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APPLICATION OF CORPORATE COMMON LAW DOCTRINES TO LIMITED LIABILITY COMPANIES

Steven C. Bahls*

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Unwisely unlamented, the corporate form now languishes, bleeding and dying, nearly done in by self-styled do-gooders.  

I. INTRODUCTION

On October 1, 1993, Montana joined the ranks of approximately thirty other states authorizing limited liability companies. Legislatures typically authorize the use of limited liability companies to provide small business with the best of both worlds from the corporate and partnership forms of business entities. Limited liability companies were created to combine the benefits of limited liability, pass-through taxation, and the flexibility of a partnership. The Montana Limited Liability Company Act was passed by the Montana legislature without any dissenting votes in the Senate and only eight dissenting votes in the House of Representatives. The Act's principal sponsor was Senator Mignon Waterman. In 1991, Billings attorney Jim Sites, then Chair of the Tax, Probate and Business Law Section of the State Bar of Montana, created a Limited Liability Company Subcommittee to study the progress of limited liability companies on the national level and to propose appropriate limited liability company legislation for Montana. The subcommittee was comprised of a bipartisan, diverse body of attorneys, which included private practitioners, members of state government and academia, as well as a law student associate member who reviewed limited liability company statutes of other jurisdictions. Committee members included Professor Steven C. Bahls, Chair and Reporter; Julieann McGarry, Co-reporter; Richard M. Baskett; Garth B. Jacobson; Alan L. Joscelyn; and Thomas C. Morrison. The subcommittee studied limited liability company legislation from the seventeen states that had then authorized limited liability companies. Those states included Colorado, Delaware, Florida, Georgia, Iowa, Kansas, Louisiana, Maryland, Minnesota, Nevada, Oklahoma, Rhode Island, Texas, Utah, Virginia, West Virginia, and Wyoming. The subcommittee also studied various drafts of the Prototype Limited Liability Company Act [hereinafter ABA Prototype Act] promulgated by the American Bar Association Subcommittee on Limited Liability Companies of the Section of Business Law. The subcommittee ultimately based its proposal on the July 1992 version of the ABA Prototype Act.

liability companies uniquely integrate the limited liability attributes of a corporation with the "pass-through" tax advantages enjoyed by a partnership. An evolutionary entity, a limited liability company provides significant advantages for today's closely held business. This new business form promises simplicity in formation, flexibility in planning and operation, limited liability, member control of the business, and significant tax advantages when compared with corporations.

In the face of almost uniform praise for limited liability companies, this Article will sound a few notes of caution. One concern about use of limited liability companies is that courts, legislatures, and regulatory agencies have not answered all of the questions about limited liability companies. One unanswered question is whether common law doctrines applicable to corporations are applicable to limited liability companies. The corporate doctrines applicable to limited liability companies might include the corporate trust fund doctrine, the doctrine of piercing the corporate veil, the business judgment rule, and the doctrines governing oppression of minority shareholders. Determination of whether corporate doctrines apply, or whether corresponding (but different) doctrines in partnership law apply, is difficult because limited liability companies share some attributes of corporations and some attributes of partnerships. The problem is compounded because most states have neither codified nor, by statute, rejected these common law doctrines for limited liability companies. This Article examines the public policy reasons behind these common law corporate doctrines and concludes that many, but not all, of the corporate doctrines should apply in some form to limited liability companies. Often, however, because of the unique attributes of limited liability companies, courts should revise the corporate doctrines when applying them to limited liability companies.

This Article first examines the history of limited liability companies and why the fundamental attributes of limited liability companies make them attractive for small businesses. The Article next analyzes whether those fundamental attributes justify application of the common law doctrines that protect creditors from inappropriate corporate conduct. The Article concludes with a dis-

5. See infra text accompanying notes 30-65.
6. See generally Gazur & Goff, supra note 4, at 462-69.
7. See infra text accompanying notes 30-65.
8. See infra text accompanying notes 66-142.
discussion of whether the corporate common law doctrines governing the duties of owners and managers ought to apply to limited liability companies. 9

II. ATTRIBUTES OF CLOSELY OWNED BUSINESSES OPERATING AS LIMITED LIABILITY COMPANIES

The attributes of limited liability companies make them an appropriate form for many business organizations currently operating as partnerships or close corporations. In order to understand why limited liability companies are so attractive for closely held businesses, it is desirable to examine both the history of limited liability companies and why neither partnerships nor corporations have historically fully satisfied the needs of small businesses.

A. History of Limited Liability Companies

The concept of limited liability companies originated in Germany more than one hundred years ago. In 1892, Germany authorized creation of a business form similar to limited liability companies called "Gesellschaft mit beschränkter Haftung (GmbH)." 10 Within ten years, Portugal authorized an organization with the attributes of limited liability corporations called "sociedad de responsabilidad limitada." 11 Today limited liability company-type organizations are common throughout Europe and Latin America. 12

Recent developments in federal tax law persuaded state legislatures to enact limited liability company legislation. In 1986, federal tax legislation repealed the General Utilities exception for gains realized from certain sales of corporate assets. 13 The same legislation reinforced the double taxation of corporations and shareholders. 14 Likewise, the inversion of the corporation and indi-

9. The three primary doctrines involving corporate common law duties analyzed in this Article are the duty of care, the duty of loyalty, and the duty to avoid oppression of minority owners. See infra text accompanying notes 143-272.


11. Id.


individual tax rates further compounded problems for businesses taxed as corporations.\textsuperscript{15}

Before 1986, only two states, Wyoming and Florida, had enacted limited liability legislation, probably because much doubt existed as to whether limited liability companies would receive the benefit of taxation as partnerships.\textsuperscript{16} In 1988, the Internal Revenue Service provided needed clarification by releasing Revenue Ruling 88-76,\textsuperscript{17} which stated that properly structured Wyoming limited liability companies would be taxed as partnerships. This Revenue Ruling settled many doubts about the future of limited liability companies and broke the way for other states to begin legislation in this area. Since then, the Internal Revenue Service has issued favorable rulings for Colorado,\textsuperscript{18} Virginia,\textsuperscript{19} Nevada,\textsuperscript{20} Florida,\textsuperscript{21} Illinois,\textsuperscript{22} and West Virginia.\textsuperscript{23}

State legislatures have been quick to jump on the limited liability company band wagon in order to provide the owners of small businesses organized in their states with limited liability and the benefits of taxation as partnerships.\textsuperscript{24} To provide states with guid-
ance, an American Bar Association subcommittee drafted a Prototype Limited Liability Company Act (ABA Prototype Act). Arkansas, Idaho, and Montana have adopted the Prototype Act. Because of the unique combination of tax benefits with limited liability, limited liability companies are likely to become the organizational form of choice for many closely held businesses. Professor Larry E. Ribstein, the Reporter for the ABA Prototype Act, ob-

25. **Prototype Limited Liability Company Act** (American Bar Ass'n 1992) [hereinafter ABA Prototype Ltd. Liab. Co. Act]. The Montana Limited Liability Company Act is patterned after the ABA Prototype Act. The Montana Limited Liability Subcommittee, however, drafted several significant additions and modifications to the ABA Prototype Act, all of which were enacted into law. Modifications include both conforming the ABA Prototype Act to Montana practice and making substantive modifications. Most of the substantive modifications were designed to protect creditors and the public from certain irresponsible conduct of limited liability companies. Those protections include:

1. **Annual reports.** The Montana Limited Liability Company Act requires limited liability companies to file annual reports. MONT. CODE ANN. § 35-8-208. The members of the subcommittee believed that because the limited liability company statute provides owners of limited liability companies with protection from liability for the debts of the organization, it is desirable to provide the public with some basic information about each limited liability company.

2. **Unknown claims against dissolved limited liability companies.** The statutory provisions protecting creditors of dissolved limited liability companies are quite strong under the Montana Limited Liability Company Act. MONT. CODE ANN. § 35-8-909. Subsection (1) makes it clear that the dissolution of a limited liability company does not negatively impact creditors' rights. Subsection (2) codifies the common law trust fund doctrine. The trust fund doctrine provides that the property of a dissolved business is considered a trust fund for the payment of business debts. 16A WILLIAM FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8161, at 517 (rev. perm. ed. 1988 & Supp. 1993); see Joseph J. Norton, Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets, 30 BUS. LAW. 1061 (1975). As a result, members of a limited liability company receive assets upon dissolution subject to the claims of creditors. Subsection (3) codifies the holding in North Am. Asbestos Corp. v. Superior Court, 225 Cal. Rptr. 877 (Ct. App. 1986) (holding that the dissolution rules of the state in which the claim arises apply to creditors' claims, not the laws of the business's state of organization).

3. **Professional limited liability companies.** Subject to certain limitations, professionals may organize as limited liability companies. See MONT. CODE ANN. §§ 35-8-1301 to -1307 (1993). At least one-half of the managers of professional limited liability companies must be qualified professionals. MONT. CODE ANN. § 35-8-1303 (1993). Individuals who render professional services are "liable for any negligent or wrongful act or omission in which the individual personally participates to the same degree as if the individual had rendered the services as a sole practitioner." MONT. CODE ANN. § 35-8-1306(1) (1993).

serves that over time, "the partnership form of business will greatly diminish in importance."\textsuperscript{27} He goes so far as to predict that "[a]fter a transitional period, partnership will survive, if at all, as a residual form for firms that have no customized agreement."\textsuperscript{28} Professor Richard Parker, of the University of Baltimore School of Law, agrees when he states: "It is difficult to conceive of a reason why any business that in the past would have adopted a general partnership form will not in the future use an LLC."\textsuperscript{29}

\textbf{B. The Entity Selection Dilemma}

Most partnerships and close corporations share the attributes of substantially similar ownership and management. In businesses organized as partnerships, all partners usually participate in management.\textsuperscript{30} In close corporations, most shareholders commonly serve both on the board of directors and as officers.\textsuperscript{31} The substantial similarity of ownership and management in closely held firms results in several related attributes. The owners/managers of closely held businesses usually have a keen interest in the identity of the other owners/managers. As a result, in the family-owned, closely held business, owners/managers typically restrict ownership of equity interests to family members. Closely held corporations also commonly restrict the ability to convey equity interests and related management rights without the approval of all or substantially all of the other members.

Because ownership and management are nearly identical in most closely held businesses, closely held businesses tend to operate more informally than their publicly owned counterparts. Often, management of closely owned firms does not make major decisions until a consensus develops. The laws governing partnerships\textsuperscript{32} and

\begin{itemize}
\item \textsuperscript{28} Id.
\item \textsuperscript{30} As a general rule, partners have equal rights in management. \textit{UNIF. PARTNERSHIP ACT} \S 401(f) (1992). Montana codified this section at \textit{MONT. CODE ANN.} \S 35-10-401(6) (1993).
\item \textsuperscript{31} Close corporations are corporations in which ownership and management are "substantially identical to the extent that it is unrealistic to believe that the judgment of the directors will be independent of that of the stockholders." Symposium, \textit{The Close Corporation}, 52 \textit{NW. U. L. REV.} 345, 345 (1957). A key characteristic of a close corporation is that it is not publicly owned, and, therefore, no market exists for its stock. \textit{Id.} at 345-47.
\item \textsuperscript{32} The Uniform Partnership Act permits partners in partnerships at will to dissolve the partnership upon a partner's express will. \textit{UNIF. PARTNERSHIP ACT} \S 801(1). Montana codified this section at \textit{MONT. CODE ANN.} \S 35-10-624(1), (2)(b) (1993).
\end{itemize}
statutory close corporations encourage consensus building, because owners are able to dissolve the businesses easily if they disagree with management decisions. Experience shows that closely held corporations often ignore the statutorily required corporate formalities of properly electing directors and officers. Even if directors are properly elected, close corporations often do not call required annual meetings and do not properly authorize corporate actions. Owners of closely owned businesses often regard the formality required by business organization statutes as unnecessary red tape or as “Mickey Mouse” requirements imposed by the government.

Closely held businesses, because they are typically dominated by one owner or only a handful of owners, often dissolve when the dominant owner withdraws from the business by virtue of retirement, death or other change in circumstance. Unlike publicly owned corporations, closely held businesses do not have perpetual life.

Partnership law adequately reflects the realities of closely held firms. The Uniform Partnership Act provides for management by members, restrictions on the transferability of interests, and dissolution upon the death or retirement of an owner. The Montana Business Corporation Act, like that of other state corporate statutes, fails to provide for the realities of closely owned businesses. Despite the 1991 amendments to the Montana Business Corporation Act intended to aid closely held corporations by eliminating needless formalities and allowing additional flexibility in corporate governance, the law governing corporations continues the attributes of continuity of life, centralized management, and


34. Bahls & Compton Quist, supra note 24, at 81.
35. Bahls & Compton Quist, supra note 24, at 81.
36. UNIF. PARTNERSHIP ACT § 401(f). Montana codified this section at MONT. CODE ANN. § 35-10-401(6).
40. Bahls, Montana’s New BCA, supra note 24, at 4-6.
free transferability of interest.\textsuperscript{43}

Though the rigid business governance provisions of state corporate statutes create incentives for closely held businesses to operate under the more flexible partnership statutes, the provisions of the partnership statutes regarding the rights of creditors discourage closely held businesses from forming as partnerships. Corporate statutes protect shareholders from individual liability to creditors,\textsuperscript{44} while partnership statutes provide that partners are jointly liable for partnership debts.\textsuperscript{46} Because of the appeal of limited liability, the owners of many closely held businesses choose to operate as corporations. In making this choice, the owners/managers of these businesses are forced to suffer the disadvantages of perpetual life, centralization of management, and free transferability of interest. Though closely held corporations can take steps to mitigate these disadvantages, forcing closely held businesses to satisfy the requirements of the Model Business Corporation Act is like trying to force a square peg into a round hole.\textsuperscript{45}

Federal tax laws compound the entity-selection dilemma for closely owned businesses. Corporations, as a general rule, are regarded as separate taxable entities, while partnerships are not. A corporation is taxed once at the corporate tax level, and shareholders must pay tax on distributions. As a result, corporations often suffer from double taxation. Partnership net income, however, is passed through to its owners, avoiding the double taxation imposed on a corporation and its shareholders. The Internal Revenue Service, through its regulations, has described the attributes of a business taxed as a corporation.\textsuperscript{47} Because partnership tax status of limited liability companies is so important, four primary attributes of an association taxable as a corporation are central to the

\textsuperscript{46}The comparison between closely held businesses and state corporation laws was first noted in J.B. Wolens, \textit{A Round Peg—A Square Hole: The Close Corporation and the Law}, 22 Sw. L.J. 811 (1968). The Model Statutory Close Corporation Supplement, enacted in Montana, was designed to mitigate many of the disadvantages of corporations for closely held businesses. See Bahls & Compton Quist, \textit{supra} note 24, at 85-103. Owners of Montana statutory close corporations are permitted to structure the business so that it is dissolvable at will and managed by the owners. See \textit{Mont. Code Ann.} §§ 35-9-301 to -302, -404. In addition, stock in Montana statutory close corporations is not freely transferable. \textit{Mont. Code Ann.} §§ 35-9-201 to -208. Statutory close corporations, while possessing the state law aspects of partnerships, are still generally subject to taxation as corporations. See Keatinge et al., \textit{supra} note 4, at 382-83.
\textsuperscript{47}Treas. Reg. § 301.7701-2 to -3 (1993).
structure of limited liability companies: (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interest.\(^{48}\) If the organization lacks two of the four corporate characteristics, the Internal Revenue Code classifies the business as a partnership.\(^{49}\) Though owners of most closely held businesses prefer to avoid corporate taxation, many business owners find that corporate limited liability outweighs the tax advantages of partnership classification. As a compromise, many businesses incorporate, but elect to be taxed as S corporations.\(^{50}\) Corporations electing taxation under Subchapter S of the Internal Revenue Code are taxed as pass-through entities.\(^{51}\) Unfortunately, in order to qualify as an S corporation, a corporation may not have more than thirty-five shareholders.\(^{52}\) Similarly, the corporation may not have owners who are nonresident aliens.\(^{53}\) S corporations may not be members of affiliated groups and may not have more than one class of stock.\(^{54}\) Likewise, in some situations S corporations face significant tax disadvantages when compared to partnerships. The disadvantages include taxation of certain in-kind distributions, the inability to adjust the inside basis, and taxation of some contributions to the business.\(^{55}\)

C. Limited Liability Companies as a Solution to the Entity-Selection Dilemma

Limited liability companies offer an innovative resolution to the closely held business entity-selection dilemma. Limited liability companies, if properly structured, enjoy the business govern-

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\(^{48}\) Treas. Reg. § 301.7701-2 to -3 (1993); see also Morrissey v. Commissioner, 296 U.S. 344, 359 (1935).


\(^{50}\) See supra note 29, at 420.

\(^{51}\) See I.R.C. § 1361-78 (West 1993).

\(^{52}\) I.R.C. § 1361(b)(1)(A) (West 1993).

\(^{53}\) I.R.C. § 1361(b)(1)(A), (C) (West 1993). This limitation poses significant barriers for Canadian-American joint ventures.

\(^{54}\) I.R.C. § 1361(b)(1)(D), (b)(2) (West 1993). The restrictions limit estate planning options. With S corporations, it is impossible to create two classes of stock having different management and dividend rights for parent and child. The restrictions also cause problems when investors contribute different types of assets or have different investment expectations. For example, with S corporations, it is impossible to create one class of stock paying fixed high dividends and another class of stock paying low dividends but enjoying capital appreciation. See Parker, supra note 29, at 421 n.103.

\(^{55}\) See Parker, supra note 29, at 422-28. Professor Parker describes these disadvantages in detail and concludes: "Beyond the fact that subchapter S may not be available to or practical for every business, it should be noted that taxation under subchapter S may, in certain situations, be significantly greater than the taxation that would have been imposed had a partnership been utilized." Parker, supra note 29, at 422.
ance aspects of partnerships (for example, limitations upon transferability of interest, management by owners, and limited life), the pass-through tax benefits of partnerships, and the limited liability attributes of corporations. State statutes provide the business governance and limited liability benefits, while a series of revenue rulings confirm that properly structured limited liability companies will enjoy pass through tax benefits.56

According to Revenue Ruling 88-76,57 for a limited liability company to qualify for partnership tax status, a limited liability company must comply with applicable Treasury Regulation requirements defining partnership attributes.58 As a result, a limited liability company must relinquish at least two of the four corporate characteristics.59 Because corporate limited liability characteristics will always exist in a limited liability company, a limited liability company must relinquish at least two of the three remaining corporate characteristics: continuity of life, centralized management, or free transferability of interests. Limited liability company statutes typically provide for lack of continuity of life,60 lack of centralized management,61 and substantial restrictions on the transferability of interests.62 Acts such as the ABA Prototype Act, however, are sufficiently flexible to allow owners to tailor the organization to meet their own needs. For example, a limited liability company, by so providing in its articles of organization, may provide centralized management by a board of managers.63 Likewise, the operating agreement or articles of organization may alter the statutory scheme of limited transferability of interest.64 Altering the statutory scheme, however, risks jeopardizing the pass-through tax treatment of limited liability companies.65

56. See supra text accompanying notes 17-23.
65. A few states, including Montana, permit one-member limited liability companies. Mont. Code Ann. § 35-8-201. One member limited liability companies are not likely to be taxed as partnerships. The definition of partnership is a "syndicate, group, pool, joint ven-
III. Applicability of Common-Law Exceptions to the Rule of Limited Liability

Limited liability company legislation provides that owners and managers of limited liability companies are not liable, solely by virtue of being an owner or manager, for the debts of the limited liability company, whether the debts arise from contract or tort. The statutory protection from liability for members of limited liability companies is nearly identical to the statutory protection from liability for corporate shareholders. This feature distinguishes limited liability companies from partnerships.

The limited liability of members should not be absolute, just as the limited liability of corporate shareholders is not absolute. Several of the major exceptions to the rules of limited liability are created by common law. This Article next examines the historical and policy justifications both for corporate limited liability and for the exceptions to corporate limited liability. Examination of these justifications demonstrates that several of the exceptions to the limited liability rule should apply to limited liability companies.

A. Historical and Policy Justifications for the Rule of Limited Liability

American law governing corporate limited liability bears many attributes of a love-hate relationship. In the 1800s, Jeffersonian Thomas Cooper described limited liability as a "mode of swindling, quite common and honorable in these United States" and "a fraud on the honest and confiding part of the public." Early in this century, President Butler of Columbia University stated a different perspective: "[T]he limited liability corporation is the greatest single discovery of modern times [and that] even steam and electricity are far less important than the limited liability corporation, and they would be reduced to comparative impotence without it."
Until the early to mid-1800s, legislation in both England and the United States did not allow just anyone to incorporate and enjoy the benefits of limited liability for owners.\textsuperscript{70} Prior to that time, corporations, as a general rule, could be created only by a special act of Parliament or a state legislature.\textsuperscript{71} Those state legislatures enacting general corporation statutes usually did so with substantial limitations on corporations. These limitations included minimum paid-in capital requirements, limited permissible purposes, and limited duration.\textsuperscript{72} These limitations mandated by state legislatures are most likely a result of legislative suspicions about authorizing a separate legal entity with the attribute of limited liability of owners. As corporations become a more accepted feature of the economic landscape, legislatures have, by statute, removed many limitations on the ability of corporations to operate.\textsuperscript{73}

To fully appreciate the statutory and legislative exceptions to the rule of limited liability, one must appreciate the reasons for granting limited liability to owners of businesses. Legislatures grant limited liability to owners of corporations in order to facilitate business formation in their states. As early as the 1800s, Jacksonian liberals made persuasive arguments that a state's failure to grant limited liability to corporate owners would drive capital to other states.\textsuperscript{74} Similar arguments are still made to legislatures today to encourage legislatures to enact limited liability company legislation.\textsuperscript{75}


\textsuperscript{71} HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 12, at 24-25 (3d ed. 1983).

\textsuperscript{72} Id. at 25-26.

\textsuperscript{73} Id. at 26-22.

\textsuperscript{74} See HOVENKAMP, supra note 68, at 50.

\textsuperscript{75} In Montana, for example, the Chair of the Limited Liability Company Subcommittee of the State Bar made the following argument to the Senate and House Judiciary Committees:

It is imperative to note that of the approximately one-third of the states with LLC legislation in effect, four of the states are in the Rocky Mountain region of the United States: Wyoming (1977), Colorado (1991), Nevada (1991), and Utah (1991). Wyoming advertises that its LLC statute provides a tremendous benefit to those doing business in Wyoming. Montana business deserves the same opportunity and advantage afforded to business in the neighboring states. To remain competitive, Montana should provide this opportunity immediately. Not only will LLCS provide an exciting alternative to more conventional forms of business organizations in our state, but legislation will facilitate a welcome improvement in Montana's business image. LLCs are proeconomic development, at virtually no cost. And as Montana strives to be a leader, not a follower in providing for small business, it makes great sense that Montana seize this opportunity now.
Aside from the political necessity of affording owners of businesses with some form of limited liability, economic necessity may also exist. Following the Industrial Revolution, capital-intensive business required increasing amounts of capital. In addition, the Industrial Revolution created a demand for workers with more specialized skills. Often workers with the necessary specialized skills could not accumulate the capital necessary to operate a post-Industrial Revolution business. As a result, those contributing the capital necessary to operate the business were not necessarily those with the specialized skills necessary to operate the business. Granting limited liability to those who contributed capital encouraged investment, because investors could invest without risking their full net worth. While investors are often willing to risk their entire net worth to businesses they operate, investors, absent limited liability, are not willing to invest in businesses that they do not operate or closely monitor. With limited liability, owners are free to invest in diverse enterprises without the need of incurring the excessive costs necessary to monitor each enterprise closely.

Granting limited liability to owners of businesses results in some risk shifting. If a creditor suffers a loss (including a loss occasioned by a corporation's tortious conduct), the creditor has little practical recourse against an insolvent corporation. Contract and tort obligations that would have been the responsibility of the owners of the business prior to the advent of limited liability are, after the advent of limited liability, absorbed by the creditors. While business creditors have always accepted some risk of loss, the limited liability of owners magnifies that risk. As a result, creditors now have an incentive to learn about the financial wherewithal of a corporation before dealing with it. Creditors also have incentive to minimize loss by requiring the personal guarantees of owners that the corporation will adequately perform. Significantly, however, creditors of a corporation who are creditors by virtue of the corporation's tortious conduct do not usually have the opportunity to investigate the corporation's finances or obtain a personal guarantee of owners prior to incurring the loss.


76. See generally Hovenkamp, supra note 68, at 49-55.


79. See generally Posner, supra note 78, at 380; see also Easterbrook & Fischel, supra note 77, at 58-59.
To illustrate how limited liability shifts risk, assume that a truck owned by ABC Transport Corporation fails to stop at a red light and injures a pedestrian. The pedestrian, absent obtaining insurance, has no way to mitigate the risk. Because the injured pedestrian did not choose to deal with the corporation, the pedestrian may not mitigate the risk by investigating the corporation's financial wherewithal or by bargaining with the shareholders for an agreement to indemnify. Limited liability shifts the risk of the accident, if ABC Transport Corporation is insolvent, from the owners to the injured pedestrian. Although the pedestrian is an innocent victim and the shareholders are not the primary culpable parties, one could argue that it is more equitable for the shareholders to bear the loss. Because the shareholders benefit from the past or future earnings of the business, an argument might be made that the shareholders bear the loss, even if those losses were unanticipated. In addition, shareholders of the corporation are usually in a better position to influence corporate management to act in a way to prevent tortious conduct. Legislatures and courts have fashioned exceptions to the rules of limited liability that shift at least a part of the risk of corporate misconduct from corporate creditors back to corporate shareholders. 80

Some commentators have persuasively argued that less justification exists for limited liability of owners in closely held businesses. 81 The primary justification for limited liability of owners is that limited liability is necessary for capital accumulation when ownership and management are separate. Ownership and management are nearly identical in most close corporations. As a result, limited liability of owners is often not necessary to encourage investment in closely held businesses. Owners/managers of these businesses are more likely to invest, without the benefit of limited liability, when they participate in control. Courts, recognizing the lesser need to protect shareholders of closely held corporations from liability, have applied the doctrine of piercing the corporate veil almost exclusively to closely held corporations. 82

80. See infra text accompanying notes 90-142.
81. See, e.g., Henry Hansmann & Reiner Kraakman, Toward Unlimited Liability for Corporate Torts, 100 YALE L.J. 1879, 1882 (1991) (arguing that the "most familiar inefficiency created by limited liability is the incentive it provides shareholder to direct the [closely held] corporation to spend too little on precautions to avoid accidents"); Paul Halpern et al., An Economic Analysis of Limited Liability in Corporation Law, 30 U. TORONTO L.J. 117, 148 (1980) (arguing that in the case of close corporations, "a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risk to creditors, thus inducing costly attempts by creditors to reduce these risks").
82. See generally F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS
Other arguments, however, may support limited liability in close corporations. A state's failure to grant limited liability to close corporations would surely drain investment capital to neighboring states. Limited liability for owners of close corporations (at the margin) may encourage owners/managers to start a desirable business that is somewhat risky, but not so excessively risky as to be socially unacceptable. Further, though management and ownership are frequently identical in closely held corporations, relatives, retired managers, and others owning equity interests, but not management stakes, in the corporation, are not uncommon. Limited liability may be necessary to encourage these investments.

State statutes and common law have, perhaps unartfully, attempted to strike a balance between encouraging entrepreneurs to take the risks necessary to conduct business and avoid socially unacceptable excessive risks. The ABA Prototype Act, for example, codifies for creditors of limited liability companies many of the protections creditors of corporations enjoy. As with corporate shareholders, members of limited liability companies are obligated to contribute cash equal to the value of the contributions that members promise to make, but have not made. Limited liability company creditors may enforce obligations of members to make promised contributions, but only if the creditors have extended credit or otherwise acted in reliance on the members’ promise. The ABA Prototype Act also codifies the trust fund doctrine. The trust fund doctrine states that creditors of a dissolved limited liability company may enforce their claims against former members to the extent the company’s assets have been distributed to those members. In effect, members hold the assets in trust for both known and unknown claimants of the limited liability company.

In addition to the statutory provisions curbing limited liability of corporate shareholders, the courts have developed other restrictions. Among the most significant restrictions that should apply to limited liability companies are doctrines governing managerial liability and piercing the corporate veil.

83. See supra note 75.
85. ABA PROTOTYPE LTD. LIAB. CO. ACT § 502(E).
86. ABA PROTOTYPE LTD. LIAB. CO. ACT § 908(D)(2). Montana codified this section at MONT. CODE ANN. § 35-8-909(2)(b) (1993).
87. ABA PROTOTYPE LTD. LIAB. CO. ACT § 908(D).
88. See infra text accompanying notes 90-96.
B. Application of Corporate Doctrines Governing Managerial Liability to Limited Liability Companies

Courts should not protect members and managers of limited liability companies from liability for the torts in which they personally participate. Agency law clearly establishes that agents are not protected from liability when they commit tortious acts in the course of their agency. The rule's obvious purpose is to discourage irresponsible conduct on the agent's part. Failure to adopt such a rule allows an agent to hide behind the principal, so that a victim of the wrongful conduct is deprived of compensation if the principal is insolvent. These agency principles have been extended to corporations. Corporate shareholders who commit tortious acts as agents of the corporation are liable for the consequences of their actions. Imposing personal liability on managers of businesses minimizes the risk of those managers engaging in socially unacceptable risk taking. To the extent that socially unacceptable risk taking is discouraged by tort law, managers of corporations, particularly inadequately capitalized corporations, are given an incentive to refrain from activities that expose them to personal liability.

As a general rule, courts should hold members who act as managers of limited liability companies responsible for their individual tortious activities. Agency principles should apply, because members who act as managers are agents of the limited liability companies. The American Bar Association, in its Commentary to the ABA Prototype Act, adopts this approach:

This section is not intended to relieve a member from liability arising out of his own acts or omissions to the extent such acts or omissions would be actionable, either in contract or in tort, against the member if he were acting in his individual capacity. . . . A member also may become liable in tort for claims against the limited liability company as a result of his negligence in appointing, supervising, or participating in the activity in question with a manager, employee, agent or other member of the limited liability company. Accordingly, with respect to his liability for the debts and obligations of the limited liability company, a

89. See infra text accompanying notes 97-142.
90. RESTATEMENT (SECOND) OF AGENCY § 343 (1957) ("An agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal.").
91. In Montana, cases such as Little v. Grizzly Manufacturing, 195 Mont. 419, 423-24, 636 P.2d 839, 841-42 (1981), clarify that shareholders, officers, or directors who participate in the negligent actions are not protected from individual liability.
92. See, e.g., ABA PROTOTYPE LTD. LIAB. CO. ACT § 301. Montana codified this section at MONT. CODE ANN. § 35-8-301 (1993).
member is analogous to a limited partner or a stockholder.93

The analysis set forth in the ABA Commentary has been adopted as part of the Montana Comments.94 The analysis is similar to existing case law applicable to Montana corporations. Cases such as Little v. Grizzly Manufacturing clarify that neither shareholders nor directors of corporations are protected from liability for their own negligent actions.95 Little v. Grizzly Manufacturing dealt with the alleged negligent design and construction of a home.96 Applying the facts of Little v. Grizzly Manufacturing to a limited liability company, for example, assume a construction company organized as a limited liability company. Further assume that a member of the limited liability company negligently designed and constructed a building. The limited liability company itself and the member who participated in the design or construction would be liable for the negligence. But just as corporate shareholders or officers who did not participate in the design or construction would not be responsible for the damages, similarly situated members of the limited liability company should not be responsible.

C. Application of the Doctrine of Piercing the Corporate Veil to Limited Liability Companies

A more difficult common-law doctrine to apply to limited liability companies is the doctrine of piercing the corporate veil. Because virtually all limited liability companies are closely held, the classic justification for limited liability (necessity of limited liability of owners to facilitate the accumulation of capital) does not strictly apply. As a result, application of the doctrine of piercing the corporate veil, thereby creating an exception to limited liability, may be justified.

Many commentators have reserved judgment as to whether courts should apply the corporate standards for piercing the corporate veil to limited liability companies.97 Others have argued the corporate standards for piercing the corporate veil should apply, seemingly without modification.98 One state has gone so far as to

95. Little, 195 Mont. at 424, 636 P.2d at 842.
96. Id. at 420, 636 P.2d at 840.
97. See Liablity Pt. 1, supra note 4, at 53-54; Hamill, supra note 4, at 744.
98. See Gazur & Goff, supra note 4, at 402-03; Keatinge et al., supra note 4, at 445; Joseph P. Fonfara & Corey R. McCool, Comment, The Wyoming Limited Liability Com-
mandate that courts apply the corporate doctrine to limited liability companies. The failure of most states to address this issue statutorily does not mean that legislatures intend that courts not pierce a limited liability company's veil in appropriate cases. In fact, the doctrine of piercing the limited liability veil of a business is typically left to common law.

Courts are willing to disregard or pierce the corporate veil if circumstances make it equitable to do so. Professors F. Hodge O'Neal and Robert Thompson observed that the appropriateness of piercing the corporate veil may be one of the most frequently litigated issues in corporate law. Despite the frequency of piercing the corporate veil cases, rules and rationales for piercing the corporate veil have been called "vague and illusory" and a "legal quagmire." Judge Frank Easterbrook and Professor Daniel Fischel have observed that the doctrine of piercing the corporate veil "like lightning . . . is rare, severe, and unprincipled." They note that the doctrine is among the most confusing in corporate law. Likewise, the Montana Supreme Court has noted that "[b]ecause the remedy is equitable, no concrete formula exists under which a court will disregard the separate identity of the corporate entity."

The doctrine becomes even more confusing when applied to limited liability companies because the classic tests for piercing the corporate veil assume business organizations should have decentralized management. Frederick Powell promulgated the classic test for piercing the corporate veil. Powell suggests that courts should pierce the corporate veil when: (1) the corporation is an

99. See COLO. REV. STAT. § 7-80-107 (Supp. 1991). Section 7-80-107 states: In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.

100. See, e.g., COMMENTS TO THE MONTANA LTD. LIAB. CO. ACT, supra note 94, at 1.


102. O'NEAL & THOMPSON, supra note 82, at 1-46.

103. PRESSER, supra note 1, § 1.01, at 1-7; see also Henry W. Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 CAL. L. REV. 12, 15 (1925).


105. Easterbrook and Fischel correctly observe that "[a]rbitrariness of these nominal tests [for piercing the corporate veil] implies lack of basis or function." EASTERBROOK & FISCHEL, supra note 77, at 55.


107. FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS § 3, at 4-6 (1931).
"instrumentality . . . adjunct, creature, pawn, puppet [or] alter ego of the owners"; (2) the corporation's actions are fraudulent or wrongful; and (3) the complainant suffers an unjust loss or injury. 108 Powell's classic test is similar to the test adopted by the Montana Supreme Court. In Montana, courts will pierce the corporate veil if: (1) the corporation is a mere agent or alter ego of its owners and (2) failure to do so will result in the corporation defeating public convenience, justifying wrong, perpetrating fraud, or defending a crime. 109

The problem with applying the corporate test for piercing the corporate veil to limited liability companies is that corporate governance statutes, unlike limited liability company statutes, provide for centralized management by mandating management by a board of directors instead of management by owners. 110 By statute, limited liability companies are usually managed by members. 111 Likewise, as a general rule, members are generally agents of a limited liability company for the purpose of conducting its affairs. 112 As a result, one could argue that the first test for piercing the corporate veil (mere agency, instrumentality, or alter ego) is usually satisfied for limited liability companies. When examining whether the mere agency, instrumentality, or alter ego relationship exists between owners and the corporation, courts often examine whether the owners of the corporation act as managers, making all corporate decisions. 113 When shareholders disregard the corporate formalities, courts are more likely to pierce the corporate veil. 114 Limited liability company members and managers are not, however, obligated to follow corporate-type formalities.

In determining whether to pierce the limited liability company veil on the basis of mere instrumentality, alter ego, or agency, courts should not consider whether members disregard corporate

108. Id.
111. See, e.g., ABA PROTOTYPE LTD. LIAB. CO. ACT § 401. Montana codified this section at MONT. CODE ANN. § 35-8-401 (1993).
112. See, e.g., ABA PROTOTYPE LTD. LIAB. CO. ACT § 301(A) ("every member is an agent of the limited liability company for the purpose of its business and affairs"). Montana codified this section at MONT. CODE ANN. § 35-8-301.
113. See, e.g., Meridian Minerals Co. v. Nicor Minerals, Inc., 228 Mont. 274, 282-85, 742 P.2d 456, 461-63 (1987) (examining two factors: whether the shareholder is a director or president and whether the shareholder makes corporate decisions without consulting other directors).
formalities. Instead courts should examine whether members disregard *limited liability company* formalities. In Montana, the Comments of the Limited Liability Company Subcommittee state:

The failure of a limited liability company to observe the formalities customarily followed by business corporations or requirements relating to the exercise of its powers or management of its business and affairs is not a ground for courts disregarding the separate entity status of [a limited liability company] or for imposing personal liability on the members for liabilities of the limited liability company. Courts should not pierce the limited liability company "veil" merely as a result of failure to follow normal formalities required of a corporation.115

While the formalities required of limited liability companies bear some resemblance to the formalities required of corporations, significant differences exist.116 As a result, when analyzing whether a limited liability company veil ought to be pierced, the court should focus on whether the limited liability company is an alter ego or mere instrumentality of the members, not on whether the organization is an agent of its members. Focusing on agency is inappropriate because the limited liability company statutes contemplate that members exercise the same control over the business of limited liability companies that principals typically exercise over agents.117 In determining whether the limited liability company is a mere alter ego or instrumentality of its members, courts should consider several factors, no one of which is to be determinative. The courts should examine the totality of these circumstances:

(1) Whether the members fail to comply with the formalities required by the limited liability company statutes. These formalities typically include maintaining a registered agent,118 acting only within its business purpose,119 maintaining required books and

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116. The primary difference is that limited liability companies need not be managed by a centralized board. *See, e.g.*, Mont. Code Ann. § 35-8-401.
117. The relationship between member/managers and the limited liability company is much like the relationship between partners and a partnership. Sell observes that the relationship between "partner and a partnership" is unique only insofar as the partner is both an agent and one of the principals whenever the partner acts in the partnership's business. W. Edward Sell, Agency § 22, at 18 (1975). Likewise, because member/managers of limited liability companies both control the management of and carry out tasks for limited liability companies, member/managers are, in one sense, both agents and principals.
records, making only those distributions statutorily permitted by statute, and filing required annual reports.

(2) Whether one member manages the limited liability company without consultation with other members.

(3) Whether the members and managers failed to keep business funds and accounts separate from the funds and accounts of members. Just as a corporation must keep accounts separate from its shareholders, a limited liability company is a separate legal entity and should do the same.

(4) Whether the members fail to keep their personal books and financial accounts and records separate from the books and financial accounts and records of limited liability companies, as required by state statute.

(5) Whether the limited liability company was originally grossly undercapitalized to meet the reasonably anticipated capital requirements, as determined at the date of organization of the business.

(6) Whether the members of the limited liability companies fail to hold the business out as a separate legal entity.

120. See, e.g., ABA Prototype Ltd. Liab. Co. Act § 405. Montana codified this section at Mont. Code Ann. § 35-8-405 (1993). These provisions require limited liability companies to keep lists of members and managers, organizational documents, operating agreements, and records of initial capital and tax returns. Failure of a limited liability company to keep required records is not enough alone to justify piercing the limited liability company veil. See, e.g., ABA Prototype Ltd. Liab. Co. Act § 405(D).

121. See, e.g., ABA Ltd. Liab. Co. Act § 604. Montana codified this section at Mont. Code Ann. § 35-8-604 (1993). These provisions prohibit distributions if the distributions would render the limited liability company insolvent under the cash flow or balance sheet tests.


123. The ABA Prototype Ltd. Liab. Co. Act provides that if the limited liability company is managed by members, “the affirmative vote, approval, or consent of more than one-half by number of the members . . . [is] required to decide any matter connected with the partnership business.” ABA Prototype Ltd. Liab. Co. Act § 403. Montana codified this section at Mont. Code Ann. § 35-8-403 (1993).


128. For corporations, courts have long recognized that a corporation may be an alter
governing limited liability company generally require that the members of limited liability companies hold their businesses out as limited liability companies by using the proper designation in the name of the businesses.129

(7) If the articles of organization require management by managers, whether the members make corporate decisions, thereby usurping the power of the managers. If those organizing the limited liability company choose to separate management and ownership, limited liability company statutes require such separation to be respected.130

(8) If the limited liability company is owned by another business entity, whether the managers of the limited liability company consist of directors, officers, or managers of the other entity.131

(9) Whether the members of the limited liability company otherwise fail to respect the separate legal entity of the limited liability company. Evidence of failure to do so might include using the limited liability company's credit to secure loans to members, distributing earnings to members through means other than authorized distributions, or members using limited liability company property as if it were their own.132

Just as proof of alter ego or mere instrumentality status alone is insufficient to make a case for piercing the corporate veil,133 such proof alone should not be enough for piercing the limited liability company veil. In addition, a successful plaintiff must demonstrate that disregard of the corporate existence is "necessary to prevent fraud or to achieve equity."134 Because of the difficulties in proving fraud, most plaintiffs will argue that piercing the corporate veil is

ego of its owner where an owner admits to third parties that the corporation and the owner are one and the same. Meridian Minerals Co., 228 Mont. at 284, 742 P.2d at 463; see also Flemmer v. Ming, 190 Mont. 403, 409, 621 P.2d 1038, 1042 (1980); Hansen Sheep Co., 53 Mont. at 333, 163 P. at 1153.

129. The ABA Prototype Act provides that the words "limited liability company" or "liability company" or the abbreviations "L.L.C.," "L.C.," "LLC," or "LC" must be used in the business's name. ABA PROTOTYPE LTD. LIAB. Co. ACT § 103. Montana codified this section at MONT. CODE ANN. § 35-8-103 (1993).

130. See, e.g., ABA PROTOTYPE LTD. LIAB. Co. ACT §§ 301(B), 401(B). Montana codified these sections at MONT. CODE ANN. §§ 35-8-301(2), -401(2).

131. This standard is similar to the standard courts use when piercing the corporate veil in parent/subsidiary corporations. See Hando v. PPG Indus., Inc., 236 Mont. 493, 498, 771 P.2d 956, 961 (1989); Meridian Minerals Co., 228 Mont. at 284, 742 P.2d at 463; Flemmer, 190 Mont. at 408-09, 621 P.2d at 1042; State ex rel. Monarch Fire Ins. Co. v. Holmes, 113 Mont. 303, 307-08, 124 P.2d 994, 996 (1942).

132. See Brewster, supra note 114, at 93.

133. See Brewster, supra note 114, at 93.

necessary to achieve equity. For instance, piercing may be necessary to achieve equity if the limited liability company is grossly undercapitalized at the time of formation. Though the statutes governing limited liability companies do not specify an amount of minimum capitalization, creditors and others dealing with limited liability companies do not expect limited liability companies to be grossly undercapitalized at the date of formation. If members deliberately or recklessly capitalize a limited liability company so inadequately that they likely violate the reasonable expectations of those dealing with the business, courts should pierce the limited liability company veil. Inadequately capitalized firms are likely to engage in unacceptably risky activities. Additionally, in the absence an effective mechanism to pierce the veil of undercapitalized firms, owners will engage in such risky activities because they have little to lose. As a result, it is equitable for courts to pierce the veil in such instances.

In addition to gross undercapitalization, courts should pierce the limited liability veil to achieve equity where actual fraud occurs; the limited liability company assets have been stripped so as to avoid payment to creditors; the limited liability company has misrepresented itself to be a form of business organization where owners are individually liable; the limited liability company has been formed with the intent of avoiding contractual liability; or the limited liability company has been formed to circumvent regulatory statutes or common-law duties. Of course, because the doctrine of piercing the veil is equitable in nature, it is not possible to list all events where piercing is necessary to prevent inequity.

Many of the policies justifying piercing of corporate veils also justify piercing limited liability company veils. As noted, however, courts facing the issue of piercing the limited liability company veil should look to corporate law for guidance, but fashion rules appropriate for the unique attributes of limited liability companies.

135. The capital contribution provisions of limited liability company statutes are usually silent as to the amount of capitalization. See, e.g., ABA PROTOTYPE LTD. LIAB. Co. ACT § 501. Montana codified this section at MONT. CODE ANN. § 35-8-501 (1993).

136. The importance of inadequate capitalization to the issue of piercing the corporate veil is noted in PRESSER, supra note 1, § 1.05[2].

137. EASTERBROOK & FISCHSEL, supra note 77, at 59.

138. Brewster, supra note 114, at 97.

139. POWELL, supra note 107, § 13(c). Stripping corporate assets from a limited liability company typically violates the governing statute. See, e.g., MONT. CODE ANN. § 35-8-604.

140. POWELL, supra note 107, § 13(d).


142. Brewster, supra note 114, at 101-02.
IV. APPLICATION OF COMMON-LAW CORPORATE DOCTRINES TO THE DUTIES OF MEMBERS AND MANAGERS

The common law establishes different duties of conduct for partners in partnerships than for the managers in corporations. Courts, attorneys, and the business community need guidance as to which, if either, standard is most applicable to limited liability companies. Courts should refrain from stating that either the corporate or partnership standard always applies because limited liability companies uniquely combine features from both partnerships and corporations.

Limited liability companies generally lack the corporate attribute of centralized management. Unless otherwise specified in the articles of organization, management of limited liability companies rests with the members. If members of a limited liability company so desire, they may provide for centralized management by including authorization to do so in the articles of organization. If limited liability companies are not member-managed, the managers of the limited liability company serve in a position analogous to corporate directors and officers. The managers are elected and removed by the members. A majority vote of the managers is needed to make decisions. If the articles of organization provide for managers, managers act as agents of the limited liability company for the purpose of conducting its business. The statutes governing limited liability companies, as such, borrow from both the partnership scheme of one member, one vote and from the corporate scheme of permitting managers who may, or may not, be owners. After examining partnership and corporate duties, clearly the duties of members of limited liability companies should be a hybrid of those found in partnership and corporate law.

A. Duties of Owners and Managers Mandated by Partnership and Corporate Law

1. Duties of Conduct Applicable to Partnerships

Historically, courts have considered partners as fiduciaries of each other. As a result, partners' duties inter se are quite strict. In the oft-quoted case of Meinhard v. Salmon, Judge Cardozo described his view of partners' duties:

[C]opartners, owe to one another . . . the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbinding and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Justice Cardozo's mandate that partners act with the "punctilio of an honor the most sensitive," while poetic, fails to provide concrete and needed guidance to partners. The Cardozo formulation fails to describe with specificity the obligations created as a result of the fiduciary duty. What sort of dealings are impermissible as conflicts of interest? What if a partner makes a misjudgment in a management decision, but has acted in good faith in doing so? Is it realistic to expect partners, whose primary objective in entering into the partnership is often some sort of personal gain, to act with the "punctilio of an honor the most sensitive?" Professor Hillman observes:

Rather than attempting to force partners to conform to a standard that is neither realistic nor desirable, emphasis should be placed on developing predictable and systematic standards to define unacceptable pursuit of private advantage within partnerships. Existing standards are impossible to define, arbitrary in ap-

149. 164 N.E. 545 (N.Y. 1928).
plication, ineffective in the achievement of their stated goals, and premature in their canonization of participants in partnerships.\(^{151}\)

To address the problems associated with defining the general standards of partners' conduct among themselves, the National Conference of Commissioners on Uniform State Laws, in its 1992 version of the Uniform Partnership Act, suggested that state statutes provide that the "only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care."\(^{152}\) According to the new Uniform Partnership Act, partners must discharge the duties of loyalty and care in good faith.\(^{153}\) The duty of loyalty obligates the partner to: (a) account to the partnership for property, profit, or benefit the partner derives from the partnership business; (b) refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and, (c) refrain from competing with the partnership.\(^{154}\) The partners' duty of care is limited to acting in a manner that does not constitute gross negligence.\(^{155}\)

When examining whether the partnership law governing the duties of owners should apply to limited liability companies, courts should examine the modern partnership duties, while avoiding the generalities of the Cardozo formation. Managers and members of limited liability companies, because it is a new form of business entity, need more than generalities to guide their conduct.

2. **Duties of Conduct Applicable to Corporations**

Corporate law also has been evolving in recent years in its definition of duties of corporate directors, officers, and controlling shareholders. Legislatures and courts have found three basic duties of corporate owners and managers in closely held corporations: (1) the duty of care; (2) the duty of loyalty; and (3) the duty to avoid illegal, oppressive, and fraudulent conduct.\(^{156}\)

The duty of care for directors requires that directors and officers act "(a) in good faith; (b) with the care an ordinarily prudent

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152. **UNIF. PARTNERSHIP ACT** § 404(a). Montana codified this section at **MONT. CODE ANN.** § 35-10-405 (1993).
153. **UNIF. PARTNERSHIP ACT** § 404(a). Montana codified this section at **MONT. CODE ANN.** § 35-10-405.
154. **UNIF. PARTNERSHIP ACT** § 404(b). Montana codified this section at **MONT. CODE ANN.** § 35-10-405(2).
155. **UNIF. PARTNERSHIP ACT** § 404(d). Montana codified this section at **MONT. CODE ANN.** § 35-10-405(4).
person in a similar position would exercise under similar circum-
cstances; and (c) in a manner the director reasonably believes to be
in the best interests of the corporation." A judicial gloss called
the business judgment rule has been applied to the duty of care.
The best statement of the business judgment rule is found in the
American Law Institute Principles of Corporate Governance:

(c) A director or officer who makes a business judgment in
good faith fulfills the duty under this Section if the director or
officer:

(1) is not interested . . . in the subject of his business
judgment;

(2) is informed with respect to the subject of his business
judgment to the extent he reasonably believes to be appropriate
under the circumstances; and

(3) rationally believes that his business judgment is in the
best interests of the corporation.

The business judgment rule is designed to encourage directors to
take the risks that entrepreneurs should take. If directors are sub-
jected to liability with the benefit of 20/20 hindsight, directors will
be unduly restrained in their decision making. The business judg-
ment rule creates a rebuttable presumption that directors acted in
good faith and on an informed basis. Courts interpret the busi-
ness judgment rule to provide that judgments by directors, if made
in good faith, are protected when the directors were informed and
not grossly negligent. Directors’ actions are grossly negligent if
the actions are taken without reason, in deliberate disregard of the
interests of the business, or with reckless indifference to the busi-
ness’s interests.

Corporate law also holds officers and directors to a duty of loy-
alty. Though not as lofty as the duty of loyalty applicable to part-

157. MODEL BUSINESS CORP. ACT §§ 8.30(a), 8.42(a) (1991). Montana codified these
sections at MONT. CODE ANN. §§ 35-1-418(1) to -443(1) (1993).
159. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS
§ 4.01(c), at 181-82 (American Law Inst. Proposed Final Draft 1992) [hereinafter ALI PRIN-
CIPLES OF CORPORATE GOVERNANCE].
160. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis,
473 A.2d 805, 812 (Del. 1984)); see also ALI PRINCIPLES OF CORPORATE GOVERNANCE, § 4.01
cmt., at 188:

Courts, when applying the business judgment rule, have often stated that a ‘pre-
sumption’ exists in favor of the propriety or regularity of the actions of the direc-
tors and officers. This correctly signifies than no inference of dereliction of duty
can or should be drawn from the fact, for example, that a corporation has suffered
a business reversal.
161. See, e.g., Van Gorkom, 488 A.2d at 872.
nerships described by Judge Cardozo, the classic statement of the duty of loyalty of officers and directors is still quite high. In the Delaware case of Guth v. Loft, Inc., the duty of loyalty required "an undivided and unselfish loyalty to the corporation" and no conflict with the officers' and directors' self-interests.\textsuperscript{163} The seminal close corporation case, Donahue v. Rodd Electrotype Co.,\textsuperscript{164} provides for a similar duty for close corporations. The court, in Donahue, prescribes a duty of "utmost good faith and loyalty."\textsuperscript{165} Though the court in Guth properly acknowledged that the duty of loyalty cannot be subjected to a "hard-and-fast rule" or a "fixed scale,"\textsuperscript{166} the American Law Institute Principles of Corporate Governance describe several "subduties" of the duty of loyalty: (1) the duty not to profit individually and unduly from transactions with the corporation;\textsuperscript{167} (2) the duty to refrain from receiving excessive compensation;\textsuperscript{168} (3) the duty to use corporate property, material, nonpublic corporate information, and corporate position only for the benefit of the corporation;\textsuperscript{169} (4) the duty to not appropriate corporate opportunities;\textsuperscript{170} and (5) the duty to refrain from competing with the corporation.\textsuperscript{171}

The final corporate duty, not clearly found in partnership law, is the duty of controlling shareholders and directors to avoid illegal, oppressive, and fraudulent conduct.\textsuperscript{172} If the duty is violated, courts are permitted by common law,\textsuperscript{173} and in some states by statute,\textsuperscript{174} to apply a broad array of equitable remedies. These remedies include ordering a dissolution of the corporation; ordering the corporation or a shareholder to purchase the shares of the oppressed shareholder; partitioning the property of the corporation; ordering payment of a dividend; and ordering appointment of spe-

\textsuperscript{163} Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. Ch. 1939).
\textsuperscript{164} 328 N.E.2d 505, 515 (Mass. 1975). The court noted that controlling shareholders "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation." Donahue, 328 N.E.2d at 515. The Donahue v. Rodd Electrotype Co. case was recently cited with approval by the Montana Supreme Court. See Daniels v. Thomas, Dean & Hoskins, Inc., 246 Mont. 125, 137, 804 P.2d 359, 366 (1990).
\textsuperscript{165} Donahue, 328 N.E.2d at 515.
\textsuperscript{166} Guth, 5 A.2d at 510.
\textsuperscript{167} ALI PRINCIPLES OF CORPORATE GOVERNANCE, §§ 5.02, 5.07.
\textsuperscript{168} Id. § 5.03.
\textsuperscript{169} Id. § 5.04.
\textsuperscript{170} Id. § 5.05.
\textsuperscript{171} Id. § 5.06.
\textsuperscript{172} See infra text accompanying notes 226-72.
\textsuperscript{174} See, e.g., MONT. CODE ANN. § 35-1-939 (1993).
cial fiscal agents, receivers, or provisional directors to assist with
the operation of the corporation. 176

Courts appropriately apply these equitable remedies when
they find oppression in closely held corporations. Owners of closely
held corporations do not have a public market for their stock. If
the directors or controlling shareholders violate their reasonable
expectations, courts will intervene to protect these expectations.
Courts usually measure violations of the duty to avoid oppression
by whether the reasonable expectations of shareholders are
protected. 176

When fashioning standards against which to test the conduct
of members and managers of limited liability companies, courts
should consider each of the three corporate duties described.
Courts should fashion clear standards against which to test the
duty of care, duty of loyalty, and duty to avoid oppression. Courts
should not, however, blindly adopt the corporate standards, be-
cause many of the attributes of corporations are not shared
by limited liability companies. 177

B. Duties of Conduct Applicable to Limited Liability
Companies

1. Policy Considerations

Comparatively little has been written about the range of du-
ties of members and managers of limited liability companies. 178

175. See Bahls, supra note 173, at 294-312.

176. See O'NEAL & THOMPSON, supra note 82, § 9.30; Donald F. Clifford Jr., Close
Corporation Shareholder Reasonable Expectations: The Larger Context, 22 WAKE FOR EST
L. REV. 41 (1987); Robert W. Hillman, Indissoluble Partnerships, 37 U. FLA. L. REV. 691
(1985); Sandra K. Miller, Should the Definition of Oppressive Conduct by Majority Share-
holdersExclude a Consideration of Ethical Conduct and Business Purpose? 97 DICK. L
REV. 227 (1993); Robert B. Thompson, Corporate Dissolution and Shareholders' Reasona-
ble Expectations, 66 WASH. U. L.Q. 193 (1988); see also Stefano v. Coppel, 705 P.2d 443
(Alaska 1985); Maschmier v. Southside Press, Ltd., 435 N.W.2d 377 (Iowa Ct. App. 1988);
Pedro, 463 N.W.2d 285 (Minn. Ct. App. 1990); Fox v. 7L Bar Ranch Co., 198 Mont. 201, 645
1986); In re Kemp & Beatley, Inc., 473 N.E.2d 1173 (N.Y. 1984); Meiselman v. Meiselman,
307 S.E.2d 551 (N.C. 1983); Balvirk v. Sylvester, 411 N.W.2d 333 (N.D. 1987); Gee v. Blue

177. See infra text accompanying notes 200-72.

178. One group of commentators, however, suggests that "the rule for LLCs probably
will evolve toward general partnership-type duties for members in member-managed LLCs,
and toward corporate director-type duties for managers in manager-managed LLCs." See
States addressing the duties by statute have taken different and incomplete approaches.¹⁷⁹ No state has enacted comprehensive legislation defining all of the duties that owners and managers of limited liability companies typically owe each other. When developing standards against which to test the duties of limited liability company members and managers, courts and legislatures should consider the theoretical underpinnings justifying the imposition of duties in both partnership and corporate law. Courts should examine whether these underpinnings justify application of corporate or partnership duties to limited liability companies.

Common-law duties of managers and owners of closely held businesses are needed for both equitable and efficient distributions of wealth. It seems equitable that managers, who act in socially unacceptable ways or who take excessive and unacceptable entrepreneurial risks, personally bear the costs of those risks. Owners of closely held businesses, however, often invest with their co-owners to diversify their risk. Assume, for example, that one co-owner takes an entrepreneurial risk of increasing production of a firm's product by ten percent. Assume further the increase in production causes a loss because sales do not increase by ten percent. If the judgment to increase production was reasonable at the time the decision was made, other co-owners might reasonably expect to share in the risk associated with increasing production. By sharing these reasonable risks, owners effectively diversify their risk.

Rules governing duties in limited liability companies should encourage acceptable entrepreneurial risk taking, but deter excessive and unacceptable entrepreneurial risk taking.¹⁸⁰ Of course, differentiating between acceptable and unacceptable excessive risk taking is difficult. While owners of businesses might bargain or contract for which specific entrepreneurial risks are acceptable and for which are not, most owners of businesses do not bargain about each entrepreneurial risk assumed.¹⁸¹ As such, the fiduciary duties of corporate law and agency law fill gaps in incomplete bargains about entrepreneurial risk.¹⁸² The duty of care fills gaps in bar-
gains involving the degree of skill used in decision making, while the duty of loyalty fills gaps in bargains relating to conflict-of-interest transactions.

Courts should also consider efficiency when fashioning the common-law duties of owners and managers. Rules fashioned by courts should maximize the owners’ wealth. Judicial intervention is an expensive way to encourage responsible entrepreneurial risk taking. If lower cost ways exist to provide incentives for responsible risk taking, then courts should exercise restraint in involving themselves in entrepreneurial decision making.

When analyzing the legal structure and resulting economic implications of limited liability companies, in some ways, the structure encourages acceptable entrepreneurial risk taking, but in other ways fails to encourage acceptable entrepreneurial risk taking. The attributes of decentralized management, limited life, and lack of free transferability of interest create conflicting incentives for managers to assume only acceptable risks.

Because of the incentives federal tax law provides to avoid centralized management (and thereby gain from partnership tax treatment), the members will likely manage the business in most limited liability companies. Unlike the relative ease with which shareholders may remove corporate directors, members of limited liability companies may not as easily remove member/managers of limited liability companies. Corporate shareholders may remove directors by failing to re-elect them at the end of their term or by removing them by shareholder vote in the middle of their term. 183

In limited liability companies, unless otherwise provided in the articles of organization, the right to participate in management is a right that cannot be taken away from a member. 184 Limited liability company statutes go so far as to provide that members retain their management rights even after their membership interest is assigned. 185 While members are permitted to remove another member, they are only permitted to do so if authorized by the articles of organization or the operating agreement. 186 Laws governing the management rights of members in limited liability companies are quite similar to the rules in the Uniform Partnership Act. 187 Be-

187. See Unif. Partnership Act § 301(1) (each partner is an agent of the partner-

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cause of the difficulty in removing members, members are less able to minimize their risks by removing a member/manager who takes unacceptable entrepreneurial risks. One could argue that the level of duty should be sufficiently higher to encourage difficult-to-remove members to act reasonably.

Though members in limited liability companies have difficulty removing members with whom they are dissatisfied, they are able to easily withdraw from a limited liability company by giving thirty days' written notice. Since limited liability companies do not possess the perpetual existence of corporations, initially the member's ability to withdraw easily from a limited liability company may suggest that less need exists for courts to scrutinize whether one member has breached a duty to another. An unhappy member of a limited liability company has the practical remedy of withdrawing and receiving the value of that member's interest. Further analysis reveals that although limited liability company statutes permit members to withdraw, the statutes create financial incentives not to withdraw before the end of the term of existence of the limited liability company. Statutes provide that if members of limited liability companies withdraw before the end of the limited liability company's term of existence, they have breached either the articles of organization or the operating agreement. The limited liability company may recover damages from the member committing the breach. As with the law governing management rights, the scheme governing members who withdraw from limited liability companies is similar to laws governing partners who withdraw from a partnership. Even if the limited liability company is an "at-will" limited liability company, members have financial incentives not to withdraw. Withdrawal often causes liquidation. When assets are liquidated under "fire sale" conditions, all owners will absorb the losses connected with the sale of the business assets at depressed sale prices. As a result, the ability to leave a limited liability company and receive fair market value for one's interest may be more illusory than real.

188. ABA prototype LTD. LIAB. Co. ACT § 802(C). Montana codified this section at MONT. CODE ANN. §§ 35-8-802(3), 35-8-802(3)(a).
189. ABA prototype LTD. LIAB. Co. ACT § 802(C). Montana codified this section at MONT. CODE ANN. §§ 35-8-802(3), 35-8-802(3)(a).
190. ABA prototype LTD. LIAB. Co. ACT § 802(C). Montana codified this section at MONT. CODE ANN. §§ 35-8-802(3), 35-8-802(3)(a).
Courts must also consider that decentralized management in both partnerships and limited liability companies results in more bargaining about acceptable entrepreneurial risks. To the extent that member/managers of limited liability companies are more likely to bargain about entrepreneurial risks, less need exists for judicial intervention to fill gaps in incomplete contracts governing these risks. Owners in closely held businesses (as compared to stockholders of publicly held corporations) are active in the management of the business. Owners typically have greater access to information and a greater ability to use that information to manage the corporation properly. Because owners of closely held businesses often put a great deal of their net worth into the business, they typically do not diversify their investments among several businesses.\textsuperscript{192} Member/managers of closely held businesses have an incentive to avoid excessive risk taking, because they personally bear a greater proportion of the costs of their misjudgments than managers of publicly held corporations.\textsuperscript{193} Because member/managers of closely held businesses are dealing in their own assets, courts might consider a lower standard of care.\textsuperscript{194}

Though limited liability companies are more similar to partnerships in management structure, one must ask what impact, if any, limited liability should have on the duties of members and managers. One might argue that the duties in a partnership should be higher than in a corporation or limited liability company, because the misjudgments or misdeeds of a partner might expose other partners to unlimited personal liability. Higher duties might create an incentive to partners to avoid taking risks exposing their copartners to such liability.

Finally, courts should consider the lack of a public market for shares in closely held businesses when defining the level of duties. A public market creates significant and powerful incentives for managers to manage corporations in a way that maximizes profits and owners' returns.\textsuperscript{195} A public market for stock allows dissatisfied shareholders to sell their shares. Sales of a significant number of shares depress stock prices, making way for new owners (sometimes corporate raiders) to buy stock and oust incompetent incumbent management. Similarly, the management of publicly held corporations is more carefully monitored by persons outside the corporation, including independent directors, accountants, and in-

\begin{itemize}
\item \textsuperscript{192} EASTERBROOK & FISCHEL, supra note 77, at 237.
\item \textsuperscript{193} EASTERBROOK & FISCHEL, supra note 77, at 243-44.
\item \textsuperscript{194} See infra text accompanying notes 204-09.
\item \textsuperscript{195} POSNER, supra note 78, at 383.
\end{itemize}
vestment bankers. As a result, the market creates incentives for managers to align their interests with the interests of shareholders.\textsuperscript{196} These market incentives are lacking for most limited liability companies. One could argue that because market incentives are lacking, courts should supply other incentives to managers in the form of stricter fiduciary duties.

Because of the dissimilarities of limited liability companies with any one other form of business organization, courts should adopt on a wholesale basis neither partnership duties nor duties applying to close corporations. The difference between limited liability companies and other forms of business organizations creates conflicting arguments for stricter or less strict standards.\textsuperscript{197} The inability of members to remove member/managers and the lack of public market for ownership interests would dictate stricter duties for member/managers of limited liability companies. The attributes of decentralized management and limited liability would seem to dictate lesser duties. As a result, courts should not promulgate a general rule adopting either corporate or partnership duties. Instead, courts should analyze each specific duty and develop separate standards for members and managers of limited liability companies. These separate standards ought to borrow from existing corporate and partnership standards only when appropriate.\textsuperscript{198} This Article provides some guidelines from which courts might develop more precise statements of duties for members and managers of limited liability companies.\textsuperscript{199}

2. Application of the Duty of Care to Limited Liability Companies

Limited liability company statutes do not address, in a comprehensive fashion, the duties members owe to one another \textit{inter se}. The ABA Prototype Act, for example, addresses the issue but does not state an affirmative duty of care.\textsuperscript{200} Instead, it provides

\textsuperscript{196} Easterbrook & Fischel, supra note 77, at 232-33.
\textsuperscript{197} Easterbrook & Fischel, supra note 77 at 243-44 (Easterbrook and Fischel similarly have noted that the differences between closely held and publicly owned corporations “do not suggest unambiguously that the level of scrutiny should vary or, if it does, in which direction”).
\textsuperscript{198} Claire M. Dickerson, \textit{Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act}, 64 U. Colo. L. Rev. 111, 156 (1993). Further compounding the problem is that both corporate duties and partnership duties are evolving and are not capable of precise definition. \textit{Id.} at 157.
\textsuperscript{199} See infra text accompanying notes 200-72.
for a limitation on the common-law duty of care between business owners. The ABA Prototype Act states:

A member or manager shall not be liable, responsible or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless such act or omission constitutes gross negligence or willful misconduct. 201

Because it provides only a limitation on the duties, the ABA Prototype Act leaves the courts to define the precise duty of care. 202 The Official Comments to the ABA Prototype Act note that because of the difference among limited liability companies, “the precise boundaries of the duty will be left to develop by case law and operating agreement rather than by statutory provision.” 203

The appropriate test to measure the conduct of those who manage limited liability companies (whether member/managers or nonmember/managers) is a corporate-type standard. Courts should borrow heavily from the American Law Institute Principles of Corporate Governance when fashioning a duty of care. Specifically, a manager (whether a member or nonmember) of a limited liability company who makes a business judgment should satisfy the manager’s duty of care if:

(a) the manager acted in good faith, 204
(b) the manager did not have a significant financial or personal interest in the subject of the manager’s business judgment, 205
(c) the manager was adequately informed with respect to the judgment to the extent the manager reasonably believed was appropriate under the circumstances, 206 and
(d) the manager rationally believed 207 that the business judg-

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202. One state, however, has gone so far as to codify a business judgment rule applicable to limited liability companies. See Va. Code Ann. § 13.1-1024.1(A) (Michie 1993).
204. The good faith standard is borrowed from both partnership law, Unif. Partnership Act § 404(d), and corporate law, ALI Principles of Corporate Governance, § 4.01(c) cmt., at 227-28.
205. ALI Principles of Corporate Governance, § 4.01(c) cmt., at 227-28. If a manager has a financial or personal stake in the transaction, the manager’s conduct may violate the duty of loyalty. For a discussion of the obligation of corporate managers to keep themselves informed, see Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).
206. Van Gorkom, 488 A.2d at 872-73.
207. The words “rationally believe” have a special significance:
The words “rationally believe” direct courts to examine a director’s subjective beliefs. Not all subjective beliefs, however, are protected from judicial scrutiny. The word “rationally” establishes a limit on the range of acceptable subjective beliefs.
ment was in the best interest of the limited liability company. The party attacking the manager’s decision as uninformed, irrational, or not made in good faith must rebut the presumption that the business judgment was informed and not grossly negligent or reckless.

This proposed standard is a business judgment rule, which is, from a manager’s point of view, less strict than a negligence standard. Statutes such as the ABA Prototype Act adopt critical elements of the business judgment rule. The ABA Prototype Act provides that members and managers are not liable for their conduct unless the act or omission complained of “constitutes gross negligence or willful misconduct.” The comments to the ABA Prototype Act make reference to the business judgment rule when they state: “In general, as long as managers avoid self-interest and grossly negligent conduct, their actions are protected by the business judgment rule.”

The business judgment rule, firmly implanted in corporate law, is gaining recognition in partnership law. The National Conference of Commissioners on Uniform State Laws (NCCUSL), in its new Uniform Partnership Act, borrows heavily from the business judgment rule. The new Uniform Partnership Act provides that as long as partners act in good faith, they have complied with their duty of care provided their conduct “does not constitute gross negligence or willful misconduct.” NCCUSL chose to “leave further development of the rule to the courts.” Courts considering partners’ duties of care have adopted a business judgment rule with increasing frequency. As a result, whether limited

Those limits are to be determined by an objective standard of what the reasonable person in a like position might do under similar circumstances.

Bahls, Montana’s New BCA, supra note 24, at 11-12.

208. ALI PRINCIPLES OF CORPORATE GOVERNANCE, § 4.01(c) cmt., at 227-28.
209. Van Gorkom, 488 A.2d at 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); see also ALI PRINCIPLES OF CORPORATE GOVERNANCE, § 4.01(c) cmt., at 238.

210. ABA PROTOTYPE LTD. LIAB. CO. ACT § 402(A).
211. ALI PRINCIPLES OF CORPORATE GOVERNANCE, § 4.01(c) cmt., at 30.
212. UNIF. PARTNERSHIP ACT § 404(d). Montana Codified this section at MONT. CODE ANN. § 35-10-405 (1993).

213. ABA PROTOTYPE LTD. LIAB. CO. ACT § 402(A).
214. Id., commentary at 71.
liability companies are more similar to partnerships than to corporations, the business judgment rule is appropriate. As a consensus develops that the business judgment rule is necessary to encourage the spirit of entrepreneurship in both partnerships and corporations, it would be appropriate to extend that rule to limited liability companies.

The salient attributes of limited liability companies seem to support a standard less strict than mere negligence. Members of limited liability companies concerned with the quality of management can, albeit at some cost, dissociate themselves from the limited liability company. In addition, while a stricter rule might be appropriate for partnerships where personal liability for misactions of copartnership is unlimited, such a strict rule is not appropriate for limited liability entities. In fact, many small business owners co-own a business with another entrepreneur in that line of business for the purpose of diversifying their risk. Part of diversification of risk is to spread the losses incurred as a result of negligent actions, including action committed by one business owner, among all owners. The business judgment rule helps accomplish this objective.

3. Application of the Duty of Loyalty to Limited Liability Companies

Courts should apply the modern partnership duty of loyalty to members and managers of limited liability companies. Most of the corporate rules relating to the duty of loyalty are too unwieldy for limited liability companies, because the corporate rules contemplate centralized management. Both statutes and common law describing the duty of loyalty in the corporate context contemplate approval of conflict-of-interest transactions by the disinterested members of the board of directors or disinterested shareholders. Partnership rules governing the duty of loyalty are simpler and more appropriate for limited liability companies. Like partnership property, limited liability company property is managed by all members, creating a special relationship of trust. Members, like partners, are all agents of the business. Both members of limited liability companies and partners, as agents, must account to the...
Limited liability companies are operated informally, making the complex corporate scheme, which requires formal director or shareholder approval, unwieldy. Recognizing these realities, the ABA Prototype Act adopts a duty of loyalty similar to the partnership duty of loyalty:

(b) Every member and manager must account to the limited liability company and hold as trustee for it any profit or benefit derived by him without the consent of a majority of the disinterested managers or members, or other persons participating in the management of the business or affairs of the limited liability company from (1) any transaction connected with the conduct or winding up of the limited liability company, or (2) any use by him of its property, including, but not limited to, confidential or proprietary information of the limited liability company or other matters entrusted to him as a result of his status as manager or member.

218. Section 404 states:

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 for it any property, profit or benefit derived by the partner, without the consent of the other partners, in the conduct and winding up of the partnership business or from a use by the partner of partnership property;

2. to refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership without the consent of the other partners; and

3. to refrain from competing with the partnership without the consent of the other partners.

UNIF. PARTNERSHIP ACT § 404. Montana adopted this section at MONT. CODE ANN. § 35-10-405.

219. ABA PROTOTYPE LTD. LIAB. CO. ACT § 402(B). Montana codified this section at MONT. CODE ANN. § 35-8-402. The ABA comments to this section state:

Subsection (B), which is based on UPA § 21, sets forth the duty of loyalty of LLC managers and managing members—that is, the duty to act without being subject to an obvious conflict of interest. The more extensive corporate rules on conflict of interest transactions are unwieldy in the informal context of closely held LLC's.

The duty of loyalty under this Section is defined to include two major components: "Self-dealing," or a manager's reaping an individual profit by or through an LLC transaction in which the manager participated; and liability for appropriating for personal use property belonging to the LLC without the firm's consent. Such appropriation would amount to, in effect, unauthorized compensation. This duty follows from the simple fact that LLC property is owned by the firm as a whole rather than by individual managers or members. Note that property is defined to include records of the LLC that are in the manager's control. Because of the similarity of this section with the UPA, the courts undoubtedly will interpret it as imposing duties similar to those in the general partnership, including the duty not to appropriate partnership opportunities.

ABA PROTOTYPE LTD. LIAB. CO. ACT, § 402(B) commentary at 30.
Though courts should apply the duty of loyalty found in partnership law to limited liability companies, the subduties of the duty of loyalty found in corporate law are a helpful starting point for courts when analyzing the subduties present in the limited liability company context. These subduties include:

(a) The duty not to "unduly profit individually" or through a related party from a transaction with the corporation.\(^{220}\)

(b) The duty to avoid causing the business to pay oneself excess compensation.\(^{221}\)

(c) The duty to use business property, business material, non-public business information, and business position only for the benefit of the corporation.\(^{222}\)

(d) The duty to avoid profiting from business opportunities.\(^{223}\)

(e) The duty to refrain from competing with the business.\(^{224}\)

Of course, in the limited liability company context, members who are not managers do not have the managers’ duties of loyalty.\(^{225}\)

The duty of loyalty will not always be sufficient to protect owners of limited liability companies. Certain conduct by the majority of the members may not strictly violate the duty of loyalty, but is nonetheless a violation of a member’s reasonable expectations. In these cases in the corporate context, courts have created a new duty, which is closely related to the duty of loyalty. The new duty is described in the next section.

4. Application of the Duty to Avoid Illegal, Oppressive, and Fraudulent Conduct to Limited Liability Companies

The final duty of owners and managers in the closely held business context is the duty to avoid illegal, oppressive, and fraudulent conduct. A violation of this duty allows courts to order a number of equitable remedies, including requiring one party to buy out the interest of another party or partitioning the property.\(^{226}\) Courts and legislatures have created this duty, and the corresponding equitable remedies, to address the special problems of minority shareholders in closely held corporations.\(^{227}\)

\(^{220}\) ALI Principles of Corporate Governance, §§ 5.02, 5.07.

\(^{221}\) Id. § 5.03.

\(^{222}\) Id. § 5.04.

\(^{223}\) Id. § 5.05.

\(^{224}\) Id. § 5.06.


\(^{226}\) See supra note 176. Broad equitable remedies are expressly permitted by Montana statute. See MONT. CODE ANN. § 35-1-939.

\(^{227}\) See Bahls, supra note 173, at 288-315.
A typical corporate oppression case involves a family owned corporation, where the founding parent of the corporation has died. The second-generation siblings develop divergent goals. One sibling might become less active in the corporation, looking primarily at the corporation as a steady source of dividends. Another sibling might stay active in the corporation, desiring a significant salary but no dividends. If these divergent goals create friction, the controlling shareholder might "freeze out" the minority shareholder. Common "freeze out" techniques include restricting the minority shareholder's access to management, information, dividends, and distributions.

Unlike shareholders in a publicly held corporation who are able to sell their stock when they wish to disassociate with the business, shareholders in a closely held corporation have few alternatives. Realistically, the only buyers are the other shareholders, who are often the shareholders staging the freeze out. Making matters worse, the majority shareholders have monopsony power. Monopsony power arises when only one buyer exists. Because of this monopsony power, the majority shareholders will often discount any purchase price they are willing to pay to lower than market price.\(^228\) Many courts have created a remedy for these shareholders by finding that minority shareholders have been oppressed when majority shareholders violate their reasonable expectations.\(^229\) The equitable remedies available to shareholders of closely held corporations are among the more meaningful rights of minority shareholders.\(^230\)

Though less common among partnerships, partnership law also recognizes the power of courts to intervene when one partner oppresses another.\(^231\) The new Uniform Partnership Act allows a court, upon application of a partner, to dissolve a partnership if "another partner has engaged in conduct relating to the partnership business that makes it not reasonably practicable to carry on the business in partnership with that partner."\(^232\) Often, when

\(^{228}\) See Posner, supra note 78, at 291-92.
\(^{229}\) See supra note 176.


courts dissolve partnerships on the grounds of misconduct, courts are responding to cases where one set of partners violates the reasonable expectations of the other partners. Professors Bromberg and Ribstein note that the approach courts take to partner misconduct cases is similar to the approach courts take in corporate shareholder oppression cases.

No limited liability company statute fully addresses the issue of whether courts should fashion equitable remedies in the face of majority oppression of minority members. Because limited liability companies are relatively new creations, case law has not developed on this issue. The ABA Prototype Act, however, partially addresses the issue by permitting courts to decree "dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement." The drafters of the ABA Prototype Act intended the "not reasonably practical" language to include "at least some of the causes of dissolution provided for in partnership law, particularly including partner misconduct." When majority members in limited liability companies commit acts of oppression, courts should consider dissolving the limited liability companies or consider ordering other equitable remedies.

Though some state statutes permit courts to dissolve a limited liability company as a result of events making it not reasonably practicable to carry on business (presumably including oppres-


236. ABA PROTOTYPE LTD. LIAB. CO. ACT § 902, commentary at 64. The Montana comments are more specific: The comments state that examples of when it might not be reasonable practice to carry on business are found in the involuntary dissolution provision of partnership law. These reasons include "a member has been guilty of such conduct as tends to affect prejudicially the carrying on of the business" and "a member willfully or persistently commits a breach of the operating agreement." COMMENTS TO THE MONTANA LTD. LIAB. CO. ACT, § 47, at 19.

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sion), state statutes do not typically authorize courts to order equitable remedies less drastic than dissolution. One might ask, then, whether courts should and could apply equitable remedies other than dissolution when courts encounter oppression or other serious misconduct within a limited liability company. A review of case law involving the same issue in the corporate context strongly suggests that courts have equitable power, even absent statutory authorization, to fashion broad equitable remedies to address misconduct committed by the owners of a business. The first recorded instance of a court intervening in a dispute between owners of a business is the 1828 English case of Hichens v. Congreve. After finding directors had improperly withdrawn funds from the corporation, the court decided “such a transaction is so incorrect, that it is quite impossible that any court of justice could permit it to stand.”

In the United States, courts have long recognized the equitable powers of courts to intervene in disputes between owners of businesses. Courts acting in equity have long fashioned equitable remedies to protect shareholders’ just expectations and to protect against other shareholders to insure that the value of their stock is not diminished as the result of oppression. Similarly, courts also have applied their broad equitable powers to resolve disputes in partnerships. In partnerships, the accounting remedy is a useful, equitable remedy to provide for a statement of the status of the affairs of the partners. In order to provide appropriate relief, courts in accounting proceedings, or in a separate suit to declare the rights of partners, may order the appropriate injunction or other ancillary relief. Though many limited liability com-

238. Id. at 220.
240. Id. at 917-20.
241. Tower Hill-Connellsville Coke Co. v. Piedmont Coal Co., 64 F.2d 817, 825 (4th Cir. 1933); Toledo, A.A. & N.M. Ry. v. Pennsylvania Co., 54 F. 746, 751 (N.D. Ohio 1893) (stating that “new remedies and unprecedented orders are not unwelcome aids to the chancellor to meet the constantly varying demands for equitable relief”).
243. See Joseph A. Joyce, ACTIONS BY AND AGAINST CORPORATIONS AT LAW AND IN EQUITY § 424 (1910).
244. See Bromberg & Ribstein, supra note 234, § 6.08, at 6:95 to :122.
245. See Bromberg & Ribstein, supra note 234, § 6.08, at 6:118.
Company statutes do not expressly provide for an accounting remedy, courts still have the equitable powers to fully adjudicate the rights of members in limited liability companies.\textsuperscript{247}

Although courts have broad equitable powers to intervene in disputes between business owners, courts should not apply those remedies as quickly to limited liability companies as they do to corporations. In many corporate cases, application of equitable remedies is appropriate because no ready market exists for close corporation stock, thereby making it impossible for majority shareholders to realize any value for their shares.\textsuperscript{248} Members of limited liability companies likewise do not have a ready market for their interest, because members' interests are subject to substantial limitations on assignability.\textsuperscript{249} A member of a limited liability company, however, may always withdraw from the limited liability company.\textsuperscript{250} If a member does so in breach of the articles of organization or operating agreement, however, the limited liability company is entitled to recover damages against the member for the breach.\textsuperscript{251} Upon the member's dissociation, the remaining members may avoid dissolution by unanimously agreeing to continue the business.\textsuperscript{252} If the other members continue the business, the dissociated member is entitled to receive, within a reasonable amount of time, the "fair value" of the member's interest.\textsuperscript{253}

\begin{footnotesize}
\textsuperscript{247} ABA Prototype Ltd. Liab. Co. Act § 1102, commentary at 86. The commentary states:
LLC members may have other remedies for breach of fiduciary duty. An accounting, which reviews and settles all financial matters in a single proceeding, is the primary mechanism for resolving claims among partners. LLC statutes do not provide for such a proceeding. . . . [However,] something like an accounting undoubtedly will occur in connection with dissolution and winding up of the firm. Prior to dissolution, LLC members can obtain full adjudication of related issues without an accounting under modern pleading and joinder rules. Indeed, it has been held that such rules make the formal accounting proceeding unnecessary even in partnerships.


\textsuperscript{248} For a detailed description of the liquidity problem experienced by corporate shareholders, see Bahls, supra note 173, at 291.

\textsuperscript{249} ABA Prototype Ltd. Liab. Co. Act § 704. While an interest in a limited liability company is assignable in whole or in part, assignment of an interest does not entitle the assignee to rights other than receiving distributions nor does assignment entitle the assignee to the right to participate in management or any of the other rights of members. \textit{Id.} Montana codified this section at MONT. Code Ann. § 35-8-704 (1993).


\textsuperscript{251} ABA Prototype Ltd. Liab. Co. Act § 802(C). Montana codified this section at MONT. Code Ann. § 35-8-802.


\textsuperscript{253} ABA Prototype Ltd. Liab. Co. Act § 602. Montana codified this section at
\end{footnotesize}
members do not agree to continue the business, the members or managers may wind up the affairs of the business. Upon the winding up of the affairs of the business and after creditors are paid, the members are entitled to a return of their contributions and their share of earnings.

As a result of the statutory schemes governing limited liability companies, members are able, at any time, to force liquidation of either their interest or the limited liability company, even in limited liability companies with a specified term of existence. Because legislatures provide avenues other than judicial actions to oppressed members of limited liability companies, courts should not intervene unless the other avenues are substantially inadequate. Requiring courts to use their equitable powers to resolve member dissension creates significant administrative and transaction costs. These costs include attorney fees, court costs, fees for appraisers and other experts, diverted managerial energy, and the added burden on the judicial system. When courts do intervene in corporate cases, a court-ordered purchase of the shares of one shareholder by the corporation is the most common remedy ordered. In most limited liability company cases, an oppressed member need not seek a court order requiring a buyout. The oppressed member is entitled by statute to dissociate and create a liquidation or buyout, without the necessity of a court action.

Courts might still properly intervene in limited liability company oppression cases in a number of circumstances. One circumstance is when an oppressed member's dissociation from the limited liability company results in a penalty to the dissociated, oppressed member. In limited liability companies with specified terms of existence, members causing premature dissolution will suffer a deduction from the amount they receive upon their dissociation equal to the amount of the damages caused by their disso-


254. ABA Prototype Ltd. Liab. Co. Act § 903(A)(1). If a member or manager has engaged in "wrongful conduct," upon a showing of cause, the district court may wind up the business. Id. § 903(A)(2). Montana codified this section at Mont. Code Ann. § 35-8-903 (1993).


256. See supra text accompanying notes 249-55.


The deduction is known as a premature dissociation penalty. In cases where innocent minority members may suffer a premature dissociation penalty because dissociation was forced at the hands of an oppressive majority member, courts should consider ordering a dissolution of the business. If a court orders a dissolution, no premature dissociation penalty is applicable. An order of dissolution may result, however, in a loss of goodwill of the business if the business is liquidated. If the business is sold at a judicial sale, buyers of the business are usually unwilling to pay the full value for the business because of the risks of losing the management team, of relying on inadequate financial statements, of encountering seller competition, or of experiencing material adverse change in the business before completion of the purchase. If limited liability company owners are likely to experience such losses, courts should consider ordering other, less drastic remedies.

Courts may also appropriately use their equitable powers when the oppressive conduct of the majority is likely to force the minority member to dissociate, thereby allowing the majority to capture control of the business. Consider a three-person limited liability company owned equally by A, B, and C. Assume that the articles of organization state that the limited liability company will operate for a five-year period. Assume A and B form an alliance for the purpose of squeezing out C from participation in the business. Assume that because of A and B's collective wrongful conduct, C sees no practical alternative but to withdraw prior to the end of the five-year period of life. Not only will C suffer a premature withdrawal penalty, C's interest can also be purchased by the limited liability company if A and B so desire. If C's interest is purchased, A and B have, in effect, gained total ownership of the business as a result of their wrongful actions. In cases such as this, courts might appropriately order a dissolution, thereby allowing A, B, and C an equal opportunity to buy the assets of the dissolved business in the winding-up process. If A and B's conduct was oppressive and C is best able to operate the business, courts might consider ordering the limited liability company to purchase A and


260. The ABA Prototype Act does not provide for any reduction for damages unless the dissociation was premature. ABA Prototype Ltd. Liab. Co. Act § 902. Montana codified this section at Mont. Code Ann. § 35-8-902.

261. See Bahls, supra note 173, at 331-32.

262. ABA Prototype Ltd. Liab. Co. Act § 903, commentary at 65 ("A 'winding up' may involve the firm's sale as a going concern to existing members or third parties rather than liquidation and termination.").
B's interest. Alternatively, courts could use their equitable powers to order a partition of the limited liability company's property. Of course, courts partitioning the limited liability company must determine that the business can be divided into two commercially viable units and take care to provide for creditors. Courts might also order a distribution to members (or to the oppressed member), appoint a receiver, remove a manager, order a for-

263. In corporate law, courts usually overlook the option of requiring those shareholders guilty of oppression to sell their stock. More typically the complaining shareholder is the shareholder bought out. See Bahls, supra note 173, at 299-300. Nonetheless, cases in at least one other country have allowed, to a limited extent, minority shareholders to purchase the interest of majority shareholders. See, e.g., Re Jermyn Street Turkish Baths, Ltd., 3 All E.R. 57 (Ch. 1970), rev'd on other grounds, 3 All E.R. 184 (C.A. 1971). I have suggested courts consider the following factors in determining whether the majority or minority owners have the option to purchase interests of the other:

(1) the respective financial situation of the shareholders;
(2) the court's ability to restrain effectively the selling shareholder from competing with the purchasing shareholder;
(3) the ability of shareholders to operate the corporation profitably (presumably, the bigger the profit potential of the corporation the greater the potential purchase price); and
(4) the ability of the shareholder whose actions were oppressive to pay money damages to the oppressed shareholder for his loss.

Bahls, supra note 173, at 299-300. The first three of these factors were suggested in Hendley v. Lee, 676 F. Supp. 1317, 1325-27 (D.S.C. 1987).

264. Courts have acknowledged that they possess the power to partition property in corporate shareholder dissension cases. See Kay v. Key West Dev. Co., 72 So. 2d 786, 788 (Fla. 1954); McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 236 (N.M. Ct. App. 1986).

265. See Bahls, supra note 173, at 306.

266. In response to corporate oppression cases, courts have ordered payment of dividends. See Kisner v. Coffey, 418 So. 2d 58, 60-62 (Miss. 1982) (reversing lower court's holding "that there be no [payments] of dividends without unanimous consent of the board of directors"); Muller v. Silverstein, 458 N.Y.S.2d 597, 598 (N.Y. App. Div. 1983); Patton v. Nicholas, 279 S.W.2d 848, 857 (Tex. 1955); see also Dodge v. Ford Motor Co., 170 N.W. 668, 681-82 (Mich. 1919) (stating that directors should not arbitrarily withhold the profits earned by the company and must exercise discretion for the profit of the shareholder); Erdman v. Yolles, 233 N.W.2d 667, 669 (Mich. Ct. App. 1975) (stating that the lower court properly found that the distribution of profits was a dividend); Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (N.Y. App. Div. 1947) (allowing the judgment of the controlling directors if made in good faith); cf. Chounis v. Laing, 23 S.E.2d 628, 640 (W. Va. 1942) (ordering the corporation to pay plaintiff a share of profit "whether represented by dividends, salaries, retained assets or otherwise").


feiture of unlawful distribution, set aside managers’ actions, or order an accounting.

When selecting the equitable remedy most appropriate to resolving dissension in limited liability companies, courts should protect the reasonable expectations of the members, while at the same time seek to minimize the costs and losses associated with the remedy. Specifically, when selecting an equitable remedy to resolve dissension, courts should measure the remedy against these standards:

(a) The remedy should maximize the ability of minority members to realize their reasonable expectations.

(b) The remedy should minimize the administrative costs associated with resolving the dissension.

(c) The remedy should maximize the value of the limited liability company business while allowing members to realize value in accordance with their reasonable expectations.

Members’ expectations deserving protection include the right to a voice in management, a prorated share of profits in the business, and the right to be treated as other members are treated. Courts ordering an equitable remedy because these expectations are violated should fashion the remedy best protecting these expectations.

V. Conclusion

Authorization of limited liability companies is the most significant national development in the law of closely owned business organizations in decades. Limited liability companies uniquely combine attributes of partnerships and corporations in a way that makes them very attractive to closely held businesses. The combi-


270. Whitman, 549 F. Supp. at 324 (enjoining executive committee from circumventing the delegated responsibilities of the directors); Katcher v. Ohman, 97 A.2d 180, 186 (N.J. Super. Ct. Ch. Div. 1953) (enjoining holding of special meeting of directors to oust minority shareholder officers and to grant salaries to majority shareholders to the exclusion of minority shareholder); Browning v. C & C Plywood Corp., 434 P.2d 339, 343 (Or. 1967) (stating that the court had the power “to cancel the stock increase and restore the stockholders to their former proportionate status”); Bank of Mill Creek v. Elk Horn Coal Corp., 57 S.E.2d 736, 751 (W. Va. 1950) (setting aside sale of corporate assets because of an inadequate price); Lierney v. United Pocahontas Coal Co., 102 S.E. 249, 255 (W. Va. 1920) (setting aside sale of corporate assets because of an inadequate price).


272. These standards are adapted from Bahls, supra note 173, at 320.
nation of selected corporate and partnership attributes creates difficulties for courts when deciding whether to apply common-law corporate and partnership doctrines to limited liability companies. The unique combination of these corporate and common-law doctrines makes it inappropriate to apply all corporate common-law rules or all partnership common-law rules without modification. This Article suggests that courts should adopt neither all corporate doctrines nor all partnership doctrines. Instead, where appropriate, courts should develop new doctrines for limited liability companies. As courts begin to resolve the uncertainty caused by the open question of which doctrines to apply, operating limited liability companies will become more certain. As a result, limited liability companies will become an even more attractive form of business organization.