

EXIT RIGHTS AND FIDUCIARY DUTIES IN AN IOWA LLC

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This article explores a problem that minority owners in Iowa limited liability companies (“LLCs”) often find intractable: how to respond to unfair or oppressive conduct by majority owners. As will be explained, there are both potential traps for the unwary drafter and apparent gaps in the default rules of the Iowa Limited Liability Company Act (the “ILLCA”).

The article considers the problem using the hypothetical situation of Fred Fenster (“Fenster”), a minority owner in an Iowa LLC who is facing oppressive conduct from the majority owner. Part I of this article addresses whether Iowa LLC law provides Fenster any “exit” rights from the Company—e.g., the right to withdraw from the Company and have his interest bought out at fair market value. Part II, which will be published next month, addresses what remedies, if any, an Iowa court can offer Fenster in litigation.

HYPOTHETICAL

Last week, Fenster was fired from his job with Kobayashi, L.C. (the “Company”). Fenster

formed the Company with Michael McManus (“**McManus**”) three years ago, and the membership was divided 40 percent to Fenster and 60 percent to McManus. Fenster contributed property to the Company with the understanding that he would be a salaried employee. In fact, Fenster’s salary is his primary return on his investment, but there was no written employment agreement.

McManus cited poor work quality as justification for the firing, but Fenster believes this was merely pretext to squeeze him out of the Company. McManus has offered to buy Fenster out, but only at a fraction of what Fenster feels his interest is worth.

The Company has three managers: Fenster, McManus, and McManus’s wife. The Company’s articles of organization contain only the minimal statutory requirements, and the operating agreement fails to address withdrawal from the Company, transfer of interests, or duties owed by members. Thus, Fenster must rely on the default rules of the ILLCA for any remedy.

PART ONE: STATUTORY EXIT RIGHTS

As Fenster’s lawyer, you recognize three potential avenues for him to exit the Company and get a fair value for his interest: (1) withdrawal followed by a buyout, (2) dissolution and winding up of the Company, and (3) sale of his interest.

(A) Withdrawal. A review of the history and policies of LLC legislation is helpful in understanding the current statutory approach to withdrawal of LLC members.

(i) History of LLC Legislation. The popularity of the LLC stems from its unique combination of limited liability protection for owners and pass-through taxation on earnings. Prior to 1997, an LLC would qualify for pass-through taxation only if it had no more than two

out of four corporate characteristics identified by the IRS, including continuity of life, centralized management, free transferability of interests, and limited liability.¹ To this end, most states, including Iowa, provided broad default exit rights under their LLC statutes much like those available to partners in a partnership.

In Iowa, section 704 of the ILLCA, which applies only to an LLC organized prior to June 30, 1997, provides that a member may withdraw upon six months notice, unless the operating agreement specifies otherwise. Upon withdrawal, section 805 of the ILLCA provides that a member is entitled to receive “the fair value of the member’s membership interest.” After 1997, however, this partnership-like approach to LLC exit rights was abandoned in favor of more restrictive default rules.

In 1997, the IRS stopped asking whether an LLC was more like a partnership or a corporation as a condition to pass-through taxation. Instead, IRS “check-the-box” regulations provided that an LLC would be given pass-through treatment unless it requested to be taxed as a corporation.² After the check-the-box regulations, LLC default exit rights were freed from having to conform to IRS tax requirements. But, ironically, a new tax consideration—estate and gift tax—encouraged legislatures to go to the other extreme and eliminate all statutory LLC exit rights.³ It was reasoned that discount valuations might be available when persons give or bequeath LLC interests to family members if the interests in question were subject to limited exit and buyout rights. In response to these estate and gift tax considerations and to provide

¹ See generally Internal Revenue Service Notice 95-14.

² See 26 C.F.R. 301.7701-3.

³ See Sandra K. Miller, What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?, 38 Harv. J. on Legis. 413, 431 (2001).

more “flexibility,” many states have eliminated or greatly restricted default exit rights.⁴ In 1997, Iowa enacted such legislation in the form of section 704A.

(ii) Withdrawal under Section 704A of the ILLCA. Section 805 of the ILLCA provides that a member is entitled to a buyout of his or her interest at fair value upon “withdrawal.” The ability of a member to “withdraw” is very limited by section 704A of the ILLCA, however. Section 704A provides that a member may “withdraw” from an LLC only as provided in the operating agreement, or, if no such time is specified, only upon the adoption of certain fundamental amendments to the articles of organization or the operating agreement over the member’s written dissent.

The plain language of section 704A seems to close the door on any right of Fenster to withdraw from the Company. Indeed, Professor Sandra Miller noted:

Iowa [] has taken an innovative approach to default exit rights by locking in LLC members, but simultaneously giving an exit right to dissenting members if the majority has changed the LLC articles or agreement in a manner that adversely affects the dissenting member’s fundamental rights or preferences. The Iowa approach appears to close the exit door, while leaving a window open to the minority where the majority has adversely changed the minority’s fundamental rights under the LLC articles or operating agreement.⁵

Unfortunately for Fenster, the window opened by section 704A is useless to him because there have been no such amendments, and the door is tightly closed.

The wisdom of removing statutory exit rights has been widely questioned because it leaves minority members vulnerable to oppressive majority action. Indeed, “[t]he vulnerability of a minority investor in an LLC is perhaps most acute where the minority actively participates

⁴ See Douglas Moll, *Minority Oppression and the Limited Liability Company: Learning (or not) from Close Corporation History*, 40 Wake Forest L. Rev. 883, 933 (2005).

⁵ Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 Harv. J. on Legis. 413, 459 (2001).

in the business and is both an investor and an employee.”⁶

The Wyoming Supreme Court was faced with facts nearly identical to Fenster’s situation in *Lieberman v. Wyoming.com LLC*, 82 P.3d 274 (Wyo. 2004). As in Fenster’s situation, there existed a gap that both the LLC statute and the operating agreement failed to address—i.e., withdrawal of a member. The Lieberman court adopted a strict contractual view of an LLC, stating that “it is the duty of this court to construe contracts made between parties, not to make a contract for them.” *Id.* at 282. Thus, the court declined to look beyond the four corners of the operating agreement, and the minority member could not withdraw. An Iowa court might disagree with the Wyoming Supreme Court and choose to borrow from the corporate law or other sources of law to allow for withdrawal and buyout of Fenster’s interest notwithstanding section 704A, but such a ruling seems unlikely in light of the plain language of the ILLCA.

(B) Dissolution under the ILLCA. Sections 1301 and 1302 of the ILLCA allow for judicial dissolution of an LLC “if it is not reasonably practicable to carry on the business in conformity with the articles of organization and any operating agreement.” There are no apparent cases explaining precisely what this language means, but it seems to focus on reasonable practicability at the entity level, not as to individual members. In other words, oppression of an individual member does not seem to make it reasonably impracticable to carry on the business of the LLC. The business of the LLC still functions as designed under the operating agreement.

(C) Transfer of Interest. Fenster will face two problems in attempting to sell his interest in the Company. First, it is very unlikely that Fenster will find a buyer interested in purchasing a

⁶ See Sandra K. Miller, What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?, 38 Harv. J. on Legis. 413, 436 (2001).

minority interest in an LLC with an oppressive majority. Second, the default transfer rules of section 902 allow a member to assign only his or her financial rights—not the member’s status as a member. Section 902 provides that such an assignee is “not entitle[d] . . . to exercise any rights of a member”, but is only entitled to receive “distributions” that the assignor would have received.

CONCLUSION: LAWYERS MUST PLAN ON THE FRONT END.

Fenster most likely does not have any right to exit the LLC by way of withdrawal or dissolution, and likely will not be able to transfer his interest. Thus, Fenster will have to pursue litigation. If litigation fails, he will be effectively and legally squeezed out of the business. Clearly, this would be a devastating result.

In organizing an LLC, lawyers need to recognize this potential trap in the default rules and avoid it on the front end. The trap is most dangerous to the practitioner who has only a general understanding of LLC law. Intuitively, it might seem that default exit rules would be the opposite of what they actually are because parties that truly wish to eliminate exit rights will presumably have contemplated the issue in their agreements.

A recent study by Professor Sandra Miller highlights this problem through surveys of a large number of business law practitioners.⁷ The study revealed that a substantial portion of the respondents incorrectly believed that their state’s default LLC rules would give a member the right to a buyout if he or she left the LLC. Furthermore, a large percentage of business lawyers responded that they do not usually include provisions allowing a minority owner to force buyout at fair market value. Perhaps most troubling, the study indicated a large disparity

⁷ Sandra K. Miller, A New Direction for LLC Research in a Contractarian Environment, 76 S. Cal. L. Rev. 351, 388–394 (2003).

between the representation of minority and majority LLC owners, which suggests that in many instances the problem cannot be solved by advanced planning because minority members are not seeking representation.

Part II, to be published next month, will analyze whether Iowa courts can offer any relief to Fenster in litigation.

PART TWO: FIDUCIARY DUTIES AND OPPRESSION

Since Fenster likely does not have any rights to exit the Company, he will probably have to pursue litigation. Part II analyzes whether McManus's conduct constitutes breach of fiduciary duty or "oppression" that would entitle Fenster to judicial relief. Since the LLC is still a relatively new entity form, the duties applicable to LLC members and managers are not well-developed. Furthermore, it is unclear whether the oppression doctrine, which has been applied in the context of a closely-held corporation, can or will be applied to LLC members.

(A) Fiduciary Duties.

(i) Fiduciary Duties Under the ILLCA. Section 706 of the ILLCA describes the duties a manager owes *to the entity*. Duties owed to individual members of an LLC or those owed by individual members of an LLC are not described in the ILLCA. Section 706 requires a manager to discharge duties (1) "in good faith," (2) "with the care an ordinary prudent person in a like position would exercise under similar circumstances," and (3) "in a manner the manager believes to be in the best interests of the [LLC]."

If McManus, in his role as a manager, was acting in his own self-interest, and not the Company's, his conduct would seemingly constitute a breach of his duties. The obvious hurdle

would be proving McManus's subjective belief. Note that section 706 does not require that the manager's belief be reasonable, just that it be in good faith. In contrast, the duties owed by corporate directors under section 830 of the Iowa Business Corporation Act (the "IBCA"), which closely tracks section 706 of the ILLCA, requires a director to act in a manner he or she "reasonably believes to be in the best interests of the corporation." The omission of the reasonableness requirement from the ILLCA combined with its express inclusion in the IBCA would seem to tie the hands of a court that wanted to read a reasonableness requirement into section 706. But even if a "reasonableness" requirement did apply, a challenge would likely run into the business judgment rule, which traditionally protects the decisions of directors or managers.

(ii) Fiduciary Duties of Close Corporation Law. Some courts have been willing to recognize more rigorous standards of fiduciary duties when minority owners are facing an oppressive majority. In the close corporation context, most jurisdictions provide that shareholders owe each other "the utmost good faith and loyalty."⁸ In fact, such shareholders may need to only "demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest."⁹

A manager-managed LLC is similar to a closely-held corporation in many respects. Indeed, "[t]he same combination of 'no exit' and majority rule—a combination that has left minority shareholders vulnerable in the close corporation for decades—exists in the LLC."¹⁰ Thus, in determining what fiduciary duties are proper in the manager-managed LLC, it would

⁸ 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE § 1.2 (Rev. 3d ed. 2004).

⁹ Wilkes v. Springfield Nursing Home, 353 N.E.2d 657, 663 (Mass. 1976).

¹⁰ Douglas Moll, Minority Oppression and the Limited Liability Company: Learning (or not) from Close Corporation History, 40 Wake Forest L. Rev. 883, 956 (2005).

seem logical to look to the law of closely-held corporations.

Unfortunately, there is little Iowa case law on duties owed in a close corporation, but one case, *Bump v. Stewart, Wimer & Bump, P.C.*, 336 N.W.2d 731 (Iowa 1983), gives some guidance. In *Bump*, the court ruled that no breach of fiduciary duty had occurred when the majority shareholders of a law firm fired the minority shareholder after he could not get along with the other attorneys in the firm. The court in *Bump* ruled that the firing was justified and in the best interest of the corporation. While the court was not particularly sympathetic to the shareholder in *Bump*, the case at least indicates that the court is willing to hear a case based on heightened duties owed by shareholders in close corporations.

Success of the close corporation analogy will depend on how active the Iowa judiciary becomes in fashioning fiduciary duties in the LLC context. If the court adopts a strict freedom of contract analysis and refuses to apply any duties beyond the agreement and the plain language of the statute, the argument will fail. Professor Sandra Miller, on the other hand, argues that “active judicial oversight is the necessary underpinning of the entire contractual process. It is precisely the threat of judicial intervention that enables the parties to rely on each others’ promises and to come to expect good faith and fundamental fairness on the part of fellow LLC investors.”¹¹ If an Iowa court agrees with Professor Miller’s view, it may be willing to impose heightened fiduciary duties on LLC managers and majority owners, which would give Fenster’s claim more strength.

(B) Oppression Doctrine. In the corporate context, section 1430 of the IBCA provides for judicial dissolution if the directors are acting in a manner that is “oppressive.” The ILLCA does

¹¹ Sandra K. Miller, A New Direction for LLC Research in a Contractarian Environment, 76 S. Cal. L. Rev. 351, 400 (2003).

not expressly provide for a similar oppression remedy. Nonetheless, using the close corporation analogy discussed above, an argument can be made that the oppression remedy should be available to minority members in an LLC.

(i) Effect of Oppression Remedy in the LLC Context. The term “oppression” is nowhere defined in the IBCA, and the only Iowa case discussing oppression is *Maschmeier v. Southside Press, Ltd*, 435 N.W.2d 377 (Iowa App. 1988). In *Maschmeier*, the court stated that “oppressive conduct . . . is an expansive term used to cover a multitude of situations dealing with improper conduct which is neither illegal nor fraudulent.” In analyzing oppressive conduct, the *Maschmeier* court analyzed fiduciary duties and “reasonable expectations held by minority shareholders in committing capital and labor to the particular enterprise” in light of a “freeze-out situation.” While the Iowa court has not defined “reasonable expectations,” other courts have defined it as “those spoken and unspoken understandings on which the founders of a venture rely when commencing the venture.”¹²

Under *Maschmeier*, the concept of oppression seems very broad, and could be a powerful tool for a minority owner facing an oppressive majority. Clearly, in committing resources to the Company, Fenster’s “reasonable expectations” were that he would be employed by the LLC and that he would receive a salary. Termination of Fenster’s employment would therefore seem to constitute oppression, unless there were particularly strong reasons to do so—i.e., the firing was reasonable when balanced against Fenster’s reasonable expectations. Overall, an oppression remedy would likely offer an oppressed minority member much more protection than traditional fiduciary duties, but it is unclear whether an Iowa court

¹² See *Scott v. Trans-System, Inc.*, 64 P.3d 1, 12 (Wash. 2003) (citing *Gimpel v. Bolstein*, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984)).

will allow for such a remedy.

(ii) Argument for Use of Oppression Doctrine in the LLC Context. A strong argument can be made that the oppression doctrine has a place in the LLC context. As Professor Douglas Moll points out, the LLC structure has “the same combination of ‘no exit’ and majority rule” that existed in the close corporation setting. “Given this setting and based on the close corporation experience,” he states, “it is inevitable that some majority owners will abuse their control at the expense of minority investors.”¹³

Nonetheless, section 1302 of the ILLCA, which authorizes judicial dissolution of an LLC, omits oppression as a ground for dissolution. Moreover, section 1430 of the IBCA expressly provides that “oppressive” conduct by a director or controlling party is grounds for judicial dissolution. The clear contemplation of oppression by the IBCA supports the conclusion that oppression was intentionally omitted from section 1302 of the ILLCA, and, therefore, it would be improper for a court to use the oppression remedy in the LLC context.

CONCLUSION

Current Iowa law does place fiduciary duties upon managers of an LLC, but the case law has not yet addressed the extent of these duties and whether relief will be granted to a minority member based on oppression. Only if Fenster’s discharge from employment was in bad faith or pretextual, can a strong argument be made that such conduct is a breach of fiduciary duties.

The oppression doctrine, on the other hand, would be much more helpful to Fenster, but it is likely not an option due to the plain language of the ILLCA. Thus, Fenster may have a

¹³ Douglas Moll, *Minority Oppression and the Limited Liability Company: Learning (or not) from Close Corporation History*, 40 Wake Forest L. Rev. 883, 957 (2005).

very difficult time getting the fair value of his membership interest through litigation. The Iowa Legislature could solve this problem by adding an oppression remedy to the ILLCA similar to that in the IBCA. The Revised Uniform Limited Liability Company Act (2006) (the “**RULLCA**”) contains such a provision. Section 701 of the RULLCA calls for judicial dissolution “on the grounds that the managers or those members in control of the company . . . have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant.” Perhaps the Iowa legislature will adopt the RULLCA in its entirety, which would likely fill the gaps in the current statute and provide more protection for minority owners facing an oppressive majority.