TENNESSEE SHOULD INCORPORATE DEFAULT PROVISIONS INTO LLC OPERATING AGREEMENTS TO SAFEGUARD UNSOPHISTICATED PARTIES AND FUTURE GENERATIONS

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In his essay, Professor Douglas K. Moll identifies and explains the similarities that closely held limited liability companies ("LLCs") share with closely held corporations.[1] In fact, he believes the two entities are so alike in their vulnerabilities to minority owner oppression that he refers to them collectively as closely-held enterprises or businesses.[2] Professor Moll goes through pain-staking effort to describe the issues and concerns of corporate minority owner oppression. He then explains how corporate law, over time, has managed to address these problems by providing manageable solutions through legislative and judicial means. Additionally, Professor Moll describes the issues facing minority owners of an LLC, which share striking parallels with corporate minority shareholders. Finally, he connects all of the dots when he reveals his proposed solution to solve minority LLC owner oppression by importing the well-developed corporate solutions into the LLC realm, thus placing both entities under the same umbrella of minority protection.

Professor Moll's thesis is that as the problem of minority oppression is "portable" between the two entities so too should be the solutions.[3] State legislatures and courts need not birth a completely new doctrine (with the attached growing pains) to deal with minority owner oppression in an LLC because those same legislatures and courts have already labored to create the same protections provided to minority corporate

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1 Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 885 (2005).

2 *Id.*

3 *Id.*

shareholders.[4] In other words, Professor Moll declares that legislatures and courts have already successfully endeavored to protect minority owners in the corporate setting; consequently, instead of reinventing the wheel over the next two decades, they simply need to apply that corporate standard to LLCs by establishing default provisions and subsequent case law to support an oppression doctrine.[5]

I. BRIEF OVERVIEW OF MINORITY OPPRESSION IN THE CORPORATE SETTING

Minority corporate shareholders face exposure to two major concerns: a lack of exit rights and the effects of majority control.[6] First, a lack of exit rights results in the "effective confiscation of the minority's investment," because closely-held corporate minority owners: (1) possess no ready/open markets, resulting in a lack of liquidity (i.e. ownership interests cannot be sold at a fair price, even if a fair price could be reasonably determined; a minority interest is also less desirable and less valuable due to lack of control); (2) are incapable of preventing the majority from choices that harm the owners' interests; and (3) suffer their invested capital being trapped in the entity while the majority decides how it is used.[7]

Second, in addition to financial expectations, members have participatory expectations due to the likelihood that closely-held corporations employ their members/owners who look to this employment for their financial security.[8] Similarly, majority rule may also have a drastic effect on a minority member's ability to participate in the business of the corporation. Some of the risks to minority corporate shareholders include: (1) termination of the minority's employment; (2) removal of the minority from management; and (3) exclusion of the minority from profits of the venture.[9]

Majority rule will be able to terminate the member's employment and eliminate that particular income stream, remove the member from the board of directors, the C-suite, or mid-level management, and finally,

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4 *See* Anderson v. Wilder, No. E200602647COAR3CV, 2007 WL 2700068, at *3 (Tenn. Ct. App. Sept. 17, 2007).

5 Moll, *supra* note 1, at 883.

6 *Id.* at 884, 896.

7 *Id.* at 896, 899

8 *Id.* at 883–84.

9 *Id.* at 884.

separate those shareholders from any voice in how corporate profits are allocated. With their financial rights essentially held captive, and now being effectively sidelined from participating in the corporation's normal business, minority shareholders are basically completely ostracized from any level of control in the fate or direction of the corporation or their capital investment.

II. WHY CORPORATE PROTECTIONS SHOULD APPLY TO LLCS

To understand how similar minority owners in closely-held corporations and LLCs are, simply substitute the term "LLC" for "corporate/corporation" and all else applies nearly the same according to Professor Moll.[10] Over the last few decades, with the ability to customize more adeptly than a corporation and at the same time enjoy pass-through taxation like a partnership, the LLC has become the preferred choice of business entity on an exponential scale.[11] The sheer increase in volume of LLCs being formed in comparison to corporations is one of the main justifications for calls for courts and legislatures to designate protections for LLCs, just as they do for corporations.[12]

States that do not provide default provisions that create possible exits for owners leave unprotected those parties who are either unsophisticated, second-generation, or who avoided the understandably uncomfortable conversations during the honeymoon phases of formation. As such, these unfortunate parties lack the ability to liquidate their capital investment, are unable to prevent the majority from taking actions that damage the entity or minority owners, and are basically trapped into the LLC with no recourse or remedy.[13]

Professor Moll claims that half of states' LLC laws default to voting on a per capita basis (one vote per member) while the other half default to voting on a pro rata basis (vote by financial interest).[14] Voting by a pro rata basis assures majority control via financial interest. Thus, minority oppression is possible; however, even a per capita basis is susceptible to minority oppression should multiple members form a coalition, or voting

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10 *Id.* at 926.

11 *Id.* at 885–86.

12 *Id.*

13 *Id.* at 896

14 *Id.* at 941–42.

block, that ostracizes the minority member.[15] Courts have discovered incidents of minority oppression in the corporate setting when a controlling group exerts power on an aggregate level; therefore, it is reasonable to assume that the same may occur in LLCs.[16]

III. MINORITY OPPRESSION PROTECTION MIGRATES FROM MASSACHUSETTS TO TENNESSEE

In fact, Tennessee courts agree with Professor Moll's views and are applying corporate majority shareholders' fiduciary duties to the minority to LLCs. The pathway from the same standard of fiduciary duty for partnerships being recognized in LLCs required three decades and a journey from Massachusetts to Tennessee. First, we must look to Massachusetts where, in *Donahue v. Rodd Electrotype Co. of New England*, the Supreme Judicial Court discovered the fundamental similarities between partnerships and closely held corporations, most notably the inherent risk to minority corporate shareholders.[17] The court held that those shareholders in close corporations owe the exact same fiduciary duty owed between partners and that the standard of fiduciary duty owed between partners is that of the "utmost good faith and loyalty."[18] One year later, the same court affirmed its holding and rationale in *Wilkes v. Springside Nursing Home, Inc.*[19]

The next step in the journey to achieve minority LLC owner protection in Tennessee required two decades occurring in *Nelson v. Martin* where the Tennessee Supreme Court approved of *Wilkes* and the reasoning behind protecting the minority corporate shareholder from majority rule.[20] The final step occurred a decade later in *Anderson v. Wilder*

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[15] *Id.* at 943–44.

[16] *Id.* at 944.

[17] Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 515 (Mass. 1975).

[18] *Id.* (citing Cardullo v. Landau, 105 N.E.2d 843, 845 (Mass. 1952)).

[19] *See* Wilkes v. Springside Nursing Home, Inc, 353 N.E.2d 657, 661 (Mass. 1976).

[20] Nelson v. Martin, 958 S.W.2d 643, 648 (Tenn. 1997), *overruled in part on other grounds by* Trau-Med of Am., Inc. v. Allstate Ins. Co., 71 S.W.3d 691, 699 (Tenn. 2002) (citing F. Hodge O'Neal and Robert Thompson, *O'Neals Oppression of Minority Shareholders* § 10:04, at 16 (2d ed. 1995)). In spite of the traditional adherence to majority rule and the business judgment rule, many courts in this country have moved steadily toward providing a remedy for oppressed minority shareholders. Some courts have made clear that they will not apply the business judgment rule unless the directors not only have acted in good faith, but also have exercised proper care, skill, and diligence. For many courts, the response has been to impose a fiduciary duty on the controlling shareholders for the

where the Tennessee Court of Appeals applied the corporate standard set forth by the Tennessee Supreme Court in *Nelson* to LLCs.[21] Upon analysis of Tenn. Code Ann. § 48-240-102, the court held that "[a] majority shareholder of an LLC stands in a fiduciary relationship to the minority, similar to the Supreme Court's teaching in *Nelson* regarding a corporation, is warranted in this case. Such a holding does not conflict with the statute, and is in keeping with the statutory requirement that each LLC member discharge all of his or her duties in good faith."[22]

IV. ARGUMENT AGAINST CREATING DEFAULT PROVISIONS FOR LLCS: LLCS ARE GOVERNED BY CONTRACT LAW

The law surrounding LLCs is renowned to be primarily contract law.[23] This allows for the advantageous ability for parties to customize (within reason) their respective LLC to meet their needs as they see fit. TCA § 48-240-102(g) grants a wide berth for parties to draft their articles or operating agreement to suit their needs and customize the terms to "reflect the understanding of the parties" as long as the terms are not manifestly

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benefit of minority interests. Courts increasingly have been willing to recognize an enhanced fiduciary duty among shareholders in a close corporation. *Id.*

[21] Anderson v. Wilder, No. E2006-02647-COA-R3-CV, 2007 WL 2700068, at *3 (Tenn. Ct. App. Sept. 17, 2007).

[22] TENN. CODE ANN. § 48-240-102(a)–(b) (2019). The statute states:

> (a) Fiduciary Duty of Members of Member-Managed LLC. Except as provided in the articles or operating agreement, every member of a member-managed LLC must account to the LLC for any benefit, and hold as trustee for it any profits derived by the member without the consent of the other members from any transaction connected with the formation, conduct, or liquidation of the LLC or from any use by the member of its property including, but not limited to, confidential or proprietary information of the LLC or other matters entrusted to the member as a result of such person's status as a member.
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> (b) Standard of Conduct. A member of a member-managed LLC shall discharge such member's duties as a member, including all duties as a member of a committee:
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> > (1) In good faith;
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> > (2) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
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> > (3) In a manner the member reasonably believes to be in the best interest of the LLC.

Id.; Anderson v. Wilder, No. E2003-00460-COA-R3-CV, 2003 WL 22768666, at *6 (Tenn. Ct. App. Nov. 21, 2003).

[23] Moll, *supra* note 1, at 920.

unreasonable.[24] Tennessee common law subjects parties to a duty of good faith and fair dealing in the performance of contracts.[25] In *TSC Industries, Inc. v. Tomlin,* the Tennessee Court of Appeals declared, "It is true that there is implied in every contract a duty of good faith and fair dealing in its performance and enforcement, and a person is presumed to know the law."[26]

Professor George Kuney argues that this freedom of navigation concerning terms that govern LLCs and subsequent reliance on the duty of good faith and fair dealing are sufficient for all parties to be protected.[27] He favors a system that requires organizers, while drafting the LLC's terms, to enter into the negotiations with their eyes wide open because they and their successors shall be held accountable to their contracting choices.[28] Professor Kuney recommends that organizing members should plan accordingly while drafting their operating agreements and keep in mind that future generations along with heirs apparent will be bound by those terms.[29]

The aspect of LLC law that Professor Kuney prefers, the complete freedom to contract, is one that Professor Joan Heminway counsels to reign in to a certain degree. She would prefer that LLCs not be allowed to contract away all fiduciary duties due to a possible lack of sophistication of the parties or attorneys.[30] Otherwise, parties may surrender powers and protections that they may never be able to bargain back.

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[24] TENN. CODE ANN. § 48-240-102(g) (2019). "Modification of Standard of Conduct in Articles or Operating Agreement. Notwithstanding anything to the contrary in this section, the articles or operating agreement may define the standard of conduct in a manner to reflect the understanding of the parties provided such definition is not manifestly unreasonable under the circumstances." *Id.*

[25] Wallace v. Nat'l Bank of Commerce, 938 S.W.2d 684, 686 (Tenn. 1996).

[26] TSC Indus., Inc. v. Tomlin, 743 S.W.2d 169, 173 (Tenn. Ct. App. 1987).

[27] George *Kuney, Lindsay Young Distinguished Professor of Law, University of Tennessee College of Law Continued Legal Education: Connecting the Threads* (Sept. 27, 2019), https://www.rev.com/transcript-editor/Edit?token=MNMJQHP7LQe5vbvLdznMzkubaNhw0AuzbIB-RfdMqJz_sMBvRGNqraFiAlILoL0NDR-Of-s54AtmnqKtG7ecD6jYOHg&loadFrom=DeliveryEmail&openShareModal=False&page=1&sortBy=Uploaded&sortOrder=Desc&pageSize=25.

[28] *Id.*

[29] *Id.*

[30] Joan Heminway, *Limited Partnership Law: Should Tennessee Follow Delaware's Lead on Fiduciary Duty Private Ordering?*, BUS. L. PROF BLOG (Sept. 5, 2016), https://lawprofessors.typepad.com/business_law/2016/09/limited-partnership-law-should-tennessee-follow-

V. POSSIBLE SOLUTION OF INCLUDING DEFAULT PROVISIONS IN THE TENNESSEE RULLCA

A. Buy/Sell Provisions in LLC Operating Agreements

The LLC statutes make clear that the legislature's intent, and one of the greatest advantages of the LLC form, is to remove restrictive corporate requirements in favor of a greater degree of latitude in which the individual LLC may operate within.[31] However, to accomplish that greater freedom, the LLC organizers must contractually draft the rules that it will operate by, i.e. the operating agreement.[32] In order to do that successfully, the organizers must plan for the worst. Professor Moll cites advance planning as a weakness in closely held enterprises.[33]

Whether the onus behind a lack of advance planning for dissension is attributed to "over-trust" based on familial/friendship relationships or a lack of sophistication of the parties, the same result occurs in that when dissension suddenly appears, minority owners find themselves beholden to the majority, and worse yet, lacking an exit route.[34] Fear of damaging those aforementioned relationships makes "hard bargaining" more uncomfortable for the parties (who are likely currently on very pleasant terms at the inception of the LLC, otherwise, the parties would not be binding themselves together) than if the LLC was not closely held, and instead, more "arms-length."[35] Similar to a hypothetical pre-nuptial agreement in all marriage licenses, the existence of default rules that plan for dissension and lay out exit strategies would serve to protect parties that seek to avoid confrontation during the initial honeymoon phase of LLC formation. A default buy/sell provision in the operating agreement would protect unsophisticated parties or attorneys from their own ignorance. LLCs are relatively simple entities to form and, undoubtedly, numerous LLCs are formed by parties who do not understand what they are doing

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delawares-lead-on-fiduciary-duty-private-ordering.html. Although Professor Heminway's post is directed toward limited partnerships, the concepts may be applied to LLCs the same.

31 Moll, *supra* note 1, at 958.

32 *Id.*

33 *Id.* at 952.

34 *Id.* at 952.

35 *Id.* at 954.

or are represented by legal counsel that is equally inept, either through a lack of education, experience, or mentor networks.[36]

B. Sunset Provisions in LLC Operating Agreements

MBCA jurisdictions allow for shareholder agreements to possess ten-year sunset provisions to protect minority shareholders.[37] Sunset provisions are those that exist for a defined term before they expire, unless they are revived by whatever standards in the chartering documents specify. Similarly, voting trusts may be agreed to for periods of up to 10 years before a mandatory expiration.[38] The renewal of these provisions might require unanimity, and should that fail, that particular provision will fall away and the LLC will default to the applicable statutes. The presence of sunset provisions in Tennessee LLC law would serve two purposes by protecting: 1) unsophisticated parties from drafting mistakes or omissions, and 2) future generations and contingent heirs-apparent from being bound by terms they had no voice in drafting. In essence, parties can contract away from the default rules as they see fit and then revisit those decisions every 10 years, allowing the benefit of experience or the introduction of new parties to determine if those provisions are renewed.

Professor Kuney believes that parties are or should be sophisticated enough to contract the terms by which they will live under, and that they should draft with the foresight that future generations of owners will also be bound to those terms. I believe that expectation, coupled with the presumption in *TSC Industries, Inc.* that all parties know the law, assumes too much from the countless parties that join together to form LLCs, as well as their chosen counsel. LLCs are relatively easy to form and undoubtedly, some parties form an LLC without knowing what they are doing. Even if they seek legal counsel, the quality of that counsel will depend on the attorney's education, experience level, and mentor network.

It is much fairer to contingent parties who at some point will be bound by those contracted terms, but who never had a voice in their drafting due to, for example, receiving ownership in the LLC as a testamentary gift. Property law displays the law's aversion to "dead hand control" with several doctrines that protect the living above the dead. The existence of

[36] Eric Franklin, *A Rational Approach to Business Entity Choice*, 64 U. KAN. L. REV. 573, 595–96 (2016).

[37] MODEL BUS. CORP. ACT § 7.32(b)(3) (2003).

[38] MODEL BUS. CORP. ACT § 7.30 (2003).

sunset provisions as default LLC rules would serve to protect future generations and contingent heirs-apparent from control from the grave.

CONCLUSION

Based on what I have learned from speaking to esteemed professors at the University of Tennessee and the University of Houston, Douglas Moll, George Kuney, Joan Heminway, and Eric Amarante, I would recommend the inclusion of certain default statutes, including buy/sell agreements and 10-year sunset provisions, in all LLC operating agreements. I believe this choice is advantageous because: (1) not all parties, or their legal counsel, are sophisticated enough to protect minority members from omissions or the unknown; (2) future generations and contingent heirs-apparent enjoy some level of protection once they have a seat at the table; and (3) it also allows for organizing members to avoid uncomfortable conversations during the honeymoon phase about possible future dissension while still protecting their respective interests.

A system of default rules where the parties also have a wide latitude to contract their terms is likely the best environment in which current minority owners can possess exit rights to activate their liquidity and protect their capital investments, while also protecting the interests of future generations who do not yet have a seat at the drafting table.