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CONTRACTUAL MECHANISMS OF INVESTOR PROTECTION IN NON-LISTED LIMITED LIABILITY COMPANIES

SUREN GOMTSIAN*

I. INTRODUCTION

LIMITED liability companies (LLCs) are the second most popular legal form of business in the United States. According to the most recent data available for active business forms, more than one-third of all firms are LLCs.¹ In the majority of the states, LLCs outnumber corporations in new business formations.² If new formations of LLCs keep increasing at the same pace, LLCs will very soon catch up with and perhaps pass corporations as the preferred form of business in the United States.

The rise of LLCs is changing the traditional governance structures and investor protection mechanisms used in firms. LLCs combine limited liability of their members with strong contractual freedom in relations of the members and internal governance matters.³ State LLC statutes, as a rule, are based on the principle of contractual freedom and are thus flexible statutes, permitting company founders to engage in private ordering to govern their internal relations. Given the default nature of almost all provisions of the LLC statutes, the founders can use LLC operating agreements to form LLCs that either replicate traditional governance structures of corporations or modify and waive any or all long-established investor protection rights, including fiduciary duties of members and managers. This flexibility permits users of the LLC form to employ contracts to draft customized rules governing their business relationships. Yet, it can also be abused by the party to an agreement that has stronger bargaining power. The controversy focuses on the question of imposing some mandatory rules that will protect the interests of LLC members. Although studying the actual contractual practices in LLCs can shed some light on the reality

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1. See Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 212–16 (2015) (presenting recent statistical data on LLCs).

2. See *id.*

3. See LARRY E. RIBSTEIN, *THE RISE OF THE UNCORPORATION* 137, 143–47, 153–56 (2010).

and provide insights for LLC members, courts, and legislators, the usual confidential nature of the private agreements complicates matters.

An earlier study analyzing the operating agreements of all publicly traded LLCs in the United States showed that although the founders of these firms extensively opted out from default statutory rules to strengthen their decision-making rights, entrench control, and limit the role of the fiduciary duties of care and loyalty, some contractual substitutes and non-legal factors played an important role in protecting the rights and interests of minority investors.⁴ The situation is different in closely held LLCs for two reasons. First, non-listed LLCs are not subject to the federal securities laws and the listing requirements of stock exchanges; additionally, market discipline plays a far weaker role. Second, investors in non-listed LLCs do not have the option of selling their interests in a liquid market. Hence, contractual mechanisms of investor protection are expected to play a larger role in non-listed LLCs, at least where members have access to the advice of professionals.

Delaware was the eighteenth state to introduce an LLC act and did so by enacting the Delaware Limited Liability Company Act (Delaware LLC Act) in 1992.⁵ Delaware's LLC rules are regarded as some of the most flexible among LLC statutes in the United States. In addition to the generally enabling nature of the statute itself, the supportive approach of Delaware courts towards contractual freedom in business organizations drafting and strong enforcement of contractual arrangements of parties of intercompany relations contributes to the high flexibility of Delaware's legislation on LLCs. The operating agreement is the primary source of governance for Delaware LLCs, and the statute applies if the agreement is silent. LLCs, in the words of former Delaware judge Chancellor William Chandler III, "*are creatures of contract.*"⁶ This flexibility, combined with the expertise of the Delaware courts, has attracted many businesses and led to the widespread use of Delaware LLCs. According to the most recent data, Delaware, a tiny state, has the third highest number of LLC formations after Florida and Texas. More than 150 LLCs are formed in Delaware annually per 1,000 state inhabitants aged eighteen and over; the runners-up—Wyoming, Nevada, Colorado, Utah, Florida, and others—are far behind with less than thirty new LLC formations.⁷

4. Gomtsian, *supra* note 1.

5. DEL. CODE ANN. tit. 6, §§ 18-101 to -1109 (2015).

6. TravelCenters, LLC v. Brog, No. 3516-CC, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (emphasis added).

7. *See app. I.* Similar calculations for corporations show that in 2013, the number of newly-formed corporations per 1,000 people aged eighteen and over was 47.32 in Delaware. Other states had much lower indicators. For example, the numbers of newly incorporated corporations in Florida, California, and Texas were 6.59, 2.63, and 1.21, respectively; in New York, which along with Illinois and Washington was among the few states where more corporations were formed than LLCs, five corporations were incorporated per every 1,000 adult inhabitants.

This empirical study analyzes the operating agreements of almost 300 non-listed LLCs formed in Delaware to establish the demand for freedom of contract in LLC governance and to examine the practice of investor rights in non-listed LLCs. All agreements were coded based on a scorecard containing eighty-four questions on investor rights. The results support the main hypothesis that in cases of changing default statutory rules, the parties used other contractual substitutes that ensure equivalent protection and, in many cases, increased clarity and reduced incentives for ex post speculative litigation. Furthermore, the choices of governance structures and investor rights were strategic; they tended to differ depending on the number of company members and underlying conflicts of interests. Given the large size of the firms in the sample, any extrapolation of these results, particularly to small businesses, should be approached very carefully. Documenting choices of sophisticated actors, though, is an asset itself, as it can be informative for different stakeholders.

This Article's analysis starts by stating the main features of the LLC, which leads to the development of two hypotheses. Section III describes data sources and research design. Then it proceeds to the presentation of detailed information on the sample companies, their ownership structure, industrial division, and the analyzed operating agreements. Section IV contains the results of the operating agreements study presented in several subsections that deal separately with procedural matters, company management, interest transfers, dissolution, amending LLC agreements, profit distribution practices, and fiduciary duties. Section V discusses these results and offers explanations for the chosen governance structures and contractual rights. The findings are briefly summarized in Section VI. The following appendices describe typical provisions of operating agreements often mentioned in the main text and present the results of the statistical analysis.

II. FEATURES OF THE LIMITED LIABILITY COMPANY AND HYPOTHESES

The introduction of the LLC to every jurisdiction in the United States has widened the pool of organizational structures available to entrepreneurs. This new business form combines many features of partnerships and corporations. In LLCs, partnership taxation rules come together with the limited member liability feature of corporations, but, different from corporate business forms, the LLC is subject to enhanced default rules that regulate its internal governance matters.⁸ However, the LLC is not a rigid statutory hybrid placed stably between partnerships and corporations. The LLC, due to its flexibility, can replicate one of these two busi-

8. See Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 11 (Robert W. Hillman & Mark J. Loewenstein eds., 2015) [hereinafter RESEARCH HANDBOOK]. Greater contractual freedom of LLCs and partnerships is one of the frequently cited distinctions between non-corporate and corporate business organizations.

ness forms and at the same time have characteristics of the other. The LLC thus has many frames around which its members build their relations.

The corporate form is not always an optimal business structure. It was created primarily to facilitate the accumulation of capital by entrepreneurs from a large number of investors who did not necessarily need to actively participate in the business. Therefore, corporate law has developed mechanisms for retaining control by entrepreneurs, on one hand, and the protection of the interests of these numerous investors, on the other.⁹ However, some of these mechanisms are not relevant for small businesses where the members do not face the same conflicts of interests that numerous stockholders in large corporations do. Because not all corporate rules are enabling, small businesses would have to comply with burdensome and costly formal legal requirements that would be of limited value if they had only the corporate form to choose from. It was this recognition of the need to differentiate large listed corporations from non-listed ones that led to changes—first, in close corporations court practice and later, in statutes.¹⁰ New statutory rules on close corporations allowed their stockholders to depart from these rules by providing for special internal governance rules in stockholder agreements.¹¹

An alternative option for small businesses is to choose partnership-type business forms. The partnership offers rules such as informal decision-making, restrictions on interest transfers, permanent appointment of managers, and simplified exit rules as defaults. Therefore, this choice, by cutting transaction costs, can facilitate the process of establishing a business. Yet, the partnership structure comes with unlimited liability for the general partners. In theory, the partners can achieve limited liability by private contracting, but this “contractual limited liability” will not be effective in tort claims of the partnership’s creditors or corporate criminal liability.¹² Alternatively, the partners, subject to the risk of corporate veil-piercing by courts, can hold interests indirectly through intermediary corporate forms that offer limited liability. Both options, however, imply greater transaction costs.

One of the most important advantages of the LLC is the feature of limited liability, which allows its members to shield their personal assets from claims of the company’s creditors. At the same time, unlike corporations, the limited liability company “*keeps the price of limited liability down by providing for flexible tax rules and the tax planner with the chance to opt for the*

9. Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 43 (2004).

10. Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 304, 312–14 (2008).

11. *See id.* at 312–14.

12. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 41 (1996); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 429 (2000).

most optimal taxation."¹³ However, the LLC choice is affected by more than tax considerations. More than 6% (148,649 LLCs) and almost 2% (40,933 LLCs) of LLCs operated under S corporation and C corporation taxation regimes in 2006, respectively.¹⁴ Apart from the several benefits of the S corporation taxation regime as compared to partnership taxation, this election suggests that the LLC, as a business form, offers more than the combination of tax advantages and limited liability.¹⁵ While the S corporation taxation regime is available to both corporations and LLCs, entrepreneurs who are driven by the demand for contractual flexibility and autonomy of firm members to structure their firm's internal affairs can form an LLC to take advantage of the structure of default rules offered by state LLC law.

Generally, the founders of an LLC are free to make it more partnership-like by entitling members to daily management functions and agreeing to dissolve the company upon the withdrawal of the members, or, alternatively, they can make it more like a corporation with a centralized management structure and indefinite existence. After the introduction of the LLC, entrepreneurs choosing the optimal organizational structure are no longer constrained by the availability of member-limited liability. The election of a partnership-like or corporation-like governance structure depends entirely on their needs.

By making default rules of partnerships automatically available to the members of an LLC, LLC statutes reduce the negotiation and contracting costs of the members. However, these default rules are not always detailed; state LLC statutes can be very general by leaving most of the work to be done by the LLC's founders. In such situations, if the founders fail to anticipate their possible needs and do not include negotiated solutions in the operating agreement of the company, they may face governance issues deriving from that legal vacuum in the future. As a result, they have to rely either on renegotiation or ex post gap-filling by courts. Both options can be problematic, as the first puts the party that requires renegotiation in a weaker bargaining position,¹⁶ while the second is subject to uncertainty, time-consuming procedures, litigation costs, and the possibility of judicial error.¹⁷

13. See JOSEPH A. MCCAHERY & ERIK P.M. VERMEULEN, *CORPORATE GOVERNANCE OF NON-LISTED COMPANIES* 114 (2008) (emphasis added).

14. See Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 *FORDHAM J. CORP. & FIN. L.* 459, 486 (2010).

15. See *id.* at 488.

16. See Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 *CALIF. L. REV.* 2005, 2020–21 (1987).

17. See ERIK P.M. VERMEULEN, *THE EVOLUTION OF LEGAL BUSINESS FORMS IN EUROPE AND THE UNITED STATES: VENTURE CAPITAL, JOINT VENTURE AND PARTNERSHIP STRUCTURES* 243 (2003); see also MCCAHERY & VERMEULEN, *supra* note 13, at 247.

The Delaware LLC Act is an example of a general statute that does not provide default solutions for many future contingencies. Do the members of Delaware LLCs, then, draft contractual rules that can supplement the general defaults of the statute? The second issue of default rules is the ability of the members to alter any, or all, traditional investor protection mechanisms. As compared to corporate stockholders, these alterations can put some members in a disadvantageous position and thus can create problems for members *vis-à-vis* other members or managers. Does this lead to situations where some members give up investor protection rights to protect themselves from opportunistic behavior by other members or managers? These are the questions addressed in this Article.

Following these raised questions are two main hypotheses. According to Hypothesis 1, the founders of LLCs include detailed rules in the operating agreements that fill the gaps of general default rules of the Delaware LLC Act. This hypothesis is mostly driven by the logic that the members of the sample companies covered by this study were large investors who have access to professional consultants and could afford to draft detailed contracts. This situation could be different in small firms where the founders' access to qualified legal advice is limited. Therefore, the choices made in the sample firms can be informative both for the legislatures that supply modified default rules for small firms and for the founders of small firms that draft LLC operating agreements. A negative alternative to Hypothesis 1 would be the ignorance of gaps by the contractual parties at the stage of *ex ante* contracting.

According to Hypothesis 2, LLC operating agreements often alter traditional investor protection mechanisms. There could be a number of reasons for this: to adapt the governance structures of firms to the specific needs of their members, depending on the circumstances of their relations, or the desire to limit the uncertainty that emanates from general standards—such as fiduciary duties—to name a few. In the latter case, if the number of members so allows, it is more reasonable to expect the operating agreement to substitute fiduciary duties with detailed decision-making rules that give veto rights to members in situations where the risks of opportunistic self-dealing are high.

Before analyzing the practice of contracting in non-listed LLCs, this Article describes the methodology of the study and the sample firms.

III. DATA, RESEARCH DESIGN, AND DESCRIPTIVE STATISTICS

The database of the LLC agreements used in this study was created by compiling the operating agreements of LLCs filed with the Securities and Exchange Commission (SEC). The sample companies thus were not startups or small “mom and pop” businesses; rather, they were independent firms or joint ventures formed by large corporations. A search of the

SEC's EDGAR database yielded LLC agreements of 887 U.S. companies.¹⁸ Some of these LLCs had more than one agreement because the initial agreements were amended or restated. The general approach was to use the latest text of any duplicative agreement.

The analysis of the ownership structures provides important insights into the possible conflicts of interests in LLCs. For this purpose, all LLCs in the sample were divided into six groups: (1) LLCs with one member, (2) LLCs with two members, (3) LLCs with 3–10 members, (4) LLCs with more than ten members, (5) LLCs that offered LLC units to a wide group of investors, but did not create a public market of these units, and (6) publicly traded LLCs.

In several cases, the LLCs in the sample had affiliated members. For instance, an LLC could be formed by “sister companies” or by a company and its subsidiary. After identifying the cases where the actual number of independent members was lower, based on the information from annual and current reports filed with the SEC and from the LLC agreements, the ownership structures of the sample firms were coded in a way to reflect this information. The data on the ownership structure of the initial sample are in Table I.

TABLE I: OWNERSHIP STRUCTURE OF THE SAMPLE LLCs

| LLCs | TOTAL | % OF TOTAL | FORMED IN DELAWARE | % OF TOTAL | FORMED IN OTHER STATES | % OF TOTAL |
|---|-------|---------------|-----------------------|---------------|------------------------------|---------------|
| 1 MEMBER | 435 | 49.04 | 328 | 36.98 | 107 | 12.06 |
| 1 MEMBER* | 481 | 54.23 | 366 | 41.26 | 115 | 12.97 |
| 2 MEMBERS | 197 | 22.21 | 164 | 18.49 | 33 | 3.72 |
| 2 MEMBERS* | 198 | 22.32 | 168 | 18.94 | 30 | 3.38 |
| 3–10 MEMBERS | 114 | 12.85 | 97 | 10.94 | 17 | 1.92 |
| 3–10 MEMBERS* | 74 | 8.34 | 62 | 6.99 | 12 | 1.35 |
| > 10 MEMBERS | 70 | 7.89 | 66 | 7.44 | 4 | 0.45 |
| > 10 MEMBERS* | 63 | 7.10 | 59 | 6.65 | 4 | 0.45 |
| WIDELY HELD (NO PUBLIC MARKET) | 51 | 5.75 | 43 | 4.85 | 8 | 0.90 |
| PUBLICLY TRADED | 20 | 2.25 | 20 | 2.25 | 0 | 0.00 |

* include data where all affiliated members were counted as one member. The maximum number of members in rows 8 and 9 is 79 and 71, respectively.

18. For a detailed description of the search strategy, see Gomstian, *supra* note 1, at 218–19. Michelle Harner and Jamie Marincic, using a similar strategy of searching for references to LLC agreements in annual reports filed during different years, identified 129 LLC agreements. See Michelle M. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879, 901 (2012). In the current study, the search was limited to annual reports filed during 2012 only, yet the number of the obtained LLC agreements is larger than the sample of a similar previous study.

The database was further refined by removing all LLC agreements of one-member companies (which could not have potential conflicts of interests between members), publicly traded LLCs, companies that were widely held by qualified investors but did not have a public market, and firms formed in states other than Delaware. The latter restriction on the data, which reduced the sample of non-listed firms with two or more independent members by less than 14%, aimed to eliminate the possible influence of state statutory differences on contractual choices that parties had made. The final database contains operating agreements of 289 LLCs formed according to the Delaware LLC Act. Of the total number, 168 firms had two non-affiliated members, sixty-two had 3–10 independent members, and the remaining fifty-nine had more than ten independent members.¹⁹ A typical operating agreement in the sample was more than fifty pages long and contained detailed rules of conduct for the parties.

The sample company groupings based on ownership characteristics is one of the features that distinguishes this study from previous empirical studies of operating agreements in non-listed LLCs.²⁰ Obviously, the operating agreements of one-member LLCs cannot be analyzed in the same group with operating agreements of publicly traded LLCs. Such a grouping can distort the results of the analysis. Similarly, in two-member LLCs used for joint ventures, the members face different conflicts of interests as compared to LLCs with a larger number of members where one of the members holds the controlling voting rights while others are minority investors.

In addition to introducing grouping samples based on number of members, this study differs from previous work by analyzing a large number of contractual provisions in the sample companies' operating agreements that could affect the rights and interests of their members. Company governance is affected by various legal and non-legal factors, which define the role of the company members in this system. The focus only on specific aspects of investor rights, such as fiduciary duties of members and managers or their ownership and voting rights, would certainly lead to incorrect conclusions about the overall level of available investor protection. For this reason, this study coded the sample LLC members' contractual rights based on a wide range of variables.

19. The study of these firms' operating agreements revealed several cases where the members, although not always formally affiliated, had special relationships that made detailed contracting unnecessary. These were cases where one group of members held top-management position(s) at the other members' board or all members were employees of a third firm. Given these special relationships, these firms were removed from the database at the stage that defined the role of different investor protection mechanisms by means of correlation analysis. Thus, for this purpose, the sample contains 158 firms with two members, fifty-six firms with the number of members from 3–10, and twenty-nine firms with more than ten members, in total 243 LLCs.

20. See, e.g., Harner & Marincic, *supra* note 18.

The coding criteria were defined based on (1) background information, (2) information about the ownership of voting and equity rights, and (3) the main differences of the legal regime of LLCs as opposed to corporate statutes. Within these three areas, eighty-four primary questions were identified.²¹ The author read all 289 sample LLC agreements and coded all variables (except background information) as either 0 (a negative answer) or 1 (a positive answer).

Delaware is famous for attracting LLC formations from businesses domiciled in other states. Similar to its large number of incorporations, Delaware leads the race of local LLC formations for large LLCs: more than 95% of LLCs with 5,000 or more employees that are formed outside the state of their principal place of business are formed in Delaware.²² Only two LLCs in the sample had their executive offices in Delaware. New York (80 firms), Texas (28), California (25), Illinois (16), Colorado (15), Florida (13), and Massachusetts (10) were the main locations of the principal places of business of the LLCs included in the sample. The remaining companies were located in twenty-eight other states.²³

Although all sample firms were formed in Delaware, five firms chose the law of other states to govern their operating agreements.²⁴ Many other companies, while still governing their operating agreements by Delaware law, chose other jurisdictions for dispute resolution.²⁵ These were not necessarily the courts of the state where a firm's principal place of business was located, though in the majority of cases, the choice of jurisdiction for dispute resolution and the place of business coincided. In more than 14.5% of the LLCs, the courts of other states were the exclusive venues of adjudication, and in another 2.7% of cases, they were the preferred venue, though the LLC agreements did not ban bringing lawsuits in

21. The full scorecard appears as an appendix in Gomstian, *supra* note 1, at 273 app.

22. Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J.L. & ECON. 741, 745 (2012).

23. These states were Pennsylvania (9), New Jersey (7), North Carolina (7), Ohio (7), Connecticut (6), Missouri (6), Oklahoma (6), Tennessee (6), Michigan (5), Arizona (4), Georgia (4), Maryland (4), Minnesota (4), Nevada (4), Indiana (3), Idaho (2), Oregon (2), Virginia (2), Washington (2), West Virginia (2), Arkansas (1), Hawaii (1), Iowa (1), Louisiana (1), Omaha (1), Rhode island (1), Utah (1), and Wyoming (1).

24. Delaware law is clear that if parties of a Delaware LLC so choose, all provisions of the LLC agreement will be governed by and construed under Delaware law. DEL. CODE ANN. tit. 6, § 18-1101(i) (2015). Although Section 29 of the 2010 bill specifically notes that the amendment is merely for the sake of clarification and is not intended “to negate the application of the internal affairs doctrine” to Delaware LLCs, it is not clear to what extent the courts of other states would apply non-Delaware law chosen by the members of a Delaware LLC to its operating agreement. See H.R. 372, 145th Gen. Assemb., Reg. Sess. (Del. 2010), available at [http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+372/\\$file/legis.html?open](http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+372/$file/legis.html?open) [<http://perma.cc/J8TC-L53D>] (emphasis added).

25. New York courts were the most popular, followed by state and federal courts of Texas.

Delaware courts.²⁶ Arbitration, often as an exclusive dispute resolution mechanism, was chosen by 26.9% of the sample companies. Hence, the Delaware Court of Chancery was the desired venue for resolving disputes between the members of the sample companies in only 55.7% of cases.

TABLE II: NUMBER OF THE LLC AGREEMENTS IN THE PERIOD
FROM 1996 TO 2013

| YEAR | DELAWARE LLC AGREEMENTS | % OF THE SAMPLE |
|-------|----------------------------|-----------------|
| 1996 | 1 | 0.35 |
| 1997 | 0 | 0.00 |
| 1998 | 3 | 1.04 |
| 1999 | 6 | 2.08 |
| 2000 | 4 | 1.38 |
| 2001 | 4 | 1.38 |
| 2002 | 4 | 1.38 |
| 2003 | 9 | 3.11 |
| 2004 | 9 | 3.11 |
| 2005 | 18 | 6.23 |
| 2006 | 12 | 4.15 |
| 2007 | 43 | 14.88 |
| 2008 | 31 | 10.73 |
| 2009 | 46 | 15.92 |
| 2010 | 37 | 12.80 |
| 2011 | 49 | 16.96 |
| 2012 | 12 | 4.15 |
| 2013 | 1 | 0.35 |
| Total | 289 | 100.00 |

Table II shows that most of the LLC agreements in the sample were entered after 2006. Low results for the years after 2011 were due to the strategy of populating the sample. Where the fiscal year coincides with the calendar year, annual reports are usually submitted in the first half of the following year. Hence, by searching for references in the annual reports filed with the SEC in 2012, it was possible to obtain mostly references to LLC agreements entered before the start of 2012. It was only possible to find LLC agreements entered during the year of 2012 in cases where the fiscal year also ended during 2012. In most cases, these agreements were filed with the SEC by the parent companies of the sample firms. However, in thirteen cases, the sample companies disclosed their own operating agreements as the (co-)issuers of senior notes or (co-)guarantors of other issuers of debt.

26. The election of non-Delaware courts as an exclusive dispute resolution venue in the LLC agreements of many sample companies is difficult to explain, given the statutory ban on waiving the right of members to sue in Delaware courts. *tit. 6, § 18-109(d)*. Hence, with the exception of arbitration agreements, the disputes with respect to organizational matters on the organization or internal affairs of the sample LLCs were subject to Delaware state court jurisdiction.

TABLE III: INDUSTRIAL DIVISION OF THE SAMPLE

| SIC CODE | INDUSTRY TITLE | NUMBER OF FIRMS | % OF THE SAMPLE | % OF ALL LLCs* |
|-------------|---|-----------------------|-----------------------|----------------------|
| 01–09 | Agriculture, forestry, and fishing | 1 | 0.35 | 2.56 |
| 10–14 | Mining (excl. oil and gas extraction) | 8 | 2.77 | 0.84 |
| 13 | Oil and gas extraction | 28 | 9.69 | n.a.† |
| 15–17 | Construction | 1 | 0.35 | 5.28 |
| 20–39 | Manufacturing | 36 | 12.46 | 1.98 |
| 40–48 | Transportation and communications | 10 | 3.46 | 1.55 |
| 49 | Electric, gas, and sanitary services | 21 | 7.27 | 0.10 |
| 50–51 | Wholesale trade | 5 | 1.73 | 2.41 |
| 52–59 | Retail trade | 6 | 2.08 | 4.68 |
| 60–67 | Finance and insurance (excl. real estate) | 55 | 19.03 | 7.09 |
| 65 | Real estate | 78 | 26.99 | 50.11 |
| 70–89 | Services | 40 | 13.84 | 21.71 |

Notes: * Includes all LLCs that filed partnership tax returns for the tax year of 2011.

† The figure for oil and gas sector is included in the data for the mining industry.

The LLC form is used in various industries. The majority of all LLCs operate in the real estate sector. Other business industries where LLCs are popular are professional services, finance and insurance, construction, and trade. The sample contains companies from different industries as well. Table III presents the industrial division of the sample based on the first two digits of the Standard Industrial Classification Codes (SIC Codes). More than 46% of the firms came from finance and real estate sectors. Services, manufacturing, oil and gas, and transportation services are strongly represented as well. Comparing the industrial representation of all LLCs taxed as partnerships reveals many similarities.²⁷ However, the sample is overrepresented in the manufacturing and oil and gas sectors and underrepresented in services and construction. The main explanation for these differences is the fact that the sample, as a rule, does not include small businesses. The different share of real estate firms can also be explained by the fact that many LLCs holding interests in real estate are formed locally.

More than 70% of the sample LLCs had a member or a group of affiliated members controlling a majority of the voting rights. This share was the highest in LLCs with more than ten members (around 83%) and the lowest in those with 3–10 members (around 64%). In two-member LLCs, 72% had a controlling member.

27. This comparison excludes one-member LLCs taxed as a sole proprietorship and is more appropriate given that the sample includes only firms with two or more members. The data on LLCs taxed as a partnership are taken from Ron DeCarlo, Lauren Lee & Nina Shumofsky, Internal Revenue Serv., *Partnership Returns, 2011*, STAT. INCOME BULL., Fall 2013, at 81, 184–86, available at <http://www.irs.gov/pub/irs-soi/13pafallbulpartret.pdf> [<https://perma.cc/YH9H-HUH4>].

Unlike the listed firms cases, it was not common for non-listed firms to detach voting and economic rights: only a small number of companies issued non-voting units. In the majority of cases, these were units issued either to company managers and employees for the purposes of incentive schemes or to creditors of the firm. In the latter case, the owners of non-voting preferred units, in addition to fixed interest payments, usually were offered additional guarantees, such as the company's obligation to repurchase the preferred units at a fixed price after a certain period of time.

Finally, all sample firms, except five LLCs taxed as corporations, elected partnership taxation.

IV. THE PRACTICE OF GOVERNANCE AND MEMBER RIGHTS IN NON-LISTED LLCs

A. *Legal Formalities*

The partnership-like structure of the LLC and the enhanced role of default rules in LLC statutes imply that formalities have a narrower scope in this entity. Only the following formalities apply to LLCs formed in Delaware: the certificate of formation of an LLC shall be filed in the office of the Secretary of State; each LLC shall have and maintain a registered office and a registered agent in Delaware; an LLC shall maintain certain records such as membership lists and tax returns; if the LLC agreement provides for the management by a manager, a manager (managers) shall be chosen; and each LLC shall pay an annual Delaware franchise tax in the amount of \$250.00.²⁸

Appraisal rights of LLC members during mergers and consolidations are only contractual, which means that they are available only if they are provided for in an LLC agreement, an agreement of merger or consolidation, or a plan of merger.²⁹ Because Delaware LLC members have the opportunity to provide for unanimous decisions on important matters such as mergers and consolidations, and they can agree on withdrawal rights, appraisal rights are less important in LLCs than they are to corporations with many minority stockholders where voting rights alone may not be an effective protection from conflicts arising in the context of control transactions. Access to the information and records of an LLC by its members and managers, by contrast, can be restricted by the LLC agreement.³⁰

According to Delaware law, procedural formalities of member and manager meetings—such as notices, establishment of a record date, quo-

28. *Id.* § 18-1107(b); *see also* tit.6, §§ 18-201(a), 18-206(a) (filing requirements); *id.* § 18-104(a) (registered office and agent requirements); *id.* § 18-305(a) (records requirements); *id.* § 18-402 (selection and assumption of office of manager); *id.* § 18-1107(b) (franchise tax). The manager can be named in the LLC agreement, or designated pursuant to the procedure set forth in the LLC agreement. *Id.* §§ 18-101(10), 18-401.

29. *See id.* § 18-210.

30. *See id.* § 18-305(a), (b), (g).

rum requirements, and minimum voting thresholds—shall be defined in an LLC agreement.³¹ As mentioned earlier, this flexibility may lead to gaps in poorly drafted governing documents.³² Therefore, the regulation of legal formalities in the sample LLCs' operating agreements sheds some light on Hypothesis 1. The absence of many corporate legal formalities in the LLC context makes it an attractive structure to organize new businesses. On the other hand, this flexibility may lead to unforeseen risks. Hence, it is reasonable to expect members to regulate, in detail, the formal aspects of the LLC management's internal affairs in the operating agreement where the number of members is large, or some of them hold minority interests, or are passive investors, or have limited means of access to the LLC and to information about its activities.

Among the two-member sample LLCs, it was uncommon to organize annual member meetings and annual board or officer elections (11.9% and 8.33%, respectively). Most of them (63.1%) had boards of directors, which often substituted for member meetings rather than functioned as traditional boards of directors. More than 90% of the LLCs from the group with boards of directors also had procedural rules for board meetings. The share of the firms with the procedural rules for member meetings was lower (just above 65%), but in more than 22% of the firms, board meetings were substituted for member meetings.

Annual member meetings and annual election of managers were not common in the companies with 3–10 members either (22.6% and 16.1%, respectively). Boards of directors functioned in almost two-thirds of the firms, though it was not common to substitute member meetings with board meetings. In the LLCs with more than ten members, boards of directors never exercised the functions of member meetings. All firms with 3–10 members that had boards of directors also adopted procedural rules for board meetings, but only 64.5% had procedural rules for member meetings. Similarly, all boards in the LLCs with more than ten members had procedural rules, which, as a rule, also specified minimum quorum requirements and notice periods.

In all sample firms, a well-adopted practice was to reduce legal formalities by allowing written decision-making by the boards of directors without holding formal meetings. Decision-making without formal meetings by members was less common. Nevertheless, in all three groups of companies, more than half of the sample provided for this option. While the operating agreements sometimes required a unanimous vote of directors for the board to act without a meeting, similar requirements were not common for written decision-making by member meetings, and unanimous member votes were never required in the LLCs with more than ten

31. *See id.* § 18-302(c) (stating requirements for member meetings); *id.* § 18-404(c) (stating requirements for manager meetings).

32. *See Friedman, supra* note 9, at 55.

members, where achieving unanimity, due to the number of members entitled to cast their votes, could be problematic.

Appraisal rights in cases of mergers were an exception: only two firms provided such rights to their members. In both, mergers could be approved without a unanimous vote.³³ The vast majority of the two-member and 3–10 member LLCs extended the statutory information rights of their members and provided access to all company books and records (82.7% and 74.2%, respectively). In both ownership groups, this access was more likely to be provided for *any* purpose than to be limited by the need to establish a *reasonable* purpose.³⁴ Given the large member holdings and the members' active roles in management, the unlimited inspection right does not come as a surprise. However, the situation changes when the number of members increases. Less than one-third of the sample firms with more than ten members entitled their members with the right to access company books and records. With the aim of ensuring necessary conditions for continued centralized management, most of the firms in this ownership group limited their members' inspection rights with the requirement to indicate a reasonable purpose. The remaining firms, as a rule, had minimum information rights provided by the Delaware LLC Act. Detailed information on legal formalities in the sample firms is provided in Table IV.

TABLE IV: LEGAL FORMALITIES IN THE SAMPLE COMPANIES, %

| | 2 MEMBERS | 3–10 MEMBERS | >10 MEMBERS |
|--------------------------------------|-----------|--------------|-------------|
| ANNUAL MEMBER MEETING | 11.90 | 22.58 | 8.47 |
| ANNUAL BOARD ELECTION | 8.33 | 16.13 | 6.78 |
| BOARD OF DIRECTORS | 63.10 | 64.52 | 40.68 |
| BOARD SUBSTITUTING MEMBER MEETINGS | 22.62 | 6.45 | 0.00 |
| PROCEDURAL RULES FOR BOARD MEETINGS* | 90.57 | 100.00 | 100.00 |

33. In one of the two companies, the LLC agreement specified that appraisal rights did not apply if the LLC units were listed on a stock exchange or the company had more than 2,000 unit-holders. This limitation is perhaps influenced by Section 262(b)(1) of the Delaware General Corporation Law, which denies appraisal rights for shares of stock listed on a national securities exchange or held by more than 2,000 holders. See DEL. CODE ANN. tit. 8, § 262(b)(1) (2015) (limiting appraisal rights for publicly traded companies).

34. Minimum information rights of LLC members provided by the Delaware LLC Act are subject to the qualifying standard of “*any purpose reasonably related to the member’s interest as a member of the limited liability company. . .*” tit. 6, § 18-305(a) (emphasis added). Similarly, in the setting of corporations, Section 220(b) of the Delaware General Corporation Law conditions the right to inspect a corporation’s books and records “*for any proper purpose.*” tit. 8, § 220(b) (emphasis added). This qualifying standard aims to balance the information right of stockholders with the need to prevent undue interference from stockholders with the management rights of directors. See *Seinfeld v. Verizon Commc’ns, Inc.*, 909 A.2d 117, 122 (Del. 2006). The LLC statute’s “reasonable purpose” standard should be considered in this context as well.

| 2015] | CONTRACTUAL MECHANISMS | | 969 |
|---|------------------------|-------|-------|
| BOARD ACTION WITHOUT MEETING* | 87.74 | 90.00 | 95.83 |
| PROCEDURAL RULES FOR MEMBER MEETINGS | 65.48 | 64.52 | 30.51 |
| WRITTEN DECISION-MAKING BY MEMBERS | 55.36 | 66.13 | 81.36 |
| APPRAISAL RIGHTS | 0.60 | 0.00 | 1.69 |
| RIGHT TO INSPECT COMPANY BOOKS & RECORDS | 83.33 | 74.20 | 28.81 |
| RIGHT TO AUDIT | 22.62 | 9.68 | 0.00 |

Note: * In the total number of the sample companies that formed a board of directors.

The data on legal formalities support both hypotheses. First, the sample LLCs tailored formal rules on decision-making to their needs, thereby saving time and reducing unnecessary costs. An example with procedural rules in the two-member sample companies is illustrative. As mentioned earlier, where the companies formed boards of directors, it was also common for them to have defined procedural rules for board meetings. However, in a few cases, these procedural rules were not full: ten companies had no quorum requirement and six firms did not define minimum notice period. Yet, two-member firms can often dispose with full procedural rules for decision-making. First, if none of the members owns enough votes to endorse decisions, then the minimum voting threshold acts as a veto right and by itself is enough to protect the interests of the members. Second, the sample firms filled gaps of the Delaware LLC Act by adopting detailed procedural rules for member and management meetings where necessary. Weak procedural rules were often supplemented with strong information rights for members. Nevertheless, some firms did not have these rules. This problem can be more acute in smaller firms. However, including default procedural rules for member and board meetings in the statute could cancel out the benefits of reduced legal formalities in small firms.

B. Management Structure

According to the default rule of the Delaware LLC Act, the management of an LLC is conducted by its members in proportion to the members' interests in the LLC's profits.³⁵ This default rule can be changed by opting for centralized management, meaning that a manager or several managers—rather than all LLC members—are responsible for the day-to-day decision-making.³⁶ Notably, choosing a centralized management structure for a Delaware LLC does not automatically activate corporate formalities like annual member meetings of LLC members or annual man-

35. See tit. 6, § 18-402.

36. See *id.* The statutory default rule is driven by the restricted transferability of an LLC interest; in the absence of the freedom to exit an LLC, its members are actively involved in the management. See Robert R. Keatinge, Larry E. Ribstein, Susan Pace Hamill, Michael L. Gravelle & Sharon Connaughton, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 428 (1992).

agement elections. Taking into account that the number of LLC members is typically small, and also that they do not encounter collective action problems, the presumption of the Delaware statute is that members should be able to organize such meetings and management elections themselves, as needed.

Unlike in close corporations, where the choice of the management structure is made in the certificate of incorporation, in LLCs this is a matter that is defined in an LLC agreement.³⁷ As the certificate of incorporation is a publicly available document that can be obtained for a certain fee, creditors of close corporations have an opportunity to find out information about the management structure of the corporation and define whether a stockholder or a manager can bind the corporation.

In Delaware LLCs, this issue is more complicated. In 1994, a new sentence was added to Section 18-402 of the Delaware LLC Act stating that unless otherwise provided in an LLC agreement, “each member and manager has the authority to bind the limited liability company.”³⁸ Given that under centralized management all members cannot be involved in the management, this sentence should be interpreted as giving each member the authority to bind the LLC in member-managed LLCs and giving each manager the authority to bind manager-managed LLCs. Yet, because the choice of management structure is made in an LLC agreement, creditors do not have any other means to obtain this information but to ask the company itself to provide a copy of the LLC agreement.

In this context, it is reasonable to expect the courts to use the general agency law concepts of actual and apparent authority to decide whether a member or a manager has authority to bind the LLC. If, according to the LLC agreement of a member-managed LLC, a member does not have actual authority³⁹ to bind the LLC (for instance, if the transaction requires the consent of all members or a majority decision, which was not obtained), then, based on the concept of apparent authority,⁴⁰ her act does not bind the LLC when a third party has notice or knowledge of the lack of authority.⁴¹ Similarly, if the Delaware Court of Chancery’s approach is

37. See tit. 6, § 18-402. Compare tit. 8, § 351 (providing management requirements for close corporations), with tit. 6, § 18-402 (providing management requirements for LLCs).

38. 69 Del. Laws 260 (1994) (internal quotation marks omitted).

39. “Actual authority is that authority which a principal expressly or implicitly grants to an agent.” *Albert v. Alex. Brown Mgmt. Servs., Inc.*, Nos. 762-N, 763-N, 2005 WL 2130607, at *10 (Del. Ch. Aug. 26, 2005) (emphasis added).

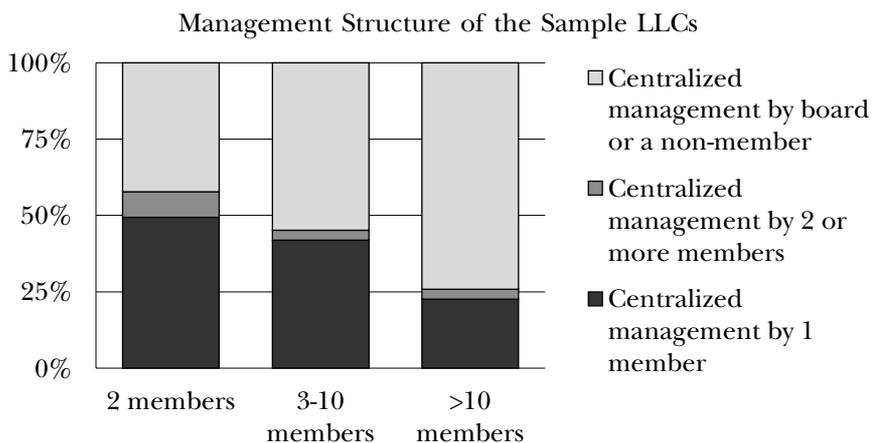
40. “Apparent authority is that authority which, though not actually granted, the principal knowingly or negligently permits an agent to exercise, or which he holds him out as possessing.” *Id.* (emphasis added).

41. *B.A.S.S. Grp., LLC v. Coastal Supply Co.*, No. 3743-VCP, 2009 WL 1743730, at *15 (Del. Ch. June 19, 2009) (“[T]he party seeking to show the existence of such [apparent] authority must ‘show reliance on indicia of authority originated by the principal, and such reliance must have been reasonable.’” (quoting *Albert*, 2005 WL 2130607, at *10 (emphasis added))).

extended to LLCs, it can be argued that if, in a manager-managed LLC, a manager (or member) does not have actual authority, her act will bind the LLC only where a third party did not have notice or knowledge of the lack of authority and reasonably relied on the authority of the manager manifested by the LLC members. Alternatively, third parties can use contractual representations and warranties to seek indemnification of damages incurred as the result of a LLC member or manager's false representation with regard to their actual authority to bind the LLC. The presence of such representations can probably also be considered by courts as a reasonable basis to rely on the authority of an LLC member or manager (in the absence of other facts that cast doubt on the reasonableness of the third party's reliance on apparent authority).

Although the Delaware approach is less certain for third parties, it allows more flexibility in defining the internal governance structure of LLCs. Moreover, the distinction between centralized management structures in member-managed and manager-managed LLCs can be very subtle. For instance, the difference is actually absent between a situation where—in a member-managed LLC—only some members can bind the company and a situation where—in a manager-managed LLC—one or two, but not all, managers can bind the company. Therefore, the disclosure of the general management structure of an LLC (member-managed or manager-managed) hardly tells third parties much about the authority of persons that can bind the company. Given this flexibility, the law should define a rule on binding a company without introducing any distinction between the general management structures. This is what the Delaware LLC Act does in Section 18-402.

FIGURE I.



The data from the sample confirm that member- and manager-managed LLCs can have very similar governance structures. More than half of the two-member sample companies were member-managed, but both

members had management rights in only fourteen companies. In most cases, the management was centralized, as only one member was responsible for it. The remaining 42.2% had centralized management by a non-member or by a board of directors. With increasing member numbers, centralized management by a board of directors became more common. Almost 55% of the 3–10 member firms had boards of directors. The corresponding figure is 74% in firms with more than ten members. Figure I illustrates these data.

C. *Transferability of Interests*

Transfers of voting rights in Delaware LLCs are restricted by a default rule. The assignee of an interest has “no right to participate in the management of the business and affairs of a limited liability company except [(1)] as provided in a limited liability company agreement, or . . . [(2)] upon the affirmative vote or written consent of all of the members [u]nless otherwise provided in a [LLC] agreement.”⁴² The assignee receives only the right to participate in sharing the profits and losses of the LLC.⁴³ At the same time, the assigning member “ceases to be a member” after the assignment of all of its LLC interest.⁴⁴ An LLC agreement can ban the assignment of an LLC interest entirely: members can agree that an LLC interest is not assignable “prior to the dissolution and winding up of the limited liability company.”⁴⁵ Combined with the statute’s default rule prohibiting members from resigning from an LLC prior to its “dissolution and winding up,” the Delaware LLC Act permits restraints on the alienation of property and makes them strongly enforceable.⁴⁶

The described rule of the Delaware LLC Act imposes an approval clause for interest transfers by default and thus limits the drafting costs for the members of an LLC. Moreover, the default transfer restriction rule also includes a statutory mechanism aimed to limit the enforcement costs of the transfer restriction. As the assignee of an LLC interest does not acquire membership rights apart from the right to share the profits and losses of the LLC, while the assigning member loses his or her member-

42. tit. 6, § 18-702(a)–(b).

43. *See id.* § 18-702(b)(2). This rule applies to involuntary transfers—for example, by a court order or as the result of forfeiture—as well. As involuntary assignees are not substituted members and cannot participate in the management, an LLC interest is a limited collateral. Yet, this is not a restriction of creditors’ rights. Creditors are supposed to be aware that the law allows only partial security in dealings with LLCs and can price this risk at the contracting stage.

44. *See id.* § 18-702(b)(3).

45. *See id.* § 18-603.

46. *See id.*; *see also* tit. 6, § 18-701 (“A limited liability company interest is personal property.”). Guided by Delaware partnership law’s requirement to honor the contractual intent of the parties, Delaware courts are inclined to uphold restraints on alienation of interests also in partnership agreements. *See In re Estate of Conaway*, No. 6056-VCG, 2012 WL 524190, at *4 (Del. Ch. Feb. 15, 2012) (“[Parties] are free to restrict the transfer of partnership interests as they see fit.”).

ship status and rights, the statute creates an effective mechanism to encourage members to conform to the restriction.⁴⁷ This effectiveness is evident if the restriction is contrasted with other transfer restrictions, such as first purchase rights, which may lead to court proceedings in cases of their breach.

Notwithstanding the default approval clause, the operating agreements of the sample LLCs very often contained various contractual interest transfer restrictions. Typical restrictions were first purchase rights and different forms of buy-sell options, including tag-along and drag-along rights. Although the outcome of approval clauses is very close to that of first purchase rights, in some companies, members agreed to have both restrictions but usually as substitutes.⁴⁸ Tag-along and drag-along rights are focused towards balancing the conflicts between present and new investors and are also an exit opportunity for incumbent investors. Therefore, they are likely to be included in LLC agreements. Contingent ownership structures (buy-sell provisions) are effective mechanisms to overcome agency and hold-up problems and deadlock situations by inducing parties to negotiate and continue relations or by determining the status of one of the conflicting parties as a member of the company.⁴⁹ Hence, they are likely to appear in the agreements as well.

In the two-member sample LLCs, more than 86% left intact the default approval clause of the Delaware LLC Act. In about 43.5% of the two-member firms, the members agreed to restrict alienation of their interests by first purchase rights: the right of first refusal and, less commonly, right of first offer.⁵⁰ These rights very often, but not necessarily, substituted

47. See tit. 6, § 18-702(b).

48. The most likely explanation for using first purchase rights is that transfer consents are extremely strong means for incumbent members to affect third-party transfers and can thus encourage hold-ups. Each member, as a rule, can block such a transfer. First purchase rights, though they give incumbent members priority in purchasing the units of selling members, do not prevent third-party transfers completely. A third party can become a substituted member subject to the willingness/ability of incumbents to exercise their preemptive rights. At the same time, first purchase rights are backed up by a default approval clause in order to prevent any transfers in violation of first purchase rights. However, if a third party buyer complies with the procedure of first purchase rights, it automatically becomes a substituted member.

49. Gilles Chemla, Michel A. Habib & Alexander Ljungqvist, *An Analysis of Shareholder Agreements*, 5 J. EUR. ECON. ASS'N 93, 103–04, 111–13 (2007).

50. For a discussion of rights of first refusal versus rights of first offer, see RCM LS II, LLC v. Lincoln Circle Assocs. LLC, No. 9478–VCL, 2014 WL 3706618, at *7 (Del. Ch. July 28, 2014) (“The key difference between the [right of first refusal and the right of first offer] is when the right is activated.”). Based on the former case, the owner of securities is entitled to sell its securities to a third party only if the right-holder passes by either refusing to buy the securities at the price and upon the terms offered by (agreed with) the third-party buyer or failing to react timely. See *id.* Under a right of first offer, the owner of securities who intends to sell, but has not formalized any transaction with a third party, must inform the right-holder about the owner’s intention to sell. See *id.* If the right-holder does not timely accept the offer or the owner rejects to sell to the right-holder accord-

default approval clauses (negative correlation at 5% level).⁵¹ Drag-along and tag-along rights appeared only in 20.8% and 26.8% of the two-member firms, respectively.⁵² Tag-along rights, if adopted, almost always were subject to activation after the first purchase rights were not used. In 36.9% of the LLCs, minority members had a right to put their units to majority members or the company, and in 43.5% of the firms, majority members had a right to call the units of minority members.⁵³ The conditions for these put-call options were a deadlock event in decision-making of an agreed schedule, a default event by a member (typically a member's bankruptcy, dissolution, or a material breach of the agreement, including the provisions on interest transfer), or anytime at the discretion of a member activating the option.

The correlation analysis of interest-transfer restriction usage in the two-member sample companies shows the restrictions' importance in balancing the conflicts between the members and protecting members' rights. The minority-put right had a strong positive correlation with companies that had an express controlling member in general and controlling managing member in particular (the correlation is significant at 10% and 0.1% levels, respectively). Thus, minority members who were not able to participate in everyday decision-making, influence board decisions, or veto major decisions could sell their interests to the company or the majority member at a fair value. In these situations, minority members were also protected by default approval clauses (positive correlation at 5% level). Minority tag-along rights played an important protective role too. This right was significantly and positively correlated with companies that waived the duties of care and loyalty of the members and managers, absent minority right to affect decision-making at the board of directors level, and allowing the controlling member to amend the LLC agreement without the consent of the minority member.

In all mentioned cases, the change of control in a firm may lead to severe risk for minority members, because they do not have effective means to curb the opportunistic behavior of a new controlling member. Hence, the agreements let minority members sell in proportion with the

ing to the terms of the right-holder's offer, the owner is entitled to sell to a third party at a price that is at least equal to the price negotiated by the owner and the right-holder. *See id.*

51. The results of the correlation analysis are reported below in Appendix III.

52. A tag-along right allows minority members to mitigate the effect of a possible change of control in a firm by selling pro rata along with the controlling seller on the same terms. A drag-along right allows its holder—a large owner of securities—to force other investors to sell along with the right-holder on the same terms in a third-party control transfer.

53. Whereas, for a minority member, the identity of the buyer does not make difference, the creditors are directly effected if the buyer is the company itself, rather than the majority member. If the buyer is the company, then a minority-put right resembles a withdrawal right in the sense of liquidating some assets for buying-out a member. This limits the pool of assets available to the firm's creditors. If the buyer is the majority member, then the firm's assets are not effected.

majority member. If the majority member exits the investment fully, the minority member receives the same opportunity; or, if the majority member retains a small stake, the majority member has to share the risks of being a minority with the minority member, thus encouraging the majority member to carefully choose a buyer.

With the growth of the number of company members, most of the interest-transfer restrictions—with the apparent exception of a tag-along right—become less common. The default approval clause was used in 71% of the 3–10 member LLCs. In many cases, this clause appeared together with first purchase rights, which were used in 38.7% of the sample firms. First purchase rights were also very likely to be combined with tag-along rights of minority members (positive correlation at 0.1% level). Tag-along rights were used in these firms more frequently than in the LLCs with two members (43.5% of the sample had a tag-along right). This could be attributed to the larger number of minority members that face conflicts with controlling members. However, the use of minority-put and majority-call rights in this group of the sample firms dropped to 24.2% and 16.1%, respectively.

In the 3–10 member companies, the evidence does not support that minority-put rights have an important role in protecting investments. Tag-along rights were actively used for this purpose, in particular in companies that waived fiduciary duties of members and managers or granted important decision-making rights to controlling members, which included rights to unilaterally amend the operating agreement and approve mergers (the correlations are significant mostly at 5% and 10% levels). The default approval clause and first purchase rights were used to prevent interest transfers to outsiders where an LLC had a controlling-managing member or a member with a power to affect decision-making by the board of directors. It is difficult to speculate whether these two provisions played a major role in protecting minority members. While this finding could suggest a special relationship between the two groups of members and minority investor reluctance to give away guarantees that stem from these relations by preventing control changes, the causation can also be reversed and the provision's use in LLC agreements could be motivated by strong controlling members who desire to prevent interest transfers by minority members to third parties. The latter, by locking minority members, can exacerbate majority-versus-minority conflicts.

In the sample companies with more than ten members, the default approval clause was used in 64.5% of cases. Contrary to the LLCs with few members, the approval often had to be given by the board or the managing member, rather than by each member. Additionally, the restriction was not likely to appear together with other strong minority rights, such as special conflict-of-interest rules for self-dealing transactions by members (negative correlation at 10% level) and managers (negative correlation at 5% level) and company purpose limitations (negative correlation at 5%

level). These data suggest that the right was an instrument for large members to control interest transfers by minority members. First purchase rights were used in only 41.9% of the sample firms with a large number of members. Drag-along and tag-along rights appeared in 51.6% and 58% of cases, respectively. However, put-call options were extremely rare: only two firms provided minority members with put-options and none had call rights for majority members. As is shown below, the rights and interests of minority members in these firms were protected by other means.

D. *Continuity of Life, Dissolution, and Member Withdrawal*

The Delaware LLC has a perpetual existence that is not terminated by the withdrawal of its members, unless otherwise provided in the LLC agreement.⁵⁴ From an organizational perspective, this is justified because the limited liability of the LLC members eliminates the need to permit each withdrawing member to trigger dissolution.⁵⁵ On the other hand, LLC units are typically illiquid investments; hence, some sort of investment liquidation option is needed to dissolve the LLC. The Delaware LLC Act offers such an option only if it is specifically included in an LLC agreement.

Indefinite existence means that if an LLC has not been formed for a limited period of time specified in the LLC agreement, it has perpetual existence and can only be dissolved in the cases defined by the statute. These cases are few. First, an LLC is dissolved upon the occurrence of events specified in the LLC agreement, for instance, after fulfilling the purpose for which the LLC has been formed.⁵⁶ Second, an LLC dissolves upon the affirmative vote or written consent of its members, who hold more than 2/3 of the interest in the LLC's profits.⁵⁷ This default rule can be changed by an LLC agreement, meaning that either the voting threshold can be changed or the right to dissolve by vote or consent can be modified or waived completely. Third, an LLC dissolves at any time there are no members.⁵⁸ Finally, an LLC can be dissolved by a court if it is not reasonably practicable to carry on its business in conformity with the LLC agreement.⁵⁹

Delaware courts very carefully approach their right to dissolve an LLC and consider judicial dissolution of LLCs as “*a limited remedy that Delaware*

54. See DEL. CODE ANN. tit. 6, § 18-801(a)(1) (2015).

55. In partnerships, the withdrawal of general partners not accompanied by dissolution rights leads to a situation where a withdrawing partner cedes his or her decision-making rights, though the partner remains liable to the partnership's creditors that pre-dated the withdrawal. See Friedman, *supra* note 9, at 86–87. This situation offers a reach ground for the remaining partners to engage in abusive acts. See *id.*

56. See tit. 6, § 18-801(a)(2).

57. See *id.* § 18-801(a)(3).

58. *Id.* § 18-801(a)(4).

59. *Id.* §§ 18-801(a)(5), 18-802.

*courts grant sparingly.*⁶⁰ Courts will not dissolve an LLC merely because it is not profitable or has not met the original expectations of the members.⁶¹ Section 18-802 of the Delaware LLC Act also does not entitle courts to order the dissolution of an LLC if the company violates the provisions of the LLC agreement.⁶² The Delaware Court of Chancery defined two cases where judicial dissolution of an LLC can be granted. First, where there is a deadlock that, given the ownership structure of the LLC (including not only joint ventures between two partners with equal interests, but also two ownership fractions with equal interests), prevents it from operating.⁶³ Second, “where the defined purpose of the [LLC] is fulfilled or is impossible to carry out.”⁶⁴ However, where the purpose of an LLC is defined broadly in the LLC agreement (e.g., any lawful act or activity), it is rather difficult to prove that it is no longer reasonably practicable for an LLC to operate in accordance with its broad purpose clause.⁶⁵ Moreover, “even in cases where the standard for dissolution [is] met,” it is within the equitable discretion of the Court of Chancery to “decide whether it should issue a decree of dissolution.”⁶⁶ Indeed, nothing prevents LLC members from agreeing in the LLC agreement to additional grounds that may lead to the judicial dissolution of the LLC—such as violation of minority interest holders’ rights—or complete waiver of the possibility of judicial dissolution based on statutory grounds.⁶⁷ In a recent

60. *Wiggs v. Summit Midstream Partners LLC*, No. 7801–VCN, 2013 WL 1286180, at *12 (Del. Ch. Mar. 28, 2013) (emphasis added) (internal quotation marks omitted).

61. *In re Arrow Inv. Advisors, LLC*, No. 4091–VCS, 2009 WL 1101682, at *2 (Del. Ch. Apr. 23, 2009) (“[S]uch events are, of course, common in the risk-laden process of birthing new entities in the hope that they will become mature, profitable ventures.” (emphasis added)).

62. *See Seneca Invs. LLC v. Tierney (In re Seneca Invs. LLC)*, 970 A.2d 259, 263 (Del. Ch. 2008) (“The role of this Court in ordering dissolution under § 18–802 is limited, and the Court of Chancery will not attempt to police violations of operating agreements by dissolving LLCs.” (emphasis added)).

63. *See Phillips v. Hove*, No. 3644–VCL, 2011 WL 4404034, at *26 (Del. Ch. Sept. 22, 2011); *In re Silver Leaf, LLC*, No. 20611, 2005 WL 2045641, at *10–11 (Del. Ch. Aug. 18, 2005) (“The vote of the members is deadlocked and the Operating Agreement provides no means around the deadlock.”); *Haley v. Talcott*, 864 A.2d 86, 95, 97–98 (Del. Ch. 2004) (finding that due to deadlock between parties and absence of reasonable exit mechanism in LLC agreement, it was not reasonably practicable for LLC to continue to carry on business in conformity with LLC agreement).

64. *See Wiggs*, 2013 WL 1286180, at *12.

65. *See id.* at *13; *Seneca Invs.*, 970 A.2d at 263. *But see Silver Leaf*, 2005 WL 2045641, at *11 (looking instead at actual purpose of LLC based on its past activities).

66. *See In re Mobilactive Media, LLC*, No. 5725–VCP, 2013 WL 297950, at *33 (Del. Ch. Jan. 25, 2013) (exercising its equitable powers, court denied request for dissolution of LLC); *Vila v. BVWebTies LLC*, No. 4308–VCS, 2010 WL 3866098, at *6 (Del. Ch. Oct. 1, 2010).

67. *See Huatuco v. Satellite Healthcare & Satellite Dialysis, LLC*, No. 8465–VCG, 2013 WL 6460898, at *5–6 (Del. Ch. Dec. 9, 2013); *R&R Capital, LLC*

judgment, however, the Delaware Court of Chancery ruled that statutory judicial dissolution is not the sole exclusive extra-contractual means of obtaining dissolution of an LLC; under specific circumstances, the court has an equitable power to dissolve an LLC.⁶⁸ Although this case has very specific circumstances and the court's judgment only created an equitable standing for de facto LLC members to seek judicial dissolution of an LLC, the move suggested that the Delaware court is not hostile to the idea that, in addition to the two statutory causes for judicial dissolution, it can rely on parallel equitable causes for dissolving a solvent LLC.

“[T]he death, retirement, resignation, expulsion, bankruptcy or dissolution of any member,” or the termination of membership in any other cases, does not lead to the dissolution of an LLC; however, this rule can be changed by an LLC agreement.⁶⁹ Similarly, the Delaware LLC Act imposes a default rule, according to which a member cannot resign from the LLC prior to its dissolution and winding up.⁷⁰ The cases where such resignation is possible prior to the dissolution and winding up of an LLC should be specified in the LLC agreement.⁷¹ This rule is combined with the restricted transferability of an LLC interest.

Taking into account the approach of the Delaware legislature and courts that minority holders of illiquid stocks and LLC units can use contractual corporate governance instruments to protect their interests—rather than expect courts to grant them ad hoc buy-out rights on a case-by-case basis—it is highly expected that such instruments can be found in stockholders' and LLC agreements. This is particularly true where opportunistic behavior by controlling parties is likely. Dammann and Schündeln have found evidence that LLCs are more likely to be formed in states with strong oppression rights—rights granting local courts the power to dissolve companies as a means of last resort when controlling members oppress minority members.⁷² Against this background, it is more likely that the LLC agreements of Delaware LLCs will either change the default rule of the statute in order to provide for broader grounds for judicial dissolution or employ substitute mechanisms that offer protection for minority investors. These mechanisms aim to prevent minority oppres-

v. Buck & Doe Run Valley Farms, LLC, No. 3803–CC, 2008 WL 3846318, at *6 (Del. Ch. Aug. 19, 2008).

68. See *In re Carlisle Etcetera LLC*, 114 A.3d 592, 601 (Del. Ch. 2015). Earlier in *Huatico*, the Delaware Court of Chancery upheld the contractual waiver of the right to seek statutory dissolution under Section 18-802, but reserved decision on “[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in all circumstances, even where it appears manifest that equity so requires.” See *Huatico*, 2013 WL 6460898, at * 1–2, *5–6 (emphasis added). *Huatico* implies that courts might create equitable grounds for judicial dissolution where LLC members are locked without any alternative exit options.

69. See DEL. CODE ANN. tit. 6, § 18-801(b) (2015).

70. See *id.* § 18-603.

71. See *id.*

72. See Dammann & Schündeln, *supra* note 22, at 757.

sion, for example, via unanimous voting and minority member veto rights, or can provide ex post exit options to minority investors in the form of buy-sell options, tag-along and drag-along rights, and resignation rights (at will or upon the occurrence of specific events).

Only one-quarter of the sample firms were formed for limited time periods, which, however, were too long to consider these restrictions as constraints on controlling members and managers. With the shortest lifetime of eight years and the longest of ninety-nine years, an average LLC with a definite existence was formed for forty-one years. The typical limited time period was fifty years. Therefore, mandatory liquidations cannot be regarded as a widespread instrument to discipline insiders by compelling them to distribute company ownership among the investors after liquidation and by incentivizing reputation-building.⁷³

None of the sample firms expanded judicial dissolution by agreeing on additional grounds that would authorize a court to issue a dissolution order, such as minority oppression, but a few of them waived the default statutory grounds for judicial dissolution. The most common of these waivers were in the sample firms with two members (12.5% of the sample), which perhaps has to do with this group's highest probability of facing decision-making deadlocks due to their ownership structure and the unanimous voting requirements in their LLC agreements.

As shown above, the minority members in the sample firms, particularly those companies with two members, were protected by minority-put rights. Tag-along rights and other transfer restrictions were important as well. In addition to this, the operating agreements of the sample companies contained unanimous voting requirements and minority veto rights for major decisions. In the companies with two or more minority members, these rights could also take the form of requiring the consent of several large minority members (rather than all of them) or, in addition to the vote of controlling members, establishing a condition to receive the majority vote of minority members for approving decisions. Minority voting rights could also be conditional and would terminate if the right-holders reduced their holdings below a certain level of the total company capital or their original interest.

Unanimous voting rights were actively practiced in the two-member LLCs in which the members had equal voting rights. In cases where the managing member had a minority interest, large investors used veto rights for major decisions to prevent opportunistic self-dealing by the minority-managing member (positive correlation at 10% level). Unanimous or majority-of-the-minority voting rights were also used to protect minority members in LLCs with more than ten members where the company waived the fiduciary duties of the managers. While also used in the 3–10-member

73. For a similar conclusion in the context of listed LLCs and LPs, see Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 580 (2012).

firms, the data do not point to these rights' role as substitutes for modified traditional investor protection mechanisms.

Some firms entitled their members to the right to dissolve the company in cases of deadlock, default by the other member (breach of the agreements or failure to make promised investments), or at anytime at their discretion. This is an extremely strong minority protection right—particularly if it allows activation at the right-holder's discretion at anytime—that can substitute for many other investor protection rights. Any action by the other member that oppresses the rights and interests of the right-holder can lead to the withdrawal of capital. On the other hand, the unchecked ability to threaten company dissolution, especially in the case of relation-specific investments, can be used strategically by right-holders to fully or partially deprive the other party of the expectations it had when it was making an investment.⁷⁴ Hence, the dissolution right had restricted use and was most often used in the two-member firms (13.3%), followed by the 3–10-member LLCs (8.9%); only one firm with more than ten members provided its members with a unilateral dissolution right.

It was not an accepted practice to condition LLC dissolution upon the resignation, retirement, expulsion, death, bankruptcy, or dissolution of its members. The right of members to resign unilaterally by receiving the fair value of their interest or the full initial interest was an exception as well.

E. Amending the LLC Agreement

The default rule of the Delaware LLC Act is that the LLC agreement may be amended with the approval of all of the LLC members.⁷⁵ This default rule can be modified by the parties of an operating agreement via substituting the unanimous-vote requirement with another standard, including one that allows amendments without the vote or approval of any member or class or group of members.⁷⁶ The amendments may also require the consent of non-members, such as managers or other third parties.

In almost 83% of the two-member LLCs, the amendments of the LLC agreements required the approval of both members, irrespective of their voting rights. Another 6% of the firms imposed a supermajority-voting threshold. In the remaining companies, amendments were possible either by the vote of a simple majority or by the decision of a board of directors. In thirteen companies (7.7% of this ownership group), there was a member that could amend the agreement unilaterally, either directly or through its control of the board. Unanimous and supermajority voting were less common among the 3–10 member firms (33.9% and 22.6%, respectively). In the LLCs with more than ten members, the unanimity re-

74. See Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 Nw. U. L. REV. 216, 232–33 (1992).

75. See tit. 6, § 18-302(f).

76. See, e.g., *id.* § 18-302(a).

quirement was never used, but approximately 22% had a supermajority voting requirement. The remaining firms allowed the majority of their members to make the amendment decisions. In the latter two ownership groups, there were more companies where one controlling member could amend the operating agreement without the consent of the other members.

The typical means for protecting minority members against abusive actions of the controlling members entitled to amend the operating agreements by their sole decision were (1) the requirement to put the matter to a minority vote if the amendments adversely affected the rights of the minority members; (2) a ban on amending certain provisions in the agreements; and (3) a tag-along right of the minority members allowing them to exit the firm if change of control occurred. Additionally, minority members may always resort to the implied contractual covenant of good faith and fair dealing in cases where the controlling member attempts to take away any minority right negotiated at the stage of making investments, though relying on this standard alone implies higher litigation costs.⁷⁷

F. *Ownership Structure and Member Contributions*

The Delaware LLC Act affords maximum flexibility with regard to member contributions. In addition to tangible contributions, the Act allows individuals to obtain membership interest in exchange for a promise to pay in the future (promissory notes) or to provide some future services (e.g., to conduct the daily management of an LLC).⁷⁸ The Act goes further to allow individuals to be admitted as members without obligating them to make a contribution.⁷⁹ In addition, unless otherwise provided in an LLC agreement, a person may be admitted to an LLC as a member without acquiring an LLC interest.⁸⁰

The ownership structure of the Delaware LLC is flexible as well. An LLC agreement may provide for classes or groups of members having such relative rights, powers, and duties as provided in the LLC agreement. Moreover, certain classes or groups of members may be sidelined from voting on actions specified in an LLC agreement, including such actions

77. See Thomas E. Rutledge, *Minority Members and Operating Agreements*, 10 J. PASSTHROUGH ENTITIES 21, 22 (2007).

78. See tit. 6, § 18-501.

79. See *id.* § 18-301(d). It is necessary to distinguish two different situations with regard to this provision. Substituted members (i.e., the transferees of units from other members) usually do not make new contributions to the firm; they succeed the contributions of the former members. For initial members and purchasers of units directly from a company, however, we would traditionally expect some contribution.

80. See *id.*

as the amendment of the LLC agreement or the creation of a new class or group of LLC interests.⁸¹

In most of the sample, flexible statutory rules to form the assets of the companies were not demanded. A few firms issued units to their initial or new members without requiring any contribution in return. These were, typically, cases where the managers and employees were issued incentive units that could be redeemed by the companies after employment termination. Indeed, this practice was more common in LLCs with more than two members, because employee participation increased with the number of the members. In several cases, contributions were made in the form of promissory notes and future services. Two firms allowed members to be admitted without issuing units.

The use of different classes of units was not common either. In the LLCs with two members, the rare cases where units were issued with different rights to the members were aimed to provide their holders' distribution and liquidation preferences. In companies with more members, different classes of units, when issued, usually included non-voting units issued to employees within incentive schemes and very seldom included units with enhanced voting rights. The likely explanation for sticking to the parity between economic and voting rights is related to the flexible management structure of LLCs. If one of the members is an investor without an active role, the direct way of giving strong control rights to an entrepreneur is to appoint the latter as the managing member of the firm. A dual-class unit structure makes sense only if an investor wishes to receive a guaranteed cumulative interest rate on investments or needs a liquidation preference.

Series LLCs were not popular either: only four firms were formed as series LLCs (less than 1.5% of the sample). In many situations, the results of using series can be achieved by establishing separate subsidiary entities. It is not clear whether the creation of different series in such situations simplifies corporate structures. There are cases, however, where the creation of series can make difference. One of the sample firms, Windermere Mortgage Services Series LLC, was formed to offer home loans. It had twenty-one series, which each allocated assets and liabilities in the business and represented one or several closely located sales offices. The series were jointly controlled by HomeStreet Bank and different brokerage franchise owners. As a result, the sales offices were legally isolated without the need to establish separate legal entities and to apply for separate licenses.⁸²

Almost 70% of the sample—mostly due to the fact that many sample firms were member-managed and one or more members were the manag-

81. *See id.* § 18-302(a).

82. For more ideas when the use of series LLCs is likely, see Allen Sparkman, *Through the Looking Glass: Series LLCs in 2015*, 18–20 (2015), available at <http://ssrn.com/abstract=2591548> [<http://perma.cc/22GZ-C4TX>].

ers—had managers holding membership units. The answer to the question of whether management holdings could align the interests of the managers with those of the other members is not straightforward. Although management holdings can be incentivizing, the sample firms were not subject to constant valuations by the market. Therefore, the results of bad management and opportunistic self-dealing were not easily reflected in the unit prices. Not constrained by regular market valuations, the managers and controlling members also had more freedom to choose actions during corporate conflicts with other members.

More effective in incentivizing managers were, perhaps, management incentive distributions—special provisions of the operating agreements promising more share in a company's profit after the distribution of an agreed level of profits to its members. For instance, as long as the distributed profit is below the agreed level, managers receive the same amount of distributions as other members. But after profits exceed this level, the share of management distributions increases at the expense of distributions to other members. The increase in management distributions could be gradual after passing certain minimum levels. Such incentive schemes were used in 11.9% of the two-member firms and in 18.6% of the LLCs with more than ten members. These schemes were hardly used in the 3-10-member firms (less than 2% of the sample).

Another profit distribution practice among the sample companies was to include specific target distribution clauses in their operating agreements requiring a minimum share of regular distributions to be made to the members. This obligation could be waived by the vote of the members on an ad hoc basis before making monthly/quarterly/annual distributions. Hence, under this provision, the traditional default rule for profit distribution is reversed—a regular distribution of profits is the rule, and without member approval the company cannot retain profits.

Theoretical literature attaches an important investor-protection role to minimum profit distribution provisions; by compelling the management and controlling members to distribute company cash, they reduce the discretion of the insiders in using the resources of the company.⁸³

The share of the firms among the sample two-member LLCs that included specific target distribution clauses in their operating agreements was almost two-thirds of the total sample. This share dropped to 41.9% in the 3-10-member firms and further dropped to 10.2% in the companies with more than ten members. By reducing the retained cash, the parties of the operating agreements limited management discretion in cases where the manager was a minority member in the two-member firms and where the manager was a controlling member in the 3-10-member firms

83. See Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 655 (1984); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986); see also RIBSTEIN, *supra* note 3, at 209–10.

(in both cases the statistical significance of the positive correlations is below 5%). In addition to requiring minimum distributions in the first group, the discretion of the management was also reduced by other mechanisms, such as (1) large transaction rules (requiring member approval for transactions above a certain amount); (2) conflict of interest rules for managers (requiring the consent of the non-interested member); and (3) company-purpose limitation clauses (defining specific fields or types of operations, or both, for the company business). In the 3-10-member LLCs, minimum distribution obligations were combined only with company-purpose limitation clauses. In general, purpose limitation clauses, with the exception of the firms with more than ten members, were widely used to limit management discretion.

Unlike in listed LLCs, specific target distribution rights, were defined narrowly if used in non-listed LLCs. The broad language of such provisions in listed non-corporate entities stems from granting management the discretion to define “available cash” for the purpose of making distributions.⁸⁴ In the sample firms, this discretion was trimmed in many cases by either specifying the exact share of distributions in net profits or, more frequently, by requiring the consent of each member to define the amount of cash available for distributions. The easiest way to do this is to provide each of the small number of company members with consent rights. Hence, the relatively smallest share of broadly defined specific target distribution provisions were in the two-member firms, while the companies with more than ten members usually opted for broad definitions.

New capital calls are a common means for financing growing firms. They are also an additional burden for the incumbent members and can be used by the majority to diffuse the holdings of minority members. The sample firms typically used two strategies to address these problems. One strategy was to grant preemptive rights to members by allowing them to buy a proportional share of new offered units before the units were issued to the other members or third parties. This strategy was commonly used where the number of company members was more than two. Preemptive rights were also used in the LLCs with two members, but only in less than 17% of those firms. It was more common to grant each member a right to block new issuances. The latter mechanism is preferable for minority members because it allows them to preclude dilution of minority interest without investing additional capital. However, it can impede business development if the number of minority members is large and each member can opportunistically block new capital calls. Both strategies are purely contractual in the sense that they are applied only if so agreed by the members of Delaware LLCs.

84. See Manesh, *supra* note 73, at 579.

G. *Fiduciary Duties*

The freedom to contract out of fiduciary duties is one of the principal differences between Delaware LLCs and corporations. Initially, the Delaware LLC Act was not clear on the elimination of fiduciary duties; the statute used the wording “duties . . . may be expanded or restricted by provisions in a limited liability company agreement.”⁸⁵ After the Delaware Supreme Court’s judgment presumably suggested that fiduciary duties could not be waived completely in partnerships and LLCs, the Delaware General Assembly amended the statute in June 2004.⁸⁶ The amendments allow the expansion, restriction, or elimination of fiduciary duties for LLC members or managers, or the limitation or elimination of any and all liabilities for breach of the fiduciary duties for LLC members or managers.⁸⁷ The Delaware Court of Chancery judgments following these amendments confirmed the legality of the waivers and, at the same time, clarified that in the absence of clear waivers in an LLC agreement, managers owed fiduciary duties to the LLC and its members, and controlling members owed those duties to minority members by default.⁸⁸ After the Supreme Court of Delaware exposed this approach to doubts in a much-publicized decision, the General Assembly again moved in promptly by amending Section 18-1104 of the Delaware LLC Act.⁸⁹ The amended act, effective August 1,

85. DEL. CODE ANN. tit. 6, § 18-1101(c) (2015).

86. Lyman Johnson, *Dynamic, Virtuous Fiduciary Regulation* (Wash. & Lee Legal Studies Paper No. 2013-14), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2273869 [<http://perma.cc/Q4CS-62FC>].

87. See 74 Del. Laws 275 (2004).

88. See, e.g., Phillips v. Hove, No. 3644-VCL, 2011 WL 4404034, at *24 (Del. Ch. Sept. 22, 2011) (“Unless limited or eliminated in the entity’s operating agreement, the member-managers of a Delaware limited liability compan[y] owe traditional fiduciary duties to the LLC and its members.”); *In re Atlas Energy Res., LLC*, No. 4589-VCN, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010) (“[I]n the absence of explicit provisions in a limited liability company agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the limited liability company context.”); Kelly v. Blum, No. 4516-VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) (“Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act Delaware cases interpreting Section 18-1101(c) have concluded that . . . ‘in the absence of a contrary provision in the LLC agreement,’ LLC managers and members owe ‘traditional fiduciary duties of loyalty and care’ to each other and to the company.” (footnote omitted)); Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) (“[I]n the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC.”).

89. See Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1219 (Del. 2012) (“[T]he merits of the issue whether the LLC statute does—or does not—impose default fiduciary duties is one about which reasonable minds could differ.”); David Benoit, *Delaware Supreme Court Judge Gives Strine Another Lash*, WALL ST. J., Mar. 21, 2013, <http://blogs.wsj.com/deals/2013/03/21/delaware-supreme-court-judge-gives-strine-another-lash/> [<http://perma.cc/E9GK-SUYB>]; Peter Latzman, *In Unusual Move, Delaware Supreme Court Rebukes a Judge*, N.Y. TIMES, Nov. 9, 2012, <http://dealbook.nytimes.com/2012/11/09/in-unusual-move-the-dela->

2013, confirms that the rules of law and equity relating to fiduciary duties apply to LLCs by default.⁹⁰

Thus, Delaware LLCs allow their members to (1) expand, restrict partially, or waive in full the fiduciary duties of members or managers, with the exception of the “implied contractual covenant of good faith and fair dealing,”⁹¹ or (2) limit or eliminate liability for breach of fiduciary duties, with the exception of acts violating the implied contractual covenant of good faith and fair dealing in bad faith (exculpation provisions).⁹² The second option means that LLC members and managers continue to owe fiduciary duties, and courts may grant positive or negative injunctions with regard to their acts; however, these members and managers cannot be held liable (or will incur only limited liability, as applicable) for damages caused by the breach of their fiduciary duties.⁹³

In LLCs with a small number of members, the concept of offering fiduciary duties by default is reasonable. The absence of the default rule creates possibilities for opportunistic behavior and increases transaction costs in cases where the duties are needed. As the initial drafters of the agreement are usually those who would benefit from opportunistic behavior, they have fewer costs opting out of duties than minority investors have in opting in. More controversial is the question of whether this should be a default rule. There are some strong arguments that in the LLC setting, these duties are often not necessary. Where LLCs have only a few members with large interests, or even those that are fully controlled by one member, members can rely on their control rights to discipline managers instead of fiduciary duties. Additionally, in small LLCs, members or managers are typically involved in day-to-day activities and do not bear high monitoring costs.⁹⁴ These members and managers can often be involved in extensive dealings with the company, and strict duty of loyalty rules may create unnecessary costs of compliance.⁹⁵ Moreover, under some circumstances parties can benefit from their waiver, for instance, to prevent ex post speculative litigation. On the other hand, the right to waive fiduciary duties can become an unlimited license in the hands of controlling insiders to engage in self-dealing and to expropriate business opportunities at the expense of the firm and its outside investors.

ware-supreme-court-rebukes-a-judge/ [http://perma.cc/Y3KP-Y3VC]. For more details on the disagreement between the two Delaware courts, its context, and possible reasons, see Mohsen Manesh, *Damning Dictum: The Default Duty Debate in Delaware*, 39 J. CORP. L. 35, 41–48, 62–64 (2013).

90. See 79 Del. Laws 74 (2013).

91. See DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (2015).

92. See *id.* § 18-1101(e).

93. See *Solar Cells, Inc. v. True N. Partners, LLC*, No. 19477, 2002 WL 749163, at *4, *8 (Del. Ch. Apr. 25, 2002).

94. Friedman, *supra* note 9, at 80–81.

95. See *id.* at 81.

In order to establish the actual role of fiduciary duties in the sample firms, the duties were divided into two main groups—the duty of care and the duty of loyalty. The latter, in turn, includes the component that prevents opportunistic self-dealing and the duty not to compete with the firm. This classification was used to define the scope of fiduciary duties of members and managers in all sample firms and the extent of their liability for the breach of these duties.

The waivers of the members' duty not to compete with the firm were quite common in all sample firms.⁹⁶ In the two-member firms, this duty was waived in 69% of the sample. Half of the LLCs with 3–10 members waived non-competition duty as well. The corresponding share of LLCs with more than ten members was the lowest: only in 27.1% of these firms were the members free to compete with the firm. Along with the members, many firms also waived the duty for managers, though the employment contracts with managers, which are outside the scope of this study, could have contained separate non-competition obligations.

The waivers and modifications of other fiduciary duties were not common. One-quarter of the firms with two members waived or modified both fiduciary duties for members. Almost the same share of the LLCs waived or modified these duties for managers. The waivers and modifications of fiduciary duties, however, did not affect all managers; in half of the firms, the duties of care and loyalty were waived only for board members, but not for officers or managing members. As indicated earlier, in the two-member sample firms, boards often replaced member meetings and the company directors acted more like member representatives. Even where boards of directors do not replace member meetings, in firms with a small number of members, it is common practice to entitle each member with a right to appoint directors that will represent their interests. In such cases, members intend that directors will promote the interests of the members who appointed them. Standard fiduciary duties can imperil such intentions. But waivers or modifications allow directors to fetter their discretion to make independent judgments as company directors ensured by fiduciary duties and to act in the interests of particular members. Under these circumstances, what becomes more important are the duties of the members to each other and their ability to compel the directors they appointed to approve decisions that unfairly promote the interests of some members at the expense of others.

Therefore, where the operating agreements waive or modify the fiduciary duties of the members and managers, it is reasonable to expect the

96. Non-competition duty is required in joint ventures where each founder can individually pursue the project either from the beginning or after accessing information and technology provided by the other founder. But many joint ventures do not face strong risks of parent competition. For example, in real estate-related firms, due to their limited purpose and property ownership, parent competition requires large investments to buy and develop similar properties. This may marginalize the role of non-competition obligations.

regulation of member and manager conduct by contractual alternatives that can achieve similar results to waived fiduciary duties. Contractual substitutes can be large transaction rules that require special approval procedures, such as member consent, for transactions above a certain amount, or special conflict-of-interest rules for a company's transactions with its members and managers. The latter can take the form of specific stand-alone procedural rules that require the consent or vote of non-interested members/managers to approve transactions in which a member or manager (or a group) is interested, or standards that establish requirements of fair price (e.g., terms of the transaction shall be substantially equivalent to the terms of a comparable unaffiliated transaction).

Under stand-alone procedural rules, compliance with these rules precludes any possible judicial review of the underlying transaction under the entire fairness standard. Hence, the transaction is never voidable if the contractually prescribed procedure of approval is met.⁹⁷ When relying on the fairness standard, which is, in effect, a contractually created fiduciary duty of loyalty, the manager or member can either bear the burden "to perform a reliable market check or valuation analysis *ex ante* or bear the risk of any uncertainty that exists *ex post*."⁹⁸ The contractual standard of fairness can be combined with a fair dealing alternative, which serves a similar role to the safe harbor provisions of corporate statutes.

There is evidence that these expectations materialized in practice and that fiduciary duty waivers did not put the minority members in a vulnerable position. In particular, it was very likely that members' duties were waived when the firm was manager-managed (positive correlation at 1% and 5% levels for duty of loyalty and duty of care, respectively). In such situations, as members do not manage the firm, waiver of their duties is

97. In the traditional corporate law setting, compliance with the procedural rules of approving interested transactions does not extinguish the duty of loyalty; such compliance either subjects the transaction to the business judgment rule (if a self-dealing transaction with a minority stockholder, director, or officer is fully disclosed and approved by disinterested directors, or the majority-of-the-minority stockholder vote or a self-dealing transaction with a controlling stockholder is conditioned upon both the approval of independent directors and informed vote of the majority-of-the-minority stockholders) or retains the entire fairness as the applicable standard of review but shifts the burden of proving the unfair nature of the transaction to the plaintiff (if an interested transaction with a controlling stockholder or its affiliates is approved by an informed majority-of-the-minority vote or by disinterested directors). See *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014); *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1213 (Del. 2012); *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115-17 (Del. 1994); *In re Wheelabrator Techs., Inc. S'holders Litig.*, 663 A.2d 1194, 1203 (Del. Ch. 1995).

98. See *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 795 A.2d 1, 27 (Del. Ch. 2001), *aff'd in part, rev'd in part*, 817 A.2d 160 (Del. 2002); see also *Gatz*, 59 A.3d at 1213.

not likely to negatively affect minority rights as long as managers owe fiduciary duties to the members and to the firm.⁹⁹

The problem is that the fiduciary duties of members and managers, as a rule, were waived in the same companies. However, as mentioned earlier, in half of the two-member firms, the waivers and modifications of managers' fiduciary duties left intact the duties of the managing members and company officers. Hence, the managing members were not bound by the fiduciary duties in only one-eighth of the firms. Additionally, in the sample two-member LLCs where the managers had no fiduciary duties, the operating agreements imposed special conflict-of-interest rules for related-party transactions with members. This means that every time the company engaged in a self-dealing transaction with a member or its affiliate, no matter whose competence was to approve the transaction, it should have been either approved by non-interested members (their board representatives) or entered at arm's-length terms. More common were clear procedural conflict-of-interest rules, rather than standards. Finally, conflict-of-interest rules for managers were widely used in the LLCs where there were managing members with minority interests, or controlling members that had the majority of board votes or were managing members (in both cases the correlation is positive at the 1% level). These rules aimed to protect large investors in the former situation and minority members in the latter.

The story, however, does not end here. If it was uncommon to waive or modify the duties of loyalty and care in the two-member LLCs without the members agreeing to contractual alternatives, very often the LLC agreements of these companies limited the liability of members and managers for breaching their fiduciary duties. In more than half of the companies, the members were not liable for the breach of their fiduciary duties, and in more than three-quarters of the LLCs, the managers were exculpated for breach of the fiduciary duties. Although in some cases exculpation clauses were for directors and did not apply to officers, the large share of firms that exculpated members and managers from the breach of their fiduciary duties is alarming for minority members. The correlation analysis does not hint that limiting the liability of members and managers who breach their fiduciary duties made the parties of the LLC agreements

99. The default rules of the Uniform Limited Liability Company Act (Section 409(h)) and the Revised Uniform Limited Liability Company Act (Section 409(g)) state that a member in a manager-managed LLC does not owe fiduciary duties to the company or to the other members but managers do. *See* Revised Uniform Limited Liability Company Act § 409(g)(5) (2006) (“In a manager-managed limited liability company, the following rules apply: . . . A member does not have any fiduciary duty to the company or to any other member solely by reason of being a member.”); Uniform Limited Liability Company Act § 409(h)(1) (1996) (“In a manager-managed company: (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member . . .”).

use alternative contractual rights to compensate for the risks created by such liability limitation clauses.

A closer look at the exculpation clauses, however, points to their limited scope. Only in exceptional cases was the limitation of liability for the breach of fiduciary duties full for both members and managers (five firms with two members, or 3.2% of the sample, fully exculpated their members and managers). Cases where the operating agreements carved out parts of fiduciary duties from these liability limitation clauses were common. Typical carve-outs included fiduciary obligations not to engage in willful or intentional misconduct or in behavior that is grossly negligent. Other common carve-outs from exculpation clauses, though less common than the former, were prohibiting actions not done in good faith, refraining from engaging in fraudulent conduct, or knowingly violating (criminal) law. These carve-outs in all sample firms were often used together and rarely acted as substitutes.

The carve-outs did not create or establish the scope of any duties; rather, they defined the extent of the liability of the fiduciaries. As long as the fiduciary duties of the members and managers were not completely waived, the members and managers were liable for the breach of the duties of care or loyalty to the extent defined by the carve-outs.¹⁰⁰ The typical carve-outs of the operating agreements were those listed in Section 409(c) of the Uniform Limited Liability Company Act¹⁰¹ as elements of the duty of care: “grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.” Therefore, as long as the duty of

100. The carve-outs were applicable not only in the context of fiduciary duties, but also in the breaches of contractual provisions, including the contractual substitutes of fiduciary duties. For instance, if an LLC agreement waived fiduciary duties but imposed an arm’s-length standard for self-dealing, carve-outs, such as willful misconduct and bad faith actions, did not allow self-dealing members and managers to benefit from liability limitation provisions. *Cf.* Dawson v. Pittco Capital Partners L.P., No. 3148–VCN, 2012 WL 1564805, at *29 (Del. Ch. Apr. 30, 2012) (determining breaches of duties listed in carve-outs can be analyzed as either breach of contract claim or breach of fiduciary duty claim).

101. *See* Uniform Limited Liability Company Act § 409(c). The Uniform Limited Liability Company Act was prepared by the National Conference of Commissioners on Uniform State Laws and was promulgated in 1994. *See id.* prefatory n. It was promulgated in 1995 and amended in 1996. *See* UNIF. L. COMM’N, *Why States Should Adopt RULLCA*, <http://www.uniformlaws.org/Narrative.aspx?title=Why%20States%20Should%20Adopt%20RULLCA> [<http://perma.cc/D8NU-ZDLZ>] (last visited Nov. 17, 2015). It had been adopted by nine states. *See* Uniform Limited Liability Company Act prefatory n. In December 2006, the National Conference published the Revised Uniform Limited Liability Company Act, which by February 2015 had been enacted by twelve states. *See* UNIF. L. COMM’N, *supra*, *Legislative Fact Sheet*, [http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20\(2006\)%20\(Last%20Amended%202013\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013)) [<http://perma.cc/W4WC-RDAC>]. Updated information on the enactment status of the Revised Act is available through the website of the National Conference of Commissioners on Uniform State Laws. *See id.*, *Legislative Enactment Status*, [http://www.uniformlawcommission.com/LegislativeMap.aspx?title=Limited%20Liability%20Company%20\(2006\)%20\(Last%20Amended%202013\)](http://www.uniformlawcommission.com/LegislativeMap.aspx?title=Limited%20Liability%20Company%20(2006)%20(Last%20Amended%202013)) [<http://perma.cc/454L-FSW3>].

care was not waived completely, the exculpation provisions did not cover large parts of this duty, and fiduciaries were liable for its breach. In most cases, the standard for liability was gross negligence; a stricter standard of reasonable or ordinary care was not practiced. The result was a standard of liability similar to the standard that results from application of the business judgment rule.¹⁰² In this way, the sample LLCs actually relaxed the standard of review for the duty of care and created a contractual equivalent of the corporate business judgment rule (see Figure II). The primary motivation for this was, perhaps, to make it clear to the members (and ex post decision-makers) that members and managers were not liable for their poor investment and management decisions.¹⁰³ Depending on the scope of the carve-outs, the extent of liability differed from company to company.

It is true that, unlike the duty of care, carve-outs usually do not cover the duty of loyalty or any parts of it. Because in the most wanting cases—namely, control of daily management and board of directors—this duty was substituted with special conflict-of-interest rules, the fiduciaries' limitation on liability for the breach of their duty of loyalty was not of much importance. Even if liability for the breach of the common law duty of loyalty was limited, the members and managers were liable for the breach of their contractually created duties—be this in the form of special stand-alone procedural rules for approving interested transactions or in the fair price standard. The only situations where the exculpation clauses could limit the liability of the members and managers for the breach of their contractual duties were the cases where the operating agreements exculpated them not only for the breach of their fiduciary duties, but also for any duties and obligations arising out of contracts. These cases, however, given the role of contractual agreements in regulating the relations between the members of non-listed LLCs, were very rare.

The situation observed in the sample firms with 3–10 members was similar. The duties of care and loyalty were waived or modified in 21.4% of the firms for members and in 23.2% of the LLCs for managers. In almost half of the cases, the waivers and modifications of the managers' fiduciary duties affected only the board members. It was very likely that in

102. For a comparison of the standards of review for the duty of care in general and the gross negligence standard of liability in particular for partnerships and LLCs with the standard of review under the business judgment rule, see Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 359–61, 365, 369 (2005) (discussing general partnerships, limited partnerships, and limited liability companies).

103. Even without carve-outs, full exculpation clauses are not likely to be enforced by courts to the maximum effect because intentional misconduct, knowing violation of law, and other similar actions are contrary to public policy. See Mark J. Loewenstein, *Freedom of Contract for Alternative Entities in Delaware: Myth or Reality?*, in RESEARCH HANDBOOK, *supra* note 8, at 28, 29. This is an alternative explanation for the described practice of contracting.

FIGURE II. FIDUCIARY DUTIES IN NON-LISTED LLCs

| OPTION | FIDUCIARY DUTY STANDARD | |
|--|---|--|
| I. FIDUCIARY DUTIES | | |
| 1.1. Default fiduciary duties | Duty of care & Duty of loyalty | |
| 1.2. Restricted fiduciary duties | Duty of care or any part of it &/or Duty of loyalty or any part of it | |
| 1.3. Fully waived fiduciary duties | No fiduciary duties | |
| 2. LIABILITY FOR THE BREACH OF FIDUCIARY DUTIES | | |
| 2.1. No exculpation | Full liability for the breach of Duty of care & Duty of loyalty | |
| 2.2. Partial exculpation | Limited liability for the breach of Duty of care or any part of it &/or Duty of loyalty or any part of it | |
| 2.3. Full exculpation | No liability for the breach of fiduciary duties | |

In combination with unrestricted duty of care create a liability standard equivalent to the business judgment rule of corporate law

CARVE-OUTS FROM PARTIAL EXCULPATION

- willful or intentional misconduct
- grossly negligent behavior
- actions in bad faith
- fraudulent conduct
- knowing violation of (criminal) law

cases of waived or modified duties of loyalty of members, the LLC agreements of the sample companies imposed special conflict of interest provisions for transactions between the members and their affiliates on the one hand and the companies on the other (the correlation is significant at 5% level). Because the waivers and modifications of the members' and managers' fiduciary duties usually coincided, these conflict of interest provisions could be invoked by minority members in the few cases where the managers did not owe to the members fiduciary duties.

Similar to the two-member firms, the firms with 3–10 members commonly employed the exculpation of liability of members and managers for the breach of their fiduciary duties. The members were exculpated in 42.9% of the LLCs, and the managers were not liable for the breach of their duties in 60.7% of the companies. Exculpatory provisions covered entire fiduciary duties of members and managers in only one company; the rest of the sample carved out parts of the duty of care in the same way as the two-member companies did in their operating agreements. Though the duty of loyalty or any parts of it were not excluded from the liability limitation clauses, conflict of interest rules prevented opportunistic self-dealing by controlling members (positive correlation between the conflict

of interest rules and the cases of waived duty of loyalty or eliminated liability of the members for its breach is significant at 5% level).

Finally, in the firms with more than ten members, members and managers' duties of care and loyalty were waived or modified in 27.6% and 24.1% of cases, respectively. The substitution of the duty of loyalty with contractual alternatives is particularly apparent in this group of the sample LLCs. The waived or modified duties of the members were, as a rule, substituted by large transaction rules and conflict-of-interest rules for members, while the managers were subject to conflict-of-interest rules where their fiduciary duties were waived or modified (10% level of statistical significance holds in all these cases). Exculpatory provisions eliminated the liability for breach of fiduciary duties in 48.3% of the LLCs for the members and 72.4% of the LLCs for the managers. The exculpation of liability, however, was never full, and the duty of care applied mostly based on the gross negligence liability standard.

V. DISCUSSION OF THE RESULTS

The analysis of sample LLCs' operating agreements provides evidence in support of the two hypotheses developed above. The detailed, private ordering of legal formalities in the absence of functionally equivalent statutory default rules in the Delaware LLC Act provides strong support for the argument that the members of LLCs tailor their governance structures to their company's specific needs by changing statutory defaults as necessary or filling the gaps. Indeed, this evidence is based on the agreements of large firms that often choose the LLC form for a specific reason and can afford the services of professional consultants. The situation, however, can be different for small firms.¹⁰⁴ First, as the result of minimum lawyering, controlling and minority groups in small firms are more likely to establish formal relations that rely on statutory default rules. Second, as a usual practice, one of the member groups—typically a controlling member—offers the terms of the LLC agreement on a take-it-or-leave-it basis and the other members either accept the terms or choose to pass on the project. The smaller the firm is, the higher the likelihood that an offeree will not review the terms thoroughly and insist on changes.

This has implications. Minimum lawyering leads to regulating member relations by LLC agreements that are full of gaps. Presenting contracts on a take-it-or-leave-it basis establishes unfavorable legal positions for non-controlling members. The likelihood of disputes between the parties increases. Because of gaps and the wide room for self-interested opportunistic behavior, the parties of poorly drafted agreements are more likely to appear before the courts and incur high ex post transaction costs. Should the Delaware LLC Act, then, maintain its general status but offer detailed gap-filling default rules for smaller firms with two or more members, for instance, in the form of a model LLC agreement that supple-

104. *Cf.* Harner & Marincic, *supra* note 18, at 888.

ments the statute? Should the legislature, in order to mitigate the effect of unequal bargaining power of LLC governance, adopt “two-layer default rules”? Under this approach, a waived default rule is automatically substituted by another statutory rule; if the parties also waive this second default, then their private regulation shall prevail.

Both strategies have their pros and cons. Preparing a supplement can reduce transaction costs for many users of the LLC form. Two-layer default rules, in turn, reduce agency costs by complicating waivers of important investor protection standards and rules and, at the same time, in contrast to mandatory rules,¹⁰⁵ leave room for an efficiency-driven choice between statutory defaults and their privately drafted alternatives. As shown later in this Section in the duty of loyalty example, such private ordering can benefit the involved parties by reducing transaction costs and uncertainty.¹⁰⁶

Yet, the same transaction costs imply that new legislative solutions will also affect optimal private ordering for those contractual parties that would do better by adopting alternatives to the statutory defaults. Moreover, as the theory of network externalities suggests, the transaction-cost bias of choosing statutory defaults will be compounded by network externalities, turning the defaults into the main rules of practice. Because default rules are more likely to be chosen, they become the rules around which contract networks are formed.¹⁰⁷ The developing networks further strengthen the position of default rules and weaken the role of their possible alternatives because more and more parties will be inclined to adopt the default structures offered by statutes.¹⁰⁸ While the network effects are not strong for simple rules such as legal formalities, they can be substantial for other default provisions directed at mitigating conflicts of interests between LLC members. The evidence that (1) smaller firms prefer to form LLCs within the state of their principal place of business, and (2) the share of out-of-state LLCs formations and Delaware LLCs increases along with the increase in the size of firms is another argument against developing detailed statutory regulations for small firms.¹⁰⁹

The evidence from this and similar studies can help in drafting default rules desired by private parties to fill the gaps of private contracting. For example, the statute could provide that if there is a board of directors in the company, then certain procedural rules apply, and the statute could go on to describe these rules. Or the statute could provide that if the

105. In a recent paper, Chief Justice Leo Strine of the Delaware Supreme Court and Vice Chancellor Travis Laster of the Delaware Court of Chancery propose a statutory framework where the fiduciary duty of loyalty is non-waivable. See Strine & Laster, *supra* note 8, at 13.

106. See *infra* notes 111–12, 116–22 and accompanying text.

107. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 828 (1995).

108. *Id.* at 827–28.

109. See Dammann & Schündeln, *supra* note 22, at 745–46.

parties waive the duty of loyalty, then all related party transactions involving conflicts of interest shall require the approval of non-interested directors or members. But cases where possible default rules are desired by most of the parties are rare. In order to be able to supply the members of LLCs with optimal defaults, statutes should offer different options depending on the circumstances of contracting. However, this makes their drafting extremely complicated and costly.

The contractual practices of the LLC members also support the hypothesis that members very often opt out of statutory defaults and develop alternative rights and obligations. In this way, they achieve governance structures that best fit their needs and, at the same time, ensure the rights and interests of the contracting parties. Waivers and modifications of traditional corporate governance mechanisms and investor protection rights do not exacerbate internal conflicts of interests inherent to the firm and do not free the hands of insiders to engage in opportunistic behavior.

The contractual alternatives developed by private parties for the protection of their rights differ depending on the number of members in a firm and the prevalence of particular conflicts of interests. In firms with a smaller number of members, interest-transfer restrictions and minority-put rights play an important role. They ensure stability among the parties, secure special relations between them,¹¹⁰ and provide minority members with exit opportunities where the potential for oppression—either by incumbent insiders or the acquirers of control—is strong. They act as a remedy where other investor protection rights are weak. Minority member exit opportunities can also be achieved by the right to dissolve an LLC at-will or conditioned upon decision-making deadlock or member default. Put-call and dissolution rights in the context of firms with a small number of members with unanimous decision-making rights encourage parties to cooperate if there is a disagreement between them. Any of the parties can threaten to put an end to the project and exercise this threat if cooperation fails. The more parties depend on each other (relation-specific investments), the stronger this effect is.

The importance of many interest transfer restrictions, contingent ownership rights, and dissolution rights decreases with the increase of the number of firm members. Firms with more members often alter the default approval clause of the Delaware LLC Act to make interest transfers by members easier. This is not surprising given the limits of unanimous consent rights where many parties are involved. Yet, tag-along rights are used in these firms more often, perhaps because the larger the number of minority members and the weaker their vote in opposing control transac-

110. Special relations of trust between members can explain situations where contractual parties vest control upon one of the members and at the same time waive almost all legal measures that can be invoked as a check on the discretion of the controlling member. A legal ban on transferring membership interests to third parties in these situations can be a strong indicator that trust is, indeed, the reason for choosing such contract design.

tions, the stronger the need is to have exit rights. Tag-along rights, by requiring controlling sellers to choose acquirers carefully and holding back acquirers that wish to enrich themselves at the expense of minority members, encourage minority investments and make possible capital accumulation in the first place.

In change-of-control transactions, tag-along rights can also effectively substitute the fiduciary duties of managers and controlling members. It is well-known that takeover regimes in Europe and the United States are based on two different approaches; whereas European legislation relies on the mandatory bid rule,¹¹¹ the dominant U.S. approach, both for listed and non-listed firms, does not support the idea of equally sharing control premiums among all shareholders, and, where it does so, the sharing occurs ex post based on the fiduciary duties of directors and controlling shareholders.¹¹² Therefore, contracting for a tag-along right is a matter of choice between (1) relying on standards and their ex post clarification by courts to protect minority members of LLCs in the event of value-decreasing control transactions and (2) opting for ex ante drafting of detailed rules in the agreement. In cases where controlling members do not owe any fiduciary duties to minority members in a sale-of-control transaction, then a tag-along right is the only means that can protect the minority interests.

In cases of major decisions, investments in firms with a small number of members are also protected by unanimous voting requirements and veto rights of outsiders. In addition to this, by requiring managers to distribute available company cash to members, the contracting parties limit the discretion of insiders. In firms with more members, fiduciary duties and their contractual substitutes—special rules allowing self-dealing upon the informed approval of non-interested members or directors—play a greater role in the protection of the rights and interests of the contractual parties. These rules are a common way of preventing opportunistic self-dealing by insiders when their liability for the breach of the duty of loyalty is eliminated. Minority members in LLCs with many members—in the absence of member fiduciary duties, minority put rights, and dissenters' rights—are also protected by special large transaction rules. These rules

111. Under the mandatory bid rule, any third-party buyer that has established control over a certain percentage of shares of a listed company has to make an offer to the remaining shareholders at the highest price paid for acquiring the initial holding.

112. See REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 225, 258 (2d ed. 2009) (stating U.S. approach relies on assumption that “permitting sales at a premium price gives both seller and acquirer [of controlling block of shares] an appropriate reward for their extra monitoring costs”). For a discussion of the duty of care and potential liability directors and managers face when their company has been threatened with a takeover and a brief comparison of European regulations with United States' regulations under these circumstances, see Marco Ventoruzzo, *Europe's Thirteenth Directive and U.S. Takeover Regulation: Regulatory Means and Political and Economic Ends*, 41 *TEX. INT'L L.J.* 171, 186–88 (2006).

require unanimous, supermajority, separate class,¹¹³ or majority-of-the-minority¹¹⁴ vote for mergers, acquisitions, other change-of-control transactions, sales of all or almost all company assets, acquisitions of assets or incurring of indebtedness above a certain amount or relative percentage,¹¹⁵ and other similar transactions.

There are several reasons that can encourage contractual parties to limit the role of fiduciary duties. An obvious situation where members can elect to dispense with the fiduciary duties of board members is where a member appoints a director as its designee who is expected to act as the member's representative and advance the member's interests on the board. This is a common practice in firms and joint ventures where agreements stipulate that directors are not elected by member vote, but rather appointed and removed by members. This practice, however, can be problematic in the traditional corporate law setting because the actions of directors serving the interests of nominating investors at the expense of other investors are treated as transactions involving a conflict of interest.¹¹⁶ Imposing traditional fiduciary duties on such representatives by a mandatory legal provision would contradict the nature of the underlying relations and hamper investments.¹¹⁷ For example, passive investors and corporate lenders condition financing upon a right to have a board designee that will advance their interests and transfer first-hand information about the company to the financier. Why negotiate an appointment right in the first place if the appointed director cannot act in the interests of the member who appointed the director?¹¹⁸ By relieving directors of their fiduciary duties in such situations, members reduce unnecessary risks of speculative litigation. Meanwhile, the officers, unlike board members, remain subject to fiduciary duties.

Another situation is where fiduciary duties are substituted by contractual alternatives. A recurring practice in the sample firms was to draft special related-party and large transaction rules for members and managers,

113. Majority of each class of units voting separately must approve a transaction.

114. Majority of minority members voting separately must approve a transaction.

115. Large transaction rules are usually defined by specific amounts, but they can also be tied to the value of the assets of a company as a certain percentage or, if members approve annual budgets, be a certain cap in absolute or relative terms on the amounts of transactions exceeding the budget.

116. See D. Gordon Smith, *Duties of Nominee Directors*, in *COMPARATIVE COMPANY LAW: A CASE BASED APPROACH* 61, 61–62 (Mathias Siems & David Cabrelli eds., 2013).

117. For the underinvestment argument, see Martin Gelter & Geneviève Helleringer, *Lift Not the Painted Veil! To Whom Are Directors' Duties Really Owed?*, 2015 U. ILL. L. REV. 1069, 1104 (showing that under assumption of incomplete contracting and inability to specify all future contingencies, parties invest if they have right to affect decision-making on non-contracted matters ex post).

118. See *id.* at 1074 (noting paradox in allowing specific shareholders to design directors and applying uniform fiduciary duties to all directors).

instead of relying on the members' or managers' duty of loyalty. Along with eliminating or restricting the role of fiduciary duty constraints on the discretion of members and managers, the sample companies strengthened the role of contractual constraints.¹¹⁹ This practice can be viewed in the prism of an efficiency-based choice between rules and standards at the stage of contracting. Where *ex ante* transaction costs are lower than *ex post* enforcement costs, the parties prefer to negotiate and draft clear rules instead of relying on abstract standards that depend heavily on the enforcement by a third-party adjudicator.¹²⁰ There is a tradeoff between incurring these costs at the two different stages, which obviously affects the choice of contracting parties.

The role of fiduciary duties is to deal with difficulties in (1) regulating the behavior of agents *ex ante* due to transaction costs and (2) monitoring after contracting due to information asymmetries between the principals and agents.¹²¹ By substituting the duty of loyalty with contractual rules, contracting parties, in effect, incur additional transaction costs to reduce the discretion of managers and members (e.g., for all transactions above a certain amount or a percentage of the firm's annual budget). This lets parties enforce the contract at a lower cost in the future. Contrary to this, relying on fiduciary duties implies a partial shifting of transaction costs to the enforcement stage. Under the fiduciary duty of loyalty, the obligations of managers and members are open-ended at the moment of decision-making, but they are subject to an *ex post* review by a court or arbitrator. This, notwithstanding broad discretion, incentivizes them "to act in the interests of . . . principal[s]." ¹²² The effect of substituting fiduciary duties with contractual rules is to limit the discretion of agents instead of giving them broad discretion that is subject to *ex post* control. This can enhance protection by reducing the unpredictability of the application of fiduciary duties by *ex post* decision-makers in particular disputes. The contractual substitutes also reduce the costs of parties by reducing litigation costs and discouraging speculative litigation. Hence, it is reasonable for the parties to incur additional transaction costs and develop clear rules of behavior for members and managers if it is not difficult to verify the outcomes of their actions (here, the amount of a transaction or the fact of an affilia-

119. According to Smith and Lee, there are four layers of constraints that limit the discretion of fiduciaries—statutory or regulatory, contractual, fiduciary, and non-legal. Among legal constraints, fiduciary duties are measures of last resort that are activated only where all other legal constraints have been exhausted. See D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 612–13 (2014).

120. See Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 840–44 (2006).

121. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1048–49 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426–27 (1993); Robert H. Sitkoff, *The Economic Structure of Fiduciary Law*, 91 B.U. L. REV. 1039, 1040–43 (2011).

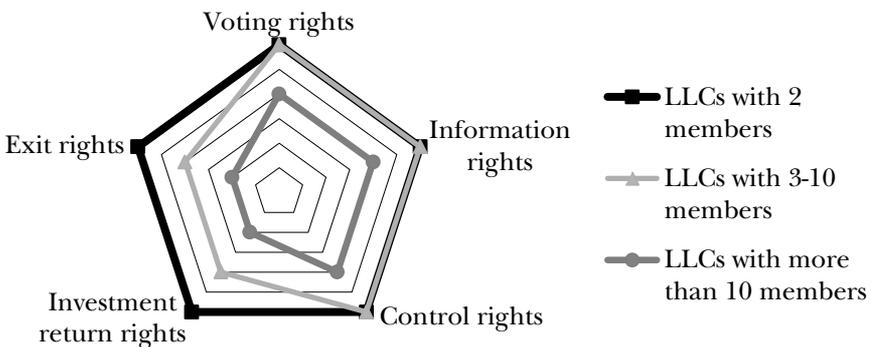
122. See Sitkoff, *supra* note 121, at 1043.

tion), and the involvement of principals instead of agents in decision-making is not complicated and costly. The latter can be problematic in publicly traded firms with many passive investors facing collective action problems, but it is easier to achieve in non-listed firms where investors are more willing and able to play an active role.

Under some circumstances, the contractual substitutes of the traditional fiduciary duties giving minority members approval rights for related-party transactions can provide even stronger protection to minority investors than the duties themselves. The reason for this is that they apply to all related-party transactions, while under fiduciary duties an agent can proceed with a related-party transaction notwithstanding the opposition of minority investors if the fair price and fair dealing standards are formally met. Indeed, there are also situations where the procedural substitutes of the duty of loyalty offer weaker protection than the duty of loyalty itself. These substitutes can be compared to the judge-made safe harbor provisions of corporate law that, as a rule, affect the allocation of the burden of proof in fiduciary duty breach litigation. However, in the traditional corporate law setting, the safe harbor provisions never substitutes duty of loyalty.

Meanwhile, in the LLC context, certain procedures for approving interested transactions typically preclude additional *ex post* judicial review under the entire fairness standard. This can be reasonable in two-member firms and other LLCs with a small number of members, where each of the members has a veto right upon important decisions, directly or via the right to appoint board representatives. Under member-veto rights or obligations to regularly distribute company profits, minority members need not worry that their refusal to approve related-party transactions with controlling members or their affiliates could possibly result in some kind of retaliation in the future. Yet, as the number of minority members grows and the influence of controlling members increases, such stand-alone procedural rules applied in lieu of duty of loyalty become more prone to controlling member abuse.

FIGURE III. STRENGTH OF INVESTOR RIGHTS IN THE SAMPLE LLCs



In summary, the protection of outside investors in non-listed LLCs within the framework of the rights to (1) vote, (2) information, (3) control, (4) return, and (5) exit¹²³ can be presented in the following way (see also Figure III). Voting rights of minority members are stronger in firms with a small number of members. For important matters, large transactions, and related-party transactions, minority members can hold voting power via member voting or board representation that exceeds their share of the capital. Sometimes minority members can influence voting through supermajority quorum requirements by refusing to attend a meeting. Minority-member control by means of appointing a minority member as a managing member also is more common in firms with few members. As the number of members increases, centralized management with the right of a controlling member to elect the majority of directors becomes the rule.

Yet, even in companies with many members, minority investors have strong voting rights where the fiduciary duties of controlling members and managers are waived or modified. All members, as a rule, have strong information rights. In addition to the right to access the books and records of a firm, which sometimes can be limited by the standards of establishing a proper or reasonable cause, members are entitled to regularly receive financial statements and balance sheets of the firm.¹²⁴ In order to ensure a return for invested capital and limit the discretion of insiders, the distribution of profits is often an obligation, rather than a discretionary choice of the management, particularly where a firm has few members. Finally, given restricted opportunities for exiting investments via a liquid market and the absence of appraisal rights, minority members receive a right to put their units to the firm or controlling member or a right to sell the units along with the controlling member in change of control transactions. While the former is common only in firms with a small number of members, the latter is widespread in all non-listed LLCs, but its use increases along with the increasing number of investors.

VI. CONCLUSION

The results of this Study demonstrate how the provisions of the Delaware LLC Act are applied or not applied (given opt-outs, modifications, or application of contractual alternatives) in the practice of non-listed LLCs. The members of these firms engage in active contractual planning with the aim of balancing the conflicts of interests and limiting opportunistic behavior. The practice of investor rights and governance models changes heavily depending on the number of firm members. The increasing number of members also changes the optimal model of governance because of

123. This framework is borrowed from Arthur R. Pinto, *Protection of Close Corporation Minority Shareholders in the United States*, 62 AM. J. COMP. L. 361, 363, 365 (2014).

124. *See id.* at 365.

the need to organize a centralized management relatively independent from the influence of individual investors. Along with the change in the management structure comes changes in the inherent conflicts of interest. Firms with few members have strong investor protection rights. As the number of members increases, however, the balance shifts towards the management and controlling members who have a strong say in the process of forming the management.

One of the controversial issues of contracting in the context of LLCs is the ability of the members and managers to contract around their fiduciary duties. If default fiduciary duties are altered without contracting for equivalent protections, outside investors can be left at the mercy of managers. This Study provides strong evidence that fiduciary duties are indeed at the center of contractual planning in LLCs. However, full waivers of the duties and full exculpation for the breach of fiduciary duties are an exception rather than a rule. In the majority of the cases, the modifications of the duties have limited extent. These modifications do not seem to be arbitrary. They tend towards minimum levels of investor protection offered previously by courts (for example, the duty of care can be modified with a new standard reflecting the business judgment rule) and lawmakers (for instance, the provisions of the model LLC acts or the Delaware General Corporation Law). In addition, the modified fiduciary duties are often substituted by contractual alternatives. This leaves the practice of investor rights in Delaware LLCs at a level that is not very different from what the corporation laws require.

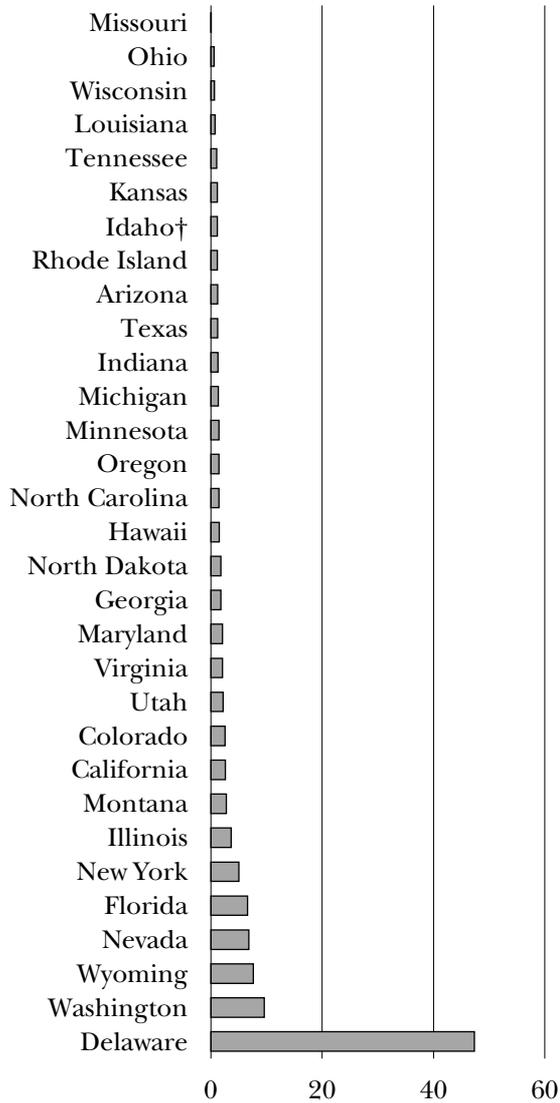
The situation, however, may be different for creditors. Contractual agreements of members, intentionally or accidentally, may deprive creditors of their legitimate expectations. For example, in two LLCs, minority members owned preferred units entitling them to a certain monthly interest, which, if not paid, was accrued. According to the operating agreements, the preferred units had a liquidation preference and the claims of their holders should be satisfied ahead of the claims of other creditors. Such a subordination of creditor claims increases uncertainty and can create wide opportunities for firms to avoid fulfilling contractual obligations. Many other companies imposed an obligation on involuntary transferees—parties who acquired LLC units as the result of a court order, forfeiture, or another reason—to sell their units to the LLC, sometimes at a price defined by the company insiders. The problem is that creditors who become involuntary transferees never agreed to such a provision. These are the cases that require careful treatment by courts and legislatures. Future research will focus on the implications of broad contractual freedom on the creditors of LLCs.

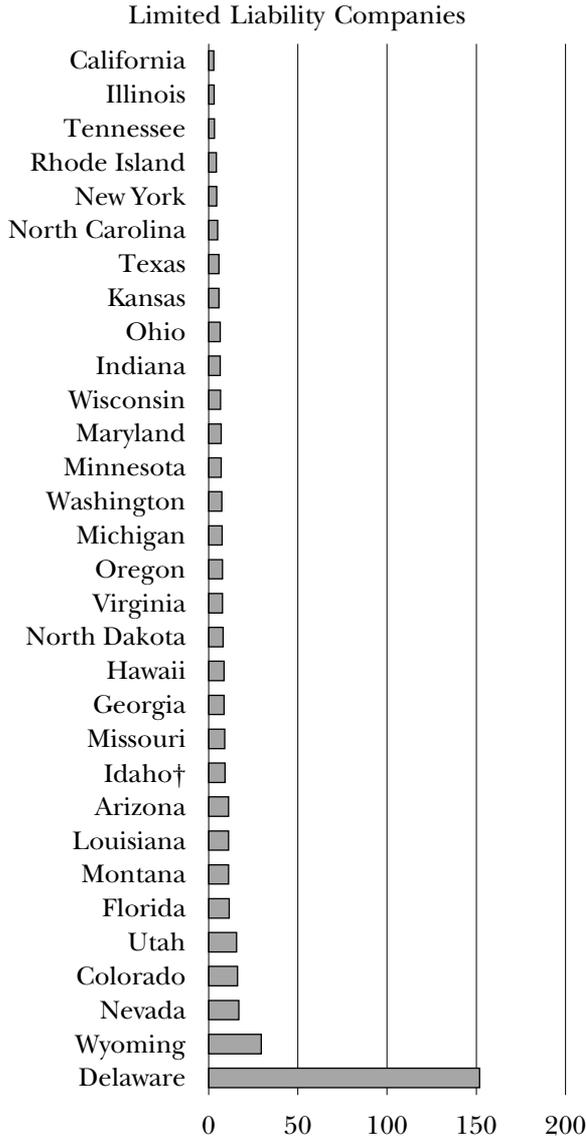
The choices of sophisticated private parties documented in this Article have important implications for the future users of the LLC form, as well as for the courts and the legislature in the debate on fiduciary duties in non-corporate business forms—should they remain default, as they are

now, or should they be imposed on LLC members and managers by the means of mandatory provisions?

APPENDIX I

Number of New Business Formations per 1,000 Inhabitants
Aged 18 and Over, 2013
Profit Corporations





Sources: Data on new business formations in 21 states were obtained from the Annual Reports of Jurisdictions made available by the International Association of Commercial Administrators, <http://www.iaca.org>; data on 10 other states were collected from the offices of the secretary of state. Population estimates come from the U.S. Census Bureau, Population Division. The estimates are based on the 2010 Census and are for July 1, 2013.

Notes: † Data for Idaho are for 2012.

The figures do not make any suggestion about the business environment in a given state; rather, they indicate the popularity of state statutes on corporations and limited liability companies for organizing business relations.

APPENDIX II

TYPICAL PROVISIONS OF LLC AGREEMENTS

**BOARD ACTION
WITHOUT A MEETING**

On any matter requiring an approval or consent of directors under this Agreement or the Delaware LLC Act, the directors may take such action without a meeting, without prior notice, and without a vote if a consent or consents in writing, setting forth the action so taken, shall be signed by all of the directors.

**MEMBER ACTION
WITHOUT A MEETING**

Any action that may be taken at any meeting of members may be taken without a meeting by written consent of members holding outstanding voting membership interests sufficient to approve such action were a meeting to be held.

**BOOKS AND
RECORDS INSPECTION
RIGHT**

Subject to the confidentiality provisions of this Agreement, any company books and records are subject to inspection and copying at a reasonable notice, and at the expense, of any member during ordinary business hours by such member or member's agent.

**DEFAULT APPROVAL
CLAUSE/TRANSFER
CONSENT**

Except as permitted by this Section, no member may sell, assign, pledge, transfer or otherwise dispose of, directly or indirectly, all or any portion of such member's units (whether with or without consideration and whether voluntarily or involuntarily or by operation of law or the sale or issuance of any securities) (a "Transfer"), and no Transfer will be effective, unless (i) the board/non-transferring members shall have approved the Transfer, except a Transfer by a member to its affiliate, and (ii) the transferee agrees to be bound by all of the terms and conditions of this Agreement.

**MINORITY PUT
RIGHT**

Beginning after the first year anniversary of the effective date of this Agreement, each non-managing member shall have the right to require the company to redeem all or a portion of the non-managing member units held by such non-managing member for the amount defined according to this Agreement.

TAG-ALONG RIGHT

If a member or members shall propose a transfer of any units to one or more third parties pursuant to a bona fide offer, then such member or members (the "Selling Member(s)") shall provide written notice of such offer to the company and each of the other members. Each of the other members shall have the right (but not the obligation), for a period of at least ten (10) business days from the receipt of the notice, to include in such transfer up to all of the units held by such members at the same price per unit, upon the same terms and conditions and for the same type of consideration. If the proposed purchaser elects to purchase less than all of the units offered for sale as a result of the members' exercise of their respective rights, the Selling Member(s) and each member exercising its tag-along rights will have the right to include its pro rata portion of the units to be transferred to the proposed purchaser.

| 2015] | CONTRACTUAL MECHANISMS | 1005 |
|-------------------------------------|---|------|
| MANDATORY DISTRIBUTION RIGHT | Except as expressly consented to by the non-managing member, the managing member shall distribute all net cash flow monthly/quarterly/annually. | |
| FIDUCIARY DUTY WAIVER | None of the members or directors, shall have any duties or liabilities to the company or any other member (including any fiduciary duties), whether or not such duties or liabilities otherwise arise or exist in law or in equity, and each member hereby expressly waives any such duties or liabilities. | |
| EXCULPATORY PROVISION | No director or officer shall be liable, responsible or accountable to the company or to any member for any mistake of fact or judgment, or doing or failing to do any act, or any loss or damage sustained by the company or any member, unless the loss or damage shall have been the result of gross negligence, reckless or intentional misconduct committed fraudulently or in bad faith, or a knowing violation of law by the director or officer. | |
| CONFLICT OF INTEREST RULE | No agreement shall be entered into by the company or any subsidiary with a member or any affiliate of a member and no decision shall be made in respect of any such agreement (including, without limitation, the enforcement or termination thereof) unless such agreement or related decision shall have been approved in writing by the non-interested members/directors. | |
| FAIR PRICE STANDARD | No agreement shall be entered into by the company or any subsidiary with a member or any affiliate of a member unless any such agreement shall be on arm's length terms and conditions. | |
| LARGE TRANSACTION RULE | <p>All of the actions listed below ("<i>Major Decisions</i>"), shall require the written approval of all members, which approval shall be in the sole discretion of each member [examples follow]:</p> <ul style="list-style-type: none"> • incurring of any cost or expense or incurring of any obligation or liability by or for the company that is in excess of ten percent (10%) with respect to each item in the operating budget approved annually by the members; • sale, lease or otherwise disposal of any asset of the company which has a reasonable value not exceeding five hundred thousand US dollars (\$500,000.00). | |

APPENDIX III

RESULTS OF THE CORRELATION ANALYSIS

The tables in this appendix show whether the pairs of the provisions of the LLC agreements of the non-listed LLCs and some other aspects of their governance structures are positively correlated (likely to appear together), negatively correlated (likely that one appears without the other), or are not correlated. The calculations are based on phi coefficient of correlation for 2x2 tables of categorical variables of each pair. ϕ values range from 0 (no relation between the pairs) to 1 (perfect positive relation) or -1 (perfect negative relation). One asterisk indicates significance at the 10% level, two asterisks at the 5% level, three asterisks at the 1% level, and four asterisks at the 0.1% level.

The results of the correlation analysis are presented separately for three different groups of the sample LLCs based on their ownership structure differences. The first group consists of the firms that had 2 members. The initial number of these companies in the sample was 168. After removing the two-member LLCs where the members had special relations, such as employment by one company or possible affiliation between the members due to the ability of one member to affect decisions of the other, 10 LLCs were removed from this group. The second group consists of the LLCs that had minimum three members and maximum ten members. The initial sample was reduced from sixty-two companies to fifty-six LLCs in order to keep the results unaffected by the special relationships between the members. The last group includes the sample companies with more than ten members. For the same reason, the initial sample of fifty-nine companies was reduced to twenty-nine.

The tables in Panels A show interactions between different provisions of the LLCs agreements and governance aspects that create risks for outside investors, on the one side, and investor protection mechanisms that potentially can deal with the former, on the other side. In Panels B the same investor protection mechanisms are analyzed as a separate group.

LLCs WITH TWOMEMBERS

LLCs WITH TWO MEMBERS
PANEL A

| | No duty of loyalty for members | Waiver or exculp. of duty of loyalty of members | No duty of loyalty for managers | Waiver or exculp. of duty of loyalty of managers | >50% member | Board control | Controlling managing member | Minority managing member | Board and managing member control | No duty of care for members | No duty of care for managers | Member who can amend the LLC agreement | Member who can dissolve the LLC | Member who can approve mergers |
|--|--------------------------------|---|---------------------------------|--|-------------|---------------|-----------------------------|--------------------------|-----------------------------------|-----------------------------|------------------------------|--|---------------------------------|--------------------------------|
| Large transaction rules | -0.034 | 0.179** | 0.030 | 0.034 | -0.025 | -0.124 | -0.024 | 0.277**** | -0.050 | -0.024 | 0.038 | -0.181** | -0.168** | -0.264**** |
| Conflict of interest rules for members | -0.003 | 0.104 | 0.164** | 0.062 | -0.082 | 0.082 | -0.121 | 0.075 | -0.069 | 0.006 | 0.133* | -0.019 | -0.085 | -0.290**** |
| Conflict of interest rules for managers | -0.038 | -0.074 | -0.016 | 0.066 | 0.079 | -0.079 | 0.011 | 0.289**** | 0.248**** | -0.055 | -0.055 | 0.042 | -0.143* | -0.141* |
| Purpose limitation | -0.036 | 0.026 | 0.036 | 0.056 | -0.048 | -0.109 | -0.001 | 0.240**** | -0.029 | -0.027 | -0.027 | -0.156** | -0.112 | -0.228**** |
| Specific target distribution right | -0.212**** | 0.025 | -0.058 | -0.075 | 0.055 | -0.114 | 0.045 | 0.211**** | 0.025 | -0.231**** | -0.108 | -0.177** | -0.016 | -0.300**** |
| Minority put right | -0.110 | 0.039 | -0.046 | 0.005 | 0.201** | -0.030 | 0.281**** | 0.048 | 0.152* | -0.091 | -0.062 | -0.086 | 0.063 | -0.003 |
| Unanimous voting or veto right | -0.063 | 0.005 | 0.116 | 0.006 | -0.245**** | -0.172** | -0.385**** | 0.148* | -0.273**** | -0.054 | 0.112** | -0.171** | -0.448**** | -0.570**** |
| Tag-along right | 0.319**** | 0.046 | 0.184** | 0.074 | 0.093 | 0.193** | 0.083 | -0.192** | 0.099 | 0.308**** | 0.144* | 0.291**** | 0.049 | 0.106 |
| Default approval clause | -0.129 | 0.017 | -0.014 | -0.044 | -0.076 | -0.175** | 0.194** | 0.072 | 0.002 | -0.122 | -0.079 | -0.071 | -0.088 | -0.103 |
| ROFO or ROFR | 0.125 | 0.001 | 0.109 | 0.088 | -0.045 | -0.039 | -0.042 | -0.066 | -0.070 | 0.111 | 0.053 | 0.056 | -0.052 | -0.159** |

LLCs WITH TWO MEMBERS
PANEL B

| | Conflict of interest rules for members | Conflict of interest rules for managers | Purpose limitation | Specific target distribution rights | Minority put right | Unanimous voting or veto right | Tag-along right | Default approval clause | ROFO or ROFR |
|---|--|---|--------------------|-------------------------------------|--------------------|--------------------------------|-----------------|-------------------------|--------------|
| Large transaction rules | 0.380**** | 0.184** | 0.247*** | 0.294**** | 0.250*** | 0.252**** | -0.147* | 0.063 | 0.043 |
| Conflict of interest rules for members | | 0.403**** | 0.162** | 0.222**** | 0.126 | 0.322**** | -0.057 | 0.169** | 0.051 |
| Conflict of interest rules for managers | | | 0.174** | 0.171** | -0.108 | 0.245**** | 0.062 | 0.141* | 0.161** |
| Purpose limitation | | | | 0.177** | 0.025 | 0.069 | -0.060 | 0.109 | 0.145* |
| Specific target distribution right | | | | | 0.066 | 0.088 | -0.323**** | 0.260**** | 0.001 |
| Minority put right | | | | | | -0.098 | -0.121 | 0.150* | -0.117 |
| Unanimous voting or veto right | | | | | | | -0.054 | 0.041 | 0.138* |
| Tag-along right | | | | | | | | -0.252**** | 0.402**** |
| Default approval clause | | | | | | | | | -0.197** |

LLCs WITH 3-10 MEMBERS
PANEL A

| | | | | | | | | | | | | | | |
|--|---------|---------|----------|-----------|--------|----------|---------|----------|--------|---------|----------|----------|----------|---------|
| Large transaction rules | 0.013 | 0.186 | -0.293** | -0.011 | -0.166 | -0.099 | -0.122 | 0.156 | -0.087 | 0.013 | -0.293** | -0.162 | -0.117 | -0.251* |
| Conflict of interest rules for members | 0.330** | 0.287** | 0.107 | 0.214 | -0.104 | 0.205 | -0.231* | 0.027 | -0.088 | 0.330** | 0.107 | 0.077 | 0.027 | -0.019 |
| Conflict of interest rules for managers | 0.045 | -0.009 | 0.011 | 0.088 | 0.031 | 0.099 | 0.098 | -0.012 | 0.010 | 0.045 | 0.011 | -0.169 | -0.012 | -0.135 |
| Purpose limitation | -0.225* | -0.138 | -0.186 | -0.088 | -0.077 | -0.178 | 0.251* | 0.197 | 0.146 | -0.225* | -0.186 | -0.217 | -0.174 | -0.135 |
| Specific target distribution right | -0.050 | -0.182 | -0.173 | -0.392*** | 0.149 | -0.181 | 0.336** | -0.010 | 0.138 | -0.050 | -0.173 | -0.341** | -0.100 | -0.137 |
| Minority put right | 0.125 | 0.062 | -0.202 | -0.231* | 0.017 | 0.074 | -0.002 | 0.048 | 0.037 | 0.125 | -0.202 | -0.035 | -0.059 | 0.022 |
| Unanimous voting or veto right | 0.115 | 0.029 | -0.009 | -0.041 | -0.199 | -0.240* | -0.009 | 0.247* | -0.041 | 0.115 | -0.009 | -0.280** | -0.306** | -0.242* |
| Tag-along right | 0.299** | 0.248* | 0.167 | 0.138 | 0.253* | 0.433*** | -0.088 | -0.190 | 0.062 | 0.299** | 0.167 | 0.220* | 0.351*** | 0.299** |
| Default approval clause | 0.041 | -0.102 | -0.027 | -0.119 | 0.212 | -0.073 | 0.254* | -0.284** | -0.119 | 0.041 | -0.027 | -0.221* | -0.185 | -0.151 |
| ROFO or ROFR | 0.144 | -0.004 | 0.017 | 0.112 | 0.149 | 0.228* | 0.017 | -0.173 | -0.115 | 0.144 | 0.017 | -0.137 | 0.008 | -0.031 |
| No duty of loyalty for members | | | | | | | | | | | | | | |
| Waiver or exculp. of duty of loyalty of members | | | | | | | | | | | | | | |
| No duty of loyalty for managers | | | | | | | | | | | | | | |
| Waiver or exculp. of duty of loyalty of managers | | | | | | | | | | | | | | |
| >50% member board control | | | | | | | | | | | | | | |
| Controlling managing member | | | | | | | | | | | | | | |
| Minority managing member | | | | | | | | | | | | | | |
| Board and managing member control | | | | | | | | | | | | | | |
| No duty of care for members | | | | | | | | | | | | | | |
| No duty of care for managers | | | | | | | | | | | | | | |
| Member who can amend the LLC agreement | | | | | | | | | | | | | | |
| Member who can dissolve the LLC | | | | | | | | | | | | | | |
| Member who can approve mergers | | | | | | | | | | | | | | |

LLCs WITH 3-10 MEMBERS
PANEL B

| | Conflict of interest rules for members | Conflict of interest rules for managers | Purpose limitation | Specific target distribution rights | Minority put right | Unanimous voting or veto right | Tag-along right | Default approval clause | ROFO or ROFR |
|---|--|---|--------------------|-------------------------------------|--------------------|--------------------------------|-----------------|-------------------------|--------------|
| Large transaction rules | 0.536*** | 0.447*** | 0.149 | -0.062 | 0.134 | 0.401*** | 0.155 | 0.011 | 0.197 |
| Conflict of interest rules for members | | 0.600*** | -0.009 | -0.105 | 0.277** | 0.337** | 0.397*** | 0.023 | 0.435*** |
| Conflict of interest rules for managers | | | -0.010 | -0.129 | 0.098 | 0.283** | 0.240* | 0.000 | 0.492*** |
| Purpose limitation | | | | 0.351*** | 0.076 | 0.019 | -0.240* | -0.408*** | -0.121 |
| Specific target distribution right | | | | | 0.167 | 0.204 | -0.077 | 0.034 | -0.116 |
| Minority put right | | | | | | 0.077 | -0.003 | 0.067 | 0.102 |
| Unanimous voting or veto right | | | | | | | -0.162 | 0.185 | 0.013 |
| Tag-along right | | | | | | | | 0.034 | 0.532*** |
| Default approval clause | | | | | | | | | 0.250* |

LLCS WITH MORE THAN TEN MEMBERS
PANEL A

| | | | | | | | | | | | | | | |
|---|--------------------------------|---|---------------------------------|--|-------------|---------------|-----------------------------|--------------------------|-----------------------------------|-----------------------------|------------------------------|--|---------------------------------|--------------------------------|
| Large transaction rules | No duty of loyalty for members | Waiver or exculp. of duty of loyalty of members | No duty of loyalty for managers | Waiver or exculp. of duty of loyalty of managers | >50% member | Board control | Controlling managing member | Minority managing member | Board and managing member control | No duty of care for members | No duty of care for managers | Member who can amend the LLC agreement | Member who can dissolve the LLC | Member who can approve mergers |
| | 0.310* | -0.154 | 0.193 | 0.168 | -0.519*** | -0.401** | -0.077 | n.a. | -0.330* | 0.310* | 0.193 | -0.285 | -0.285 | -0.362* |
| Conflict of interest rules for members | 0.330* | 0.044 | 0.261 | 0.061 | -0.447** | -0.038 | -0.441** | n.a. | -0.171 | 0.330* | 0.261 | 0.170 | -0.265 | -0.111 |
| Conflict of interest rules for managers | 0.265 | 0.080 | 0.344* | 0.147 | -0.409** | -0.053 | -0.383** | n.a. | -0.169 | 0.265 | 0.344* | 0.127 | -0.315* | -0.137 |
| Purpose limitation | -0.123 | -0.180 | 0.099 | 0.070 | -0.222 | -0.216 | 0.053 | n.a. | -0.170 | -0.123 | 0.099 | -0.221 | -0.221 | -0.020 |
| Specific target distribution right | 0.066 | -0.127 | 0.110 | -0.309* | -0.236 | -0.289* | -0.008 | n.a. | -0.358 | 0.066 | 0.110 | -0.371** | -0.012 | -0.083 |
| Minority put right | -0.117 | -0.242 | -0.107 | 0.107 | 0.143 | -0.170 | -0.086 | n.a. | -0.196 | -0.117 | -0.107 | -0.137 | -0.137 | 0.225 |
| Unanimous voting or veto right | -0.117 | 0.148 | 0.335* | 0.107 | -0.258 | -0.170 | -0.086 | n.a. | -0.196 | -0.117 | 0.335* | -0.137 | -0.137 | -0.159 |
| Tag-along right | 0.005 | 0.121 | 0.109 | 0.223 | -0.244 | -0.153 | -0.584*** | n.a. | -0.329* | 0.005 | 0.109 | 0.119 | -0.180 | 0.080 |
| Default approval clause | 0.123 | 0.031 | 0.240 | -0.070 | 0.222 | -0.075 | 0.139 | n.a. | 0.025 | 0.123 | 0.240 | 0.068 | 0.221 | 0.168 |
| ROFO or ROFR | 0.219 | -0.010 | 0.302 | 0.184 | -0.352* | -0.255 | -0.228 | n.a. | -0.239 | 0.219 | 0.302 | -0.216 | -0.070 | -0.194 |

LLCS WITH MORE THAN TEN MEMBERS
PANEL B

| | Conflict of interest rules for members | Conflict of interest rules for managers | Purpose limitation | Specific target distribution rights | Minority put right | Unanimous voting or veto right | Tag-along right | Default approval clause | ROFO or ROFR |
|---|--|---|--------------------|-------------------------------------|--------------------|--------------------------------|-----------------|-------------------------|--------------|
| Large transaction rules | 0.484*** | 0.421** | 0.201 | 0.066 | -0.117 | -0.117 | 0.005 | -0.201 | 0.219 |
| Conflict of interest rules for members | | 0.870*** | 0.170 | 0.018 | -0.183 | -0.183 | 0.329* | -0.315* | 0.100 |
| Conflict of interest rules for managers | | | 0.274 | 0.089 | -0.159 | -0.159 | 0.512*** | -0.422** | 0.228 |
| Purpose limitation | | | | 0.525*** | -0.137 | 0.260 | 0.119 | -0.389** | 0.221 |
| Specific target distribution right | | | | | -0.097 | -0.097 | -0.127 | -0.167 | 0.053 |
| Minority put right | | | | | | -0.036 | 0.148 | 0.137 | -0.170 |
| Unanimous voting or veto right | | | | | | | 0.148 | 0.137 | 0.210 |
| Tag-along right | | | | | | | | -0.119 | 0.419** |
| Default approval clause | | | | | | | | | 0.070 |