standards).

183. For the text of ULLCA § 103(b), see *supra* note 73.

### *4. Permitted Harm Analysis Applied to LLCs*

We have created a sliding scale for the standards of performance.[184] What does this analysis add to our review of the LLC?

The bad acts considered so far by the permitted harm analysis are abuse by the controlling shareholder or by the active partner. In this context, the analysis will not allow a reduction in the owner's obligation. Now let us see what happens if the bad actor is an owner of an LLC. The structure of the LLC limits the potential harm to an owner-victim in much the same way as the corporate structure limits the risk to which a shareholder is exposed. Since an LLC cannot be formed by inadvertence, the likelihood of imposing on an owner totally unexpected liability is less than for partners. Further, an LLC will tend to have few owners although, if Treasury adopts new regulations that substitute an election for the current analysis of four corporate characteristics as the way of determining the LLC's tax status, the LLC may in the future have a relatively greater number of owners than today.[185] An LLC member should, therefore, have the same level of responsibility as a similarly-situated shareholder in a close corporation. A member who is also a manager should be subject to the delicately balanced common-law duty of a controlling shareholder[186] — and this duty should be mandatory and irreducible. Unfortunately, this is not the analysis of ULLCA.

ULLCA reproduces the objectionable contractarian terms of RUPA that allow the general partners to reduce their obligation by agreement down to a level of good faith. Under ULLCA, the members of an LLC have the same ability to opt out, whether or not they are managers. What makes this statutory intervention less shocking in the context of LLCs than in general partnerships is that the limited liability of the LLC members places a ceiling on the permitted harm they can suffer due to obligations created by a co-owner. If the parties can and do negotiate an enforceable reduction in the standard of performance, the harm permitted to be inflicted by a partner on its co-partners is potentially far greater than the harm inflicted by a member of an LLC on its co-members: the partners have unlim-

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184. Fiduciary duty and good faith are on the same continuum. *See* Dickerson, *supra* note 5, Part II(B).

185. *See supra* Part II(A).

186. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975). See *supra* Part III(A), describing the common law standards as balanced.

ited personal liability, while the LLC members stand to lose only their investment and any upside.[187] Even if an LLC managing member's control is relatively great, the victim's harm still is limited by the structure of the entity. Therefore, the manager-owner of an LLC can legitimately be subjected to a lower standard of performance than for a partner.[188]

However, there are consequences of ULLCA that I cannot accept. Because of its unsubtle trigger, ULLCA standards of performance may result in an automatically and uniformly lower standard for a member of an LLC than for the controlling shareholder in a closely-held corporation.[189] ULLCA's trigger defined by the extent of an owner's official, as opposed to actual, status as manager, may mean that a person in actual control of an LLC will not be subject to any fiduciary standard. The problem may be particularly acute if the non-manager owner is exercising control through veto: it is not at all clear that this person will be recognized as a manager.[190] Further, if a fiduciary standard does apply initially to the LLC owner, the draft

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187. See *supra* notes 128–33 and accompanying text for a discussion of the effect of limited liability on an owner's risk.

188. *See* Dickerson, *RUPA Fiduciary Duties*, *supra* note 14; Dickerson, *supra* note 5.

189. A slight variation can be justified in proportion to the greater difficulty in piercing an LLC as opposed to corporate veil, *see supra* note 143 and accompanying text, but the difference here is gross.

On a more general point, while both the contractarian majority and the dissent in *Jordan* believed that the parties can opt out of whatever fiduciary duty would otherwise restrict the controlling shareholder, Jordan v. Duff & Phelps, Inc., 815 F.2d (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988), it is not at all clear when even contractarians would apply a contract-law standard to a shareholder in control. *Id.*; *see supra* note 52 (discussing the views of Judge Easterbrook in the court's opinion, as compared with those of Judge Posner in his dissent). The conclusions of Judges Easterbrook and Posner in this case can be harmonized as different views of the standard to be applied to waiver of fiduciary duty or differing views as to the duties themselves. Judge Posner considers them to exist if any contract has been entered into by the parties, only if the contract so provides, while Judge Easterbrook views duties as default provisions, applicable unless clearly eliminated by agreement entered into by the parties. *See* Dickerson, *supra* note 5, at 974 n.76.

190. *See generally supra* Part II(B)(2); *see also* Part II(A)(2). Historically, courts have seemed more willing to find that an owner exercising a veto, is exercising control if the business is incorporated rather than unincorporated. The LLC should be considered more like a corporation, but we do not have sufficient experience with the LLC to know how the courts will deal with vetoes where the statute is silent. *Compare* Smith v. Atlantic Properties, Inc., 422 N.E.2d 798 (Mass. App. Ct. 1981) (treating a vetoing shareholder as a controlling shareholder) (*see supra* note 94 and accompanying text) *with* Martin v. Peyton, 158 N.E. 77 (N.Y. 1927) (stating lenders exercising veto power are not recharacterized as partners, and are not personally liable).

statute allows the parties to opt out without taking their relative positions into account. ULLCA is not even procedurally responsive to conflict and control, beyond the trigger, when addressing the very serious issue of standards of performance. It does not recognize that the complaining owner will be more susceptible to harm if the business is relatively closely held and, therefore, the complaining owner will typically not have diversified. In contrast, the permitted harm analysis that I have outlined in Part III is substantively and automatically responsive even to the LLC's status as a limited liability form. Before effecting the fine-tuning that would take into consideration the extent of the member-manager's actual control and conflict, the permitted harm analysis would factor in the LLC's characteristics. Because the extent of the permitted harm that an LLC-member can suffer is capped by that person's limited liability, the standard applied to an owner-actor in an LLC, i.e., to a member-manager, would presumptively be lower than that applicable to a partner in a general partnership. After that presumptive level for the standard has been determined, the permitted harm analysis factors in the active owner's control and conflict, and considers the harm that a particular standard would permit that active owner to inflict on the co-owner. The standard of performance thus determined is mandatory.

Unless the standard of performance varies depending on the active owner's control and conflict, and on the harm that the active owner can inflict, ULLCA facilitates abuse. The owner-manager is sheltered from personal liability to third parties. If the owner-manager convinces its co-owners to agree to allow it to opt out of duties down to the good faith threshold of ULLCA, the owner-manager will also have minimal liability to co-owners. Any act that would be permissible by an arms-length party to a garden variety contract may well be permissible if effected by an opting-out owner, even if also a manager and even if the non-managing co-owner is particularly vulnerable. Co-owners would thus suffer harm without a right to a remedy.

## *IV. CONCLUSION*

The most radical change represented by the LLC is its severing of an owner's responsibility from its liability, in the context of an unincorporated business. The LLC's structure provides that a member of an LLC can be a manager and still have limited personal liability in its capacity as owner. This change in turn should have an impact on the extent of fiduciary duty owed by one owner to another.

In the context of a business entity that provides limited liability to its owners, ULLCA allows for opting out of fiduciary duty, down to a good faith level, again, even for members who are also managers. Members who are not deemed managers owe no fiduciary duty whatsoever to their co-owners. This reverses a trend in the law of close corporations: depending on how management is defined, an LLC member acting as would a controlling shareholder, might not be considered a manager.[191]

In addition to that technical problem, ULLCA errs far more fundamentally by using management as the trigger. That trigger applies only a small portion of one out of three relevant factors that distinguish the various business forms from each other. To the extent that management is a subset of control, the control factor is not fully covered, and the factors of conflict and potential to inflict harm are covered, if at all, only to the extent subsumed in the concept of management. The permitted harm analysis reintroduces these factors, and mandates the resultant standard of performance. Otherwise, we are merely inviting further abuse, to be judged at the lower, contract standard of good faith.

ULLCA treatment of fiduciary duty succeeds in that it recognizes that the presumptive level for the standard of performance need not be as high as for partnerships under pre-RUPA partnership law. Given that ULLCA's starting point is apparently RUPA,[192] ULLCA arguably sets a high moral tone: it applies the same standards to owner-managers of LLCs as RUPA does to partners, even though the potential loss of an LLC member is less than that of a general partner. However, ULLCA fails in the bigger picture. It has created a standard of performance for members of an LLC that is even lower than the standard currently in place for the owners in the traditional business entity having limited liability, the corpora-

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191. *See supra* Part III(C)(2).

192. The provisions of ULLCA §§ 409, 103 are virtually identical to those in RUPA §§ 404, 103. *Compare* text at notes 72 & 73 *with* text at notes 66 & 67.

tion. Further, it does so in a context where tax considerations limit the number of owners, thereby increasing the vulnerability of the owners who lack control.

Unless we revise ULLCA's standard of performance to take into account the active owner's control and conflict, and its potential to inflict harm, the LLC will become the vehicle of choice for all who wish to avoid responsibility.